

# HONG KONG TAX

November 2018

[www.bdo.com.hk](http://www.bdo.com.hk)

## HONG KONG INTRODUCED ENHANCED TAX DEDUCTION FOR RESEARCH & DEVELOPMENT EXPENDITURES



### CONTENTS

- ▶ Introduction
- ▶ Key features
- ▶ Our observation

The Inland Revenue (Amendment) (No. 3) Bill 2018 (Amendment Bill) passed its third reading in the Legislative Council on 24 October 2018 after one minor amendment<sup>1</sup> and has become new law to grant enhanced tax deductions for qualifying research and development (R&D) activities carried out in Hong Kong. The new R&D tax deduction regime has retrospective effect for R&D expenditure incurred on or after 1 April 2018.

### Key features

1. Deduction under the old section 16B of the Inland Revenue Ordinance (IRO)
  - R&D expenditures incurred by a taxpayer in relation to trade, profession or business are deductible, subject to some specific conditions. The deductible R&D expenditures could be in the form of (i) payments to approved research institutes<sup>2</sup>; or (ii) expenditures incurred in-house by taxpayers themselves.
  - Expenditure on research and development includes capital expenditure, except expenditure on land or buildings.

## 2. The new R&D deduction regime

- The old section 16B has been substituted by a new section 16B and Schedule 45 which sets out the details of the deduction. Under the enhanced R&D deduction regime, R&D expenditures are classified into two types: Type A expenditure qualifies for a basic 100% tax deduction whereas Type B expenditure qualifies for the enhanced two-tiered tax deduction (300% tax deduction for the first HK\$2 million and 200% for the remaining amount), subject to meeting certain conditions.
- The tax deduction for Type A expenditures is largely the same as the deduction under the old section 16B while Type B expenditures will qualify for enhanced deduction. In simple terms, Type B expenditures refer to qualifying expenditures on qualifying R&D activities wholly undertaken and carried on in Hong Kong. This is further explained below.

## 3. Enhanced R&D deductions

- To qualify for Type B expenditure, the following conditions must be met:
  - (a) The expenditure arises from an activity that falls into the definition of a qualifying R&D activity and related to the trade, profession or business; and
  - (b) The expenditure incurred falls into the definition of R&D expenditure.
- A **qualifying R&D activity** refers to the R&D activity that is wholly undertaken and carried on in Hong Kong and falls within one of the following<sup>3</sup>:
  - (a) an activity in the fields of natural or applied science to extend knowledge;
  - (b) an original and planned investigation carried on with the prospect of gaining new scientific or technology knowledge and understanding; or
  - (c) the application of research findings or other knowledge to a plan or design for producing or introducing new or substantially improved materials, devices, products, processes, systems or services before they are commercially produced or used.

- **Qualifying R&D expenditure** that enjoys the enhanced two-tiered deduction comprises:

- (a) Payment made to a designated local research institution; or
- (b) In-house expenditure in relation to (i) an employee engaged directly and actively in a qualifying R&D activity; or (ii) a consumable item that is used directly in a qualifying R&D activity.

Expenditure in relation to an employee means any salary, wages, contributions to a recognised occupational retirement scheme/mandatory provident fund scheme and any other benefit that constitutes a cash outlay paid by the employer. Director's remuneration is specifically excluded.

## 4. Deemed taxable trading receipts

- The following will be deemed as taxable trading receipts:
  - (a) Proceeds from the sale of plant and machinery for, or rights generated from, any R&D activity for which the expenditure has been allowed as a deduction under section 16B (taxable amount limited to the amount of deduction previously allowed).
  - (b) Royalties received for the use or right to use outside Hong Kong of any intellectual property or know-how generated from any R&D activity for which the expenditure has been allowed as a deduction under section 16B.

## 5. Advice from Commissioner for Innovation & Technology (CIT)

- Where an R&D claim under the new section 16B or an advance ruling application is made by a taxpayer, the Commissioner of Inland Revenue may seek advice from the CIT to ascertain, among others, whether (i) an activity is a qualifying R&D activity; and (ii) an R&D expenditure was incurred in relation to a qualifying R&D activity.
- The CIT may designate any local university or college or any other local institution that undertakes qualifying R&D activities in Hong Kong as a designated local research institution.

## Our observations

1. We welcome the Government's effort to introduce tax measures to promote R&D activities to be carried out in Hong Kong.
2. Apart from enhanced deductions for certain R&D expenditure, however, the conditions to be met in order to obtain deductions under the old section 16B and the new section 16B remain largely the same and are rather stringent. A taxpayer can only obtain deductions on part or all of the in-house expenditure incurred, payments to universities and colleges both in Hong Kong and overseas as well as payments to designated local research institutes. No deductions shall be allowed on expenditure incurred on outsourcing R&D activities to entities other than designated local research institutes.
3. Nowadays, it is not uncommon for multinational corporations to centralise the R&D functions in one constituent entity as local designated research institutes may not have the industry expertise and knowledge to suit the requirements of taxpayers. While the group entity in Hong Kong would potentially derive taxable income from the benefits of the R&D work, it is not entitled to claim any R&D costs recharged as deductible expenses under the old and new regime. Unless there is a relaxation of the criteria in qualifying R&D expenditure, the effectiveness of the new measure would be undermined.

### Notes:

1. An amendment was made to the Amendment Bill to allow payment by a taxpayer to a local institution qualifies as R&D expenditure if the local institution is designated as a designated local research institution within 6 months after the date of payment.
2. An approved institute means any university, college, institute, association or organisation which is approved in writing by the Commissioner of Inland Revenue as an institute, association or organisation for undertaking research and development which is or may prove to be of value to Hong Kong.
3. A qualifying R&D activity does not include:
  - (a) any efficiency survey, feasibility study, management study, market research or sales promotion;
  - (b) the application of any publicly available research findings or other knowledge to a plan or design, with an anticipated outcome and without any scientific or technological uncertainty;
  - (c) an activity that does not seek to directly contribute to achieving an advance in science or technology by resolving scientific or technological uncertainty; or
  - (d) any work to develop the non-scientific or non-technological aspect of a new or substantially improved material, device, product, process, system or service.

## BDO'S SUPPORT AND ASSISTANCE

25th Floor, Wing On Centre  
111 Connaught Road Central  
Hong Kong  
Tel: +852 2218 8288  
Fax: +852 2815 2239  
info@bdo.com.hk

AGNES CHEUNG  
Director and Head of Tax  
Tel: +852 2218 3232  
[agnescheung@bdo.com.hk](mailto:agnescheung@bdo.com.hk)

CAROL LAM  
Director  
Tel: +852 2218 8296  
[carollam@bdo.com.hk](mailto:carollam@bdo.com.hk)

ENOCH HSU  
Director, Transfer Pricing  
Tel: +852 2218 8780  
[enochhsu@bdo.com.hk](mailto:enochhsu@bdo.com.hk)

ABIGAIL LI  
Principal  
Tel: +852 2218 3372  
[abigailli@bdo.com.hk](mailto:abigailli@bdo.com.hk)

BEATRICE YUEN  
Principal  
Tel: +852 2218 2771  
[beatriceyuen@bdo.com.hk](mailto:beatriceyuen@bdo.com.hk)

CELESTINE YEUNG  
Principal  
Tel: +852 2218 2773  
[celestineyeung@bdo.com.hk](mailto:celestineyeung@bdo.com.hk)

NAVY TANG  
Principal  
Tel: +852 2218 8944  
[navytang@bdo.com.hk](mailto:navytang@bdo.com.hk)

LEO LI  
Principal, China Tax  
Tel: +852 2218 2774  
[leoli@bdo.com.hk](mailto:leoli@bdo.com.hk)

BDO Limited, a Hong Kong limited company, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms.

BDO is the brand name for the BDO network and for each of the BDO Member Firms.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact BDO to discuss these matters in the context of your particular circumstances. BDO, its directors, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.