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Legislative Council
Panel on Commerce, Industry, Innovation and Technology

Introduction of a "Patent Box" Tax Incentive in Hong Kong

PURPOSE

This paper briefs Members on the Government's proposal to amend the Inland Revenue Ordinance (Cap. 112) ("IRO") to implement the "patent box" tax incentive, so as to put into effect a major policy measure under the 2023 Policy Address to promote the development of intellectual property ("IP") trading. The amendments of the IRO aim to encourage businesses in Hong Kong to engage in more research and development ("R&D") and IP trading activities (such as buying/selling and licensing of IP and development of new products and services) by providing tax incentive, thereby further developing Hong Kong into a regional IP trading centre.

BACKGROUND

Policy Context

2. The "Outline of the 14th Five-Year Plan for National Economic and Social Development of the People's Republic of China and the Long-Range Objectives Through the Year 2035" promulgated in 2021 supports Hong Kong to develop into, among others, an international innovation and technology ("I&T") centre, an East-meets-West centre for international cultural exchange and a regional IP trading centre.

3. IP has become an essential capital for enterprises in a knowledge-based economy. Encouraging the industrial and R&D sectors as well as the creative industries to create and exploit IP will stimulate and promote the development of IP trading. Enhanced R&D and IP trading activities (like buying/selling and licensing) will in turn lead to more creation and exploitation of IP through, for example, acquiring foundation technologies or IP and conducting R&D on products and services by enterprises, followed by obtaining patent protection for the newly developed technologies or inventions, and in turn the pursuit of commercialisation of the patents in-

house or through licensing, thereby creating business opportunities to facilitate the upgrading of products or services to move up the value chain. Prosperity of IP trading activities will also create more opportunities for professional services such as IP legal, valuation, management, consultation and agency services to further develop vigorously.

4. The provision of tax incentives will encourage the industrial and R&D sectors, creative industries and IP users to engage in more IP creation or exploitation and promote IP trading activities. Many jurisdictions outside Hong Kong have widely adopted the "patent box" tax incentive, i.e. the provision of tax concessions to businesses for qualifying profits generated from eligible IP assets, typically patents, as a key policy tool to drive innovation and a knowledge-based economy.

Experience outside Hong Kong

5. To date, the "patent box" tax incentive is offered in Mainland China and many jurisdictions outside Hong Kong[1] to encourage businesses to –

(a) develop and retain eligible IP assets (typically patents), and use patents to protect their inventions that would have otherwise been kept secret;

(b) increase investment in R&D activities;

(c) promote the commercialisation of the R&D results for generating profits; and

(d) refrain from relocating their eligible IP assets or transferring their sources of IP income to other jurisdictions that offer a more favourable or competitive tax treatment.

IMPLEMENTATION OF THE "PATENT BOX" TAX INCENTIVE IN HONG KONG

6. In order to encourage the I&T sector to forge ahead with more R&D activities and create more IPs with market potential as a catalyst for promoting I&T and IP trading activities with a view to maintaining Hong Kong's competitiveness as a regional IP trading centre, it was announced in

[1] Jurisdictions outside Hong Kong that have implemented "patent box" tax incentives include Belgium, France, Greece, Hungary, India, Ireland, Israel, Korea, Luxembourg, Netherlands, Poland, Singapore, Spain, Switzerland, Thailand, Turkey, the United Kingdom and Uruguay (see https://qdd.oecd.org/data/IP_Regimes).

the 2023-24 Budget that the Government would introduce a "patent box" tax incentive to provide tax concessions for qualifying profits sourced in Hong Kong and derived from eligible IP assets created through R&D activities.

7. The nexus approach was adopted by the Organisation for Economic Co-operation and Development ("OECD") as a minimum standard under Action 5 of the Base Erosion and Profit Shifting ("BEPS") package, and has been applied by the OECD Forum on Harmful Tax Practices to evaluate the harmfulness of preferential tax regimes for IP income put in place by individual jurisdictions. As a member of the Inclusive Framework on BEPS[2], Hong Kong is obliged to apply the nexus approach in determining the extent of IP income that is entitled to preferential tax treatment (the key features of the nexus approach as promulgated by the OECD are set out in the **Annex**).

8. The key parameters of the "patent box" tax incentive that we are going to implement and the related legislative proposal are summarised in the following paragraphs.

Calculation of Assessable Profits under the "Patent Box" Regime: Definition of "Eligible IP Assets"

9. In accordance with the OECD's nexus approach, only income derived from an eligible IP asset could benefit from the preferential tax treatment based on the nexus ratio under the "patent box" regime. Under the nexus approach, eligible IP assets that could qualify for preferential tax treatment are limited to patents and other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes (if any) where such processes are relevant, which include –

(a) patents;

(b) copyrighted software; and

[2] The Inclusive Framework on BEPS allows interested jurisdictions to work with the OECD and G20 members to develop standards on BEPS-related issues and review and monitor the implementation of the BEPS package on an equal footing. As at November 2023, the Inclusive Framework on BEPS had 145 member jurisdictions.

(c) plant variety rights[3].

10. Furthermore, in defining the scope of eligible IP assets, we will take a more liberal approach with a view to enhancing the competitiveness of the "patent box" tax incentive. For instance, eligible IP assets will include applications for patents and plant variety rights[4], as well as those patents[5] and plant variety rights granted in or outside Hong Kong. In other words, taxpayers with qualifying profits derived from eligible IP assets registered in other jurisdictions could benefit from the "patent box" tax incentive.

Requirements for Patents and Plant Variety Rights to be Registered in Hong Kong

11. To encourage and promote more filings under the local patent system (in particular the original grant patent ("OGP") system[6]) and plant varieties protection system for obtaining legal protection locally, and to ensure that the underlying inventions or R&D outcomes comply with Hong Kong's requirements for patent and plant variety right registrations, if the eligible IP asset is a patent or plant variety filed or granted outside Hong Kong (i.e. a non-Hong Kong patent or a non-Hong Kong plant variety right), we will additionally require that:

(a) <u>for a non-Hong Kong patent</u> – the taxpayer should file an application for or be granted an OGP or a short-term patent ("STP") in Hong Kong for the underlying invention of the non-Hong Kong patent. If the taxpayer chooses to apply for a STP in Hong Kong for the invention, he/she should file a post-grant substantive

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[3] Plant variety rights are rights granted to the owners of plant varieties over cultivated plant varieties they have bred or discovered and developed. In Hong Kong, the procedures for applying for such rights are set out in the Plant Varieties Protection Ordinance (Cap. 490) administered by the Agriculture, Fisheries and Conservation Department.

[4] If the applications for patents and plant variety rights concerned do not eventually result in a grant, the portion of assessable profits for which tax concessions are claimed will be subject to the standard profits tax rate accordingly.

[5] The eligible patents concerned do not include patents under re-registration applications filed in Hong Kong by taxpayers after the transitional period of 24 months as mentioned in paragraph 12 of this paper.

[6] Following a fundamental review of the local patent system, the Government launched the OGP system in 2019. The OGP system provides an alternative but direct filing route for seeking standard patent protection in Hong Kong, which runs in parallel with the existing re-registration system. It allows applicants to seek standard patent protection in Hong Kong directly without having to first file an application with a designated patent office outside Hong Kong as required under the re-registration route, thereby enabling OGP applicants (particularly those in Hong Kong) to secure the first date of patent filings as early as possible. Standard patent applications filed under the OGP system are subject to substantive examination, in addition to formality examination, by the Patents Registry.

examination request[7,8]; and

(b) for a non-Hong Kong plant variety right – the taxpayer should file an application for or be granted a plant variety right in Hong Kong for the plant variety to which the non-Hong Kong plant variety right relates[9].

12. In order to give sufficient notice to taxpayers of the requirements set out in paragraph 11 above, such requirements will not apply if the application for an eligible IP asset is filed within the transitional period of 24 months after the commencement date of the "patent box" tax incentive.

Calculation of Assessable Profits under the "Patent Box" Regime: Definition of "Eligible IP Income"

13. We will also be taking a more liberal approach so that the "patent box" tax incentive would cover a wide scope of income derived from eligible IP assets as follows –

(a) income derived from an eligible IP asset in respect of the exhibition or use of, or a right to exhibit or use the asset (whether in or outside Hong Kong); or the imparting of, or undertaking to impart, knowledge directly or indirectly connected with the use of the asset (whether in or outside Hong Kong);

(b) income arising from the sale of an eligible IP asset; and

(c) where the sales price of a product or service includes an amount which is attributable to an eligible IP asset – such portion of the income from those sales that, on a just and reasonable basis (e.g. based on the transfer pricing principles[10]), is attributable to the value

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[7] Any STP owner may request the Patents Registry to carry out substantive examination on the underlying invention. This post-grant mechanism, which was introduced together with the launch of the OGP system in 2019, safeguards the integrity of the STP system while maintaining its overall cost-effectiveness.

[8] If the patent application does not eventually result in a grant or the STP fails to comply with the post-grant substantive examination requirements, the portion of assessable profits for which tax concessions are claimed will be subject to the normal profits tax rate accordingly.

[9] If the application for the plant variety right does not eventually result in a grant, the portion of assessable profits for which tax concessions are claimed will be subject to the standard profits tax rate accordingly.

[10] See paragraph 48 in Chapter 4 of the Final Report on Action 5 of the BEPS package ("BEPS Action 5 Report") at –https://www.oecd-ilibrary.org/docserver/9789264241190-en.pdf?expires=1655950284&id=id&accname=guest&checksum=5FC7BB519AECC489918BCD296D05428B.

of the asset.

Calculation of Assessable Profits under the "Patent Box" Regime: Definition of "Eligible Expenditures"

14. In accordance with the OECD's nexus approach, only eligible expenditures that have been incurred by taxpayers to develop the eligible IP asset will be taken into consideration in the calculation of a nexus ratio, which determines the portion of assessable profits that could benefit from the preferential tax treatment under the "patent box" regime. Specifically, eligible expenditures only include R&D expenditures that are directly connected to the eligible IP asset. Acquisition costs of the IP asset are not considered as eligible expenditures.

Jurisdictional Approach for Calculating the Nexus Ratio

15. Having regard to the design of the "patent box" tax incentives in other jurisdictions and to maintain Hong Kong's tax competitiveness in attracting IP-related business activities, we will adopt the jurisdictional approach for determining the scope of eligible expenditures when calculating the nexus ratio. Under this approach, eligible expenditures cover the expenditures on R&D activities (a) undertaken by the taxpayer inside or outside the jurisdiction providing the IP tax regime ("IP regime jurisdiction"); (b) outsourced to unrelated parties and undertaken inside or outside the IP regime jurisdiction; and (c) outsourced to resident related parties and undertaken inside the IP regime jurisdiction.

Concessionary Tax Rate

16. To ensure the competitiveness of the "patent box" tax incentive and having regard to (a) the existing normal profits tax rate (i.e. 16.5%) and the concessionary tax rate commonly adopted under other preferential tax regimes (i.e. 8.25%) in Hong Kong; (b) the tax rates of overseas "patent box" regimes (e.g. Luxembourg at 4.99%, Ireland at 10%, Israel at 5% to 16%, Korea at 4.5% to 18% and Singapore at 5% or 10%); and (c) the views collected during the trade consultation, the Chief Executive has announced in the 2023 Policy Address that the concessionary tax rate for the "patent box" tax incentive would be set at 5%, with a view to encouraging more R&D activities, as well as transformation and commercialisation of the R&D results.

Treatment of Losses and Related Offsets

17. The BEPS Action 5 Report published by the OECD requires that any tax loss associated with the income benefiting from an IP regime should be allowed in a manner that is consistent with domestic legislation. Such a loss should not be allowed to directly set off against income that is taxed at the ordinary rate.

18. Taking into account the requirements of the BEPS Action 5 Report, we will adopt a mechanism similar to the existing provisions for cross set-off of losses subject to different tax rates under sections 19CAB and 19CAC of the IRO. In other words, a loss incurred in relation to income benefiting from the "patent box" tax incentive can be allowed to set off against assessable profits subject to a tax rate other than that provided under the regime so long as the amount of loss allowed is to be adjusted with reference to the tax rate difference.

Record Keeping Requirements

19. One of the essential requirements of the nexus approach is the tracking and tracing of R&D expenditures and income derived from the eligible IP assets. This requires a detailed mechanism of record keeping, for example, information sufficient to establish that the income concerned is eligible IP income and details of the eligible IP assets to which the income relates. However, as a transitional measure and to be consistent with the standards provided in the BEPS Action 5 Report, a taxpayer will be allowed to apply a ratio where eligible expenditures and overall expenditures were calculated on a three-year average rolling basis. Upon the expiration of the transitional period, the taxpayer will need to change from using the three-year average to using a cumulative ratio[11].

CONSULTATION

20. We have conducted a one-month trade consultation[12] on the key parameters, related legislative proposal and level of concessionary tax rate of the upcoming "patent box" tax incentive in September this year. Apart from issuing a consultation document to the trade, the Commerce and Economic Development Bureau, the Intellectual Property Department, the

[11] See Annex A of BEPS Action 5 Report.

[12] Organisations consulted included professional bodies and industry associations of the taxation, accounting and legal professions, major local chambers of commerce, major local professional bodies of IP (including patent) practitioners, local universities and research institutions.

Inland Revenue Department and the Agriculture, Fisheries and Conservation Department also organised two engagement sessions on 11 and 12 September to brief and seek views from relevant stakeholders on the arrangements of the proposed "patent box" tax incentive. The trade was generally supportive of the Government's proposal to introduce the "patent box" tax incentive. A majority of the respondents hoped that we could take a more liberal approach when devising the tax arrangements to ensure the competitiveness of Hong Kong's "patent box" tax incentive, while some trade representatives expressed different views on certain arrangement details. After considering the views of the trade, we have determined the concessionary tax rate as mentioned in paragraph 16 above and are going to finalise the implementation details of the "patent box" tax incentive.

LEGISLATIVE TIMETABLE

21. We will amend the IRO to implement the "patent box" tax incentive, and our target is to introduce the relevant amendment bill into the Legislative Council in the first half of 2024.

ADVICE SOUGHT

22. Members are invited to note the contents of this paper and support the legislative proposal.

Commerce and Economic Development Bureau
Intellectual Property Department
Inland Revenue Department
December 2023

Annex

Key Features of the Nexus Approach

The nexus approach was adopted by the Organisation for Economic Co-operation and Development as a minimum standard under Action 5 of the Base Erosion and Profit Shifting ("BEPS") package promulgated in 2015[1] and has been applied internationally on the IP-related tax regimes since then. All members of the Inclusive Framework on BEPS are required to adopt the nexus approach promulgated in their IP-related regimes including "patent box". Under the nexus approach, **the portion of income from an eligible IP asset that can qualify for preferential tax treatment is based on a nexus ratio of the eligible expenditures to the overall expenditures that have been incurred by the taxpayer to develop the IP asset**. The proportion of R&D expenditures is a proxy of substantial economic activities. This seeks to ensure that there is a direct nexus between the income receiving benefits and the expenditures contributing to that income. Specifically, the nexus approach includes the following features –

(a) **IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are functionally equivalent to patents** if those IP assets are both legally protected and subject to similar approval and registration processes (if any) where such processes are relevant, such as copyrighted software and protected plant variety rights[2];

(b) the income benefiting from a regime should not be defined as the gross income from the IP assets, but should instead be calculated by subtracting IP expenditure allocable to IP income and incurred in the year from gross IP income earned in the year[3];

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[1] See Chapter 4(II) of the Final Report on Action 5 of the BEPS package ("BEPS Action 5 Report") at https://www.oecd-ilibrary.org/docserver/9789264241190-en.pdf?expires=1655950284&id=id&accname=guest&checksum=5FC7BB519AECC489918BCD296D05428B.

[2] See paragraphs 34 and 35 of the BEPS Action 5 Report which state that: "*Under the nexus approach as contemplated, the only IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, where such processes are relevant. IP assets that are functionally equivalent to patents are (i) patents defined broadly, (ii) copyrighted software, and (iii) in certain circumstances set out below, other IP assets that are nonobvious, useful, and novel.*" and "*IP assets that grant protection to plants and genetic material would include plant breeders' rights, which grant exclusive control over new varieties of plants.*"

[3] See paragraph 47 in Chapter 4 of the BEPS Action 5 Report.

(c) **eligible expenditures <u>only include</u> R&D expenditures that are directly connected to the eligible IP asset. Acquisition costs of the IP asset are not considered as eligible expenditures**, and therefore do not qualify for preferential tax treatment;

(d) in order not to over-penalise taxpayers for acquiring IP or outsourcing R&D activities to related parties (which are not otherwise considered as eligible expenditures), a jurisdiction may permit taxpayers to apply a 30% uplift on the eligible expenditures subject to the extent that the taxpayer has incurred non-eligible expenditures. However, the nexus ratio cannot exceed 100%, i.e. the increased amount of eligible expenditures may not exceed the taxpayer's overall expenditures; and

(e) the nexus approach would allow all eligible expenditures for R&D activities of unrelated parties (regardless of whether they were undertaken within the jurisdiction providing the tax incentives) to qualify, while all expenditures for R&D activities undertaken by related parties (regardless of whether they were undertaken within the jurisdiction providing the tax incentives) would not be counted as eligible expenditures (i.e. the entity approach). However, jurisdictions that are not member states of the European Union could modify the limitation to include all eligible expenditures for R&D activities undertaken by both unrelated parties and resident related parties in the definition of eligible expenditures (i.e. the jurisdictional approach).