KPMG

Hong Kong (SAR) Tax Alert

July 2024 | Issue 7

The patent box tax incentive in Hong Kong comes into operation

Summary

The legislation to introduce a patent box tax incentive in the Hong Kong SAR (Hong Kong) was enacted on 5 July 2024. This means that from the year of assessment (YOA) 2023/24 onwards, taxpayers can elect to enjoy a 5% concessionary tax rate for Hong Kong-sourced taxable profits derived from use or sale of eligible intellectual property (IP), subject to fulfilment of the specified conditions.

The Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Ordinance 2024[1] (the Ordinance) was gazetted on 5 July 2024. The Ordinance introduces a **patent box tax incentive** in Hong Kong that offers a **5% concessionary tax rate** for Hong Kong-sourced taxable (i.e. non-capital) profits derived from the use or sale of eligible IPs, subject to certain conditions. The incentive **applies retrospectively from YOA 2023/24**.

For more details of the patent box tax incentive as set out in the draft legislation (the Bill) previously released[2], please refer to our Hong Kong (SAR) Tax Alert – Issue 4, April 2024.

The Legislative Council formed a Bills Committee to scrutinise the Bill gazetted and invited submissions on the Bill[3]. The HKSAR Government subsequently provided its responses to the submissions received[4] and proposed an amendment (as a Committee Stage Amendment)[5] to the Bill based on the comments received (see discussion below).

The amendment to the Bill

In our submission on the Bill, we highlighted that the originally drafted Bill would give rise to a seemingly unintended outcome. Specifically, the transitional arrangement[6] for computing the R&D fraction when insufficient records are kept by taxpayers would apply to eligible IP income accrued during the whole basis period for YOA 2023/24 for taxpayers with an accounting year-end date of March 31, but only part of the basis period for YOA 2023/24 for taxpayers with other accounting year-end dates.

In response to the comments received, the government put forward an amendment to the Bill to clarify that the transitional arrangement applies to the three-year period **from the first day of the taxpayer's basis period for YOA 2023/24 (instead of 1 April 2023)** to the last day of the taxpayer's basis period for YOA 2025/26 for all taxpayers, regardless of their accounting year-end dates. The amendment has been incorporated into the final legislation enacted.

1 The Ordinance can be accessed via this link.
2 The Bill can be accessed via this link.
3 KPMG is one of the parties that made a submission on the Bill. Please refer to this link for all the submissions received.
4 The government's responses can be accessed via this link.
5 For details of the amendment to the Bill, please refer to this link.
6 Under the transitional arrangement, a taxpayer can elect to compute the R&D fraction based on the total eligible R&D expenditure and total non-eligible expenditure incurred by the taxpayer in respect of all IP assets during a 3-year rolling period, and there is no need to track and link the expenditure to individual eligible IP.

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Key clarifications/updates in the government's responses

1. Copyrighted software as eligible IP

Eligible IP for the purposes of the patent box tax incentive includes a copyright subsisting in software under the Copyright Ordinance in Hong Kong or the law of any place outside Hong Kong. While registration of copyrighted software is generally not required under the Hong Kong or foreign law, the government indicated that the copyrighted software must fall within the scope of the relevant legal protection for it to be regarded as an eligible IP and that further guidance and illustrative examples on this will be provided.

Giving the relatively wide application of copyright software in different industries, it would be helpful if the guidance could shed light on what information / evidence is required from taxpayers to satisfy the IRD that the software "fall within the scope of the relevant legal protection" given that such copyright / protection is usually acquired automatically when an original work is generated.

2. Cost-sharing arrangement (CSA)

Similar to the IRD's current assessing practice for deduction of R&D expenditure under a CSA[7], where a taxpayer has undertaken part or all of the underlying R&D activities under a development CSA, the taxpayer's share of R&D costs under the CSA could qualify as eligible R&D expenditure incurred by the taxpayer for the purposes of the patent box tax incentive, subject to certain conditions.

The IRD plans to provide relevant guidance and illustrative example on its website or in a Departmental Interpretation and Practice Note on the application of the incentive under a CSA after the law is enacted.

3. Family of eligible IPs

The government confirms that the patent box tax incentive does not adopt the product-based approach set out in the OECD's BEPS Action 5 report. In cases where a taxpayer's R&D activities generate a family of eligible IPs, taxpayers would be required to apportion and allocate the relevant R&D expenditure to each of the eligible IPs on a just and reasonable basis. The pros of this apportionment approach is it may offer greater flexibility to taxpayers in allocating the R&D expenditures to different IPs whereas the cons is there could be considerable uncertainty on what is regarded by the IRD as a "just and reasonable" basis and what taxpayers have to do to discharge the burden of proving the apportionment is just and reasonable. More guidance on this from the IRD would be welcomed.

KPMG Observations

We commend the HKSAR Government for introducing the patent box tax incentive in Hong Kong. We look forward to the business-friendly implementation of the incentive and timely issuance of practical guidance on its administration.

We set out a high-level comparison between the patent box tax incentive in Hong Kong and the Intellectual Property Development Incentive (IDI) in Singapore in the **Appendix**. As can be seen from the comparison, the incentive in Hong Kong is more competitive in a number of aspects - e.g., a lower concessionary tax rate (in certain circumstances), a wider scope of application, no economic substance requirements (other than the nexus requirement), no application, pre-approval or renewal requirements, and no sunset clause for the incentive.

Business groups in Hong Kong that carry out IP development and exploitation activities should consider whether they can benefit from the patent box incentive in Hong Kong and whether any restructuring of the IP holding structure or business operation models would be necessary. They should also stay tuned on the guidance and illustrative examples on the incentive to be issued by the IRD.

[7] The IRD's assessing practice for R&D tax deduction under a CSA is set out in paragraphs 87 to 97 of DIPN 55.

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Appendix

Tax incentive for IP income – A high-level comparison between Hong Kong and Singapore

Key features	Patent box tax incentive (Hong Kong)	Intellectual Property Development Incentive (Singapore)
1. Concessionary tax rate	**5%**	**5%** or **10%**[1]
2. Eligible industries	No restriction	Entities in certain industries are **not** eligible – e.g. certain financial institutions, shipping enterprises and tobacco manufacturers, etc.
3. Eligible intellectual property (IP)	• Patent • Plant variety rights • Copyrighted software *Note: The eligible IP assets can be under the law of Hong Kong or any place outside Hong Kong*	• Patent • Copyrights subsisting in software *Note: The eligible IP assets can be under the law of Singapore or any place outside Singapore*
4. Local registration requirement	• **Local registration is required** for patent/plant variety rights granted outside Hong Kong after the "24-month grace period"[2]	• **No** local registration requirement
5. Eligible income	• Royalties • Income derived from sale of an eligible IP • The portion of income from sale of a product or service that is attributable to the value of an embedded eligible IP • Any insurance, damages or compensation amount derived in relation to an eligible IP	• Royalties • Other income received as consideration for the commercial exploitation of qualifying IPs
6. Key conditions	• The OECD's nexus approach • No additional economic substance requirements	• The OECD's nexus approach • **Quantitative** economic substance requirements in terms of (1) **number of skilled employees in Singapore** and (2) annual **total business expenditure** • Assessment on the **qualitative** aspects of the project

1. The 5% rate applies with a higher requirement on the amount of annual total business expenditure. The concessionary tax rate will increase by at least 0.5% at regular time intervals during the extended tax relief period.
2. The local registration requirement will not apply if the date of filing / application of an overseas patent/plant variety right is within 24 months after the commencement date of the Ordinance on the patent box tax incentive.

Appendix

Tax incentive for IP income – A high-level comparison between Hong Kong and Singapore

Key features	Patent box tax incentive (Hong Kong)	Intellectual Property Development Incentive (Singapore)
7. Eligible R&D expenditure for computing the nexus ratio	Expenditure incurred for: • R&D activities undertaken by the taxpayer **in or outside Hong Kong** • R&D activities outsourced to **non-associated parties** and undertaken **in or outside Hong Kong** • R&D activities outsourced to **Hong Kong resident associated parties** and undertaken **in Hong Kong**	Expenditure incurred for: • R&D activities undertaken by the taxpayer **in or outside Singapore** • R&D activities outsourced to **unrelated parties** and undertaken **in or outside Singapore** • R&D activities outsourced to **Singapore resident related parties** and undertaken **in Singapore**
8. Pre-approval requirement	• No formal application is required (i.e. election is made in the tax return filed) • No pre-approval is required	• Formal application (i.e. submission of a Core Form and a Supplementary Form) is required • Pre-approval is required
9. Others	• Need to track/apportion income and R&D expenditure to individual eligible IP • No annual progress update on meeting the terms and conditions of the incentive is required • No limitation on the incentive period • No sunset clause for the incentive	• Qualifying IPs can be grouped into families if they are interlinked for tracking income and R&D expenditure • Need to submit an annual progress update on meeting the terms and conditions of the incentive • Incentive period is limited to **10 years** in general, with possible extension of the period of **not exceeding 10 years each time** (with incremental economic commitments) • Sunset clause till **31 December 2028**

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