KPMG

Hong Kong (SAR) Tax Alert

September 2023 | Issue 16

The HKSAR Government consults on the proposed Patent Box regime in Hong Kong

Summary

As highlighted in the 2023-24 Budget speech, the National 14th Five-Year Plan supports Hong Kong to develop into a regional intellectual property trading centre. The Government has committed to implementing various measures, including the introduction of a Patent Box regime in Hong Kong, to foster the domestic development in the innovation and technology sector.

On 1 September 2023, the HKSAR Government launched a one-month consultation on the proposed Patent Box regime in Hong Kong, which will introduce tax concessions for onshore profits from qualifying intellectual properties.

In this tax alert, we summarise the key features of the proposed regime and share our observations.

As announced in the 2023-24 Budget speech[1], the HKSAR Government will introduce a Patent Box regime to provide **tax concessions for onshore profits from qualifying intellectual properties** (IPs), with the aim to foster the local development in the innovation and technology sector and enhance Hong Kong's competitiveness as a regional IP trading centre.

The HKSAR Government has launched a consultation on the proposed Patent Box regime and seeks views from stakeholders on the key features and in particular the tax concessionary measure of the regime.

1. The proposed Patent Box regime

The tax concession

- Under the proposed regime, a concessionary tax rate (HKSAR government is seeking views on the level of the concessionary tax rate) would be applied to a portion of the **onshore Eligible IP Income** derived from **Eligible IP Assets** calculated under the nexus approach[2], that is to be computed based on the nexus ratio (the **Eligible Expenditures** divided by the overall expenditures incurred by the taxpayer to develop the Eligible IP Asset).

[1] The 2023/24 Budget Speech can be accessed via this link: [The 2023-24 Budget – Home]

[2] The nexus approach was adopted by the OECD as a minimum standard for preferential tax regimes for IP income under Action 5 of the BEPS 1.0 Action Plan.

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Eligible IP Assets

- Under the proposed regime, only patents and other IP assets that are functionally equivalent to patents would qualify as Eligible IP Assets. They include registered patents, copyrighted software and plant variety rights[3].
- Regarding the patents and plant variety rights,
  - in addition to the ones granted under the original grant patent (OGP) system, those rights where the applications filed under Hong Kong's OGP system would also be considered Eligible IP Assets. Nevertheless, if the OGP applications fail subsequently, the relevant tax concessions claimed would be clawed back.
  - taxpayers would have to comply with the relevant local registration requirements[4] – A **transitional measure** is proposed to extend the eligibility scope to those applications made and granted outside Hong Kong if the date of filing of these two types of IP asset is within 24 months after the commencement of the Patent Box regime.

Eligible IP Income

The Eligible IP Income will include:

- Income derived from an Eligible IP Asset in respect of (1) the exhibition or use of, or a right to exhibit or use (whether in or outside Hong Kong) the asset; or (2) the imparting of, or undertaking to impart, the knowledge directly or indirectly connected with the use (whether in or outside Hong Kong) of the asset;
- Income arising from the sale of an Eligible IP Asset; and
- The portion of income, determined on a just and reasonable basis (e.g. based on the transfer pricing principles), attributable to the Eligible IP Asset's element included in a sale of product or service.

Eligible Expenditures

- Eligible Expenditures refer to those incurred by the taxpayer to develop the Eligible IP Asset. Acquisition costs of IP assets are not Eligible Expenditures in this regard.
- It would cover the expenditures on research and development (R&D) activities (1) undertaken by the taxpayer in or outside Hong Kong; (2) outsourced to resident related parties to conduct the R&D activities in Hong Kong; and (3) outsourced to unrelated parties to undertake the R&D activities in or outside Hong Kong.

Treatment of losses

- Considering the requirements of the BEPS Action 5 Report[5], the Government proposes to allow a loss in relation to income benefiting from the proposed Patent Box regime to set off against the taxpayer's other assessable profits, after being adjusted with reference to the tax rate difference (if any).

Record keeping requirements

- As one of the essential requirements of the nexus approach, taxpayers would need to track and trace the historical R&D expenditures and income derived from each individual Eligible IP Asset.
- A **transitional measure** will be introduced to ensure that taxpayers would have sufficient time to adapt to the tracking and tracing requirements (on individual sets of data). under which a taxpayer will be allowed to apply a nexus ratio where qualifying expenditures and overall expenditures are calculated on a three-year average rolling. After the transition period, the taxpayer will need to adopt the cumulative nexus ratio (i.e. to include the expenditures from the first applicable year to all subsequent years).

2. Implementation timeline

The consultation will end on 30 September 2023. The government plans to introduce a bill with the necessary legislative amendments into the Legislative Council in the first half of 2024.

[3] They refer to the rights granted to the owners of plant varieties over cultivated plant varieties the owners have bred or discovered and developed, in which the applications for such rights are governed by the Plant Varieties Protection Ordinance (PVPO)(Cap. 490) administered by the Agriculture, Fisheries and Conservation Department.

[4] It is required that (i) the invention of any eligible patent must be (1) included in an application filed under Hong Kong's OGP system, (2) a granted OGP, (3) a short-term patent (STP) application or (4) a granted STP for which a post-grant substantive examination requirement has been filed; and (ii) the plant variety of any eligible plant variety right must be the subject plant variety of a Hong Kong application for or grant of a plant variety right under the PVPO in respect of such plant variety.

[5] Any tax losses associated with the income benefiting from a preferential IP regime should be used in a manner that is consistent with domestic legislation and that does not allow the set-off of those losses against income that is taxed at the ordinary rate.

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KPMG observations

We are glad to see that the HKSAR Government has taken commendable initiative in introducing a Patent Box regime aimed at promoting the local development of R&D activities and the commercialisation of the R&D results. By providing the tax incentive, we believe that a conducive environment can be created for businesses to invest in R&D endeavors, which could be crucial for stimulating the economic growth and blostering the overall competitiveness of Hong Kong as a regional IP trading centre. This is particularly helpful as a wide range of IP income may have become (partially) chargeable to Profits Tax on the enactment of the Foreign-Sourced Income Exemption (FSIE) regime on 1 January 2023. The Patent Box regime would give a relief to the relevant corporate taxpayers. Other related measures have to be looked into to enable R&D activities to be undertaken in Hong Kong, e.g. talent strategy, subsidies and other non-tax support, etc.

Businesses would also welcome to see relaxation in various aspects relating to the proposed regime, for example, to cover more types of IP assets as Eligible IP Assets; providing deductions for the acquisition of IPs (or the so-called “black-hole expenditures”), etc.

Businesses closely connected with IP investments shall monitor the future developments in this area and be aware of the eligibility assessment and other compliance concerns arising from claiming the tax concessions and the on-going tracking and tracing of the relevant figures of each and every Eligible IP Asset.

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