

Client Alert

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Hong Kong introduces an enhanced tax deduction regime for qualifying R&D expenditures

The Inland Revenue (Amendment) (No. 3) Bill 2018 (the "**Bill**") proposing an enhanced tax deduction regime for qualifying research and development (**R&D**) expenditures was gazetted on 20 April 2018 and introduced into the Legislative Council on 2 May 2018. The enhanced tax deduction, which was proposed by the Chief Executive in her 2017 Policy Address, is intended to encourage more enterprises to invest in R&D activities in Hong Kong. This alert outlines the key features of the proposed regime.

Conditions to qualify for R&D tax deduction under the new regime

The Bill seeks to revamp the current section 16B of the Inland Revenue Ordinance (**IRO**), which provides a tax deduction for certain outsourced and in-house R&D expenditures, and introduce a new schedule (Schedule 45) to specify the details of tax deduction of R&D expenditures under the new regime. Under the proposed new section 16B and Schedule 45, there are two types of tax deductible R&D expenditures: (i) Type A expenditure, which qualifies for standard tax deduction of 100% of the expenditure amount; and (ii) Type B expenditure, which is eligible for enhanced tax deduction of 300% for the first HK\$2 million and 200% for the remaining amount.

The following table summarises the conditions required for R&D expenditures to qualify for the standard (100%) and enhanced (200/300%) tax deductions:

	Standard tax deduction	Enhanced tax deduction
Tax deduction rate	100%	300% for the first HK\$2 million and 200% for the remainder (without limit)
R&D activities qualifying for tax deduction	<p>An "R&D Activity" which means:</p> <p>(a) an activity in the fields of natural or applied science to extend knowledge;</p> <p>(b) a systematic, investigative or experimental activity carried on for the purposes of any feasibility study or in relation to any market, business or management research;</p> <p>(c) an original and planned investigation carried on with the prospect of</p>	<p>A "Qualifying R&D Activity" which means:</p> <ul style="list-style-type: none"> ▪ an R&D Activity which falls within the description in paragraphs (a), (c) or (d); and ▪ is wholly undertaken and carried on in Hong Kong; but ▪ excludes activities which are not generally regarded as innovative activities involving advancement in science or technology (e.g., feasibility studies, market research,





	Standard tax deduction	Enhanced tax deduction
	<p>gaining new scientific or technical knowledge and understanding; or</p> <p>(d) 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.</p>	<p>applications of publicly available research findings without any scientific or technological uncertainty, activities which do not seek to directly contribute to achieving an advance in science or technology by resolving uncertainty in those areas, and works to develop the non-scientific or non-technological aspects of a new or improved product or system).</p>
R&D expenditures qualifying for tax deduction	<p>A "Type A Expenditure", which is an R&D Expenditure (as defined below) other than a Type B Expenditure, e.g.</p> <ul style="list-style-type: none"> ▪ a payment to a university which is not a Designated Local Research Institution (as defined below) for an R&D Activity; and ▪ capital expenditure on plant or machinery used for an R&D Activity. <p>Where a Type A Expenditure is incurred for an R&D Activity carried on outside Hong Kong in relation to the taxpayer's trade, profession or business which is carried on partly in and partly outside Hong Kong, an apportionment of the expenditure will be required for tax deduction purposes.</p>	<p>A "Type B Expenditure", which is an R&D Expenditure (as defined below) that falls within any of the following descriptions:</p> <ul style="list-style-type: none"> ▪ a payment to a Designated Local Research Institution (as defined below) for a Qualifying R&D Activity related to the taxpayer's trade, profession or business; ▪ a payment to a Designated Local Research Institution to undertake a Qualifying R&D Activity related to the taxpayer's class of trade, profession or business; or ▪ a "Qualifying Expenditure", which is an expenditure: <ul style="list-style-type: none"> – in relation to an employee who is engaged directly and actively in a Qualifying R&D Activity related to the taxpayer's trade, profession or business; or – on a consumable



	Standard tax deduction	Enhanced tax deduction
		item that is used directly in a Qualifying R&D Activity related to the taxpayer's trade, profession or business.
	<p>No tax deduction will be allowed in the following circumstances:</p> <ul style="list-style-type: none"> ▪ where any rights generated from the R&D Activity are not, or will not be, fully vested in the taxpayer; ▪ where the R&D Activity is undertaken by the taxpayer for another person; ▪ where the R&D Expenditure is or will be met directly or indirectly by a government, a public or local authority or a person other than the taxpayer; or ▪ the R&D Expenditure is incurred under an arrangement of which the main purpose, or one of the main purposes, is to enable the taxpayer to obtain a deduction or a greater deduction which he would not otherwise be entitled to. 	

An "**R&D Expenditure**" means:

- a payment to an "**R&D Institution**" (i.e., a university or college or a Designated Local Research Institution as defined below) for an R&D Activity relating to the taxpayer's trade, profession or business; or
- a payment to an R&D Institution to undertake an R&D Activity related to the taxpayer's class of trade, profession or business; or
- any other expenditure on an R&D Activity, including capital expenditure except capital expenditure on land or buildings; but
- excludes any payment to an R&D Institution for acquiring rights generated from an R&D Activity and any expenditure for acquiring rights generated from an R&D Activity.

A "**Designated Local Research Institution**" means any university or college in Hong Kong or any other local institution which undertakes qualifying R&D Activities in Hong Kong designated by the Commissioner for Innovation and Technology (**CIT**).

In summary, only Type B Expenditures, i.e., R&D payments made to a Designated Local Research Institution or Qualifying Expenditures (direct staff costs and consumables) in respect of Qualifying R&D Activities, which must be wholly undertaken and carried on in Hong Kong, will be eligible (subject to the abovementioned conditions) for enhanced tax deduction. R&D expenditures which do not fall within the scope of Type B Expenditures, i.e.,



Type A expenditures, may still qualify for 100% standard tax deduction provided the relevant conditions are met.

Involvement of the CIT

The Bill empowers the Inland Revenue Department (**IRD**) to consult with the CIT in determining whether an activity falls within the scope of an R&D Activity or a Qualifying R&D Activity and whether an R&D Expenditure was incurred in relation to such activities qualifying for tax deduction. The IRD may disclose any necessary information to the CIT for the purpose of such consultation. However, the final decision on whether a deduction should be allowed will be made by the IRD, not the CIT.

The Bill also stipulates that Designated Local Research Institutions will be determined by the CIT. In contrast, approved research institutes, the counterparts of Designated Local Research Institutions in the current section 16B, are determined by the IRD. Service providers which provide R&D services in Hong Kong may apply to the CIT for designation.

Deemed taxable trading receipts

The Bill retains, with modifications, the deeming provisions under the current section 16B which treat proceeds of sale of plant or machinery used for, or rights generated from, an R&D activity where the expenditure has been allowed as an R&D deduction as taxable trading receipts, to the extent that does not exceed the amount of deduction previously allowed. In other words, any previous R&D deduction claimed will be "clawed back" upon the sale of the relevant plant or machinery used for or rights generated from the R&D activity.

The Bill also introduces provisions which deem the following sums in relation to R&D as taxable receipts:

- royalties received for the use, or the right to use, outside Hong Kong of any intellectual property or know-how generated from any R&D Activity in respect of which a deduction is allowable under section 16B; and
- sums received for imparting or undertaking to impart knowledge directly or indirectly connected to the use outside Hong Kong of such intellectual property or know-how generated from any R&D Activity in respect of which a deduction is allowable under section 16B.

Effective date

Once the Bill is enacted, the new regime will have retrospective effect for qualifying R&D expenditures incurred on or after 1 April 2018. Companies currently engaging in or planning to engage in R&D activities should therefore review their R&D processes in light of the proposed legislative provisions and assess how their processes can be best structured to benefit from the new regime.

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