KPMG Tax Services Limited
8th Floor, Prince's Building
Central, Hong Kong
G P O Box 50, Hong Kong
Telephone +852 2522 6022
Fax +852 2845 2588
Internet kpmg.com/cn

Hon Edmund WONG Chun-sek
The Chairman
Bills Committee on Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Bill 2024
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Sent by email to: bc_03_24@legco.gov.hk

27 May 2024

Submission on the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Bill 2024

Dear Hon Edmund Wong,

We refer to the Bills Committee's invitation for submission on the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Bill 2024 (the Bill) and would like to set out our comments as follows.

1. Eligible intellectual property (IP)

The Bill defines "eligible intellectual property" as (i) an eligible patent (which includes a utility model, a utility certificate and an inventor's certificate registered / issued by an overseas patent office), (ii) an eligible plant variety right and (ii) a copyrighted software.

Under the OECD's nexus approach, patents and other IP assets that are functionally equivalent to patents (with certain conditions) are qualifying IP assets. For the purposes of "other IP assets that are functionally equivalent to patents", the OECD's final report on BEPS Action 5 mentioned that patents are not just patents in a narrow sense of the word but also include IP assets that grant protection to genetic materials and orphan drug designations, etc. In addition, other IP assets that are non-obvious, useful and novel and subject to a transparent certification process by a competent government agency could also be a qualifying IP asset in certain circumstances.

We welcome the inclusion of a utility model, a utility certificate and an inventor's certificate in the scope of an eligible patent. However, given that the terms "eligible intellectual property" and "eligible patent" are currently defined in the Bill to refer to an exhaustive list of IP assets, we recommend that these definitions be reviewed periodically and updated where necessary to ensure the coverage is as broad as possible provided that it is allowable under the OECD's nexus approach. This would make the patent box tax incentive in Hong Kong more competitive.

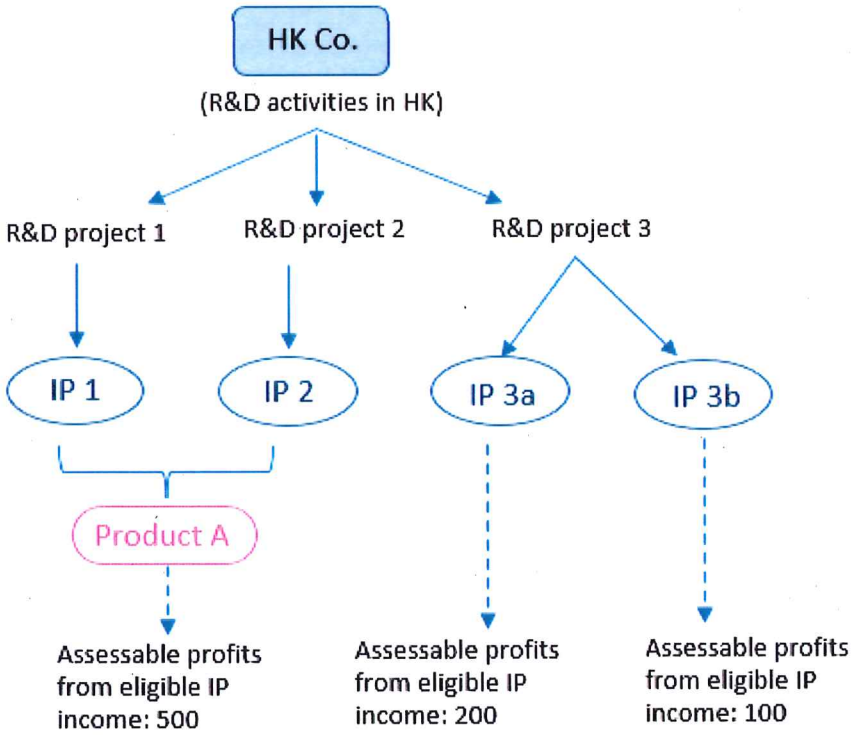
2. Family of eligible IPs / the OECD's "product-based" approach

The OECD's nexus approach allows the adoption of the "product-based approach" to cater for situations where the results of research and development (R&D) projects contribute to the development of multiple IP assets that are incorporated into one product to generate IP income.

In addition, the patent box regimes in Singapore, Ireland and the UK all cater for "a family of qualifying IP assets" (i.e. qualifying IP assets can be grouped into families if they are interlinked such that it is not possible to reasonably identify and attribute the income/expenditure of these IP assets to each IP asset separately). Based on the factsheet on the Intellectual Property Development Incentive (IDI) issued by the EDB in Singapore[1], taxpayers are allowed to track and trace R&D expenditure to either **individual or groups of IPs to the extent separable** for the purpose of calculating the nexus ratio.

Based on the current drafting of the Bill, it is not absolutely clear whether the "product-based approach" can be adopted and whether "family of eligible IPs" can be catered for. We therefore would like to seek clarifications from the government on how the draft legislation would be applied in the following example:

Example 1:



[1] See the factsheet on the IDI issued by the EDB in Singapore.

- HK Co. has generated 4 eligible IPs from R&D activities conducted by itself in Hong Kong;
- IP 1 and IP 2 are embedded in Product A which generates overall assessable profits (AP) of 500;
- IP 3a and IP 3b are family of IP assets generated from one single R&D project and the R&D expenditure contributing to them is inseparable;
- IP 3a generates AP of 200 whereas IP 3b generates AP of 100; and
- The eligible R&D expenditure (i.e. EE) and non-eligible expenditure (i.e. NE) incurred by HK Co in respect of the 4 eligible IPs are as follows:

	IP 1	IP 2	IP 3a	IP 3b	**Total**
EE	60	40	200		**300**
NE	30	20	50		**100**

Clarifications sought:

(i) **The product-based approach** - Given Product A generates an overall AP from eligible IP income of 500, can the concessionary portion of the AP (from IP 1 and IP 2 together) be computed under Part 3 of Schedule 17FD as: 500 x 100/150 = 333?

(ii) **Family of eligible IPs** - Given that requiring HK Co. to attribute the R&D expenditure to IP 3a and IP 3b would require arbitrary judgements, can the AP from IP 3a and IP 3b be aggregated (i.e. 200 + 100 = 300) and the concessionary portion of the aggregated AP be computed under Part 3 of Schedule 17FD as: 300 x 200/250 = 240?

We urge the government to adopt the product-based approach and cater for family of eligible IPs for the patent box tax incentive in Hong Kong to make it on par with the patent box regimes in the above mentioned jurisdictions.

3. The local registration/filing requirement of the eligible IP assets

The Bill imposes a requirement for the patents/plant variety rights to be registered or an application for such patents/rights to be filed under the local system of Hong Kong to promote the use of the local protection system. In contrast, there is no such domestic registration requirement under the Intellectual IDI in Singapore[2] and the Knowledge Development Box (KDB) regime in Ireland[3].

We therefore recommend removing such local registration/filing requirement to make the Hong Kong regime on par with those in Singapore and Ireland. In addition, we suggest that the government explores other ways of increasing the popularity of the local protection system in Hong Kong rather than imposing such local registration/filing requirement under the patent box tax incentive to promote the use of the local system.

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[2] For more details, please refer to section 43X of the Singapore Income Tax Act 1947, the relevant Income Tax Regulations on the IDI and the factsheet on the IDI issued by the EDB in Singapore.

[3] For more details, please refer to the guidance notes on the KDB in Ireland in this link.

4. Transitional arrangement for calculating the R&D fraction

The Bill provides for a transitional arrangement for calculating the R&D fraction based on a "3-year rolling average" in the case of insufficient records kept by taxpayers. We have the following comments on the transitional arrangement:

(i) By reading sections 13(1)(b) and 23(2)(c) of Schedule 17FD together, it appears that in calculating the R&D fraction under the transitional arrangement, EE (i.e. the numerator of the R&D fraction) would include **any expenditure incurred during the specified period for an R&D activity** that is carried out by the taxpayer itself or outsourced to another party (if the specified conditions are met), regardless of whether the R&D activities are linked to eligible IPs or non-eligible IPs. We would like to clarify whether this is the intended definition of EE. If EE is intended to include eligible R&D expenditure linked to eligible IPs only, we recommend that revisions be made to the Bill to make that clear.

(ii) If EE is intended to cover eligible R&D expenditure linked to **eligible IPs only**, it would appear that there is a "mismatch" between the numerator and the denominator of the R&D fraction because based on the current drafting of sections 14(1)(b) and 23(2)(c) of Schedule 17FD, NE in the denominator would include costs of acquiring **any IPs** as defined under section 15H(1) of the IRO and not just eligible IPs whereas EE in the numerator would only include eligible R&D expenditure linked to eligible IPs only. As a result of this mismatch, the R&D fraction would be dragged down and less eligible IP income would benefit from the 5% tax rate. We therefore recommend that the government revisits the current definitions of EE and NE under the transitional arrangement and make any necessary adjustments to the definitions.

(iii) Under the Bill, the patent box regime would apply from **year of assessment (YOA) 2023/24** but the transitional arrangement would only apply to eligible IP income accrued during the period from **1 April 2023** to the last day of the taxpayer's basis period for YOA 2025/26. That is, it does not apply to eligible IP income accrued before 1 April 2023. As a result, for YOA 2023/24, the transitional arrangement would not apply to eligible IP income accrued to (a) D-code taxpayers for the period from 1 January 2023 to 31 March 2023 and (b) N-code taxpayers (e.g. those with an accounting year-end date of 30 June) for the period from 1 July 2022 to 31 March 2023 (i.e. it would only apply to part of the basis period for D-code and N-code taxpayers) whereas it would apply to the entire basis period for M-code taxpayers. We would like to clarify whether these differential tax treatments based on different accounting year-end dates is intended and if yes, the rationale behind.

5. Cost sharing arrangements (CSAs)

Under a typical CSA for carrying out R&D activities to develop an IP, the participants of the CSA will jointly make financial contributions towards the costs of the R&D activities and jointly share the risks and expected benefits of the IP created by the R&D activities.

Given that the Bill is silent on the treatment of CSAs, we would like to seek clarification on whether a taxpayer's share of R&D costs under a CSA (or CSA payments made) could qualify as EE incurred by the taxpayer for the purpose of the patent box tax incentive, provided that certain

conditions are met (e.g. the taxpayer has undertaken part of the R&D activities under the CSA and the arm's length principle under the transfer pricing rules is complied with, etc.).

We note that under the IDI in Singapore, CSA payments borne by taxpayers for carrying out R&D are included as qualifying expenditure in the nexus ratio except when none of the R&D is carried out by the (i) IDI company, (ii) an unrelated party or (iii) a Singapore resident related party where the R&D is carried out in Singapore[1].

6. The nexus ratio as a rebuttable presumption

The OECD's nexus approach allows jurisdictions to treat the nexus ratio as a rebuttable presumption when certain conditions are met and with additional review and record keeping requirements. This means that in exceptional circumstances (e.g. a complete or partial write-down of acquired IP) where a taxpayer can establish that applying the nexus ratio would lead to an outcome not consistent with the nexus approach (i.e. the level of IP income eligible for the regime is not commensurate with the level of R&D activities), the nexus ratio could be rebutted with the necessary adjustments.

Currently, the Bill does not provide for this rebuttable presumption. We recommend that the government considers including the flexibility of treating the nexus ratio as a rebuttable presumption in the Bill.

7. Interaction between the patent box tax incentive and Pillar 2 of BEPS 2.0

We recommend that the government monitors the development of the BEPS Pillar 2 rules and periodically review the impacts of the Subject-to-Tax Rule and the Hong Kong minimum top-up tax on the patent box tax incentive for in-scope MNE groups. Where necessary, the government may consider offering government grants/subsidies additional to what is available currently and/or refundable R&D tax credits to serve as additional incentives to encourage domestic R&D activities.

8. Interaction between the FSIE regime and the patent box tax incentive

Under the foreign sourced income exemption (FSIE) regime recently introduced in Hong Kong, foreign sourced royalty income and gains from disposal of IP assets received (or deemed received) in Hong Kong by an MNE entity is tax exempt only if (1) it is derived from a patent or an asset similar to patent **and** (2) the nexus requirement is met.

This effectively limits the offshore claim on IP income to very limited circumstances. In particular, businesses in the filming and e-gaming industries in Hong Kong are being significantly impacted by the FSIE regime as in most cases, they would not be able to meet the above "patent or similar assets" and nexus requirements and therefore would need to pay Hong Kong profits tax at 16.5% on their foreign sourced royalty income and IP disposal gains that was previously exempt from Hong Kong profits tax.

The introduction of a patent box tax incentive in Hong Kong would not alleviate the impact of the FSIE regime on these industries because taxpayers wishing to enjoy the 5% tax rate under the patent box tax incentive would need to meet the same requirements as those under the FSIE regime. This means that taxpayers who do not qualify for the tax exemption under the FSIE

regime would also be ineligible for the 5% tax rate under the patent box tax incentive. They will end up paying Hong Kong profits tax at 16.5% on their IP income.

In view of the above, we recommend that the government has a separate dialogue/consultation with the stakeholders in those industries that would not benefit from the patent box tax incentive (e.g. the filming and e-gaming industries) and seeks their views on what other government measures could be put in place to support them.

9. Other comments

Other than a patent box tax incentive, we recommend that the government considers the following tax measures to enhance the tax regime for IP income in Hong Kong to promote the development of the innovation and technology sector in Hong Kong:

- Allowing a tax deduction for amortisation expenses of intangible assets in general, provided that the intangible assets are used in generating profits subject to Hong Kong profits tax, with a claw-back on the amortisation expenses previously allowed upon disposal of the assets at a gain.

- Enhancing the current special tax deduction for the purchase costs of specified intellectual property rights (IPRs) as defined under section 16EA of the IRO by revisiting the following anti-avoidance provisions in the IRO:

    - section 16EC(2) - a blanket denial of tax deduction if the IPR is purchased from an associate[4];

    - section 16EC(4)(b) - a denial of tax deduction if the IPR is purchased and owned by a Hong Kong taxpayer and licensed to another person for use outside Hong Kong, even though the payments for use of such IPR received by the Hong Kong taxpayer are fully subject to profits tax in Hong Kong.

- Refining the current tax deduction for R&D expenditure - e.g.

    - allowing tax deduction for expenditure on R&D activities outsourced to group entities which is not a designated local research institution; and

    - extending the enhanced R&D tax deduction to cover R&D activities carried out in the Greater Bay Area.

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[4] In Singapore, the capital expenditure incurred on acquiring an IPR from a related party is deductible (by means of writing-down allowances) although a third-party independent valuation report on the value of the IPR acquired is required if the acquisition cost is ≥S$0.5 million. Please refer to this link for more details.

If you have any questions on our submission, please feel free to contact me ( ) or Anita Tsang ( ).

Yours sincerely,
For and on behalf of KPMG Tax Services Limited

John Timpany
Head of Tax, Hong Kong