

## LEGISLATIVE COUNCIL BRIEF

Inland Revenue Ordinance  
(Chapter 112)

### INLAND REVENUE (AMENDMENT) (TAX CONCESSIONS FOR INTELLECTUAL PROPERTY INCOME) BILL 2024

#### INTRODUCTION

At the meeting of the Executive Council on 26 March 2024, the Council ADVISED and the Chief Executive ORDERED that the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Bill 2024 (“the Bill”) at Annex A should be introduced into the Legislative Council (“LegCo”).

A

#### JUSTIFICATIONS

##### Policy Objective

2. The “Outline of the 14th Five-Year Plan for National Economic and Social Development of the People’s Republic of China and the Long-Range Objectives Through the Year 2035” (“14th Five-Year Plan”) promulgated in 2021 supports Hong Kong to develop into, among others, an international innovation and technology (“I&T”) centre, an East-meets-West centre for international cultural exchange and a regional intellectual property (“IP”) trading centre.

3. IP has become an essential capital for enterprises in a knowledge-based economy. Encouraging the industrial and research and development (“R&D”) sectors as well as the creative industries to create and exploit IP will stimulate and promote the development of IP trading. Enhanced R&D and IP trading activities like buying/selling and licensing will in turn lead to more creation and exploitation of IP through, for example, acquiring foundation technologies or IP and conducting R&D on products and services by enterprises, followed by obtaining patent protection for the

newly developed technologies or inventions, and in turn the pursuit of commercialisation of the patents in-house or through licensing, thereby creating business opportunities to facilitate the upgrading of products or services to move up the value chain. Prosperity of IP trading activities will also create more opportunities for professional services such as IP legal, valuation, management, consultation and agency services to further develop vigorously.

4. One policy tool that has been employed by other jurisdictions for encouraging the industrial and R&D sectors, creative industries and IP users to engage in more IP trading activities is the provision of tax incentive, through the setting up of a “patent box” regime, on qualifying profits derived from eligible IP.

### **Experience outside Hong Kong**

5. The “patent box” tax incentive is offered in Mainland China and many overseas jurisdictions<sup>1</sup> to encourage businesses to –

- (a) develop and retain eligible IP (typically patents), and use patents to protect their inventions that would have otherwise been kept secret;
- (b) increase investment in R&D activities;
- (c) promote the commercialisation of the R&D results for generating profits; and
- (d) refrain from relocating their eligible IP or transferring their sources of IP income to other jurisdictions that offer a more favourable or competitive tax treatment.

### **LEGISLATIVE PROPOSAL**

6. The key parameters of our proposed “patent box” tax incentive and the related legislative proposal are summarised in the following paragraphs.

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<sup>1</sup> Overseas jurisdictions that have implemented “patent box” tax incentives include Belgium, France, Greece, Hungary, India, Ireland, Israel, Korea, Luxembourg, Netherlands, Poland, Singapore, Spain, Switzerland, Thailand, Türkiye, the United Kingdom and Uruguay.

## **Applying the International standard**

7. The nexus approach adopted by the Organisation for Economic Co-operation and Development (“OECD”) as a minimum standard under Action 5 of the Base Erosion and Profit Shifting (“BEPS”) package has been applied by the OECD Forum on Harmful Tax Practices to evaluate the harmfulness of preferential tax regimes for IP income put in place by individual jurisdictions. As a member of the Inclusive Framework on BEPS<sup>2</sup>, Hong Kong is obliged to apply the nexus approach in determining the extent of IP income that is entitled to preferential tax treatment (the key features of the nexus approach as promulgated by the OECD are set out in **Annex B**).

B

### **Calculation of Assessable Profits under the “Patent Box” Regime: Definition of “Eligible IP”**

8. In accordance with the OECD’s nexus approach, only income derived from an eligible IP could benefit from the preferential tax treatment based on the nexus ratio under the “patent box” regime. Under the nexus approach, eligible IP that could qualify for preferential tax treatment are limited to patents and other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes (if any) where such processes are relevant, which include –

- (a) patents;
- (b) plant variety rights<sup>3</sup>; and
- (c) copyrighted software.

9. Based on the above, in defining the scope of eligible IP, we have taken a more liberal approach with a view to enhancing the competitiveness of our proposed “patent box” tax incentive. For instance, eligible IP will

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<sup>2</sup> The Inclusive Framework on BEPS allows interested jurisdictions to work with the OECD and G20 members to develop standards on BEPS-related issues and review and monitor the implementation of the BEPS package on an equal footing. As at November 2023, the Inclusive Framework on BEPS had 145 member jurisdictions.

<sup>3</sup> Plant variety rights are rights granted to the owners of plant varieties over cultivated plant varieties they have bred or discovered and developed. In Hong Kong, the procedures for applying for such rights are set out in the Plant Varieties Protection Ordinance (Cap. 490) administered by the Agriculture, Fisheries and Conservation Department.

include **applications** for patents and plant variety rights<sup>4</sup>, as well as those patents<sup>5</sup> and plant variety rights **granted in or outside Hong Kong**. In other words, taxpayers with qualifying profits derived from eligible IP registered in other jurisdictions could benefit from the “patent box” tax incentive.

## **Requirements for Patents and Plant Variety Rights to be Registered in Hong Kong**

10. To encourage and promote more filings under the local patent system (in particular the original grant patent (“OGP”) system<sup>6</sup>) and plant varieties protection system for obtaining legal protection locally, and to ensure that the underlying inventions or R&D outcomes comply with Hong Kong’s legal requirements for patent and plant variety right registrations, if the eligible IP is a patent or plant variety filed or granted outside Hong Kong (i.e. a non-Hong Kong patent or a non-Hong Kong plant variety right), we will additionally require that:

- (a) for a non-Hong Kong patent – there must be an application for or a grant of an OGP or a short-term patent (“STP”) in Hong Kong for the underlying invention of the non-Hong Kong patent. A post-grant substantive examination request must also be filed for a STP<sup>7,8</sup>; and

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<sup>4</sup> If the applications for patents and plant variety rights concerned do not eventually result in a grant, the portion of assessable profits for which tax concessions are claimed will be subject to the standard profits tax rate accordingly.

<sup>5</sup> The eligible patents concerned do not include patents under re-registration applications filed in Hong Kong by taxpayers after the period of 24 months as mentioned in paragraph 11 of this paper.

<sup>6</sup> Following a fundamental review of the local patent system, the Government launched the OGP system in 2019. The OGP system provides an alternative but direct filing route for seeking standard patent protection in Hong Kong, which runs in parallel with the existing re-registration system. It allows applicants to seek standard patent protection in Hong Kong directly without having to first file an application with a designated patent office outside Hong Kong as required under the re-registration route, thereby enabling OGP applicants (particularly those in Hong Kong) to secure the first date of patent filings as early as possible. Standard patent applications filed under the OGP system are subject to substantive examination, in addition to formality examination, by the Patents Registry.

<sup>7</sup> Any STP owner may request the Patents Registry to carry out substantive examination on the underlying invention. This post-grant mechanism, which was introduced together with the launch of the OGP system in 2019, safeguards the integrity of the STP system while maintaining its overall cost-effectiveness.

<sup>8</sup> If the patent application does not eventually result in a grant or the STP fails to comply with the post-grant substantive examination requirements, the portion of assessable profits for which tax concessions are claimed will be subject to the normal profits tax rate accordingly.

- (b) for a non-Hong Kong plant variety right – there must be an application for or a grant of a plant variety right in Hong Kong for the plant variety to which the non-Hong Kong plant variety right relates<sup>9</sup>.

11. In order to give sufficient advance notice to taxpayers of the foregoing additional requirements, there would be a 24-month grace period before these requirements start to kick in. That is to say, such requirements will start to apply only for those applications for registration of an eligible IP which are filed outside the period of 24 months after the commencement date of the Bill.

### **Calculation of Assessable Profits under the “Patent Box” Regime: Definition of “Eligible IP Income”**

12. As regards the eligible income covered by the “patent box” regime, we will also adopt a more liberal approach so that the “patent box” tax incentive would cover a wide scope of income derived from eligible IP, as follows –

- (a) income derived from an eligible IP in respect of the exhibition or use of, or a right to exhibit or use (whether in or outside Hong Kong) the IP; or the imparting of, or undertaking to impart, knowledge directly or indirectly connected with the use (whether in or outside Hong Kong) of the IP;
- (b) income arising from the sale of an eligible IP;
- (c) where the sales price of a product or service includes an amount which is attributable to an eligible IP – such portion of the income from those sales that, on a just and reasonable basis (e.g. based on the transfer pricing principles<sup>10</sup>), is attributable to the value of the IP; and
- (d) insurance, damages or compensation derived in relation to an eligible IP.

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<sup>9</sup> If the application for the plant variety right does not eventually result in a grant, the portion of assessable profits for which tax concessions are claimed will be subject to the standard profits tax rate accordingly.

<sup>10</sup> See paragraph 48 in Chapter 4 of the Final Report on Action 5 of the BEPS package (“BEPS Action 5 Report”) at – <https://www.oecd-ilibrary.org/docserver/9789264241190-en.pdf?expires=1655950284&id=id&accname=guest&checksum=5FC7BB519AECC489918BCD296D05428B>.

## **Calculation of Assessable Profits under the “Patent Box” Regime: Definition of “Eligible R&D Expenditure”**

13. In accordance with the OECD’s nexus approach, only eligible R&D expenditures that have been incurred by taxpayers to develop the eligible IP will be taken into consideration in the calculation of a nexus ratio, which determines the portion of assessable profits that could benefit from the preferential tax treatment under the “patent box” regime. Specifically, eligible expenditures only include R&D expenditures that are directly connected to the eligible IP. Acquisition costs of the IP are not considered as eligible expenditures.

### **Jurisdictional Approach for Calculating the Nexus Ratio**

14. Having regard to the design of the “patent box” tax incentives in other jurisdictions and to maintain Hong Kong’s tax competitiveness in attracting IP-related business activities, we will adopt the jurisdictional approach for determining the scope of eligible R&D expenditures when calculating the nexus ratio. Under this approach, eligible R&D expenditures cover the expenditures on R&D activities that are:

- (a) undertaken by the taxpayer inside or outside the jurisdiction providing the IP tax regime (“IP regime jurisdiction”);
- (b) outsourced to unrelated parties and undertaken inside or outside the IP regime jurisdiction; and
- (c) outsourced to resident related parties and undertaken inside the IP regime jurisdiction.

### **Concessionary Tax Rate**

15. To ensure the competitiveness of the “patent box” tax incentive and having regard to (a) the existing normal profits tax rate (i.e. 16.5%) and the concessionary tax rate commonly adopted under other preferential tax regimes (i.e. 8.25%) in Hong Kong; (b) the tax rates of “patent box” regimes outside Hong Kong (e.g. Luxembourg at 4.99%, Ireland at 10%, Israel at 5% to 16%, Korea at 4.5% to 18% and Singapore at 5% or 10%); and (c) the views collected during the trade consultation, the concessionary tax rate for the “patent box” tax incentive, as announced in the 2023 Policy Address, would be set at 5%, with a view to encouraging more R&D activities, as well as transformation and commercialisation of the R&D results.

## **Treatment of Losses and Related Offsets**

16. The BEPS Action 5 Report published by the OECD requires that any tax loss associated with the income benefiting from an IP regime should be allowed in a manner that is consistent with domestic legislation. Such a loss should not be allowed to directly set off against income that is taxed at the ordinary rate.

17. Taking into account the requirements of the BEPS Action 5 Report, we will adopt a mechanism similar to the existing provisions for cross set-off of losses subject to different tax rates under sections 19CAB, 19CAC and 19CB of the Inland Revenue Ordinance (“IRO”). In other words, a loss incurred in relation to income benefiting from the “patent box” tax incentive can be allowed to set off against assessable profits subject to a tax rate other than that provided under the regime so long as the amount of loss allowed is to be adjusted with reference to the tax rate difference.

## **Record Keeping Requirements**

18. One of the essential requirements of the nexus approach is the tracking and tracing of R&D expenditures and income derived from the eligible IP. This requires a detailed mechanism of record keeping, for example, keeping record of information sufficient to establish that the income concerned is eligible IP income and details of the eligible IP to which the income relates. However, as a transitional measure and to be consistent with the standards provided in the BEPS Action 5 Report, a taxpayer will be allowed to apply a ratio where eligible R&D expenditures and overall expenditures were calculated on a three-year average rolling basis. Upon the expiration of that period, the taxpayer will need to change from using the three-year average to using a cumulative ratio<sup>11</sup>.

## **OTHER OPTIONS**

19. Other than introducing amendments to the IRO, there is no other viable option to take forward the proposal.

## **THE BILL**

20. The main provisions of the Bill are as follows –

(a) **Clause 1** sets out the short title.

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<sup>11</sup> See Annex A of BEPS Action 5 Report.

- (b) **Clause 6** adds new sections 19CC to 19CG to the IRO, in order to deal with the set off of unabsorbed losses where profits and losses are subject to different profits tax rates (these additions are occasioned by the introduction of a new profits tax concession regime for certain assessable profits from an eligible IP income under the Bill, and therefore the possibility of more than one concessionary profits tax rate available under the IRO). The new sections 19CC to 19CG contain the following provisions –
- (i) the new section 19CC provides for the interpretation of defined terms including that of *adjustment factor*;
  - (ii) the new section 19CD provides for the treatment of unabsorbed losses where some concessionary trading receipts as defined by section 19CA of the IRO (“concessionary trading receipts”) that sustain unabsorbed losses are chargeable to profits tax at a lower rate than the rate for other chargeable concessionary trading receipts are chargeable to profits tax;
  - (iii) the new section 19CE provides for the treatment of unabsorbed losses where some concessionary trading receipts that sustain unabsorbed losses are chargeable to profits tax at a higher rate than the rate for other concessionary trading receipts are chargeable to profits tax;
  - (iv) the new section 19CF provides for the set off of concessionary trading receipts that are chargeable to profits tax at 2 different concessionary tax rates as defined by the new section 19CC;
  - (v) the new section 19CG provides for the rules by which sections 19CAB, 19CAC, 19CB, 19CD, 19CE and 19CF are to apply when dealing with the treatment of unabsorbed losses under different scenarios.
- (c) In connection with the addition of new sections 19CC to 19CG by **Clause 6** –



- (i) **Clause 4(3)** adds a new paragraph (f) to section 19C(6) of the IRO to prevent the set off of losses sustained from activities or transactions mentioned in the concession provisions if assessable profits derived from such activities or transactions are exempt from tax or chargeable to tax at 0%;
  - (ii) **Clause 5** amends the definitions of *chargeable concessionary trading receipts*, *concession provision*, and *unabsorbed loss in respect of the concessionary trading receipts* in section 19CA of the IRO in order to adapt those defined terms for the purposes of the new sections 19CC to 19CG.
- (d) **Clause 7** adds a new Part 6G to the IRO, which includes new section 40AY to introduce a new Schedule 17FD to the IRO dealing with eligible IP income and its tax treatment.
- (e) **Clause 12** adds the new Schedule 17FD to the IRO, which contains operative provisions on eligible IP income and its tax treatment as follows –
- (i) Part 1 of the Schedule contains preliminary provisions. Section 1 of the Schedule introduces the defined terms and section 2 of the Schedule provides that the Schedule is to be read in the way that best secures consistency with the requirements and guidance in Chapter 4 of the Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report published by the OECD in 2015;
  - (ii) Part 2 of the Schedule contains provisions on tax concession for eligible IP income. Section 3 of the Schedule contains operative provisions on the concessionary tax treatment and specifies the concessionary tax rate as 5%. Sections 4, 5 and 6 of the Schedule provide for the election required for the application of the concessionary tax rate. Sections 7, 8 and 9 of the Schedule respectively provide in detail for the meaning of the terms *eligible IP income*, *eligible patent* and *eligible plant variety right*;

- (iii) Part 3 of the Schedule contains provisions on ascertaining the concessionary portion of the assessable profits from an eligible IP income. Sections 10, 11 and 12 of the Schedule respectively provide for the formula for ascertaining the concessionary portion, the assessable profits from an eligible IP income and the R&D fraction. Sections 13 and 14 of the Schedule provide in detail for the meaning of *eligible R&D expenditure* and *non-eligible expenditure* for ascertaining the R&D fraction in section 12 of the Schedule;
  
- (iv) Part 4 of the Schedule contains provisions on the tax treatments under certain circumstances or conditions, which are exceptions to the application of the concessionary tax rate under section 3 of the Schedule. In particular, sections 16 and 17 of the Schedule provide for the tax treatment when certain circumstances occur, such as the abandonment, cancellation, declination, lapse, unconditional revocation and withdrawal, etc. that appear in that Part. Section 20 of the Schedule provides for the tax treatment when divisional patent applications are involved. Sections 18 and 19 of the Schedule provide for the tax treatment in relation to certain eligible IP in respect of which an election is made under section 4 of the Schedule under certain conditions, in particular –
  - (A) for a non-Hong Kong eligible IP — the abandonment, refusal, unconditional revocation or withdrawal of, or the absence of a request for substantive examination of, the corresponding local patent or corresponding local plant variety right, as the case may be, that is required for that non-Hong Kong eligible IP; or
  - (B) for an eligible IP that is a short-term patent — the absence of a request for substantive examination of that eligible IP;
  
- (v) Part 5 of the Schedule contains provisions on the keeping of records by an eligible person and

transitional provisions for an eligible person with insufficient records.

- (f) **Clauses 10(1) and 11** respectively amend sections 80 and 82A of the IRO to extend the existing penalties and the imposition of additional tax to the contravention of sections 21 and 22 of the Schedule in respect of notification to the Commissioner of Inland Revenue.
- (g) **Clauses 3, 4(1), 8, 9, 10(3), 13 and 14** provide for amendments consequential to the addition of the new sections 19CC to 19CG and the new Schedule 17FD, including the addition of references to the new provisions in suitable places.

## **LEGISLATIVE TIMETABLE**

21. The legislative timetable will be as follows –

Publication in the Gazette	28 March 2024
First Reading and commencement of Second Reading debate	10 April 2024
Resumption of Second Reading debate, committee stage and Third Reading	To be notified

## **IMPLICATIONS OF THE PROPOSAL**

22. The proposal is in conformity with the Basic Law, including the provisions concerning human rights. It will not affect the binding effect of the existing provisions of the IRO and its subsidiary legislation. Our proposal has no environmental, family, gender or productivity implications, and no sustainability implications other than those set out in the economic implications paragraph in **Annex C**. The financial and civil service implications of the proposal are also set out in **Annex C**.

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## **PUBLIC CONSULTATION**

23. We have conducted a one-month trade consultation<sup>12</sup> on the key parameters, related legislative proposal and level of concessionary tax rate of the upcoming “patent box” tax incentive in September 2023. Apart from issuing a consultation document to the trade, the Commerce and Economic Development Bureau, the Intellectual Property Department, the Inland Revenue Department and the Agriculture, Fisheries and Conservation Department also organised two engagement sessions on 11 and 12 September 2023 to brief and seek views from relevant stakeholders on the arrangements of the proposed “patent box” tax incentive. The trade was generally supportive of the Government’s proposal to introduce the “patent box” tax incentive. We have taken into account the trade’s feedback when preparing the proposal in paragraphs 7 to 18 above.

24. We briefed the LegCo Panel on Commerce, Industry, Innovation and Technology on the proposal on 19 December 2023. Panel members generally supported the proposal.

## **PUBLICITY**

25. A press release will be issued upon the publication of the Bill in the Gazette, and a spokesperson will be available to answer media enquiries. We will also further promote the “patent box” tax incentive to Mainland and overseas businesses through our network of Economic and Trade Offices and Mainland Offices, as well as offices of the Hong Kong Trade Development Council and InvestHK.

## **BACKGROUND**

26. In order to encourage the I&T sector to forge ahead with more R&D activities and create more IPs with market potential as a catalyst for promoting I&T and IP trading activities with a view to maintaining Hong Kong’s competitiveness as a regional IP trading centre, it was announced in the 2023-24 Budget that the Government would introduce a “patent box” tax incentive to provide tax concessions for qualifying profits sourced in Hong Kong and derived from eligible IP created through R&D activities. The Chief Executive has also announced in the 2023 Policy Address that the concessionary tax rate for the “patent box” tax incentive would be set

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<sup>12</sup> Organisations consulted included professional bodies and industry associations of the taxation, accounting and legal professions, major local chambers of commerce, major local professional bodies of IP (including patent) practitioners, local universities and research institutions.

at 5%, with a view to encouraging more R&D activities, as well as transformation and commercialisation of the R&D results.

## **ENQUIRIES**

27. Enquiries on this brief can be directed to Ms Joanna Cheung, Principal Assistant Secretary for Commerce and Economic Development at telephone number 2810 2862.

**Commerce and Economic Development Bureau  
Intellectual Property Department  
Inland Revenue Department  
Agriculture, Fisheries and Conservation Department  
27 March 2024**

**Inland Revenue (Amendment) (Tax Concessions for  
Intellectual Property Income) Bill 2024**

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## A BILL

### To

Amend the Inland Revenue Ordinance to give profits tax concessions for certain assessable profits from an eligible intellectual property income; to provide for the treatment of losses in relation to assessable profits chargeable to profits tax at more than one concessionary tax rate; and to provide for related matters.

Enacted by the Legislative Council.

**1. Short title**

This Ordinance may be cited as the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Ordinance 2024.

**2. Inland Revenue Ordinance amended**

The Inland Revenue Ordinance (Cap. 112) is amended as set out in sections 3 to 14.

**3. Section 14 amended (charge of profits tax)**

Section 14(5), after “14ZV(7)(b)”—

**Add**

“or section 4 of Schedule 17FD”.

**4. Section 19C amended (treatment of losses after 1 April 1975)**

(1) Section 19C(1), (2), (4) and (5)—

**Repeal**

“section 19CB”

**Substitute**

“sections 19CB and 19CF”.

(2) Section 19C(6)(e)—

**Repeal the full stop**

**Substitute a semicolon.**

(3) After section 19C(6)(e)—

**Add**

“(f) if, because of a concession provision (as defined by section 19CA), a person is exempt from payment of tax, or chargeable to tax at 0%, in respect of the person’s assessable profits derived from the activities or transactions specified in the concession provision for the basis period of the person for a year of assessment, the amount of any loss sustained from any of those activities or transactions by the person is not available for set off against—

- (i) any of the person’s assessable profits for that basis period; and
- (ii) any of the person’s assessable profits for the basis period for any subsequent year of assessment.”.

**5. Section 19CA amended (treatment of unabsorbed losses under sections 19CAB and 19CAC: interpretation)**

(1) Section 19CA, heading, after “19CAC”—

**Add**

“(concessionary trading receipts chargeable to tax at same rate and normal trading receipts)”.

(2) Section 19CA, definition of *chargeable concessionary trading receipts*, paragraph (c)—

**Repeal**

“and”.

- (3) Section 19CA, definition of *chargeable concessionary trading receipts*, paragraph (d)—

**Repeal the semicolon**

**Substitute**

“; and”.

- (4) Section 19CA, definition of *chargeable concessionary trading receipts*, after paragraph (d)—

**Add**

“(e) if the assessable profits in respect of the concessionary trading receipts fall within the description in section 3(1) and (2) of Schedule 17FD—the amount of the concessionary portion of the assessable profits ascertained in accordance with section 10 of that Schedule;”.

- (5) Section 19CA, definition of *concession provision*, paragraph (h)—

**Repeal**

“or”.

- (6) Section 19CA, definition of *concession provision*, paragraph (i)—

**Repeal the semicolon**

**Substitute**

“; or”.

- (7) Section 19CA, definition of *concession provision*, after paragraph (i)—

**Add**

“(j) section 3 of Schedule 17FD;”.

- (8) Section 19CA, definition of *unabsorbed loss in respect of the concessionary trading receipts*, paragraph (c)—

**Repeal**

“; and”

**Substitute a semicolon.**

- (9) Section 19CA, definition of *unabsorbed loss in respect of the concessionary trading receipts*, paragraph (d)—

**Repeal the semicolon**

**Substitute**

“; and”.

- (10) Section 19CA, definition of *unabsorbed loss in respect of the concessionary trading receipts*, after paragraph (d)—

**Add**

“(e) if the assessable profits in respect of the concessionary trading receipts fall within the description in section 3(1) and (2) of Schedule 17FD—any loss ascertained in accordance with section 19D and section 10 of that Schedule;”.

**6. Sections 19CC to 19CG added**

After section 19CB—

**Add**

**“19CC. Treatment of unabsorbed losses under sections 19CD and 19CE: interpretation**

In this section and sections 19CD and 19CE—



**adjustment factor** (調整分數), in relation to a year of assessment, means the factor calculated in accordance with the formula—

$$\frac{A}{B}$$

- where:
- A in relation to any concessionary trading receipts, means the concessionary tax rate that applies to the receipts for that year of assessment; and
  - B in relation to any concessionary trading receipts other than those referred to in A, means the concessionary tax rate that applies to the receipts for that year of assessment that is lower than A;

**chargeable concessionary trading receipts** (應課稅的獲特惠的營業收入) has the meaning given by section 19CA;

**concession provision** (寬減條文) has the meaning given by section 19CA;

**concessionary tax rate** (特惠稅率), in relation to any concessionary trading receipts for a year of assessment, means the rate specified in the relevant concession provision at which the receipts are chargeable to profits tax for that year of assessment;

**concessionary trading receipts** (獲特惠的營業收入) has the meaning given by section 19CA;

**unabsorbed loss in respect of the concessionary trading receipts** (關乎獲特惠的營業收入的未吸納虧損) has the meaning given by section 19CA.

**19CD. Treatment of unabsorbed losses: concessionary trading receipts chargeable to tax at lower rate**

- (1) This section applies if, for a year of assessment—
  - (a) a person has chargeable concessionary trading receipts;
  - (b) there is an unabsorbed loss in respect of the concessionary trading receipts of the person; and
  - (c) the concessionary tax rate applicable to the receipts described in paragraph (b) is lower than the concessionary tax rate applicable to the receipts described in paragraph (a).
- (2) If the amount of the unabsorbed loss does not exceed the amount arrived at by multiplying the chargeable concessionary trading receipts by the adjustment factor for the year of assessment (**adjusted higher rate amount**)—
  - (a) for the purpose of ascertaining the assessable profits of the person for the year of assessment—the chargeable concessionary trading receipts are to be reduced by the amount arrived at by dividing the amount of the unabsorbed loss by the adjustment factor; and
  - (b) for other purposes—the amount of the unabsorbed loss is taken to be zero.
- (3) If the amount of the unabsorbed loss exceeds the adjusted higher rate amount—
  - (a) for the purpose of ascertaining the loss sustained by the person for the year of assessment—

- (i) the amount of the unabsorbed loss is to be reduced by the adjusted higher rate amount; and
  - (ii) the balance of the unabsorbed loss is to be dealt with in accordance with sections 19C and 19CF; and
- (b) for other purposes—the chargeable concessionary trading receipts are taken to be zero.

**19CE. Treatment of unabsorbed losses: concessionary trading receipts chargeable to tax at higher rate**

- (1) This section applies if, for a year of assessment—
- (a) a person has chargeable concessionary trading receipts;
  - (b) there is an unabsorbed loss in respect of the concessionary trading receipts of the person; and
  - (c) the concessionary tax rate applicable to the receipts described in paragraph (b) is higher than the concessionary tax rate applicable to the receipts described in paragraph (a).
- (2) If the amount of the unabsorbed loss does not exceed the amount arrived at by dividing the chargeable concessionary trading receipts by the adjustment factor for the year of assessment (*adjusted lower rate amount*)—
- (a) for the purpose of ascertaining the assessable profits of the person for the year of assessment—the chargeable concessionary trading receipts are to be reduced by the amount arrived at by multiplying the amount of the unabsorbed loss by the adjustment factor; and

- (b) for other purposes—the amount of the unabsorbed loss is taken to be zero.
- (3) If the amount of the unabsorbed loss exceeds the adjusted lower rate amount—
- (a) for the purpose of ascertaining the loss sustained by the person for the year of assessment—
    - (i) the amount of the unabsorbed loss is to be reduced by the adjusted lower rate amount; and
    - (ii) the balance of the unabsorbed loss is to be dealt with in accordance with sections 19C and 19CF; and
  - (b) for other purposes—the chargeable concessionary trading receipts are taken to be zero.

**19CF. Set off: concessionary trading receipts chargeable to tax at 2 different rates**

- (1) If—
- (a) in accordance with section 19C(1), (2), (4) or (5), a loss is to be set off against assessable profits for a year of assessment; and
  - (b) the loss is sustained, and the assessable profits arise, in respect of the concessionary trading receipts to which different concessionary tax rates apply,
- this section applies for the purpose of ascertaining the amount of the loss so set off and the resulting reduction in the assessable profits.
- (2) Subsection (3) applies if, for a year of assessment, the concessionary tax rate applicable to the concessionary trading receipts in respect of which the loss is sustained is lower than the concessionary tax rate applicable to the

- concessionary trading receipts in respect of which the assessable profits arise.
- (3) If—
- (a) the amount of the loss does not exceed the amount of the assessable profits as multiplied by the adjustment factor—
- (i) for the purpose of ascertaining the assessable profits—the amount of the assessable profits is taken to be reduced by the amount arrived at by dividing the amount of the loss by the adjustment factor; and
- (ii) for other purposes—the loss is taken to have been fully set off; and
- (b) the amount of the loss exceeds the amount of the assessable profits as multiplied by the adjustment factor—
- (i) for the purpose of the set off—the loss is taken to have been set off to the extent of the amount arrived at by multiplying the amount of the assessable profits by the adjustment factor; and
- (ii) for other purposes—the amount of the assessable profits is taken to be zero.
- (4) Subsection (5) applies if, for a year of assessment, the concessionary tax rate applicable to the concessionary trading receipts in respect of which the loss is sustained is higher than the concessionary tax rate applicable to the concessionary trading receipts in respect of which the assessable profits arise.
- (5) If—

- (a) the amount of the loss does not exceed the amount of the assessable profits as divided by the adjustment factor—
- (i) for the purpose of ascertaining the assessable profits—the amount of the assessable profits is taken to be reduced by the amount arrived at by multiplying the amount of the loss by the adjustment factor; and
- (ii) for other purposes—the loss is taken to have been fully set off; and
- (b) the amount of the loss exceeds the amount of the assessable profits as divided by the adjustment factor—
- (i) for the purpose of the set off—the loss is taken to have been set off to the extent of the amount arrived at by dividing the amount of the assessable profits by the adjustment factor; and
- (ii) for other purposes—the amount of the assessable profits is taken to be zero.
- (6) In this section—
- adjustment factor* (調整分數) has the meaning given by section 19CC;
- concessionary tax rate* (特惠稅率) has the meaning given by section 19CC;
- concessionary trading receipts* (獲特惠的營業收入) has the meaning given by section 19CA;
- loss* (虧損) includes part of a loss.

**19CG. Application of sections 19CAB, 19CAC, 19CB, 19CD, 19CE and 19CF if both concessionary trading receipts (chargeable to tax at different rates) and normal trading receipts are involved**

- (1) If—
  - (a) a loss is sustained in respect of concessionary trading receipts;
  - (b) assessable profits arise in respect of normal trading receipts; and
  - (c) more than one concessionary tax rate applies to the concessionary trading receipts,subsection (2) applies in relation to the loss in respect of the concessionary trading receipts.
- (2) For the purposes of subsection (1), sections 19CAB and 19CB(2), if applicable, are to apply—
  - (a) first in relation to—
    - (i) the amount of the loss in respect of the concessionary trading receipts to which the highest concessionary tax rate applies; and
    - (ii) the amount of the assessable profits in respect of the normal trading receipts; and
  - (b) if there is any amount of the assessable profits still remaining afterwards, then in relation to—
    - (i) the amount of the loss in respect of the concessionary trading receipts to which the next highest concessionary tax rate applies; and
    - (ii) the remaining amount of the assessable profits in respect of the normal trading receipts,

and so on until either the amount of all the loss in respect of the concessionary trading receipts, or the amount of the assessable profits in respect of the normal trading receipts, is reduced to, or taken to be, zero.

- (3) If—
  - (a) a loss is sustained in respect of normal trading receipts;
  - (b) assessable profits arise in respect of concessionary trading receipts; and
  - (c) more than one concessionary tax rate applies to the concessionary trading receipts,subsection (4) applies in relation to the loss in respect of the normal trading receipts.
- (4) For the purposes of subsection (3), sections 19CAC and 19CB(3), if applicable, are to apply—
  - (a) first in relation to—
    - (i) the amount of the loss in respect of the normal trading receipts; and
    - (ii) the amount of the assessable profits in respect of the concessionary trading receipts to which the highest concessionary tax rate applies; and
  - (b) if there is any amount of the loss still remaining afterwards, then in relation to—
    - (i) the remaining amount of the loss in respect of the normal trading receipts; and
    - (ii) the amount of the assessable profits in respect of the concessionary trading receipts to which the next highest concessionary tax rate applies,

- and so on until either the amount of all the loss in respect of the normal trading receipts, or the amount of the assessable profits in respect of the concessionary trading receipts, is reduced to, or taken to be, zero.
- (5) If—
- (a) a loss is sustained in respect of concessionary trading receipts;
  - (b) assessable profits arise in respect of both concessionary trading receipts and normal trading receipts; and
  - (c) more than one concessionary tax rate applies to the concessionary trading receipts,
- subsections (6) and (7) apply in relation to the loss in respect of the concessionary trading receipts.
- (6) For the purposes of subsection (5), sections 19CAB and 19CB(2), if applicable, are to apply—
- (a) first in relation to—
    - (i) the amount of the loss in respect of the concessionary trading receipts to which the highest concessionary tax rate applies; and
    - (ii) the amount of the assessable profits in respect of the normal trading receipts; and
  - (b) if there is any amount of the assessable profits in respect of the normal trading receipts still remaining afterwards, then in relation to—
    - (i) the amount of the loss in respect of the concessionary trading receipts to which the next highest concessionary tax rate applies; and

- (ii) the remaining amount of the assessable profits in respect of the normal trading receipts,
- and so on until either the amount of all the loss in respect of the concessionary trading receipts, or the amount of the assessable profits in respect of the normal trading receipts, is reduced to, or taken to be, zero.
- (7) If there is any amount of the loss in respect of the concessionary trading receipts still remaining after applying sections 19CAB and 19CB(2) in accordance with subsection (6), sections 19CD, 19CE and 19CF, if applicable, are to apply—
- (a) first in relation to—
    - (i) the remaining amount of the loss in respect of the concessionary trading receipts to which the highest concessionary tax rate applies; and
    - (ii) the amount of the assessable profits in respect of the concessionary trading receipts to which the highest concessionary tax rate applies; and
  - (b) if there is any amount of the loss in respect of the concessionary trading receipts and any amount of the assessable profits in respect of the concessionary trading receipts still remaining afterwards, then in relation to—
    - (i) the remaining amount of the loss in respect of the concessionary trading receipts to which the next highest concessionary tax rate applies; and
    - (ii) the amount of the assessable profits in respect of the concessionary trading receipts to which the next highest concessionary tax rate applies,
- and so on until either the amount of all the loss in respect of the concessionary trading receipts, or the amount of

- the assessable profits in respect of the concessionary trading receipts, is reduced to, or taken to be, zero.
- (8) If—
- (a) a loss is sustained in respect of both normal trading receipts and concessionary trading receipts;
  - (b) assessable profits arise in respect of concessionary trading receipts; and
  - (c) more than one concessionary tax rate applies to the concessionary trading receipts,
- subsections (9) and (10) apply in relation to the loss in respect of the normal trading receipts.
- (9) For the purposes of subsection (8), sections 19CAC and 19CB(3), if applicable, are to apply—
- (a) first in relation to—
    - (i) the amount of the loss in respect of the normal trading receipts; and
    - (ii) the amount of the assessable profits in respect of the concessionary trading receipts to which the highest concessionary tax rate applies; and
  - (b) if there is any amount of the loss in respect of the normal trading receipts still remaining afterwards, then in relation to—
    - (i) the remaining amount of the loss in respect of the normal trading receipts; and
    - (ii) the amount of the assessable profits in respect of the concessionary trading receipts to which the next highest concessionary tax rate applies,and so on until either the amount of all the loss in respect of the normal trading receipts, or the amount

- of the assessable profits in respect of the concessionary trading receipts, is reduced to, or taken to be, zero.
- (10) If there is any amount of the assessable profits in respect of the concessionary trading receipts still remaining after applying sections 19CAC and 19CB(3) in accordance with subsection (9), sections 19CD, 19CE and 19CF, if applicable, are to apply—
- (a) first in relation to—
    - (i) the amount of the loss in respect of the concessionary trading receipts to which the highest concessionary tax rate applies; and
    - (ii) the remaining amount of the assessable profits in respect of the concessionary trading receipts to which the highest concessionary tax rate applies; and
  - (b) if there is any amount of the loss in respect of the concessionary trading receipts and any amount of the assessable profits in respect of the concessionary trading receipts still remaining afterwards, then in relation to—
    - (i) the remaining amount of the loss in respect of the concessionary trading receipts to which the next highest concessionary tax rate applies; and
    - (ii) the amount of the assessable profits in respect of the concessionary trading receipts to which the next highest concessionary tax rate applies,and so on until either the amount of all the loss in respect of the concessionary trading receipts, or the amount of the assessable profits in respect of the

- concessionary trading receipts, is reduced to, or taken to be, zero.
- (11) If the Commissioner is satisfied that it is impracticable to apply subsection (1), (2), (3), (4), (5), (6), (7), (8), (9) or (10) in a particular case, the amounts of the loss and the assessable profits are to be determined in a manner that the Commissioner considers reasonable in the circumstances.
- (12) For the purposes of applying sections 19CAB and 19CAC to this section—
- (a) a reference in this section to a loss in respect of concessionary trading receipts is to be read as if it is a reference to an unabsorbed loss in respect of the concessionary trading receipts;
- (b) a reference in this section to a loss in respect of normal trading receipts is to be read as if it is a reference to an unabsorbed loss in respect of the normal trading receipts;
- (c) a reference in this section to assessable profits in respect of concessionary trading receipts is to be read as if it is a reference to chargeable concessionary trading receipts; and
- (d) a reference in this section to assessable profits in respect of normal trading receipts is to be read as if it is a reference to chargeable normal trading receipts.
- (13) In this section—
- concessionary tax rate* (特惠稅率) has the meaning given by section 19CC;
- concessionary trading receipts* (獲特惠的營業收入) has the meaning given by section 19CA;
- loss* (虧損) has the meaning given by section 19CF(6);

*normal trading receipts* (一般營業收入) has the meaning given by section 19CA.”.

7. **Part 6G added**

After Part 6F—

**Add**

**“Part 6G**

**Eligible IP Income and its Tax Treatment**

**40AY. Schedule 17FD: concessionary tax treatment and nexus requirement for ascertaining concessionary portion**

- (1) Schedule 17FD contains provisions about the tax treatment of eligible IP income within the meaning of that Schedule.
- (2) Schedule 17FD applies in respect of a year of assessment beginning on or after 1 April 2023.

**40AZ. Power to amend Schedule 17FD**

- (1) The Secretary for Financial Services and the Treasury may, by notice published in the Gazette, amend Schedule 17FD.
- (2) A notice published under subsection (1) may contain any incidental, supplemental, evidential, consequential, savings and transitional provisions that are necessary and expedient in consequence of the amendments made under that subsection.”.

8. **Section 51C amended (business records to be kept)**

- (1) Section 51C(5)(c)—

**Repeal**

“etc.).”

**Substitute**

“etc.);”.

- (2) After section 51C(5)(c)—

**Add**

“(d) section 22 of Schedule 17FD (eligible IP income: concessionary tax treatment and nexus requirement for ascertaining concessionary portion).”.

**9. Section 63H amended (amount of provisional profits tax)**

Section 63H(1D), after “14ZV(7)(b)”—

**Add**

“or section 4 of Schedule 17FD”.

**10. Section 80 amended (penalties for failure to make returns, making incorrect returns, etc.)**

- (1) After section 80(2ZB)—

**Add**

“(2ZC) A person who, without reasonable excuse, fails to comply with section 21 of Schedule 17FD commits an offence and is liable on conviction to—

- (a) a fine at level 3; and  
(b) a further fine of treble the undercharged amount.”.

- (2) Section 80(6)(c)—

**Repeal**

“etc.).”

**Substitute**

“etc.);”.

- (3) After section 80(6)(c)—

**Add**

“(d) section 22 of Schedule 17FD (eligible IP income: concessionary tax treatment and nexus requirement for ascertaining concessionary portion).”.

**11. Section 82A amended (additional tax in certain cases)**

- (1) After section 82A(1J)—

**Add**

“(1K) If—

- (a) a person, without reasonable excuse, fails to comply with section 21 of Schedule 17FD; and  
(b) no prosecution for an offence under section 80 has been instituted in respect of the same facts,

the person is liable to be assessed under this section to additional tax of an amount not exceeding treble the undercharged amount.”.

- (2) After section 82A(4)(a)(i)(G)—

**Add**

“(H) for additional tax to be assessed under subsection (1K)—the alleged failure to comply with section 21 of Schedule 17FD;”.

**12. Schedule 17FD added**

After Schedule 17FC—

**Add**



## “Schedule 17FD

[ss. 14, 19CA, 40AY,  
40AZ, 51C, 63H, 80 &  
82A]

### Eligible IP Income: Concessionary Tax Treatment and Nexus Requirement for Ascertaining Concessionary Portion

#### Part 1

#### Preliminary

##### 1. Interpretation of Schedule 17FD

(1) In this Schedule—

*application for a standard patent (R)* (轉錄標準專利的申請)  
and *standard patent (R) application* (轉錄標準專利申  
請) have the meaning given by section 3 of Cap. 514;

*Cap. 490* (《第 490 章》) means the Plant Varieties Protection  
Ordinance (Cap. 490);

*Cap. 514* (《第 514 章》) means the Patents Ordinance (Cap.  
514);

*concessionary portion* (特惠部分)—see section 10 of this  
Schedule;

*concessionary tax rate* (特惠稅率)—see section 3(3) of this  
Schedule;

*corresponding local patent* (相應本地專利) has the meaning  
given by section 6(3) of this Schedule;

*corresponding local plant variety right* (相應本地植物品種  
權利) has the meaning given by section 6(3) of this  
Schedule;

*date of filing* (提交日期) means—

(a) in relation to a patent application that is filed with,  
or a patent that is granted by, a patent office of any  
place outside Hong Kong—

(i) if the patent application, or the application for  
the patent, is an international application that  
has validly entered its national phase in a  
patent office—the international filing date  
accorded to the international application for  
the purposes of Article 11 of the Patent  
Cooperation Treaty; or

(ii) in any other case—the date of filing accorded  
to the patent application, or the application for  
the patent, by the patent office with which the  
application is filed;

(b) in relation to a standard patent (R) application or a  
standard patent (R)—

(i) if the corresponding designated patent  
application within the meaning of section  
4(2)(b) of Cap. 514 is an international  
application that has validly entered its national  
phase in the corresponding designated patent  
office—the international filing date accorded  
to the international application for the  
purposes of Article 11 of the Patent  
Cooperation Treaty; or

- (ii) in any other case—
  - (A) for a standard patent (R) application—the date of filing of the corresponding designated patent application; or
  - (B) for a standard patent (R)—the deemed date of filing (within the meaning of section 38 of Cap. 514) of the application for the standard patent (R);
- (c) in relation to a standard patent (O) application or a standard patent (O)—the date of filing accorded under section 37M(2) or 37Z(2) of Cap. 514 to the standard patent (O) application or application for the standard patent (O); or
- (d) in relation to a short-term patent application or a short-term patent—
  - (i) for a short-term patent application or an application for a short-term patent based on an international application designating the People's Republic of China that has entered its national phase in the People's Republic of China—the international filing date referred to in section 125(5) of Cap. 514 that is deemed to be the date of filing of the short-term patent application or application for the short-term patent; or
  - (ii) in any other case—the date of filing accorded under section 114(2) or 116 of Cap. 514 to the short-term patent application or application for the short-term patent;

*designated patent office* (指定專利當局) has the meaning given by section 4(1) of Cap. 514;

*divisional patent application* (專利的分開申請) means—

- (a) in relation to a patent application that is made under Cap. 514—
  - (i) if the patent application is a standard patent (R) application—a request to enter a record of a divisional patent application filed under section 22(1) of Cap. 514;
  - (ii) if the patent application is a standard patent (O) application—a divisional standard patent (O) application filed under section 37Z of Cap. 514; or
  - (iii) if the patent application is a short-term patent application—a divisional short-term patent application filed under section 116 of Cap. 514; or
- (b) in relation to a patent application that is filed with a patent office of any place outside Hong Kong—an application for a divisional patent filed under the law, instruments or rules of the patent office applicable to that application;

*eligible intellectual property* (具資格知識產權) means any of the following intellectual property that is generated from an R&D activity—

- (a) an eligible patent;
- (b) an eligible plant variety right;
- (c) a copyright subsisting in software under the Copyright Ordinance (Cap. 528) or under the law of any place outside Hong Kong;

*eligible IP income* (具資格知識產權收入)—see section 7 of this Schedule;

- eligible patent** (具資格專利)—see section 8 of this Schedule;
- eligible person** (具資格人士) means a person who is entitled to derive eligible IP income from an eligible intellectual property;
- eligible plant variety right** (具資格植物品種權利)—see section 9 of this Schedule;
- eligible R&D expenditure** (具資格研發開支)—see section 13 of this Schedule;
- Hong Kong resident person** (香港居民人士) has the meaning given by section 50AAC(1);
- non-eligible expenditure** (不具資格開支)—see section 14 of this Schedule;
- non-Hong Kong resident person** (非香港居民人士) has the meaning given by section 50AAC(1);
- patent office** (專利當局), in relation to a place outside Hong Kong, means a competent authority in that place that receives or processes patent applications, or grants patents;
- R&D activity** (研發活動) has the meaning given by section 2 of Schedule 45;
- R&D fraction** (研發分數)—see section 12 of this Schedule;
- specified date** (指明日期) means the date of expiry of a period of 24 months after the commencement date of the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Ordinance 2024 ( of 2024);
- specified period** (指明期間), in relation to an eligible person to whom any eligible IP income accrues, means the period—
- (a) beginning on 1 April 2023 or on an earlier date elected by the eligible person; and

- (b) ending on the last day of the eligible person's basis period for the year of assessment during which the income accrues.
- (2) In this Schedule, the following expressions have the meanings given by section 2(1) of Cap. 514—

**application for a short-term patent** (短期專利的申請) and **short-term patent application** (短期專利申請);

**application for a standard patent (O)** (原授標準專利的申請) and **standard patent (O) application** (原授標準專利申請);

**international application** (國際申請);

**Patent Cooperation Treaty** (《專利合作條約》);

**short-term patent** (短期專利);

**standard patent (O)** (原授標準專利);

**standard patent (R)** (轉錄標準專利);

**substantive examination** (實質審查).
  - (3) For the purposes of this Schedule—
    - (a) a person is to be regarded as associated with another person if, as between them, the participation condition is met under section 50AAG; and
    - (b) a reference to an associated person is to be read accordingly.
  - (4) In this Schedule—
    - (a) a reference to a patent granted by a patent office of a place outside Hong Kong, includes—
      - (i) the registration of a utility model by the patent office;

- (ii) a utility certificate issued by the patent office; and
  - (iii) an inventor's certificate issued by the patent office,
- and a patent application filed with a patent office of a place outside Hong Kong is to be construed accordingly; and
- (b) a reference to a divisional patent application includes all subsequent divisional patent applications in respect of that application.

## 2. Consistency with OECD 2015 Report

- (1) This Schedule is to be read in the way that best secures consistency with the requirements and guidance in Chapter 4 of the OECD 2015 Report.
- (2) In this section—

**OECD 2015 Report** (《經合組織 2015 年報告》) means the Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report published by the Organisation for Economic Co-operation and Development in 2015.

## Part 2

### Tax Concession for Eligible IP Income

#### 3. Concessionary portion of assessable profits from eligible IP income subject to concessionary tax rate

- (1) This section applies in relation to the assessable profits of an eligible person from an eligible IP income for a year of assessment.

- (2) If—
  - (a) the eligible IP income is derived from an eligible intellectual property; and
  - (b) an election is made under section 4 of this Schedule in respect of the eligible intellectual property,then, subject to Part 4 of this Schedule, the concessionary portion of the assessable profits is chargeable to tax at the concessionary tax rate specified in subsection (3).
- (3) The concessionary tax rate is 5%.

#### 4. Election for purposes of section 3 of this Schedule

- (1) The election to apply the concessionary tax rate in relation to the concessionary portion of the assessable profits of an eligible person from an eligible IP income is to be made—
  - (a) in respect of an eligible intellectual property; and
  - (b) in writing.
- (2) The election, once made, is irrevocable.

#### 5. Election: granted patents and divisional patent applications

If an election has been made under section 4 of this Schedule in respect of an eligible patent that is a patent application (*original patent application*), the election is to be regarded as having also been made, for the purposes of section 3 of this Schedule, in respect of—

- (a) the patents granted in pursuance of the original patent application; and
- (b) the divisional patent applications of the original patent application and the patents granted in pursuance of such divisional patent applications.

**6. Election: eligible patent or eligible plant variety right with date of filing on or after specified date**

(1) This section applies to an election under section 4 of this Schedule in respect of any of the following eligible intellectual property the date of filing of which is on or after the specified date—

- (a) an eligible patent that is not—
  - (i) a standard patent (O);
  - (ii) a standard patent (O) application;
  - (iii) a short-term patent; or
  - (iv) a short-term patent application;
- (b) an eligible plant variety right that is not—
  - (i) a grant as defined by section 2 of Cap. 490; or
  - (ii) an application as defined by section 2 of Cap. 490.

(2) An election under section 4 of this Schedule is not valid unless, in addition to meeting the requirements of that section—

- (a) for an election made in respect of the eligible patent—there is a corresponding local patent; or
- (b) for an election made in respect of the eligible plant variety right—there is a corresponding local plant variety right.

(3) In this section—

**corresponding local patent** (相應本地專利), in relation to an eligible patent in respect of which an election is made under section 4 of this Schedule, means—

- (a) a standard patent (O);

(b) a standard patent (O) application;

(c) a short-term patent; or

(d) a short-term patent application,

the subject of which is the same invention as the invention that is the subject of the eligible patent;

**corresponding local plant variety right** (相應本地植物品種權利), in relation to an eligible plant variety right in respect of which an election is made under section 4 of this Schedule, means—

(a) a grant; or

(b) an application,

the variety of which is the subject variety of the eligible plant variety right.

(4) In the definition of **corresponding local patent** in subsection (3), a reference to the same invention—

(a) for a standard patent (O) or a standard patent (O) application—is to be construed in the same way as it is construed for the purposes of section 37C(2) of Cap. 514; and

(b) for a short-term patent or a short-term patent application—is to be construed in the same way as it is construed for the purposes of section 110(1A) of Cap. 514.

(5) In the definition of **corresponding local plant variety right** in subsection (3), the following expressions have the meanings given by section 2 of Cap. 490—

**application** (申請);

**grant** (授權證);

**variety** (品種).

### 7. Meaning of *eligible IP income*

- (1) In this Schedule, an eligible IP income is an income of any one or more of the following descriptions—
  - (a) income derived from an eligible intellectual property in respect of—
    - (i) the exhibition or use of, or a right to exhibit or use, (whether in or outside Hong Kong) the property; or
    - (ii) the imparting of, or undertaking to impart, knowledge directly or indirectly connected with the use (whether in or outside Hong Kong) of the property;
  - (b) income derived from the sale of an eligible intellectual property;
  - (c) if the price of a sale of a product or service includes an amount that is attributable to an eligible intellectual property—such portion of the income from that sale as, on a just and reasonable basis, is attributable to the value of the property (*embedded IP income*);
  - (d) amount of insurance, damages or compensation derived in relation to an eligible intellectual property.
- (2) For the purpose of ascertaining the embedded IP income under subsection (1)(c), the income attributed to the eligible intellectual property is to be calculated in the way that best secures consistency with the requirements and guidance in the OECD rules.
- (3) In subsection (2)—

*OECD rules* (《經合組織規則》) means—

- (a) the commentary on the business profits article as defined by section 50AAC(1); and
- (b) the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by the Organisation for Economic Co-operation and Development on 10 January 2022.

### 8. Meaning of *eligible patent*

- (1) In this Schedule, an eligible patent is—
  - (a) a patent—
    - (i) that is granted under Cap. 514 or granted by a patent office of any place outside Hong Kong; and
    - (ii) if the date of filing of the application for the patent is on or after the specified date—that is not a standard patent (R); or
  - (b) a patent application—
    - (i) that is made under Cap. 514 or filed with a patent office of any place outside Hong Kong; and
    - (ii) if the date of filing of the patent application is on or after the specified date—that is not a standard patent (R) application.
- (2) For the purposes of subsection (1)(b)(i), if the patent application is an international application, the reference to the patent application being filed with a patent office of any place outside Hong Kong is a reference to the patent application having validly entered its national phase in the patent office in which the national phase is entered.

**9. Meaning of *eligible plant variety right***

In this Schedule, an eligible plant variety right is—

- (a) a right—
  - (i) that is granted under Cap. 490; or
  - (ii) that corresponds to the right mentioned in subparagraph (i) and subsists under the law of any place outside Hong Kong; or
- (b) an application—
  - (i) that is an application as defined by section 2 of Cap. 490; or
  - (ii) that corresponds to the application mentioned in subparagraph (i) and subsists under the law of any place outside Hong Kong.

**Part 3**

**Concessionary Portion of Assessable Profits from Eligible IP Income**

**10. Ascertaining concessionary portion**

The concessionary portion of the assessable profits from an eligible IP income is to be ascertained in accordance with the following formula—

$$P = I \times F$$

- where:
- P means the concessionary portion;
  - I means the assessable profits from the eligible IP income; and

- F means the R&D fraction applicable to those assessable profits..

**11. Ascertaining assessable profits from eligible IP income**

The assessable profits from an eligible IP income is to be ascertained in accordance with the following formula—

$$I = A - B - C + D$$

- where:
- I means the assessable profits from the eligible IP income;
  - A means the eligible IP income;
  - B means the outgoings and expenses to the extent that they are incurred during the basis period for the year of assessment (*relevant basis period*) to produce A;
  - C means the allowances allowed under Part 6, to the extent that the relevant assets counted for the allowances are used during the relevant basis period to produce A; and
  - D means the balancing charge to be made under Part 6, to the extent that the relevant assets counted for the balancing charge are used during the relevant basis period to produce A.

**12. Ascertaining R&D fraction**

- (1) For any assessable profits from an eligible IP income, the R&D fraction applicable to those profits is to be ascertained in accordance with the following formula—

$$F = \frac{EE \times 130\%}{EE + NE}$$

- where: F means the R&D fraction;
- EE means the eligible R&D expenditure incurred in respect of the eligible intellectual property to which the eligible IP income relates (*subject intellectual property*); and
- NE means the non-eligible expenditure incurred in respect of the subject intellectual property.

- (2) An R&D fraction is to be regarded as 100% if the percentage ascertained in accordance with subsection (1) is more than 100%.

### 13. Meaning of EE: eligible R&D expenditure

- (1) Any expenditure (including capital expenditure) incurred by an eligible person during the specified period for an R&D activity that—
- (a) is connected to the eligible intellectual property to which the eligible IP income relates (*subject intellectual property*); and
- (b) is carried out—
- (i) by the eligible person;
- (ii) on behalf of the eligible person by a person that is not associated with the eligible person; or

- (iii) in Hong Kong on behalf of the eligible person by an associated person of the eligible person that is a Hong Kong resident person,

is, subject to subsections (2), (3), (4) and (5), an eligible R&D expenditure incurred in respect of the subject intellectual property.

- (2) The following expenditures are not to be regarded as eligible R&D expenditures—
- (a) interest payments;
- (b) payments for any land or building, or for any alteration, addition or extension to any building;
- (c) any expenditure (including capital expenditure) incurred by the eligible person for obtaining the subject intellectual property or any right in respect of the property (whether by acquisition, licensing, amalgamating with another company or otherwise) from another person.
- (3) Subsection (4) applies if—
- (a) the subject intellectual property or any right in respect of the property is or was vested in a company that is a Hong Kong resident person (*original owner*) (whether by acquisition, licensing, amalgamating with another person or otherwise);
- (b) the eligible person—
- (i) obtained the property or any right in respect of the property by amalgamating with the original owner; or
- (ii) acquired all equity interests in the original owner and subsequently acquired, or obtained



- a licence for, the property from the original owner; and
- (c) the original owner has sufficient records of the expenditures it incurred in respect of the property, so that the eligible person would still be able to comply with section 51C (as modified by section 22(2) and (3) of this Schedule) in respect of the expenditures even if—
- (i) the references to the eligible person in subsections (1) and (2)(c) were regarded as including the original owner; and
- (ii) as a result, the expenditures became eligible R&D expenditures.
- (4) Subsections (1) and (2)(c) apply as if the references to the eligible person in those subsections included the original owner.
- (5) If, in addition to the subject intellectual property, an eligible R&D expenditure is also connected to other items of intellectual property (including other items of eligible intellectual property), the expenditure is to be apportioned between the subject intellectual property and those other items on a just and reasonable basis.
- (6) For the purposes of subsection (5), an expenditure is apportioned between the subject intellectual property and other items on a just and reasonable basis if the amount apportioned to the subject intellectual property represents the extent to which the expenditure was incurred in respect of the property.

#### 14. Meaning of NE: non-eligible expenditure

- (1) Each of the following expenditures is, subject to subsections (2), (3), (4), (5) and (6), a non-eligible expenditure incurred in respect of the eligible intellectual property to which the eligible IP income relates (*subject intellectual property*)—
- (a) any expenditure (including capital expenditure) incurred by the eligible person during the specified period for obtaining the subject intellectual property or any right in respect of the property (whether by acquisition, licensing, amalgamating with another company or otherwise) from another person;
- (b) any expenditure (including capital expenditure) incurred by the eligible person during the specified period for an R&D activity that—
- (i) is connected to the subject intellectual property; and
- (ii) is carried out—
- (A) on behalf of the eligible person by an associated person of the eligible person that is a non-Hong Kong resident person; or
- (B) outside Hong Kong on behalf of the eligible person by an associated person of the eligible person that is a Hong Kong resident person.
- (2) The following expenditures are not to be regarded as non-eligible expenditures—
- (a) interest payments;

- (b) payments for any land or building, or for any alteration, addition or extension to any building.
- (3) Subsections (4) and (5) apply if—
  - (a) the subject intellectual property or any right in respect of the property is or was vested in a company that is a Hong Kong resident person (*original owner*) (whether by acquisition, licensing, amalgamating with another person or otherwise);
  - (b) the eligible person—
    - (i) obtained the property or any right in respect of the property by amalgamating with the original owner; or
    - (ii) acquired all equity interests in the original owner and subsequently acquired, or obtained a licence for, the property from the original owner; and
  - (c) the original owner has sufficient records of the expenditures it incurred in respect of the property, so that the eligible person would still be able to comply with section 51C (as modified by section 22(2) and (3) of this Schedule) in respect of the expenditures even if—
    - (i) the references to the eligible person in subsection (1) were regarded as including the original owner; and
    - (ii) as a result, the expenditures became non-eligible expenditures.
- (4) Subsection (1) applies as if the references to the eligible person in that subsection included the original owner.

- (5) In calculating the total amount of non-eligible expenditures, the expenditure incurred by the eligible person during the specified period for obtaining the subject intellectual property or any right in respect of the property from the original owner is to be deducted.
- (6) If, in addition to the subject intellectual property, a non-eligible expenditure is also connected to other items of intellectual property (including other items of eligible intellectual property), the expenditure is to be apportioned between the subject intellectual property and those other items on a just and reasonable basis.
- (7) For the purposes of subsection (6), an expenditure is apportioned between the subject intellectual property and other items on a just and reasonable basis if the amount apportioned to the subject intellectual property represents the extent to which the expenditure was incurred in respect of the property.

#### Part 4

### Exception to Section 3 of this Schedule: Tax Treatments under Certain Circumstances and Conditions

15. **Meaning of abandonment, cancellation, declination, lapse, unconditional revocation and withdrawal, etc.**
- (1) In this Part, a reference to the abandonment, refusal, unconditional revocation or withdrawal of a patent or patent application is to be construed—

- (a) in relation to a patent granted, or a patent application made, under Cap. 514—in accordance with Cap. 514; and
  - (b) in relation to a patent granted by, or a patent application filed with, a patent office of any place outside Hong Kong—in accordance with the law, instruments or rules of the relevant patent office, court or competent authority applicable to the abandonment, refusal, unconditional revocation or withdrawal of the patent or patent application.
- (2) In this Part, a reference to the cancellation, declination, lapse or withdrawal of a plant variety right or plant variety right application, or a reference to a plant variety right or plant variety right application being no longer in subsistence, is to be construed—
- (a) in relation to a plant variety right granted, or a plant variety right application made, under Cap. 490—in accordance with Cap. 490; and
  - (b) in relation to a plant variety right granted, or a plant variety right application made, under the law of any place outside Hong Kong—in accordance with the law of that place applicable to the plant variety right or plant variety right application.
- (3) In subsection (2)—
- plant variety right** (植物品種權利) means a right mentioned in section 9(a)(i) or (ii) of this Schedule;
- plant variety right application** (植物品種權利申請) means an application mentioned in section 9(b)(i) or (ii) of this Schedule.

**16. Tax treatment under certain circumstances**

- (1) The tax treatment under subsection (2) applies for a year of assessment (*relevant year*) in relation to the concessionary portion of the assessable profits of an eligible person from an eligible IP income derived from an eligible intellectual property, in respect of which an election is made under section 4 of this Schedule, unless during the relevant year, none of the circumstances specified in section 17 of this Schedule occurs in relation to the eligible intellectual property.
- (2) The tax treatment is—
  - (a) section 3 of this Schedule does not apply in relation to the eligible IP income derived from the eligible intellectual property for the relevant year and subsequent years of assessment;
  - (b) all concessionary portions of the assessable profits from the eligible IP income subject to the concessionary tax rate under section 3 of this Schedule for the years of assessment preceding the relevant year (*relevant concessionary portions*) are to be regarded as trading receipts of the trade, profession or business of the eligible person for the relevant year; and
  - (c) for the purpose of computing the tax payable on the trading receipts referred to in paragraph (b)—the assessor is to take into account the tax that has already been charged on the relevant concessionary portions at the concessionary tax rate under section 3 of this Schedule.

**17. Circumstances for purposes of section 16 of this Schedule**

- (1) For the purposes of section 16 of this Schedule, in relation to an eligible intellectual property that is an eligible patent, the circumstances are—
  - (a) if the eligible patent is a patent—the eligible patent is unconditionally revoked; and
  - (b) if the eligible patent is a patent application—the eligible patent is abandoned, refused or withdrawn.
- (2) For the purposes of section 16 of this Schedule, in relation to an eligible intellectual property that is an eligible plant variety right, the circumstances are—
  - (a) if the eligible plant variety right is a right mentioned in section 9(a) of this Schedule—the eligible plant variety right is cancelled or no longer subsists; and
  - (b) if the eligible plant variety right is an application mentioned in section 9(b) of this Schedule—the eligible plant variety right lapses, is declined or withdrawn or no longer subsists.

**18. Tax treatment: eligible intellectual property with date of filing on or after specified date**

- (1) This section applies in relation to the concessionary portion of the assessable profits of an eligible person from an eligible IP income derived from any of the following eligible intellectual property, in respect of which an election is made under section 4 of this Schedule, the date of filing of which is on or after the specified date—
  - (a) an eligible patent;
  - (b) an eligible plant variety right.

- (2) The tax treatment under subsection (3) applies in relation to the concessionary portion for a year of assessment (*relevant year*), unless during the relevant year, all the conditions specified in section 19 of this Schedule applicable to the eligible intellectual property have been met.
- (3) The tax treatment is—
  - (a) section 3 of this Schedule does not apply in relation to the eligible IP income derived from the eligible intellectual property for the relevant year and subsequent years of assessment;
  - (b) all concessionary portions of the assessable profits from the eligible IP income subject to the concessionary tax rate under section 3 of this Schedule for the years of assessment preceding the relevant year (*relevant concessionary portions*) are to be regarded as trading receipts of the trade, profession or business of the eligible person for the relevant year; and
  - (c) for the purpose of computing the tax payable on the trading receipts referred to in paragraph (b)—the assessor is to take into account the tax that has already been charged on the relevant concessionary portions at the concessionary tax rate under section 3 of this Schedule.

**19. Conditions for purposes of section 18 of this Schedule**

- (1) For the purposes of section 18 of this Schedule, in relation to an eligible intellectual property that is an eligible patent, in respect of which an election is made under section 4 of this Schedule, the conditions are—

- (a) if the eligible patent is a short-term patent—a request for substantive examination of the eligible patent has been made in the year of assessment immediately following the year of assessment in which—
  - (i) any election under section 4 of this Schedule is made in respect of the eligible patent; or
  - (ii) the short-term patent is granted,whichever is the later; and
- (b) if the eligible patent is a patent granted by, or a patent application filed with, a patent office of any place outside Hong Kong—
  - (i) if the corresponding local patent of the eligible patent is a standard patent (O)—the corresponding local patent has not been unconditionally revoked;
  - (ii) if the corresponding local patent of the eligible patent is a short-term patent—
    - (A) the corresponding local patent has not been unconditionally revoked; and
    - (B) a request for substantive examination of the corresponding local patent has been made in the year of assessment immediately following the year of assessment in which—
      - (I) any election under section 4 of this Schedule is made in respect of the eligible patent; or
      - (II) the short-term patent is granted,whichever is the later; and

- (iii) if the corresponding local patent of the eligible patent is a standard patent (O) application or short-term patent application—the corresponding local patent, or any of its divisional patent applications, has not been abandoned, refused or withdrawn.
- (2) For the purposes of section 18 of this Schedule, in relation to an eligible intellectual property that is an eligible plant variety right mentioned in section 9(a)(ii) or (b)(ii) of this Schedule, in respect of which an election is made under section 4 of this Schedule, the conditions are—
- (a) if the corresponding local plant variety right of the eligible plant variety right is a grant as defined by section 2 of Cap. 490—the corresponding local plant variety right has not been cancelled; and
  - (b) if the corresponding local plant variety right of the eligible plant variety right is an application as defined by section 2 of Cap. 490—
    - (i) the corresponding local plant variety right has not been withdrawn and has not lapsed; and
    - (ii) the Registrar of Plant Variety Rights has not declined to make a grant in respect of the corresponding local plant variety right.

## 20. Tax treatment for divisional patents

- (1) For the purposes of sections 5 and 16 of this Schedule, if—
- (a) an election has been made under section 4 of this Schedule in respect of an eligible patent that is a patent application (*original patent application*);

- (b) a divisional patent application has been made in pursuance of the original patent application;
- (c) the original patent application is abandoned, refused or withdrawn; and
- (d) a patent is granted in pursuance of the divisional patent application,

section 16(2)(b) of this Schedule does not apply in relation to the part of the concessionary portion of the assessable profits derived from the original patent application attributable to the patent mentioned in paragraph (d) (*relevant part*).

- (2) For the purposes of subsection (1), the relevant part is to be calculated in the way that best secures consistency with the requirements and guidance in the OECD rules.
- (3) In subsection (2)—

*OECD rules* (《經合組織規則》) has the meaning given by section 7(3) of this Schedule.

#### 21. Notification by eligible person

- (1) This section applies if—
  - (a) there is a notifiable matter in relation to an eligible intellectual property in respect of which an election is made under section 4 of this Schedule; and
  - (b) the concessionary tax rate is applicable to the concessionary portion of the assessable profits of an eligible person from an eligible IP income derived from the eligible intellectual property for a year of assessment.
- (2) The eligible person must notify the Commissioner in writing of the notifiable matter within 4 months after the

end of the basis period for the year of assessment in which the notifiable matter takes place, unless the eligible person has already been required to furnish a return under section 51(1).

- (3) In this section—

*notifiable matter* (須具報事宜), in relation to an eligible intellectual property in respect of which an election is made under section 4 of this Schedule, means any of the following—

- (a) an occurrence of any of the circumstances specified in section 17 of this Schedule;
- (b) a failure to meet any of the conditions specified in section 19 of this Schedule.

### Part 5

#### Keeping of Records

#### 22. Records to be kept

- (1) Section 51C applies, with the modifications specified in subsections (2) and (3), in relation to an eligible person who makes an election under section 4 of this Schedule that the concessionary tax rate is applicable to the concessionary portion of the assessable profits of the eligible person from an eligible IP income for a year of assessment.
- (2) The eligible person must retain records of transactions, acts or operations relating to the eligible IP income under section 51C at least until the later of the following—
  - (a) the expiry of 7 years after the completion of those transactions, acts or operations; or

- (b) the expiry of 7 years after making the election mentioned in subsection (1).
- (3) The eligible person must keep records of the following, in addition to records within the meaning of section 51C(3) and (4)—
  - (a) information sufficient to establish that the income concerned is an eligible IP income;
  - (b) details of all corresponding expenditures incurred;
  - (c) details of the eligible intellectual property to which the income relates;
  - (d) if an apportionment is made under section 13(5) or 14(6) of this Schedule—information sufficient to establish that the apportionment is made on a just and reasonable basis.
- (4) To avoid doubt, the records mentioned in subsection (3) are records of transactions, acts or operations relating to the eligible IP income.
- (5) Section 80 applies to a failure to comply with section 51C as modified by subsections (2) and (3) in the same way as section 80 applies to a failure to comply with section 51C.
- (6) In this section—

*corresponding expenditures* (相應開支), in relation to an eligible IP income, means all of the following expenditures—

  - (a) eligible R&D expenditures incurred in respect of the eligible intellectual property to which the income relates;
  - (b) non-eligible expenditures incurred in respect of the eligible intellectual property to which the income relates;

- (c) any other expenditures incurred in producing the income.
- 23. Transitional arrangement for eligible person with insufficient records**
- (1) This section applies if—
    - (a) an eligible IP income accrues to an eligible person during the period—
      - (i) beginning on 1 April 2023; and
      - (ii) ending on the last day of the eligible person's basis period for the year of assessment beginning on 1 April 2025; and
    - (b) the eligible person is unable to ascertain the R&D fraction applicable to the income under Part 3 of this Schedule because there are insufficient records.
  - (2) For ascertaining the R&D fraction and keeping records, the eligible person may elect that sections 13, 14 and 22 of this Schedule apply on the following basis—
    - (a) the references to “specified period” in sections 13(1) and 14(1)(a) and (b) of this Schedule are to be regarded as references to the period of 3 years ending on the last day of the eligible person's basis period for the year of assessment during which the eligible IP income accrues;
    - (b) the references to “subject intellectual property” in sections 13(2)(c) and 14(1)(a) of this Schedule are to be regarded as references to any intellectual property as defined by section 15H(1);
    - (c) the following provisions of this Schedule are to be omitted—

- (i) section 13(1)(a), (3), (4), (5) and (6);
- (ii) section 14(1)(b)(i), (3), (4), (5), (6) and (7);
- (iii) section 22(3)(d).”.

**13. Schedule 17J amended (qualifying amalgamations—special tax treatment)**

- (1) Schedule 17J, section 24(3)—

**Repeal**

“and 19CB”

**Substitute**

“, 19CB, 19CD, 19CE, 19CF and 19CG”.

- (2) Schedule 17J, section 24(6), definition of *pre-amalgamation loss*, paragraph (a)(ii) and (b)(ii)—

**Repeal**

“or 19CB”

**Substitute**

“, 19CB, 19CD, 19CE, 19CF or 19CG”.

- (3) Schedule 17J, section 25(2)—

**Repeal**

“and 19CB”

**Substitute**

“, 19CB, 19CD, 19CE, 19CF and 19CG”.

- (4) Schedule 17J, section 25(5), definition of *pre-amalgamation loss*, paragraph (a)(ii) and (b)(ii)—

**Repeal**

“or 19CB”

**Substitute**

“, 19CB, 19CD, 19CE, 19CF or 19CG”.

**14. Schedule 45 amended (deduction of R&D expenditures)**

Schedule 45—

**Repeal**

“Schs. 17FC & 17JJ”

**Substitute**

“Schs. 17FC, 17FD & 17JJ”.



### Explanatory Memorandum

The objects of this Bill are to amend the Inland Revenue Ordinance (Cap. 112) (*Ordinance*) to—

- (a) give profits tax concessions for certain assessable profits from an eligible intellectual property income;
  - (b) provide for the treatment of losses in relation to assessable profits chargeable to profits tax at more than one concessionary tax rate; and
  - (c) provide for related matters.
2. The Bill contains 14 clauses.
3. Clause 1 sets out the short title.
4. Clause 6 adds new sections 19CC to 19CG to the Ordinance, in order to deal with the set off of losses where profits and losses are subject to different profits tax rates. This is occasioned by the introduction of a new profits tax concession regime for certain assessable profits from an eligible intellectual property income under the Bill, and therefore the possibility of more than one concessionary profits tax rate available under the Ordinance. The new sections 19CC to 19CG contain the following provisions—
- (a) the new section 19CC provides for the interpretation of defined terms including that of *adjustment factor*;
  - (b) the new section 19CD provides for the treatment of unabsorbed losses where some concessionary trading receipts as defined by section 19CA of the Ordinance (*concessionary trading receipts*) that sustain unabsorbed losses are chargeable to profits tax at a lower rate than the rate for other chargeable concessionary trading receipts;

- (c) the new section 19CE provides for the treatment of unabsorbed losses where some concessionary trading receipts that sustain unabsorbed losses are chargeable to profits tax at a higher rate than the rate for other chargeable concessionary trading receipts;
  - (d) the new section 19CF provides for the set off of concessionary trading receipts that are chargeable to profits tax at 2 different concessionary tax rates as defined by the new section 19CC;
  - (e) the new section 19CG provides for the rules by which sections 19CAB, 19CAC, 19CB, 19CD, 19CE and 19CF are to apply when dealing with the treatment of unabsorbed losses under different scenarios in which—
    - (i) a loss is sustained, and assessable profits arise, in respect of both concessionary trading receipts and normal trading receipts as defined by section 19CA of the Ordinance; and
    - (ii) more than one concessionary tax rate applies to the concessionary trading receipts.
5. In connection with the addition of the new sections 19CC to 19CG by Clause 6—
- (a) clause 4(3) adds a new paragraph (f) to section 19C(6) of the Ordinance so that if a person is exempt from profits tax because of a concession provision as defined by section 19CA of the Ordinance in respect of the person's assessable profits derived from the activities or transactions for the basis period for a year of assessment, any loss sustained from those activities or transactions is not available for set off against the person's assessable profits for that basis period, and the basis period for any subsequent years of assessment; and

- (b) clause 5 amends the definitions of *chargeable concessionary trading receipts*, *concession provision* and *unabsorbed loss in respect of the concessionary trading receipts* in section 19CA of the Ordinance in order to adapt those defined terms for the purposes of the new sections 19CC to 19CG.
6. Clause 7 adds a new Part 6G to the Ordinance, which includes new section 40AY to introduce a new Schedule 17FD dealing with eligible IP income and its tax treatment.
7. Clause 12 adds the new Schedule 17FD to the Ordinance, in which—
- (a) Part 1 of the Schedule contains preliminary provisions. Section 1 of the Schedule introduces the defined terms including those of *date of filing*, *eligible intellectual property*, *eligible IP income*, *eligible patent person*, *eligible plant variety right*, *eligible R&D expenditure* and *R&D activity*. Section 2 of the Schedule provides that the Schedule is to be read in the way that best secures consistency with the requirements and guidance in Chapter 4 of the Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report published by the Organisation for Economic Co-operation and Development in 2015;
- (b) Part 2 of the Schedule contains provisions on tax concession for eligible IP income. Section 3 of the Schedule contains operative provisions on the concessionary tax treatment and specifies the concessionary tax rate as 5%. Sections 4, 5 and 6 of the Schedule provide for the election required for the application of the concessionary tax rate. Section 7, 8 and 9 of the Schedule respectively provide in detail for the

meaning of the terms *eligible IP income*, *eligible patent* and *eligible plant variety right*;

- (c) Part 3 of the Schedule contains provisions on ascertaining the concessionary portion of the assessable profits from an eligible IP income. Sections 10, 11 and 12 of the Schedule respectively provide for the formula for ascertaining the concessionary portion, the assessable profits from an eligible IP income and the R&D fraction. Sections 13 and 14 of the Schedule provide in detail for the meaning of eligible R&D expenditure and non-eligible expenditure for ascertaining the R&D fraction under section 12 of the Schedule;
- (d) Part 4 of the Schedule contains provisions on the tax treatments under certain circumstances or conditions, which are exceptions to the application of the concessionary tax rate under section 3 of the Schedule—
- (i) section 15 of the Schedule explains the meaning of the references to abandonment, cancellation, declination, lapse, unconditional revocation and withdrawal, etc. that appear in that Part;
- (ii) sections 16 and 17 of the Schedule provide for the tax treatment when certain circumstances occur, such as the abandonment, cancellation, declination, lapse, unconditional revocation and withdrawal, etc. of the eligible intellectual property in respect of which an election is made under section 4 of the Schedule;
- (iii) sections 18 and 19 of the Schedule provide for the tax treatment in relation to certain eligible intellectual property in respect of which an election

is made under section 4 of the Schedule under certain conditions, in particular—

(A) for a non-Hong Kong eligible intellectual property—the abandonment, refusal, unconditional revocation or withdrawal of, or the absence of a request for substantive examination of, the corresponding local patent or corresponding local plant variety right, as the case may be, that is required for that non-Hong Kong eligible intellectual property; or

(B) for an eligible intellectual property that is a short-term patent—the absence of a request for substantive examination of that eligible intellectual property;

(iv) section 20 of the Schedule provides for the tax treatment when divisional patent applications are involved; and

(v) section 21 of the Schedule provides for notification by an eligible person of any of the occurrence of the circumstances, or the failure to meet any of the conditions, set out respectively in sections 17 and 19 of the Schedule; and

(e) Part 5 of the Schedule contains provisions on the keeping of records by an eligible person and transitional provisions for an eligible person with insufficient records.

8. Clauses 10(1) and 11 respectively amend sections 80 and 82A of the Ordinance to extend the existing penalties and the imposition of additional tax to the contravention of sections 21 and 22 of the new Schedule 17FD.

9. Clauses 3, 4(1), 8, 9, 10(3), 13 and 14 provide for amendments consequential to the addition of the new sections 19CC to 19CG and the new Schedule 17FD, including the addition of references to the new provisions in suitable places.

**Key Features of the Nexus Approach**

The nexus approach was adopted by the Organisation for Economic Co-operation and Development as a minimum standard under Action 5 of the Base Erosion and Profit Shifting (“BEPS”) package promulgated in 2015<sup>1</sup> and has been applied internationally on the intellectual property (“IP”)-related tax regimes since then. All members of the Inclusive Framework on BEPS are required to adopt the nexus approach promulgated in their IP-related regimes including “patent box”. Under the nexus approach, **the portion of income from an eligible IP asset that can qualify for preferential tax treatment is based on a nexus ratio of the eligible expenditures to the overall expenditures that have been incurred by the taxpayer to develop the IP asset.** The proportion of research and development (“R&D”) expenditures is a proxy of substantial economic activities. This seeks to ensure that there is a direct nexus between the income receiving benefits and the expenditures contributing to that income. Specifically, the nexus approach includes the following features –

- (a) **IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are functionally equivalent to patents** if those IP assets are both legally protected and subject to similar approval and registration processes (if any) where such processes are relevant, such as copyrighted software and protected plant variety rights<sup>2</sup>;
- (b) the income benefiting from a regime should not be defined as the gross income from the IP assets, but should instead be calculated by subtracting IP expenditure allocable to IP income and incurred in the year from gross IP income earned in the year<sup>3</sup>;

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<sup>1</sup> See Chapter 4(II) of the Final Report on Action 5 of the BEPS package (“BEPS Action 5 Report”) at [https://www.oecd-ilibrary.org/docserver/9789264241190-en.pdf?expires=1655950284&id=id&accn\\_ame=guest&checksum=5FC7BB519AECC489918BCD296D05428B](https://www.oecd-ilibrary.org/docserver/9789264241190-en.pdf?expires=1655950284&id=id&accn_ame=guest&checksum=5FC7BB519AECC489918BCD296D05428B).

<sup>2</sup> See paragraphs 34 and 35 of the BEPS Action 5 Report which state that: “*Under the nexus approach as contemplated, the only IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, where such processes are relevant. IP assets that are functionally equivalent to patents are (i) patents defined broadly, (ii) copyrighted software, and (iii) in certain circumstances set out below, other IP assets that are nonobvious, useful, and novel.*” and “*IP assets that grant protection to plants and genetic material would include plant breeders’ rights, which grant exclusive control over new varieties of plants.*”

<sup>3</sup> See paragraph 47 in Chapter 4 of the BEPS Action 5 Report.

- (c) **eligible expenditures only include R&D expenditures that are directly connected to the eligible IP asset. Acquisition costs of the IP asset are not considered as eligible expenditures, and therefore do not qualify for preferential tax treatment;**
- (d) in order not to over-penalise taxpayers for acquiring IP or outsourcing R&D activities to related parties (which are not otherwise considered as eligible expenditures), a jurisdiction may permit taxpayers to apply a 30% uplift on the eligible expenditures subject to the extent that the taxpayer has incurred non-eligible expenditures. However, the nexus ratio cannot exceed 100%, i.e. the increased amount of eligible expenditures may not exceed the taxpayer's overall expenditures; and
- (e) the nexus approach would allow all eligible expenditures for R&D activities of unrelated parties (regardless of whether they were undertaken within the jurisdiction providing the tax incentives) to qualify, while all expenditures for R&D activities undertaken by related parties (regardless of whether they were undertaken within the jurisdiction providing the tax incentives) would not be counted as eligible expenditures (i.e. the entity approach). However, jurisdictions that are not member states of the European Union could modify the limitation to include all eligible expenditures for R&D activities undertaken by both unrelated parties and resident related parties in the definition of eligible expenditures (i.e. the jurisdictional approach).

## **IMPLICATIONS OF THE PROPOSAL**

### **Economic Implications**

The proposal which provides tax concessions for qualifying profits sourced in Hong Kong and derived from eligible intellectual property (“IP”) created through research and development (“R&D”) activities will encourage the industrial and innovation and technology (“I&T”) sectors, creative industries and IP users with profits sourced in Hong Kong to engage in more R&D and IP trading activities (such as buying/selling and licensing of IP and development of new products and services), which will in turn lead to more creation and exploitation of IP. The increase in IP trading activities will also be conducive to creating more business and employment opportunities for professional services such as IP legal, valuation, management, consultation and agencies services, thereby further developing and strengthening the IP ecosystem. All these will help foster Hong Kong’s development into an international I&T centre and a regional IP trading centre as set out in the 14<sup>th</sup> Five-Year Plan, providing impetus for sustaining competitiveness and economic development of Hong Kong.

### **Financial and Civil Service Implications**

2. The proposal would involve tax revenue foregone. However, it is not feasible to arrive at a precise estimation as there is no information on the total amount of income to be derived from all eligible IP and nexus ratio since such information is not generally required to be reported in tax returns. Having said that, we believe that the launch of the "patent box" tax incentive will help encourage local companies to conduct more R&D activities, instead of moving such R&D activities to other jurisdictions implementing patent box regimes with lower tax rates. The proposal will also provide incentives for companies outside Hong Kong to transfer their R&D operations to Hong Kong.

3. The patent box regime will be implemented by the Inland Revenue Department (“IRD”), with the support of the Intellectual Property Department and the Agriculture, Fisheries and Conservation Department. The IRD will absorb the additional workload arising from the proposal with its existing resources. Should the regime result in further increase in the IRD’s workload which could not be coped with by existing resources, the IRD will review the manpower position and seek additional resources in accordance with the established mechanism.