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IRD issued guidance on tax deduction for R&D expenditures

Author:

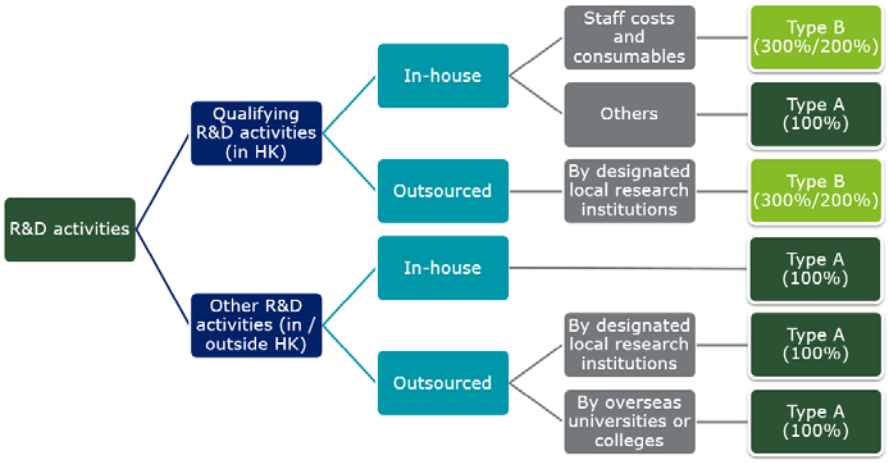
Hong Kong
Ryan Chang
Tax Partner
Tel: +852 2852 6768
Email: ryanchang@deloitte.com

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

The long-awaited Departmental Interpretation and Practice Notes No. 55 (DIPN 55) was recently issued by the Inland Revenue Department (IRD) to set out its views on various issues relating to the deduction regime for research and development (R&D) expenditures. With a view to encouraging more enterprises to conduct R&D activities in Hong Kong, the IRD provides flexibilities and concessions in R&D regime as mentioned in DIPN 55. The DIPN contains 100 pages with detailed explanation and various examples. In this article, we will highlight some of the key points contained in DIPN 55.

Overview of the regime

As a recap, qualifying R&D expenditures are eligible for either 100% tax deduction (Type A expenditures) or 300% tax deduction for the first HK$2 million and 200% deduction for the remainder, not subject to any cap (Type B expenditures) under the amended Section 16B and Schedule 45 of the Inland Revenue Ordinance (IRO).



For details of the deduction regime, please refer to our *Tax Analysis (Issue H82/2018)* published on 4 May 2018 and *Tax Newsflash (Issue 80)* published on 5 November 2018.

The key points of DIPN 55 are highlighted as follows:

Definition of R&D activities

The definition of an R&D activity is discussed and explained in detail in DIPN 55 and such discussion occupies 13 pages with numerous examples in the appendices. Indeed, the definition is no different from that for R&D activities under the pre-amended Section 16B of IRO. R&D activities for Section 16B purpose are in line with those that are regarded as "research" and "development" in the Hong Kong Accounting Standard 38. Much emphasis is put on the concepts of advance in science or technology, resolving scientific or technological uncertainty, substantially improved etc. If a taxpayer would like to reduce uncertainty on whether its R&D activity is eligible for deduction under Section 16B, it may apply for an advance ruling from the IRD.

Abortive R&D projects

Scientific or technological planning activities associated with projects which are not taken forward may still be qualifying R&D activities. The key is whether there is an intention to achieve an advance in science or technology, not whether a successful result or intellectual property is generated from the R&D activities. Registration of patent is not a pre-requisite for an activity to be regarded as an R&D activity.

Location of R&D activities

While Schedule 45 of the IRO provides that qualifying R&D activity should be "wholly undertaken and carried on in Hong Kong" in order to be eligible for enhance deduction, the IRD clarifies in DIPN 55 that it does not mean that the whole of an R&D project must be carried on in Hong Kong. In the case where some of activities of an R&D project are carried on outside Hong Kong, enhanced tax deduction may still be claimed for the R&D expenditures incurred on those activities carried on in Hong Kong, provided that other conditions are met.

Staff cost for enhanced deduction

An expenditure in relation to an employee who is engaged directly and actively in qualifying R&D activity may be Type B expenditure eligible for the enhanced deduction. In addition to the conditions in Section 16B and Schedule 45, the following conditions should be met:

Engaged directly and actively Whether an employee is directly and actively engaged in qualifying R&D activity is based on the duties performed and not on the job title. For example, the Head of R&D department spent certain time in managing the research team as well as carrying out scientific studies. Strictly speaking, the time involved in the management work may not be regarded as "engaged directly and actively" in qualifying R&D activity. Nevertheless, if such time is not significant, the IRD would be prepared to accept the full payroll cost of this employee as qualifying expenditure for enhanced deduction.

Employer-employee relationship Such relationship should exist between the enterprise and the employee engaged directly and actively in a qualifying R&D activity in order to be qualified for enhanced deduction. Secondees or expatriates sponsored by the enterprise, expert consultants under a temporary employment contract with the enterprise, and part-time R&D staff would be regarded as employees of the enterprise given that these individuals are subject to the supervision, direction or control by the enterprise. Their costs could be qualified for enhanced deduction provided that other conditions are met. On the contrary, fees paid to freelancers or staff providers who supply R&D personnel would not qualify for enhanced deductions as they are not the employees of the enterprise, but may still be eligible for 100% deduction as Type A expenditure.

Remuneration to director Compensation paid to directors is not qualified for enhanced deduction strictly speaking. Nevertheless, the IRD may allow apportionment of the relevant expenditure for enhanced deduction where a person occupies a dual role (i.e. a director and an employee directly and actively engaged in a qualifying R&D activity). The remaining amount may still be eligible for 100% deduction as Type A expenditure.

Co-ownership of rights

The tax law specifies that no deduction is allowed if the rights generated from the R&D activity (e.g. intellectual properties) are not fully vested in the enterprise. It is clarified in DIPN 55 that co-ownership of rights is covered. For example, some enterprises may jointly carry on an R&D activity and the rights generated from that R&D activity are fully and jointly vested in them. Each of the enterprises involved

may claim deduction for the R&D expenditure incurred under Section 16B, provided that other conditions are met.

Use of nominee to hold the rights

Holding the rights generated from the R&D activity through a nominee company could also be accepted. For example, if the enterprise uses a special purpose vehicle (SPV) as a nominee for the enterprise to hold the intellectual property generated from the R&D activities undertaken by the enterprise, the intellectual property would be regarded as fully vested in the enterprise and hence it is eligible to claim deduction for the R&D expenditures (Type A and/or Type B) incurred under Section 16B, provided that other conditions are met.

Undertaking R&D activity for another person

Schedule 45 of the IRO denies deduction for R&D expenditure incurred where an R&D activity is undertaken by a person for another person. For example, payments made to a Designated Local Research Institution (DLRI) for a qualifying R&D activity is eligible for enhanced deduction by the payer if other conditions are met. However, as the DLRI carries on the R&D activity for another person, the DLRI cannot claim deduction of its R&D expenditures under Section 16B. Instead, the DLRI may claim deduction of its expenditures under the general expense deduction provision Section 16(1) of the IRO.

In contrast, a group sets up a special-purpose vehicle (SPV) to undertake R&D activities. If the SPV owns the rights generated from the R&D activities and receives royalties from its associates for use of the rights, the IRD would not regard the SPV as undertaking the R&D activities for its associates. As such, the SPV would be eligible to claim deduction for R&D expenditures (Type A and/or Type B) incurred under Section 16B, if other conditions are met.

Subcontracting certain R&D activities to overseas associates

According to the IRD's practice under the old regime, R&D subcontracting fee paid to an overseas associate, which was not an approved R&D institution, was not deductible under Section 16B. In DIPN 55, the IRD provides a concession where the core part of the R&D project is undertaken in Hong Kong by the enterprise and only an insignificant part of an R&D project is subcontracted to its affiliates outside Hong Kong, the subcontracting fee paid to the overseas associate could be deductible under Section 16B, provided that other conditions are met. In particular, it is prepared to allow deduction (@100% for Type A expenditures) of a subcontracting fee paid to an overseas affiliate for the R&D services if such fee is not more than 20% of the total costs of the R&D project and does not exceed HK$2 million.

Cost Contribution Arrangement (CCA)

Companies within a multinational group may enter into a CCA for carrying out an R&D activity. While Section 16B and Schedule 45 do not explicitly state the treatment of CCA, DIPN 55 contains more than 10 pages of discussion regarding CCA. Where an enterprise has undertaken part or all R&D activity under a development CCA, the share of R&D expenditure borne by the enterprise under the CCA may be accepted as its in-house R&D expenditure for deduction under Section 16B if certain conditions are satisfied. For example, the enterprise must actively participate in the R&D project under the CCA but not merely make monetary contributions. Any rights generated from the R&D activity must be co-owned by the enterprise with other participants under the CCA.

For the contribution borne by the enterprise for the qualifying R&D activities undertaken in Hong Kong, the portion of expenditures attributable to direct R&D staff cost and consumables could be eligible for enhanced deduction (300%/200% Type B expenditures) if other conditions are met. For its share of contribution attributable to the part of the R&D project carried on outside Hong Kong, the enterprise may still claim 100% deduction as Type A expenditures. For details, please refer to DIPN 55.

Designated Local Research Institution (DLRI)

Payments made to a DLRI are qualified for enhanced deduction provided that other conditions are met. The deduction is generally allowed irrespective of the actual usage of the funds by the DLRI for either capital or revenue purposes (e.g. administration, actual R&D work, establishing the R&D institution etc.). Nonetheless, the payments made to DLRI which subcontracts part of the R&D activity outside Hong Kong would only be eligible for 100% deduction as Type A expenditures for that part of payments. A taxpayer needs to declare the amount of payments to DLRI for the R&D activities in Hong Kong and outside Hong Kong respectively when it claims the Section16B deduction in the supplementary form (S3) to the Profits Tax Return.

Depending on the group's situation, it may be efficient to have a DLRI to undertake the R&D activities for various group companies. A local entity may apply to Innovation and Technology Commission (ITC) to become a DLRI if specific conditions are met. ITC has recently published the application guidelines in its website. In particular, a local institution, including a company incorporated in Hong Kong and a non-Hong Kong company with a place of business in Hong Kong, may apply to become a DLRI if it can meet the criteria in the areas of manpower, experience in providing R&D services, R&D facilities and equipment, and governance and management structure. Please refer to ITC's guidelines for details. For a less complex application case, ITC may complete the assessment within 6 weeks. In general, the designation as DLRI carries a validity period of two to four years and can be applied for renewal before the expiry.

Applying for the designation as a DLRI may not be straightforward because a DLRI must have expertise in the fields of natural or applied science and technology, track records of experience etc. as set out in the ITC's guidelines. Taxpayers should seek professional advice when considering whether to apply for the designation e.g. whether it can meet the DLRI criteria, whether the arrangement would be eligible for enhanced tax deduction etc.

Our comments

While Section 16B and Schedule 45 of the IRO do not explicitly state the tax treatments on some arrangements (e.g., subcontracting, CCA) for the deduction regime of R&D expenditures, DIPN 55 clarifies and provides detailed explanation on some silent areas with various illustrative examples. In particular, we are glad to see that the IRD is prepared to adopt a practical and less stringent approach in applying the regime, such as allowing deduction of subcontracting fees for certain R&D work outsourced to overseas associates, accepting co-ownership of rights, nominee arrangement, CCA etc.

With more guidance on the IRD's views and practice, multinational groups with R&D activities in Hong Kong and overseas, particular involving CCA and/or subcontracting arrangements, are strongly encouraged to review their existing arrangements. Groups with more than one R&D project in Hong Kong and intellectual property rights may also review the structure and consider if it is efficient for the Hong Kong entity to apply as a DLRI. Professional advice should be obtained to tackle the complexities and challenges involved and the tax developments ahead. In any cases, taxpayers should retain relevant documentation regarding its R&D projects to support its deduction claim under Section 16B for profits tax return filing purpose.

We welcome the government's effort to introduce tax measures to promote R&D activities in Hong Kong. Overall, there are still limitations to make the tax measures attractive, such as the deduction cap on subcontracting fee paid to overseas affiliates, the exclusion of deduction for payments made to non-employees (e.g., independent contractors), the high criteria for DLRI status etc. Comparing to other jurisdictions that also offer tax incentives for R&D activities, there are rooms for Hong Kong to make its regime more competitive. We look forward to the government improving or exploring other tax incentives to provide a more favourable tax environment for innovation and technology industries in Hong Kong.

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Beijing
Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 7326
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
Partner
Tel: +86 571 2811 1900
Fax: +86 571 2811 1904
Email: qilu@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
Rosemary Hu
Partner
Tel: +86 25 5791 6129
Fax: +86 25 8691 8776
Email: roshu@deloitte.com.cn

Shanghai
Maria Liang
Partner
Tel: +86 21 6141 1059
Fax: +86 21 6335 0003
Email: mliang@deloitte.com.cn

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

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

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

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

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

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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
Partner
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.