

Client Alert

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Hong Kong's New Tax Incentives for R&D

The Inland Revenue (Amendment) (No. 7) Ordinance 2018 (the “**Amendment**”) has come into operation on 2 November 2018 to put in place an enhanced tax deduction regime for qualifying research and development (**R&D**) expenditures in Hong Kong. The Amendment, the key features of which are discussed below, is substantially similar to the bill introduced in April 2018. The enhanced tax deduction regime applies to qualifying R&D expenditures incurred on or after 1 April 2018. Companies engaging in or planning to engage in R&D activities should review their R&D activities and assess whether they can benefit from the new regime.

Enhanced tax deduction regime for qualifying R&D expenditures

The Amendment distinguishes between two types of deductible R&D expenditures:

- Type A expenditures which are eligible for the standard tax deduction of 100% of the expenditure amount.
- Type B expenditures which are eligible for the enhanced tax deduction at 300% for the first HK\$2 million and 200% for the remaining amount.

The expenditures which qualify as Type A and Type B expenditures are set out in the table below:

Type A expenditures qualifying for standard tax deduction	Type B expenditures qualifying for enhanced tax deduction
<p>Expenditures which fall within any one of the following descriptions:</p> <ul style="list-style-type: none"> • a payment to a university, college or a Designated Local Research Institution (defined below): <ul style="list-style-type: none"> ◦ for an R&D Activity (defined below) related to the taxpayer's trade, profession or business; or ◦ to undertake an R&D Activity related to the class of the taxpayer's trade, profession or business; or • an expenditure incurred on any R&D Activity related to the taxpayer's trade, profession or business, including capital expenditure except for expenditure on land or buildings, <p>but do not qualify as a Type B expenditure, excluding any payment or expenditure for acquiring rights generated from an R&D Activity.</p>	<p>Expenditures which fall within any one of the following descriptions:</p> <ul style="list-style-type: none"> • a payment to a Designated Local Research Institution: <ul style="list-style-type: none"> ◦ for a Qualifying R&D Activity (defined below) related to the taxpayer's trade, profession or business; or ◦ to undertake a Qualifying R&D Activity related to the taxpayer's class of trade, profession or business; or • an expenditure incurred: <ul style="list-style-type: none"> ◦ in relation to an employee engaged directly and actively in; or ◦ on a consumable item used directly in, <p>a Qualifying R&D Activity related to the taxpayer's trade, profession or business, excluding any payment or expenditure for acquiring rights generated from an R&D Activity.</p>

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 that are designated as such by the Commissioner for Innovation and Technology (**CIT**). A payment will be considered as a



payment to a Designated Local Research Institution if that institution becomes a Designated Local Research Institution within six months after the date of the relevant payment.

R&D Activity is an activity falling within any one of the following descriptions:

- (a) an activity in the fields of natural or applied science to extend knowledge;
- (b) a systematic, investigative or experimental activity carried on for the purposes of a feasibility study or in relation to market, business or management research;
- (c) an original and planned investigation carried on with the prospect of gaining new scientific or technical knowledge and understanding; or
- (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.

Qualifying R&D Activity is defined more narrowly, covering only the activities described in paragraphs (a), (c) and (d) above which are wholly undertaken and carried on in Hong Kong, excluding any activity which is not generally regarded as an innovative activity involving advancement in science or technology.

However, no tax deduction will be allowed in respect of any R&D expenditure, regardless of whether it qualifies as a Type A or Type B expenditure, in the following circumstances:

- (a) where any rights generated from the R&D Activity are not, or will not be, fully vested in the taxpayer;
- (b) where the R&D activity is undertaken by the taxpayer for another person;
- (c) where the expenditure is or will be met directly or indirectly by a government, a public or local authority or a person other than the taxpayer (i.e., subsidized expenditure); or
- (d) where the 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 to which he would not otherwise be entitled.

In addition, in respect of Type A expenditures 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 expenditures will be required for tax deduction purposes.

Involvement of the Commissioner for Innovation and Technology

The Amendment 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 expenditures incurred in relation to such activity qualify for tax deduction. The IRD may disclose any necessary information to the CIT for the purpose of such consultation. The final decision on whether a deduction should be allowed will be made by the IRD.

The Amendment also stipulates that Designated Local Research Institutions will be determined by the CIT. Service providers which provide R&D services in Hong Kong may apply to the CIT for designation.

Deemed taxable trading receipts

The Amendment retains, with modifications, the deeming provisions under the former section 16B which provides that any previous R&D deduction claimed will be clawed back upon the sale of the relevant plant or machinery used for, or the rights generated from, the R&D Activity.

The Amendment 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.

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