The law on the enhanced R&D tax deduction was enacted

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In brief

The Inland Revenue (Amendment) (No. 3) Bill 2018 on tax deduction of research and development (R&D) expenditure (the R&D Bill) was passed by the Legislative Council on 24 October 2018 with one major Committee Stage Amendment (CSA)[1]. The CSA provides for a six-month grace period for R&D payments made to a local research institution so that such payments may qualify for the enhanced tax deduction if the institution became a designated local research institution (DLRI) within six months after the payments. The final law on the new R&D tax deduction regime was gazetted as the Inland Revenue (Amendment) (No. 7) Ordinance 2018[2] (the R&D Ordinance) on 2 November 2018. The new R&D tax deduction regime takes retrospective effect for expenditure incurred or payment made on or after 1 April 2018.

It is expected that the Inland Revenue Department (IRD) will soon issue a Departmental Interpretation and Practice Note (DIPN) to provide more guidance on the interpretation and application of the new R&D tax deduction regime. In addition, the Innovation and Technology Commission (ITC) will draw up an assessment framework for DLRI applications and set up an expert panel comprising members from relevant industries and the academia to advise on the DLRI assessment process. The detailed conditions and application procedures for designation will be available on the ITC webpage shortly.

We welcome the introduction of the enhanced R&D tax deduction in Hong Kong as a first step to encourage more R&D activities in Hong Kong through the use of tax incentives. However, we hope the government can revisit the effectiveness of the new regime on a regular basis and refine the regime based on the practical situation in Hong Kong by, for example, reconsidering granting an enhanced tax deduction for R&D activities conducted partly in Hong Kong and partly outside Hong Kong. On the other hand, taxpayers who wish to benefit from the new R&D tax deduction regime should (1) review the current R&D arrangement, (2) assess if any changes are required to capture the benefits of the newly introduced tax incentive and whether such changes are commercially feasible and (3) examine if the current financial reporting system is capable of capturing the required R&D expense data, records and documents accurately to substantiate a tax deduction claim.

In detail

The new R&D tax deduction regime

Under the new regime, there are two types of qualifying R&D expenditure, namely Type A expenditure and Type B expenditure. Subject to fulfillment of certain specified conditions, the tax deductions available for these two types of R&D expenditure are as follows:

- Type A expenditure (R&D expenditure other than Type B expenditure) – a 100% normal deduction; and
- Type B expenditure (R&D expenditure on in-house qualifying R&D activities (limited to direct staff costs and expenditure on R&D consumable items) or payments to a DLRI for qualifying R&D activities) – a 300% deduction for the first HK$2 million and a 200% deduction for the remaining amount, without any limit on the amount eligible for the 200% deduction.

In addition, both expenditure incurred for in-house R&D activities conducted by taxpayers themselves and payments made by taxpayers to a university, college or DLRI for subcontracted R&D activities may be eligible for normal or enhanced tax deduction if the specified conditions are met.

For a more detailed discussion of the new R&D tax deduction regime and the other provisions in the new law (e.g. the deeming provisions on certain receipts in relation to R&D), please refer to our *Hong Kong Tax News Flash, April 2018, Issue 7*[3].

The CSAs incorporated into the R&D Ordinance

The only major CSA was proposed by the Administration in response to the comments received during the deliberation of the R&D Bill at the Bills Committee. The CSA introduces a grace period of six months so that a taxpayer may claim an enhanced 300%/200% deduction for subcontracted R&D payments made to a local research institution for a qualifying R&D activity before the institution was designated as a DLRI, provided that the institution became a DLRI within six months after the date of the payment. The other minor CSAs only involve renumbering and reorganisation of several provisions in the R&D Bill.

DIPN on the new R&D tax deduction regime

The IRD will issue a DIPN to provide more guidance on the interpretation and application of the new R&D tax deduction regime. It is understood that the DIPN will contain (1) examples of R&D activities in different fields and industries, (2) practical guidance on issues such as treatment of staff costs of R&D staff under secondment and payments made under a cost sharing arrangement and (3) documentation requirements to substantiate a deduction claim, etc.

The roles of the Innovation and Technology Commission

Pursuant to the R&D Ordinance, the Commissioner of Inland Revenue may seek advice from the Commissioner for Innovation and Technology (CIT) when processing a R&D tax deduction claim or an advance ruling application in relation to a R&D tax deduction claim. In addition, the CIT is empowered by the R&D Ordinance to designate any (1) university or college located in Hong Kong or (2) any other local institution (including any institute, association, organisation or corporation) that undertakes qualifying R&D activities in Hong Kong as a DLRI for tax deduction purpose. The ITC will be responsible for processing applications for a DLRI status and the subsequent monitoring of these DLRIs.

The ITC currently has 61 professional officers who provide advice and support on science and technology matters and is planning to create 11 new professional posts in the coming two years. The ITC has indicated that a local institution or corporation, irrespective of its scale, may apply to become a DLRI if it has the capability, capacity and experience and is competent to undertake the R&D activities in the relevant technology areas. Factors that will be considered by the ITC include: (1) expertise in one or more specified fields of science or technology, (2) sufficient qualified and experienced R&D talents, equipment and facilities in the specified fields, (3) sound project management experience and (4) appropriate track records. The ITC will set up an expert panel comprising members from relevant industries and the academia to advise on the DLRI assessment process. In addition, the ITC will draw up an assessment framework for DLRI applications and the detailed conditions and application procedures for designation will be available on the ITC webpage shortly[4].

The takeaway

We welcome the introduction of the enhanced R&D tax deduction in Hong Kong as a first step to encourage more R&D activities in Hong Kong through the use of tax incentives. However, we hope the government can revisit the effectiveness of the new regime on a regular basis and refine the regime based on the practical situation in Hong Kong by, for example, reconsidering granting an enhanced tax deduction for R&D activities conducted partly in Hong Kong and partly outside Hong Kong.

On the other hand, taxpayers who wish to benefit from the new R&D tax deduction regime should (1) review the current R&D arrangement, (2) assess if any changes are required to capture the benefits of the newly introduced tax incentive and whether such changes are commercially feasible and (3) examine if the current financial reporting system is capable of capturing the required R&D expense data, records and documents accurately to substantiate a tax deduction claim.

Endnotes

1. A list of all the CSAs can be accessed via this link: http://www.legco.gov.hk/yr18-19/english/counmtg/papers/cm20181024cb3-25-e.pdf
2. The Inland Revenue (Amendment) (No. 7) Ordinance 2018 can be accessed via this link: https://www.gld.gov.hk/egazette/pdf/20182244/es12018224429.pdf
3. The Hong Kong Tax News Flash, April 2018, Issue 7 can be accessed via this link: https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-apr2018-7.html
4. For more details, please refer to these links: https://www.legco.gov.hk/yr17-18/english/bc/bc08/papers/bc0820180612cb1-1073-2-e.pdf and https://www.legco.gov.hk/yr17-18/english/bc/bc08/papers/bc08cb1-1123-1-e.pdf

Let's talk

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