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Tax Incentives for Intellectual Property Income – Patent Box Regime

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In order to promote the creation, use and trading activites of intellectual property (IP), the Hong Kong Government (the government) reformed the tax law of the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Ordinance 2024 (Patent Box Regime). The tax rate on eligible income derived from eligible patents, plant variety rights, and copyrights subsisting in software can now be reduced from the normal profits tax rate of 16.5% to the concessionary tax rate of 5%. This article will give a brief introduction of the structure of the Patent Box Regime in Hong Kong as well as the key points to be aware of.

BACKGROUND

Many tax jurisdictions have established patent box incentives to encourage the development of the industrial, research and development (R&D) sectors and creative industries. The “Policy Address 2023” and the “2023-24 Budget” also mentioned the development of Hong Kong as a regional IP trading centre an important policy direction.

To further promote IP related activities, the Patent Box Regime in Hong Kong was enacted on 5 July 2024. By setting the tax rate for profits derived from patents at a preferential tax rate of 5%, the government is aiming to encourage IP innovation and market competitiveness, while taking into account the tax rates of similar tax systems outside Hong Kong[1].

HIGHLIGHTS OF THE PATENT BOX REGIME

Below summarises the requirements to enjoy the tax regime.

	Content (Extract)
Requirements	▪ A taxpayer must meet all of the following requirements: i. Be an eligible person (see below) ii. Derive eligible IP income from an eligible IP iii. Make an election in writing
Eligible Person	▪ A person who is entitled to derive eligible IP income from an eligible IP ▪ For instance, a licensee who obtains a licence to use an eligible IP from its owner and then sub-licenses the eligible IP to another person to earn a sub-licensing fee, falls within the definition of “eligible person”
Eligible IP	▪ Any of the following IP that is generated from an R&D activity: i. An eligible patent (a patent application made under Cap. 514, or an application for a short-term patent or standard patent application is required if the patent application is filed with a patent office of any place outside Hong Kong) ii. An eligible plant variety right iii. A copyright subsisting in software under the Copyright Ordinance (Cap. 528) or under the law of any place outside Hong Kong

[1] Luxembourg at 4.99%, Ireland at 10%, Israel at 5% to 16%, Korea at 4.5% to 18% and Singapore at 5% or 10%

<table>
<tr>
<td>Eligible IP Income</td>
<td>
An income of any one or more of the following descriptions:
<ol type="i">
Income derived from the use or right to use of an eligible IP
Income derived from the sale of an eligible IP (Income that is capital in nature is tax-exempt)
The price of a sale of a product or service includes an amount that is attributable to an eligible IP
Amount of insurance, damages or compensation derived in relation to an eligible IP

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<tr>
<td>Calculation of R&D Faction</td>
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The nexus approach is adopted to determine the portion of assessable profits to be charged to profits tax at the concessionary tax rate of 5%, which is ascertained in accordance with the following formula:
P = I × F

P = the concessionary portion
I = the assessable profits from the eligible IP income
F^ = the R&D fraction applicable to those assessable profits
$$^\wedge\mathrm{F} = \frac{\mathrm{EE\ x\ 130\%}}{\mathrm{EE} + \mathrm{NE}}$$
EE = the eligible R&D expenditure incurred in respect of the eligible IP to which the eligible IP income relates (subject IP)
NE = the non-eligible expenditure incurred in respect of the subject IP
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<tr>
<td>R&D expenditures of Eligible IP</td>
<td>
For the purpose of ascertaining the R&D fraction in respect of eligible IP to which the income relates, R&D expenditures are classified into EE and NE as follows:
<table>
<tr><th>R&D Expenditures*</th><th>EE</th><th>NE</th></tr>
<tr><td>An R&D activity carried out by the eligible person</td><td>✓</td><td></td></tr>
<tr><td>An R&D activity carried out by a non-associated person on behalf of the eligible person</td><td>✓</td><td></td></tr>
<tr><td>An R&D activity carried out by an associated person (HK resident) on behalf of the eligible person in HK</td><td>✓</td><td></td></tr>
<tr><td>An R&D activity carried out by an associated person (HK resident) on behalf of the eligible person outside HK</td><td></td><td>✓</td></tr>
<tr><td>An R&D activity carried out by an associated person (non-HK resident) on behalf of the eligible person</td><td></td><td>✓</td></tr>
</table>
*Both EE and NE exclude interest payments, payments for any land or building, or for any alteration, addition or extension to any building
</td>
</tr>
<tr>
<td>Beginning of Adoption</td>
<td>Year of assessment beginning on or after 1 April 2023</td>
</tr>
</table>

COMMENTS

When it comes to income and expenditure that qualifies under the Patent Box Regime, the government is taking a generous approach to broaden the scope of income derived from IP eligible for preferential treatment. This includes costs spent on outsourcing R&D to non-associated third parties, as long as such activities are carried out in Hong Kong, in accordance with the OECD's nexus approach. In addition, income recognized as qualifying income is not only limited to IP registered in Hong Kong, but also includes Hong Kong onshore income generated by IP registered overseas. For foreign patents and plant variety rights, re-registration in Hong Kong is required, but there will be a 24-month grace period from the enactment date of the Amendment Ordinance. It means that overseas registered patents only need to finalize either a standard or short-term patent application in Hong Kong by 5th July 2026. Furthermore, the election is to made in writing and will apply to all subsequent years after the assessment year. Applicants are not required to elect annually, but once made, the election is irrevocable.

Corporations should take into consideration that profits tax treatment may vary based on the origin of IP income. The purpose of this regime is to stimulate the IP development in Hong Kong, thus the favourable tax rate of 5% is exclusively offered to income generated from onshore transactions in Hong Kong. Offshore-sourced income is generally tax-exempt in Hong Kong but is subject to FSIE scheme[2], which was recently amended in response to the European Union (EU) guidance. Regardless of economic substance requirement, offshore IP income that does not qualify for preferential tax treatment under the nexus approach, will be subject to the standard profits tax rate at 16.5%.

Moreover, it is paramount to note the global minimum tax rate under Pillar Two by the OECD's Base Erosion and Profit Shifting (BEPS) 2.0 initiative. As mentioned in the "2023-24 Budget", the government intends to enforce a global minimum tax rate of 15% on in-scope multinational enterprise (MNE) groups beginning from 2025. In principle, if an MNE entity in Hong Kong has an effective tax rate lower than 15%, the tax imposed will be adjusted up to 15%. At present, a framework unique to Hong Kong has yet to be announced, leaving uncertainty on whether relief measures will be provided. Nevertheless, this implies that companies utilizing tax incentives, such as the Patent Box Regime, might be subject to a top-up tax if their effective tax rate falls below 15%. Attention should be paid to anticipated legislative amendments related to this matter, expected to be introduced into the Legislative Council in the second half of this year.

With the establishment of the Patent Box Regime, if corporations wish to apply preferential treatment are advised to consult with tax professionals for calculation of the R&D fraction as well as to identify taxation risks. Furthermore, if a group base outside Hong Kong possesses IP rights, it may be necessary to review the capital structure of IP holdings in response to preferential treatments among the regions. We will pay attention to regulatory developments related to Hong Kong's taxation system.

[2] FSIE (Foreign-sourced Income Exemption): With effect from January 1, 2023, a portion of offshore-sourced passive income will be chargeable to profits tax for companies that are members of MNE groups. Only the MNE entity that meets the exception requirements specifically for the particular types of income will be exempt from taxation.

	Publish date	Title
No.1 2024	2024/4/30	Hong Kong Budget 2024/25
No.4 2023	2023/12/13	Tax Certainty Enhancement Scheme
No.3 2023	2023/11/13	The Chief Executive's 2023 Policy Address

- Please refer to the below links for previous News Focus:

  (English) https://www.bk.mufg.jp/report/chi200402/Archive_ENG.pdf

  (Japanese) https://www.bk.mufg.jp/report/chi200402/Archive_JPN.pdf