



Hong Kong Tax Newsflash: Enhanced Deduction Regime for R&D Expenditure in Effect

The Inland Revenue (Amendment) (No. 7) Ordinance 2018, which introduces an enhanced tax deduction regime for qualifying research and development (R&D) expenditure was passed by Hong Kong's Legislative Council on 25 October 2018 and became effective on 2 November 2018.

Overview of the regime

The regime classifies R&D expenditure as one of two types:

1. Type A expenditure, which qualifies for the existing standard deduction of 100% of the expenditure; and
2. Type B expenditure, which qualifies for an enhanced deduction of 300% for the first HKD 2 million of R&D expenditure and 200% on the remainder (without any cap on the amount of the enhanced deduction).

The enhanced deduction applies retroactively to expenditure incurred on or after 1 April 2018. (For details, see the [Tax Analysis \(Issue H82/2018\)](#) published on 4 May 2018).

To ensure symmetry of the tax rules, royalties derived from the intellectual property generated from the R&D activities will be considered trading receipts chargeable to tax. This provision applies to amounts received or accrued on or after 2 November 2018.

Changes made to bill

A number of issues were discussed and clarified in the Bills Committee before the bill was passed, including the following:

Qualifying R&D activity: The definition of R&D activity that qualifies for the enhanced deduction is not straightforward. As

a general rule, if an R&D project seeks to directly contribute to achieving an advance in science or technology by resolving scientific or technological uncertainty, it will be considered a qualifying R&D activity. However, an item does not become an advance in science or technology simply because science or technology is used in its creation. Taxpayers are expected to provide comprehensive and accurate information in their tax returns to support a deduction claim and provide sufficient supporting documents at the request of the Inland Revenue Department (IRD). To reduce any potential uncertainty, a taxpayer may request an advance ruling from the IRD to clarify whether a planned R&D project meets the requirements and would be eligible for the enhanced tax deduction.

Overseas R&D activities: Considering that the objective of the enhanced tax deduction regime is to encourage Hong Kong R&D activities, the government concluded that the enhanced deduction would not be available for R&D activities conducted outside Hong Kong. Nevertheless, such expenditure still may qualify for the 100% standard deduction as Type A expenditure if the relevant conditions are fulfilled.

Cost-sharing arrangements: In some cases, taxpayers may make payments for R&D activities outsourced to group companies under a cost-sharing arrangement (CSA). The government clarified that if a taxpayer has undertaken part or all of the underlying R&D activities under a CSA, the portion of R&D expenditure borne by the taxpayer under the arrangement may be treated as its in-house R&D expenditure and may be eligible for the standard or the enhanced deduction. Based on this, we may interpret that if the payment is made to an overseas group company under a CSA where the R&D activities are undertaken outside Hong Kong, the expenditure borne by the taxpayer may be regarded as Type A expenditure and hence eligible for the standard deduction. If the payment is made to another Hong Kong group company under a CSA, assuming that it is not a designated institution and the R&D activities are carried out in Hong Kong, can the portion of expenditure attributable to direct R&D staff cost and consumables (i.e. Type B expenditure) be eligible for enhanced deduction? The IRD will provide more guidelines in the Departmental Interpretation and Practice Notes (DIPN).

Designated local research institution: In general, a payment made to a designated local research institution would qualify for the enhanced tax deduction. Currently there are a limited number of approved institutions. Local research entities may now apply for designated status from the Innovation and Technology Commission (ITC) if they meet certain requirements. Given the time needed for the ITC to process applications, the bill was amended to allow a taxpayer to take the standard or an enhanced deduction for a payment made to a local institution if that institution becomes a designated local research institution within six months after the date the payment is made. The government will set up an expert panel to advise on the process for assessing whether an institution should receive designated status.

Comments

The enhanced R&D expenditure deduction regime is not a simple regime, and taxpayers need to be aware of various aspects of the regime, such as whether the R&D activities qualify for the enhanced deduction, whether payments made under cost-sharing arrangements may be deducted, etc. The IRD is expected to issue further guidance in the form of DIPN. We also look forward to the government releasing specific requirements for entities to apply for designated research institution status. In the meantime, potentially affected entities may wish to seek professional advice for assistance in obtaining the benefits of the new tax incentive.

Tax Newsflash is published for the clients and professionals of Deloitte Touche Tohmatsu. 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.

If you have any questions, please contact one of the following professionals:

Ryan Chang

Tax Partner

+852 2852 6768

ryanchang@deloitte.com

Doris Chik

Tax Senior Manager

+852 2852 6608

dchik@deloitte.com.hk

Sam Yeung

Tax Manager

+852 2238 7191

syeung@deloitte.com.hk



Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see [About Deloitte](#) for a more detailed description of DTTL and its member firms.

Privacy

Thank you for your interest in Deloitte China services. Deloitte China would like to continue to use your personal information (in particular name and contact details) for the purpose of sending you marketing and regulatory updates, invitations to seminars and other events organized, sponsored or promoted by Deloitte China. If you do not wish to receive further communications from Deloitte China, please send a return email to the sender with the word "Unsubscribe" in the subject line.

If you would like to update your personal information, please click [here](#).

Deloitte China refers to Deloitte Touche Tohmatsu in Hong Kong, Deloitte Touche Tohmatsu in Macau, Deloitte Touche Tohmatsu Certified Public Accountants LLP in the Chinese Mainland and their respective affiliates practising in Hong Kong, Macau and the Chinese Mainland.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the "Deloitte Network") is by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2018 Deloitte Touche Tohmatsu in Hong Kong, Deloitte Touche Tohmatsu in Macau, and Deloitte Touche Tohmatsu Certified Public Accountants LLP in the Chinese Mainland. All rights reserved.

To no longer receive emails about this topic please send a return email to the sender with the word "Unsubscribe" in the subject line.