Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email (pb_consultation@cedb.gov.hk)

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Commerce and Economic Development Bureau
22/F – 23/F, West Wing,
Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Attn: Ms Vivian Chan

Dear Sirs,

Consultation on the introduction of patent box tax incentive in Hong Kong

The Hong Kong Institute of Certified Public Accountants ("the Institute") appreciates the opportunity to provide feedback on the proposals regarding the introduction of a patent box tax incentive for Hong Kong-sourced intellectual property ("IP") income. The Institute's Taxation Faculty Executive Committee has reviewed the proposals in the consultation paper ("CP") and broadly supports the Hong Kong SAR Government ("the Government")'s initiative to introduce the patent box regime as a means to encourage more research and development ("R&D") and IP trading activities in Hong Kong. Our general and more specific comments are set out below for your consideration.

1. General comments on the proposals

One of the roles envisaged for Hong Kong under the 14th National Five-Year Plan ("14th FYP"), is an IP trading hub. However, responding to the concerns of the European Union ("EU") over possible double non-taxation arising from tax exemptions for offshore passive income in Hong Kong, the Government made a commitment to refine Hong Kong's foreign-source income exemption ("FSIE") regime for passive income. Under the refined FSIE regime, four types of offshore income, including income from IP, are deemed to be sourced from Hong Kong and are subject to profits tax. This applies if the income is "received in Hong Kong" by a taxpayer that is a constituent entity of a multinational enterprise ("MNE") group, and where it does not meet the relevant test of having sufficient economic activity in, or "nexus to", Hong Kong, or a participation exemption does not apply, depending on the type of income. The refined FSIE regime came into force on 1 January 2023 and, due to changes in the scope of the EU FSIE guidance, it will be further extended to also cover gains from disposals of assets other than shares or equity interests, such as IP and debt instruments, regardless whether such gains are revenue or capital in nature, by the end of 2023.

For foreign-sourced IP income that is received in Hong Kong, the nexus approach adopted by the Organisation for Economic Cooperation and Development ("OECD") is now used to determine the granting of tax exemptions. While income from certain IP rights (i.e. patents and patent-like IP) may continue to be non-taxable, the legislation has resulted in a very limited scope of non-taxable offshore IP income. This is likely to discourage companies from establishing IP-related businesses in Hong Kong.

Over the past few years, numerous stakeholders, including the Institute, have been calling for enhancement of the IP regime (including considering a "patent box" regime) in Hong Kong to incentivise more R&D and foster the development of innovation and technology ("I&T"). Therefore, we are pleased to see that the Government has responded to these calls and initiated a consultation to gauge stakeholders' views regarding the design of a proposed patent box regime. The patent box regime could serve as a valuable complement to the enhanced tax deduction regime for qualifying R&D expenses introduced in 2018. It will provide additional incentives for the creation and trading of IP assets in Hong Kong, alongside the R&D activities that support them, and help to boost Hong Kong's competitiveness as a regional and international I&T hub and IP trading centre.

That said, we believe that the Government should, as far as possible, take a holistic view towards encouraging the growth and development of I&T and R&D in Hong Kong. As such, in addition to the proposed patent box regime, we hope that the Government will continue to explore enhancements to other IP and R&D-related tax rules that may impact taxpayers' decisions on locating or expanding their IP business in Hong Kong. We are referring to measures such as the existing deduction rules in respect of IP-related and R&D costs; for example, the restrictions on deductions for the acquisition costs of IP assets acquired from associates and payments for outsourced R&D activities carried out by persons other than "R&D institutions", as defined in the Inland Revenue Ordinance (Cap. 112) ("IRO") should be revisited. In fact, we believe that it is vital that these rules be enhanced for the patent box regime to work effectively.

As announced in its Budget 2023, Singapore will introduce the Enterprise Innovation Scheme ("EIS")[1] to enhance the existing tax measures and introduce a new measure to encourage businesses to engage in R&D, innovation and capability development activities. In brief, the EIS provides enhanced tax deductions and allowances for various IP-related activities, such as R&D, IP registration, IP acquisition and licensing, training, and innovation, for a broader range of IP assets, including trade secrets or information that has commercial value, which may not be legally protected or subject to approval and registration processes. In comparison to Hong Kong, it appears that Singapore offers more comprehensive and generous tax benefits for IP-related activities. To maintain Hong Kong's competitiveness, in future, the Government may need to take stock of new developments elsewhere and consider introducing comparable tax benefits, such as super deductions on other types of IP-related expenditure.

At the same time, sounding a slight note of caution, while the aim of the proposal is, ultimately, to attract more business overall to Hong Kong, the Government will need to weigh up the expected impact of implementing a patent box regime, including the potential reduction of tax revenues from IP income and the additional complexity in the legislative framework, as well as uncertainties for taxpayers and the Inland Revenue Department that may arise from any lack of clarity and possible variations in assessing practice. In addition, the possible impact of the Global Anti-Base Erosion ("GloBE") Rules, under Pillar Two of the OECD's base erosion and profit shifting ("BEPS") 2.0 initiative, will also need to be considered.

The Government should also explore other possible non-tax support measures, to help create an environment conducive for businesses to invest in R&D and IP in Hong Kong. These measures may include, among other initiatives, a comprehensive talent

[1] For more details of EIS, please see: https://www.iras.gov.sg/schemes/disbursement-schemes/enterprise-innovation-scheme-(eis)

strategy to attract and retain R&D talents, the provision of financial subsidies to bolster R&D infrastructure, the streamlining of IP registration procedures and simplification of requirements for application documents, etc.

2. *Comments on the specific proposals in the CP*

Definition of "eligible IP assets" (paragraphs 8 to 9 of the CP)

The CP states that, in accordance with the OECD's nexus approach, eligible IP assets that qualify for tax benefits under the proposed patent box regime are patents and, subject to certain conditions, other IP assets that are functionally equivalent to patents. Specifically, such assets include:

(a) patents;
(b) copyrighted software; and
(c) plant variety rights.

While the above list is expressed as being inclusive, we also understand that, at this stage, it is not the intention to cover any other IP assets.

Paragraph 35 of Chapter 4 of the Action 5 report[2] of the BEPS initiative indicates that patent-like IP assets that qualify are not just patents in a narrow sense of the word, but also utility models, IP assets that grant protection to plants and genetic material, orphan drug designations, and extensions of patent protection.

Drawing reference from established patent box tax regimes, such as those in the United Kingdom ("UK")[3] and Israel[4], the Government should consider providing for a wide range of BEPS-compliant IP assets.

In view of the above, we would suggest that the future patent box legislation leave open the possibility of adding other IP assets to the list in the future, without having to further amend the primary legislation.

Furthermore, since an R&D outcome is often not directly correlated to a specific product, or individual R&D project, we suggest including the concept of a "family" of eligible IP assets, which would allow the grouping of two or more eligible IP assets into a "family" when it is impractical to reasonably identify or separate their respective expenditures or incomes from each other.

According to our understanding, some other patent box regimes, including the UK regime, are quite flexible and taxpayers are eligible to claim the concessions even if they are not the owners of IP rights but, e.g., hold an exclusive licence for qualifying IP rights, subject to certain conditions. In addition, there are specific provisions in the

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[2] https://www.oecd-ilibrary.org/docserver/9789264241190-en.pdf?expires=1695112776&id=id&accname=oid033622&checksum=E6ED78DCB8D66F090F56FC7A6D38C3BF

[3] Under the UK patent box regime, qualifying IP assets appears to cover a patent and other rights including rights under certain supplementary certificates and certain plant breeders' rights. Where a product benefits from specific marketing protection or data protection, the person who holds the relevant marketing authorisation in respect of the product is treated as having been granted a right to which the regime applies in respect of the product.

[4] The Israeli Innovation Box regime includes certain medicinal products for humans or animals, as defined under the Pharmaceutical Ordinance of Israel, as qualifying assets. With respect to registering non-Israeli products, the Israeli Pharmaceutical Ordinance requires approval from the relevant foreign regulators and refers directly to the United States Food and Drug Administration approval or the European Conformité Européenne Marking. Accordingly, pharmaceutical companies and other life sciences companies may be able to access the Israeli Innovation Box regime with respect to income generated from a potentially wide range of regulator-approved products.

UK legislation that cover ownership of qualifying IP rights acquired through a cost-sharing arrangement ("CSA"), and deem a company (within a group) that has been conferred all the rights held by another member of the same group, as holding an exclusive licence. Since the UK patent box regime is generally well received, it should be made clear that similar facilities will also be available under the proposed Hong Kong regime.

As a practical matter, it should also be explained what evidence the Inland Revenue Department will require taxpayers to produce when seeking concessions for qualifying IP income and expenditure in relation to copyrighted software, given that copyright is not a registrable IP.

Requirements for registered patents and plant variety rights in Hong Kong (paragraphs 12 to 13 of the CP)

The CP indicates that eligible IP assets will include patents and plant variety rights granted in or outside Hong Kong, as well as applications made for patents and plant variety rights. However, if an application does not eventually result in a grant, accordingly, the portion of eligible IP income for which tax concessions were claimed will be subject to the standard profits tax rate.

To encourage and promote more filings under the local patent system and plant varieties protection system, and to ensure that the relevant inventions or R&D outcomes comply with Hong Kong's requirements for patent and plant variety right registrations, the relevant patent or plant variety rights are required to be included in an application filed under the specified local registration system, as indicated in the CP. Nevertheless, such requirement will not apply if the date of filing of an eligible IP asset is within a transitional period of 24 months after the commencement date of the patent box regime.

Indeed, a number of jurisdictions, such as the UK and Ireland, allow patent box tax concessions for certain patents granted by the European Patent Office and by listed foreign jurisdictions.

It is also noted that, while Singapore provides IP tax incentives that follow the modified nexus approach set out in the Action 5 report, it offers a mix of incentives for different types of IP and R&D activities to ensure that companies can benefit from the tax regime, no matter whether their IP is legally protected/ registered or not. Hong Kong should consider doing likewise. For example, some companies, such as those in the chemical industry, may choose not to patent their trade secrets due to concerns about reverse engineering or the potential disclosure of proprietary information. As such, consideration could be given to extending the tax benefits to cover more IP assets, such as trade secrets, which may not be registered, but which include valuable confidential information, such as formulas and manufacturing processes.

In general, in order to make Hong Kong's patent box tax regime more attractive, the Government should consider:

- whether eligible IP assets under the proposed patent box regime would need to be confined to those locally applied for, or registered or protected by the local laws only; and
- whether there are other alternative or more appropriate means of promoting the Hong Kong patent filing system.

In addition, it should be clarified whether overseas IP assets filed during the 24-month transitional period will be required to be registered/ granted in Hong Kong after the transitional period.

Definition of "eligible expenditures" (paragraph 10 of the CP)
Jurisdictional approach for calculating the nexus ratio (paragraph 11 of the CP)

In calculating the nexus ratio, the OECD guidelines allow jurisdictions that are not member states of the European Union to take either an "entity approach" or "jurisdictional approach". The jurisdictional approach permits domestic related-party costs to be included in the numerator while the entity approach does not.

We concur with the adoption of the jurisdictional approach in Hong Kong as it would be more favourable and is consistent with the approach adopted in the refined FSIE regime. It is anticipated that the definition of R&D expenditure under the proposed patent box regime will align with that employed in the refined FSIE regime. As noted above, the Government should confirm whether payments made under a CSA will be considered as eligible expenditure within the scope of the patent box regime. The UK Patent Box regime contains detailed rules for determining under what conditions R&D expenditures incurred under a CSA will be considered as qualifying R&D expenditures for the nexus ratio.

As pointed out above, we believe that the Government needs to take a more holistic approach to support I&T and R&D development in Hong Kong. In this regard, we continue to propose that deductions in relation to the acquisition of IP assets, which could involve very substantial costs (sometimes referred to as "black hole" expenditure, due to their lack of deductibility) should be allowable.

Eligible IP income (paragraph 14 of the CP)

According to the CP, eligible IP income would cover (a) licensing income derived from an eligible IP asset; (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 as, on a just and reasonable basis (e.g. based on transfer pricing principles), is attributable to the value of the asset (i.e. embedded IP income).

To provide more certainty, we suggest making clear in the legislation whether eligible IP income would also cover any damages for infringements or other forms of compensation resulting from infringements. This is important as such inclusions are allowable under BEPS Action 5 and they are commonly found in the patent box regimes of other jurisdictions, such as the UK. By explicitly specifying the scope of eligible IP income, the legislation can provide a more transparent and comprehensive framework for taxpayers under the patent box regime.

Concessionary tax rate (paragraph 15 of the CP)

We understand that the Government is gathering views on the tax rate to be imposed on the concessionary portion of qualifying IP income. Since the proposed tax incentive will be an important policy tool for encouraging the use and commercialisation of IP assets arising from R&D activities carried out by taxpayers, we hope that the proposed regime will be truly competitive. Having regard to the rates adopted in overseas patent box regimes (which may be as low as 4.5%), we would recommend that the tax rate for the patent box regime in Hong Kong be between 0% - 5%.

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Some tax practitioners have expressed concerns regarding the potential impact that the GloBE Rules may have on taxpayers enjoying the concessions under the proposed patent box regime. In general, even if the patent box incentive results in an effective tax rate ("ETR") below 15% in certain instances, the effect of the GloBE Rules could be lessened if there are other substantial activities carried out, resulting in a total ETR in that jurisdiction above 15%. Their impact will be dependent upon several factors, e.g., percentage of tax deduction, overall activities performed, costs incurred in relation to IP activities.

Generally speaking, it appears reasonable to expect that the patent box regime would be attractive notwithstanding the minimum ETR requirement, although it may be difficult to define a priori the full effect of Pillar Two on the proposed incentive. Still, it is important to consider carefully the potential interaction between the proposed patent box regime and the forthcoming implementation of Pillar Two in Hong Kong. This will enable the Government to design the regime in a more cohesive manner, ensuring that it aligns with the global tax rules and fulfils its intended objectives while preserving Hong Kong's competitiveness.

To conclude, while we broadly welcome the proposed patent box regime, we hope that the Government will consider and address the issues raised in this submission and provide sufficient clarification and guidance before proceeding with it. Furthermore, we encourage the Government to explore, at the same time, possible non-tax incentives and measures aimed at fostering the growth of the I&T sector. By providing a more supportive ecosystem that extends beyond tax incentives, Hong Kong will be in a stronger position to nurture the I&T sector, stimulate innovation, and bolster its position as a global hub for technology and IP development.

Should you have any questions on this submission, please do not hesitate to contact me at peter@hkicpa.org.hk or on 2287 7084.

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Yours faithfully,

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