

Tax

Issue H123/2026 – 9 October 2026

Hong Kong Tax Analysis

Interaction between Pillar Two and the enhanced research and development tax deduction in Hong Kong

Hong Kong's enhanced research and development (R&D) tax deduction allows companies to claim an enhanced profits tax deduction on eligible R&D expenditures (300% on the first HKD 2 million and 200% on the remaining balance).

However, for large multinational enterprise (MNE) groups with consolidated revenues exceeding EUR 750 million, this enhanced deduction historically posed a significant risk. Because the enhanced R&D deduction reduces taxable profits substantially, it lowers a group's jurisdictional effective tax rate (ETR) and may even push it below the 15% global minimum tax threshold under BEPS Pillar Two and trigger a top-up tax (specifically, the Hong Kong Minimum Top-up Tax (HKMTT)).

The interaction between Hong Kong's enhanced R&D deduction and the Pillar Two global minimum tax framework represents a classic conflict between domestic tax policy and international rules.

This article analyses how this conflict is being mitigated by the Substance-based Tax Incentive (SBTI) Safe Harbour under the OECD's Side-by-Side (SbS) package and may be useful for corporate tax directors, Chief Financial Officers of large MNEs, and in-house R&D and technology teams operating in Hong Kong.

Key summary: Hong Kong enhanced R&D tax deduction

Hong Kong's R&D tax incentive divides expenditures into two distinct categories to determine the applicable deduction rate:

- **Type A expenditures (standard 100% deduction):** Covers general R&D costs, such as market research, routine product testing, and capital expenditure on R&D plants or machinery.

Authors:

Derek Lam

Tax Partner

Tel: +852 2238 7388

Email: derekclam@deloitte.com.hk

Simon Chung

Tax Director

Tel: +852 2258 6136

Email: simochung@deloitte.com.hk

For more information, please contact:

Tax & Business Advisory

Southern Region Leader

Jennifer Zhang

Tax Partner

Tel: +852 2258 6228

Email: jennifzhang@deloitte.com.hk

Hong Kong Leader

Anthony Lau

Tax Partner

Tel: +852 2852 1082

Email: antlau@deloitte.com.hk

- **Type B expenditures (enhanced 200%–300% deduction):** Covers qualifying R&D expenditures directly tied to core activities conducted in Hong Kong (e.g., staff payroll, consumables, or outsourced R&D to designated local research institutions (DLRIs))¹. The enhanced deduction applies as follows:
 - **300% deduction** on the first HKD 2 million of qualifying expenditure.
 - **200% deduction** on the remaining balance, with no upper limit on total claimable amount.

To qualify for the enhanced deduction, R&D activities and expenditures must meet the strict criteria set by the Inland Revenue Department (IRD):

- **Objective:** The activity must aim to achieve an advance in science or technology or resolve a specific scientific or technological uncertainty.
- **In-house staff costs and consumables:** Staff costs must relate to employees **actively engaged** in R&D activities. Consumables must be fully used or transformed during the process.
- **Outsourced R&D restriction:** Only R&D contracted to a DLRI qualifies for the enhanced deduction. Payments to group companies or third-party sub-contractors which are not DLRIs do not qualify.

The conflict: Enhanced deductions vs. Pillar Two ETR

The global tax landscape changed dramatically following the implementation of Pillar Two.

Traditional corporate tax deductions create permanent book-to-tax differences. When a company utilizes Hong Kong's 200%–300% enhanced R&D tax deduction, it significantly drags down its GloBE covered taxes without a corresponding reduction in GloBE income, thereby lowering its ETR.

The table below illustrates the impact:

Metric	Without Enhanced Deduction	With Enhanced Deduction (Pre-2026 Rules)
Accounting Profit	HKD 100,000,000	HKD 100,000,000
Qualifying R&D Spend	HKD 10,000,000	HKD 10,000,000
Tax Deduction Allowed	HKD 10,000,000 (100%)	HKD 22,000,000 (Enhanced 200%–300%)
Assessable Profits	HKD 90,000,000	HKD 78,000,000
Profits Tax (16.5%)	HKD 14,850,000	HKD 12,870,000
GloBE ETR*	14.85%	12.87%
Pillar Two Top-up Tax Exposure	0.15%	2.13%

* Assumes no other adjustments to GloBE income or taxes.

The solution: The SBTI Safe Harbour

What is the SBTI Safe Harbour?

The SBTI Safe Harbour is a specialized relief mechanism introduced by the OECD/G20 Inclusive Framework as part of the SbS package.

Its purpose is to preserve genuine, expenditure-linked domestic tax incentives by preventing Pillar Two from neutralizing them.

¹ List of DLRIs: https://www.itc.gov.hk/en/fund_app/dlri/list.html

- **Mechanism:** When an in-scope MNE elects into the SBTI Safe Harbour, the tax benefit of a Qualified Tax Incentive (QTI), subject to a substance cap, is added back to the numerator (i.e. covered tax) of the jurisdictional ETR calculation.
- **Impact:** The add-back prevents the local incentive from decreasing the ETR, thereby eliminating or minimizing top-up tax liabilities under Pillar Two or HKMTT.

Why Hong Kong's enhanced R&D deduction qualifies as a QTI?

Hong Kong's enhanced R&D deduction qualifies as a QTI under the SBTI Safe Harbour because it meets the requirements outlined in the SbS package.

- **Tied to local expenditure:** The SBTI Safe Harbour was specifically designed to protect incentives linked to local corporate spending. Hong Kong's enhanced R&D deduction operates entirely on this basis by providing a 300% / 200% enhanced deduction on actual R&D costs incurred locally.
- **Generally available to all taxpayers:** The incentive is codified in Section 16B of the Inland Revenue Ordinance and is available to all taxpayers that fulfill the statutory criteria.
- **Excludes timing differences:** Timing differences (such as accelerated depreciation, tax loss carry-forwards, or deferred tax assets/liabilities) are explicitly excluded from the definition of QTI. Hong Kong's enhanced R&D deduction is not a timing difference, and thus qualifies.
- **Tax benefit does not exceed expenditure:** Although Hong Kong allows a 300% tax deduction, the value of the tax benefit (i.e. deduction x 16.5% tax rate) does not exceed the expenditure.

Assuming the group's jurisdictional substance cap (based on local payroll and tangible assets) is large enough to cover the tax benefit, the table below demonstrates how the SBTI Safe Harbour completely neutralizes the Pillar Two risk:

Metric	Without Enhanced Deduction	With Enhanced Deduction (Pre-2026 Rules)	With Enhanced Deduction + SBTI Safe Harbour
Accounting Profit	HKD 100,000,000	HKD 100,000,000	HKD 100,000,000
Taxes Paid	HKD 14,850,000	HKD 12,870,000	HKD 12,870,000
QTI used	HKD 0	HKD 0	HKD 1,980,000[^]
Adjusted Covered Taxes (Numerator)	HKD 14,850,000	HKD 12,870,000	HKD 14,850,000
GloBE ETR*	14.85%	12.87%	14.85%
Pillar 2 Top-up Tax Exposure	0.15%	2.13%	0.15%

* Assume no other adjustments to GloBE income or taxes.

[^] (HKD 22,000,000 – HKD 10,000,000) x 16.5% = HKD 1,980,000

Key considerations for in-scope MNEs in Hong Kong

1. **Apply the SBTI Safe Harbour on a jurisdictional basis:** The SBTI Safe Harbour calculates tax benefit and substance cap on a jurisdictional basis, rather than on an individual entity basis. This allows MNEs greater flexibility in structuring their domestic R&D operations, so that engineers, laboratory equipment, and tax incentive claims need not be consolidated into a single legal entity to benefit from the safe harbour.
2. **Review DLRI contract terms carefully:** While outsourcing R&D to a DLRI qualifies for a 200%–300% deduction, which would be recognized as a QTI and could be added back to the covered taxes to increase the ETR, the add-back is limited to the lesser of the incentive's tax value or the jurisdictional

substance cap. MNEs in Hong Kong should carefully review their R&D contracts to optimize the benefits.

- 3. Meet compliance and reporting obligations:** In-scope groups must comply with Hong Kong's Pillar Two filing requirements, including submitting the annual top-up tax notification within 6 months of the financial year-end and the annual top-up tax return within 15 months (or 18 months for the transition year) via the IRD's Pillar Two Portal.

Additionally, the updated GloBE Information Return (GIR) released by the OECD in September 2026 increases data requirements for SBTI Safe Harbour elections by adding specialized fields for disclosing the amount of QTIs claimed and the substance cap limits. This new version of GIR will apply to GIR filings for fiscal years commencing on or after 31 December 2025 (normally referred to as FY26 GIR filing).

Deloitte's comments

Balancing global tax compliance with domestic innovation incentives requires corporate leaders to shift from a reactive mindset to a strategic, data-driven approach. While the Pillar Two framework fundamentally alters the economics of corporate tax planning, the SBTI Safe Harbour provides a vital compliance pathway to preserve the financial value of genuine, substance-backed R&D operations in Hong Kong.

To mitigate the impact of HKMTT, MNEs with R&D activities in Hong Kong should optimize the use of SBTI Safe Harbour, and in particular break down internal divisions and bridge the gap between operational R&D tracking and tax reporting. With the complex data requirements of the FY26 GIR filing rules fast approaching, early preparation and proactive compliance steps are essential. By taking the above steps, corporate leaders can safeguard their enhanced R&D tax deductions and ensure their Hong Kong operation remains a competitive, high-yield hub for technological advancement.

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Deloitte China Tax and Business Advisory

Victor Li

National Leader

Tel: +86 755 3353 8113

Fax: +86 755 8246 3222

Email: vicli@deloittecn.com.cn

Northern and Western China

Xiaoli Huang

Partner

Tel: +86 10 8520 7707

Fax: +86 10 6508 8781

Email: xiaolihuang@deloittecn.com.cn

Eastern China

Maria Liang

Partner

Tel: +86 21 6141 1059

Fax: +86 21 6335 0003

Email: mliang@deloittecn.com.cn

Southern China

Jennifer Zhang

Partner

Tel: +852 2258 6228

Fax: +852 2815 8005

Email: jennifzhang@deloitte.com.hk

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Northern and Western China

Tony Zhang

Partner

Tel: +86 28 6789 8008

Fax: +86 28 6317 3500

Email: tonzhang@deloittecn.com.cn

Eastern China

Kevin Zhu

Partner

Tel: +86 21 6141 1262

Fax: +86 21 6335 0003

Email: kzhu@deloittecn.com.cn

Southern China (Mainland)

Tony Yao

Partner

Tel: +86 20 2831 1369

Fax: +86 20 3888 0115

Email: heyao@deloittecn.com.cn

Southern China (Hong Kong)

Doris Chik

Partner

Tel: +852 2852 6608

Fax: +852 2543 4647

Email: dchik@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify national marketing team of Deloitte China by email at cimchina@deloitte.com.hk.

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