# Bill on patent box tax incentive passed into law

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Issue 9

## In brief

On 26 June 2024, the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Bill 2024 (Bill), as amended by way of a committee stage amendment (CSA)[1], passed its third reading in the Legislative Council. The Bill aims to establish a patent box regime in Hong Kong, aligning with international trends to incentivise research and development (R&D) activities and intellectual property (IP) development. It is anticipated that the Bill will be gazetted as an amendment ordinance on 5 July 2024, which will take retrospective effect from the year of assessment 2023/24.

The CSA is technical in nature and seeks to clarify that the three-year transitional period, during which an eligible person with insufficient records is allowed to compute the R&D fraction using a three-year rolling average, commences from the first day of the eligible person's basis period for the year of assessment 2023/24, as opposed to the previously stated date of 1 April 2023.

This news flash explains the CSA and discusses the key clarifications and responses to written submissions regarding the Bill as provided by the Hong Kong SAR government (the Government) during the legislative process, along with our observations.

## In detail

### Overview of the proposed patent box regime under the Bill

The Bill seeks to introduce a patent box regime specifically designed to stimulate the use and commercialisation of IP arising from R&D activities. The proposed regime confers a concessionary tax rate of 5% on a portion of eligible IP income, which is determined by the 'nexus approach' endorsed by the Organisation for Economic Co-operation and Development (OECD) in its Base Erosion and Profit Shifting (BEPS) Action 5 Report. Broadly, this means that the concessionary tax treatment will only apply to a proportion of assessable profits of the eligible IP income from an eligible IP based on the ratio of the eligible R&D expenditures to the overall expenditures incurred to develop the eligible IP. Please refer to our previous news flash for an overview of the key aspects of the proposed patent box regime[2], which are essentially identical to those under the amendment ordinance, except for the CSA discussed below.

### CSA to the Bill as regards the commencement date of the three-year transitional period

To allow sufficient time for taxpayers to adapt to the new tracking and tracing requirements, the Bill proposes a transitional measure that allows an eligible person with insufficient records to apply a transitional R&D fraction during a three-year transitional period.

The CSA is technical in nature and seeks to clarify that the three-year transitional period commences from the first day of an eligible person's basis period for the year of assessment beginning on or after 1 April 2023 (i.e. the year of assessment 2023/24), rather than the previously stated date of 1 April 2023.

This clarification implies that for the three years of assessments from 2023/24 to 2025/26, such a person is allowed to compute the R&D fraction using a ratio derived from a three-year rolling average of eligible R&D expenditures to overall expenditures. The Government has further clarified that in determining the transitional R&D fraction, taxpayers are not required to distinguish between the relevant expenditures in relation to eligible IPs and non-eligible IPs. In other words, both the numerator and the denominator will include relevant expenditures in relation to all IPs.

After the three-year transitional period, the taxpayer will be required to transition from employing the three-year rolling average to using a cumulative ratio, and only expenditures incurred in respect of the eligible IPs to which the eligible IP income relates will be considered.

Moreover, the Government has indicated that, according to the OECD BEPS Action 5 Report, the transitional R&D fraction does not include any expenditures incurred before the three-year period. This applies even if the R&D activity connected to the IP began before the commencement of the period. Therefore, if an eligible IP has already been created through R&D undertaken prior to the year of assessment 2023/24, and no additional expenditures were incurred from the year of assessment 2023/24 onwards, the taxpayer will not be able to take advantage of the regime from the year of assessment 2025/26 onwards. This is because the transitional R&D fraction for the year of assessment 2025/26 (the last year of assessment in which the transitional arrangement applies) would be zero, while the taxpayer will not be able to calculate the cumulative R&D fraction from the year of assessment 2026/27 onwards if there are insufficient records.

## The Government's responses and clarifications on the Bill

Several organisations, including PwC, made submissions to the Bills Committee seeking clarifications on certain provisions of the Bill and offering related recommendations. Some of the concerns raised in these submissions, and the Government's response to the same are discussed below[3].

### Eligible IP qualifying for the regime

In reply to submissions seeking further clarifications regarding the eligibility of certain IPs for the proposed regime, the Government has reiterated that the scope of eligible IPs under the proposed regime already covers the widest possible IPs permitted by the OECD nexus approach (i.e., patents and other IPs that are functionally equivalent to patents) at this stage. Specifically, for medicinal products, the Government has clarified that only income derived from such products that are generated through inventions protected by patents would qualify for the regime.

The Government has also indicated that the Inland Revenue Department (IRD) will provide guidance and illustrative examples on its website regarding the patent box regime, similar to other recently enacted regimes, to facilitate compliance.

***Our observations:*** *We are pleased to note the Government's indication that the IRD will provide guidance and examples concerning different aspects of the patent box regime, particularly regarding IPs that could qualify for the regime. In this context, we have suggested that industry-tailored guidance should be provided, as the relevant R&D activities vary significantly across sectors. Furthermore, we believe it would be helpful for the IRD to provide additional guidance and examples that elucidate the criteria under which copyrighted software, including mobile applications, could qualify for the regime. Unlike patents and plant variety rights which require registration, copyrighted software is merely required to be protected legally to qualify for the regime. However, the OECD BEPS Action 5 Report indicates that an IP preferential regime should only cover copyrighted software that are functionally equivalent to patents, which means being novel, non-obvious, and useful. Clarification on this matter would assist taxpayers in ascertaining their eligibility under the regime.*

### IPs that are developed or exploited in an interlinked manner (i.e., family of IPs)

Several submissions proposed that the Government should allow a product-based approach to accommodate families of eligible IPs under the regime. In response, the Government has clarified that eligibility for the regime is assessed individually for each IP. Where an expenditure, whether eligible or not, covers different IPs, it may be apportioned on a just and reasonable basis. The determination of whether a basis for apportionment is just and reasonable will depend on the specific facts and circumstances of each case.

***Our observations:*** *We welcome the Government's clarification that a pragmatic approach will be adopted to address the circumstances in which relevant expenditures relate to the development of multiple IPs. This implies that it will be essential for taxpayers to prepare robust and contemporaneous documentation to substantiate the determination of a reasonable basis for apportioning such expenditures.*

**Local registration requirement**

The Government has rejected the submission to remove the local registration requirement. According to this requirement, taxpayers who wish to avail of the proposed regime must, where patents are concerned, have their patents or patent applications filed under the applicable local registration system if they are filed after the expiry of 24 months following the commencement date of the amendment ordinance. The Government has justified this requirement as a means to encourage and promote more filings under the local patent system, in particular the original grant patent (OGP) system, and to ensure that the relevant R&D outcomes adhere to Hong Kong's requirements for patent registration.

Furthermore, the Government has clarified that taxpayers are not required to first file a patent application in Hong Kong to enable a non-Hong Kong patent to qualify as an eligible patent or fulfill the local registration requirement. In most cases, taxpayers only need to prepare a single specification with minor adjustments to file a patent application in multiple jurisdictions, including Hong Kong. As such, it is the Government's view that the requirement for an additional registration in Hong Kong will not impose an undue burden on taxpayers in terms of cost and effort.

In response to PwC's suggestion to explore the possibility with relevant Chinese mainland authorities of extending protection of patents registered via the OGP or short-term patent (STP) systems to the Chinese mainland (or at least the Greater Bay Area cities), while the Government noted that IP protection is generally territorial in nature, and the Chinese mainland and Hong Kong have distinct IP protection systems and laws with no reciprocal recognition of IP registrations, they have indicated that the Intellectual Property Department has engaged in discussions with the relevant Chinese mainland authorities to explore measures that would facilitate cross-boundary IP protection. For instance, a pilot program allowing Hong Kong applicants to request prioritised examination for their patent applications in the Chinese mainland has been in place since 1 January 2023.

***Our observations:*** *We welcome the Government's clarification regarding the local registration requirement. However, it is important to note that it is not possible to file an OGP or STP application directly from a Patent Co-operation Treaty application[4]. Taxpayers who wish to benefit from the regime may need to consider whether adjustments to their global patent strategy are necessary.*

**Other clarifications**

The Government also clarified that:

- Similar to the current tax treatment for R&D expenditures under the enhanced R&D tax deduction regime, where a taxpayer has undertaken part or all of the underlying R&D activity under a development cost sharing arrangement[5], the share of R&D expenditures borne by the taxpayer under such an arrangement can be accepted as eligible expenditures in calculating the R&D fraction, provided that other conditions of eligible expenditures prescribed under the OECD's nexus approach are satisfied.

- The patent box regime is not subject to the anti-tax arbitrage provision contained in section 16(1A) of the IRO. In other words, no adjustment will be made to the amount of tax deduction that can be claimed by a connected person subject to normal profits tax rate in respect of payments made to an eligible person qualifying for the patent box regime.

**Recommendations on other related matters**

In addition to recommendations on the design of the proposed patent box regime, submissions were made on related matters deemed crucial to bolster the overall appeal of Hong Kong's IP regime. Specifically, these submissions proposed two key measures: (i) providing unilateral tax credits (UTC) to relieve taxpayers from double taxation suffered on eligible IP income in both Hong Kong and jurisdictions that have not entered into a tax treaty with Hong Kong; and (ii) relaxing the restrictive tax deduction rules pertaining to IP-related costs and R&D expenditures.

The Government dismissed all these submissions, stating that providing UTC for onshore IP income would effectively cede Hong Kong's taxing rights to other jurisdictions. Moreover, the Government pointed out that relaxing the relevant tax deduction rules could either contradict the original legislative intent or pose a risk of abuse by taxpayers.

***Our observations:*** *The patent box regime, as passed by the legislature, is relatively attractive. However, the restrictive tax deduction rules under the current tax regime may, under certain circumstances, render a taxpayer subject to the 5% concessionary tax rate on gross income rather than a net basis. This would significantly undermine the attractiveness of the regime. We are of the view that the Government's concerns about the potential for abuse with further relaxation of the deduction rules can be adequately addressed through more targeted anti-abuse rules. Furthermore, considering developments in both the economic environment and tax law over the years, we believe that it is now an opportune time to revisit these rules to assess the relevance and appropriateness of these rules in the current environment. We will continue to advocate for such changes.*

## The takeaway

The clarifications provided by the Government on the Bill bring welcome clarity to the application of the regime. Taking into account Hong Kong's other favourable attributes such as its robust IP protection regime and strong government support for R&D activities, the introduction of the patent box regime is posed to further position Hong Kong as an ideal jurisdiction for developing, protecting, and exploiting IP assets within the Asia-Pacific region.

Businesses should now begin assessing the potential benefits of the patent box regime for their operations. While gathering the necessary underlying data may not be straightforward, this challenge can be overcome with early preparation. The tax concessions secured as a result will justify the additional effort required. At PwC, we have a dedicated, multidisciplinary team of experienced tax and legal professionals who can provide timely and relevant advice to support your business throughout the IP development lifecycle. This includes assistance with patent box tax concession and enhanced R&D tax deduction claims, government grant applications, and IP protection. Should you require assistance, please do not hesitate to contact us.

## Endnotes

1. The Bill and the CSA can be accessed via these links:
   https://www.gld.gov.hk/egazette/pdf/20242813/es3202428136.pdf
   https://www.legco.gov.hk/yr2024/english/bc/bc03/papers/bc03cb1-760-1-e.pdf

2. Our news flash on the Bill can be accessed via this link:
   https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-apr2024-6.html

3. Our submission and the Government's responses to all the written submissions including ours can be accessed via these links:
   https://www.legco.gov.hk/yr2024/english/bc/bc03/papers/bc03cb1-670-3-e.pdf
   https://www.legco.gov.hk/yr2024/english/bc/bc03/papers/bc03cb1-742-1-e.pdf

4. Patent Co-operation Treaty (PCT) is an international patent registration system administered by the World Intellectual Property Organization (WIPO). Membership to PCT is confined to sovereign states. The PCT enables the filing of one 'international application' with a single patent office in one language and with a single set of forms (and fees) instead of filing numerous separate national and/or regional patent applications. Such an application may be filed by anyone who is a national or resident of a PCT contracting state with the national patent office of the relevant contracting state, or, at the applicant's option, with the International Bureau of WIPO in Geneva.

5. Cost sharing arrangement or cost contribution arrangement is a contractual arrangement among business enterprises to share contributions and risks involved in the joint development, production or obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangibles assets or services are expected to create benefits for the individual businesses of each of the participants. The IRD indicates in its Departmental Interpretation and Practice Notes No. 55 that where an entity has undertaken R&D activity under a development cost sharing arrangement or cost contribution arrangement, its share of R&D expenditure under such an arrangement may be accepted as in-house R&D expenditure as opposed to outsourced R&D expenditure.

## Let's talk

For a deeper discussion of how this impacts your business, please contact:

**PwC's Corporate Tax Leaders based in Hong Kong**

Charles Lee
+852 2289 8899
charles.lee@cn.pwc.com

Jeremy Ngai
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

Jeremy Choi
+852 2289 3608
jeremy.choi@hk.pwc.com

Rex Ho
+852 2289 3026
rex.ho@hk.pwc.com

Cecilia Lee
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Jenny Tsao
+852 2289 3617
jenny.np.tsao@hk.pwc.com

Kenneth Wong
+852 2289 3822
kenneth.wong@hk.pwc.com


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For more information, please contact:

Long Ma
+86 (10) 6533 3103
long.ma@cn.pwc.com

Charles Chan
+852 2289 3651
charles.c.chan@hk.pwc.com

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