Deloitte. 德勤

Tax
Issue H82/2018 – 4 May 2018

Hong Kong Tax Analysis

Enhanced Deduction for R&D Expenditures Introduced

Author:

Hong Kong
Ryan Chang
Tax Partner
Tel: +852 2852 6768
Email: ryanchang@deloitte.com

Doris Chik
Tax Senior Manager
Tel: +852 2852 6608
Email: dchik@deloitte.com.hk

An enhanced tax deduction regime for qualifying research and development (R&D) expenditures, which targets to encourage R&D activities in Hong Kong, was proposed by the Chief Executive in October 2017. The relevant Inland Revenue (Amendment) (No. 3) Bill 2018 (the Bill) was gazetted on 20 April 2018 and introduced to the Legislative Council on 2 May 2018.

This article highlights the features of this enhanced tax deduction regime and analyses the implications to the Hong Kong economy and businesses.

Key features of the enhanced deduction regime

Currently, certain R&D expenditures are deductible under Section 16B of the Inland Revenue Ordinance (IRO), subject to some specific conditions. Under the new regime, such R&D expenditures can generally continue to be eligible for deduction, while certain qualifying expenditures would be eligible for enhanced deduction.

The new regime classifies R&D expenditures into two types, Type A and Type B. Type A expenditures are eligible for normal deduction While Type B expenditures are eligible for enhanced deduction. In particular, the first HK$2 million of Type B expenditures will be deductible at 300%, and the remaining at 200%, without any cap on the amount of enhanced deduction.

The new R&D deduction regime is relatively complicated with various conditions to be fulfilled in order to be qualified for deduction. The conditions for Type A and Type B expenditures deduction are simplified in the table below:

<table>
<tr><th></th><th>Type A</th><th>Type B</th></tr>
<tr><td>Deduction</td><td>100%</td><td>300% for the first HK$2million;
200% for the remaining amount</td></tr>
<tr><td rowspan="2">R&D activities</td><td colspan="2">• an activity in the fields of natural or applied science to extend knowledge
• investigation for gaining new scientific or technical knowledge
• application of research findings for new products, processes or services, etc.</td></tr>
<tr><td>• feasibility study or market, business or management research</td><td>[§1]</td></tr>
<tr><td>Location of R&D activities</td><td>in or outside Hong Kong</td><td>wholly in Hong Kong</td></tr>
<tr><td>In-house expenditures</td><td>• expenditures on an R&D activity, including capital expenditures (other than Type B)</td><td>• expenditures in relation to an employee[§2] who is engaged directly and actively[§3] in an R&D activity
• expenditures on a consumable item used directly[§4] in an R&D activity</td></tr>
<tr><td rowspan="2">Outsource payment</td><td colspan="2">Payment to:
• a designated local research institution</td></tr>
<tr><td>• a university or college (not a designated local research institution)</td><td></td></tr>
<tr><td>No deduction allowed</td><td colspan="2">• expenditures for acquiring rights generated from an R&D activity
• expenditures for land or building
• where the R&D activity is undertaken for another person or the rights generated are not fully vested
• where the R&D expenditures are met by the government or another person
• where the main purpose, or one of the main purposes, is to obtain a deduction under s16B</td></tr>
<tr><td>Apportionment of deduction</td><td>• R&D activity outside Hong Kong and relate to business partly outside Hong Kong</td><td>• the employee is partly engaged directly in the R&D activity; or
• the consumable item is partly used directly in the R&D activity</td></tr>
</table>

[§1] Examples of R&D activities excluded:
- feasibility study, market research, sales promotion;
- application of publicly available research findings;
- development of non-scientific or non-technological aspect of a new product, process or service etc.

[§2] Exclude any remuneration of a director

[§3] An employee provides services in support of the R&D activity is not regarded as engaged directly and actively in the R&D activity. Such support services include accounting, administration, secretarial services.

[§4] A consumable item is used in providing services in support of the R&D activity is not regarded as used directly and actively in the R&D activity. Such support services include accounting, administration, secretarial services.

Subject to the enactment of the legislation, the enhanced tax deduction will apply to expenditures incurred on or after 1 April 2018 retrospectively.

Other features of the Bill

Clawback of subsequent sale

Similar to the existing regime under Section 16B, proceeds of sale of plant and machinery or sale of rights generated from the R&D activities will be treated as taxable trading receipts, to the extent that do not exceed the total amount of deductions allowed under Section 16B.

Deeming Provision

The Bill introduces a new provision under Section 15(1) which deems the following sums as taxable:

- royalties for the use outside Hong Kong of any intellectual property (IP) or know-how generated from any R&D activity in respect of which a deduction is allowable under Section 16B; or
- sums for imparting knowledge connected with the use outside Hong Kong of any such IP or know-how.

Subject to the enactment of legislation, this proposed provision will apply to sums accrued on or after the day on which the legislation comes into operation.

Anti-avoidance provision

The Bill contains an anti-avoidance provision which disallows deduction under Section 16B if the expenditures are incurred under an arrangement the main purpose, or one of the main purposes, of which is to enable the person to obtain a deduction, or a deduction of a greater amount, under section 16B. This anti-avoidance provision is to prevent artificial inflated claims and is the government's practice in other recent Bills to align with the international standard.

The Bill also contains a "no multiple deduction" provision where "an R&D expenditure may only be deducted for one trade, profession or business". It may be helpful if the *Inland Revenue Department* (IRD) can elaborate and provide an example of a situation where this proposed provision will apply.

Information disclosure

The Bill empowers the IRD to consult the Commissioner for Innovation and Technology (CIT) in ascertaining whether an activity constitutes an R&D activity or whether the expenditures were incurred in relation to an R&D activity. In other words, the IRD may disclose to the CIT any details of the business for the purpose of such consultation.

Implications to businesses

Currently, many multinational groups established their R&D centres in a location with the relevant talents and resources e.g., the United States, Australia, China, etc. One of the common issues faced by Hong Kong businesses is that payments for R&D activities made to group companies, which are not approved institutions, may not be eligible for deduction according to the IRD's stringent practice because such expenditures are considered as capital in nature and cannot fulfil the conditions under Section 16B. In addition, certain IP related expenditures (e.g. upfront lump sum payment for licensing fees) may be regarded as capital expenditures by the IRD and being treated as non-deductible. The deduction rules for purchasing IPs are also quite restrictive (see our *Tax Analysis Issue H81/2018*) and can only provide limited benefit. In view of these restrictions, Hong Kong currently may not be the best choice for multinational groups to hold their IPs. Can this new enhanced R&D expenditures deduction regime effectively attract multinational groups to relocate their R&D activities in Hong Kong?

To analyse the implications of the new enhanced deduction regime to businesses, please see below for the comparison of some common R&D expenditures under the existing and new regimes under Section 16B of the IRO:

Expenditures	***Existing regime***	***New regime***
Staff cost for in-house R&D staff with activities carried out in Hong Kong	100% deductible	300%/200% deductible
Staff cost for in-house R&D staff with activities carried out in the PRC	100% deductible	100% deductible
Payment to a designated local research institution for qualifying R&D activities in Hong Kong	100% deductible	300%/200% deductible
Payment to a group company for subcontracted R&D activities	Non-deductible*	Non-deductible*
Capital expenditures on purchase of plant and machinery for an R&D activity	100% deductible	100% deductible
Purchase consideration for a property which is used as a laboratory for an R&D activity	Non-deductible (but eligible for Industrial Building Allowances)	Non-deductible (but eligible for Industrial Building Allowances)

Note: The above are general classes of expenditures for illustration only. The deductibility of each case should be analysed based on the actual circumstances.

* based on the IRD's interpretation and practice

From the above analysis, a company may only benefit from the enhanced deduction regime by having the R&D activities carried out in Hong Kong, either in-house or outsourced to a designated local research institution. The new R&D deduction regime does not solve the issues as mentioned above. Payments made to group companies for R&D activities may still not be eligible for any deduction in general.

Our comments

It is welcomed that the government continues to introduce measures to encourage the development of innovation and technology (I&T) industries. In particular, this Bill for enhanced R&D expenditures deduction regime was introduced shortly after the Bill for expanded deduction of capital expenditures on purchase of IP.

While the government's efforts in introducing tax incentives on I&T are appreciated, the effectiveness of these incentives may be affected by other factors. The aim of this enhanced deduction regime is to attract more investment on local R&D. However, whether a multinational group would re-locate its R&D activities to Hong Kong is not purely tax-driven. Other business factors, such as high land costs and lack of talents, may be the restrictions of putting R&D activities in Hong Kong. In addition, as analysed above, there are rooms for improving the tax incentives to provide a more favourable tax environment for I&T industries in Hong Kong. The government may also formulate a short to medium-term strategy in co-operating with Mainland, such as the initiative of Greater Bay Area scheme, to overcome the land and talents issues.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

Beijing
Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 1326
Email: andzhu@deloitte.com.cn

Chengdu
Frank Tang / Tony Zhang
Partner
Tel: +86 28 6789 8188
Fax: +86 28 6500 5161
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Chongqing
Frank Tang / Tony Zhang
Partner
Tel: +86 23 8823 1208 / 1216
Fax: +86 23 8859 9188
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Dalian
Bill Bai
Partner
Tel: +86 411 8371 2816
Fax: +86 411 8360 3297
Email: bilbai@deloitte.com.cn

Guangzhou
Victor Li
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: vicli@deloitte.com.cn

Hangzhou
Qiang Lu / Fei He
Partner / Director
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn
fhe@deloitte.com.cn

Harbin
Jihou Xu
Partner
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056
Email: jihxu@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Jinan
Beth Jiang
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@deloitte.com.cn

Macau
Raymond Tang
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: raytang@deloitte.com.hk

Nanjing
Frank Xu / Rosemary Hu
Partner
Tel: +86 25 5791 5208 / 6129
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn
roshu@deloitte.com.cn

Shanghai
Eunice Kuo
Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@deloitte.com.cn

Shenzhen
Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

Suzhou
Maria Liang / Kelly Guan
Partner
Tel: +86 512 6289 1328 / 1297
Fax: +86 512 6762 3338
Email: mliang@deloitte.com.cn
kguan@deloitte.com.cn

Tianjin
Jason Su
Partner
Tel: +86 22 2320 6680
Fax: +86 22 2320 6699
Email: jassu@deloitte.com.cn

Wuhan
Gary Zhong
Partner
Tel: +86 27 8526 6618
Fax: +86 27 6885 0745
Email: gzhong@deloitte.com.cn

Xiamen
Jim Chung / Charles Wu
Partner / Director
Tel: +86 592 2107 298 / 055
Fax: +86 592 2107 259
Email: jichung@deloitte.com.cn
chwu@deloitte.com.cn

About the Deloitte China National Tax Technical Centre

The Deloitte China National Tax Technical Centre ("NTC") was established in 2006 to continuously improve the quality of Deloitte China's tax services, to better serve the clients, and to help Deloitte China's tax team excel. The Deloitte China NTC prepares and publishes "Tax Analysis", "Tax News", etc. These publications include introduction and commentaries on newly issued tax legislations, regulations and circulars from technical perspectives. The Deloitte China NTC also conducts research studies and analysis and provides professional opinions on ambiguous and complex issues. For more information, please contact:

National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader
Ryan Chang
Partner
Tel: +852 2852 6768
Fax: +852 2851 8005
Email: ryanchang@deloitte.com

Southern China (Hong Kong)
Ryan Chang
Partner
Tel: +852 2852 6768
Fax: +852 2851 8005
Email: ryanchang@deloitte.com

Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Southern China (Mainland/Macau)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Eastern China
Kevin Zhu
Director
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

Western China
Tony Zhang
Partner
Tel: +86 23 8823 1216
Fax: +86 23 8859 9188
Email: tonzhang@deloitte.com.cn

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.