

HONG KONG TAX ALERT

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Enhanced tax deduction for R&D activities in Hong Kong

Summary

A Bill that was introduced into the Legislative Council on 2 May 2018 provides for enhanced tax deductions for qualifying R&D activities carried out in Hong Kong.

If enacted, to ensure that companies are in a position to claim the new benefit, it is vital that they have systems and processes in place to correctly identify projects and classify their R&D expenditure. The new R&D tax regime will commence from the year of assessment 2018/19.

On 2 May 2018, the Inland Revenue (Amendment) (No. 3) Bill 2018 ("the Bill"; click [here](#)) was introduced into the Legislative Council. This bill provides enhanced tax deductions for certain expenses incurred in relation to research and development ("R&D") activities.

The Bill contains safeguards to prevent the abuse of tax deductions in respect of R&D activities. It also deems certain sums to be trading receipts and thus chargeable to tax.

Current R&D deductions

Currently, any R&D expenditure incurred by a taxpayer related to its business qualifies for a 100% tax deduction, subject to certain conditions. The R&D expenditure must be incurred in respect of R&D activities undertaken by the taxpayer itself or paid to an approved research institution.

Enhanced R&D tax incentive

The enhanced R&D tax incentive will commence from the year of assessment 2018/19. There are transitional provisions for payments incurred before the date of enactment.

Consistent with international experience with R&D incentives, the Bill contains relatively complex provisions which define the relevant R&D activities. To this end, a new Schedule 45 deals with qualifying R&D activities and introduces two new types of R&D expenditures (Type A and Type B).

New Section 16B and Schedule 45

The new Section 16B of the Inland Revenue Ordinance provides for (i) deduction of expenditures on R&D activities; and (ii) taxability of the proceeds of sale of plant or machinery for, and rights generated from, R&D activities. Schedule 45 provides definitions and operational details for the calculation of the deduction and income from any sale.

The Bill proposes classifying R&D expenditure into two broad categories (Type A and Type B expenditures) which are deductible subject to meeting certain conditions. Type A qualifies for a basic 100% tax deduction. It is Type B expenditure that qualifies for the enhanced two-tiered tax deduction (300% tax deduction for the first HKD2 million and 200% for the remaining amount).

Where Type A expenditure is incurred for an R&D activity performed outside or partly outside Hong Kong, the deduction for the expenditure is subject to apportionment. By contrast, Type B expenditure will qualify for enhanced tax deduction only if the relevant R&D activity is wholly carried out in Hong Kong.

Qualifying R&D activity

The critical element to qualify for Type B expenditure is that the R&D activity is wholly undertaken in Hong Kong and meets one of the following conditions:

- an activity in the fields of natural or applied science to extend knowledge;
- any original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding; or
- the application of any research finding 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.

However, the Bill excludes certain activities from qualifying as Type B expenditure through a series of somewhat vague definitions. Excluded activities include:

- any efficiency survey, feasibility study, management study, market research or sales promotion;
- 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;
- any activity that does not seek to directly contribute to achieving an advance in science or technology by resolving scientific or technological uncertainty; or
- any work to develop the non-scientific or non-technological aspect of a new or substantially improved material device, product, process, system or service.

Qualifying R&D expenditure

In order for expenditure on a qualifying R&D activity to be deductible, it must be incurred in relation to the taxpayer's business and must be:

- paid to a designated local research institution; or
- paid to a designated local research institution which has, as an object, the undertaking of a qualifying R&D activity related to the class of business to which the taxpayer's business belongs, where the payment is used for pursuing that object; or
- an 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.

Again, there are some key exclusions where no R&D deduction is allowed. This includes where the R&D expenditure is undertaken for another person,

any rights generated from the R&D activity are not fully vested in the person, or the costs are met by the government or another person.

Deemed taxable trading receipts

The Bill also includes deeming provisions. Where proceeds are earned from the sale of plant or machinery for, or rights generated from, an R&D activity for which the capital expenditure has been allowed as a deduction, such proceeds will be taxable (but limited to the amount of deduction previously allowed).

Also, certain receipts (such as 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 capital expenditure has been allowed as a deduction) will be treated as taxable income.

Other miscellaneous matters

Where an R&D claim or an advance ruling application is made by a taxpayer, the Commission of Inland Revenue ("CIR") may seek advice from the Commissioner for Innovation & Technology ("CI&T") to ascertain whether: (i) an activity is a qualifying R&D activity; and (ii) a R&D expenditure was incurred in relation to a R&D activity or a qualifying R&D activity.

The CIR may disclose details to the CI&T during the consultation. However, it is the CIR who makes the final decision as to whether the R&D expenditure is deductible.

KPMG observations

This is another welcome tax incentive that will provide Hong Kong with a competitive advantage in promoting R&D activities to be carried out in Hong Kong. Not surprisingly, with a particularly generous R&D deduction, there are onerous and complex conditions that need to be satisfied in order to qualify for an enhanced tax deduction.

In our experience, many companies will find that they are conducting quality R&D activities as part of their product and process improvement activities. To ensure that they are in a position to claim the new benefit, it will be vital that they have the systems and processes in place to correctly identify projects and classify their R&D expenditure.

Furthermore, as the Inland Revenue Department ("IRD") has the ultimate discretion to determine whether the R&D expenditure incurred is deductible, in practice, the IRD's attitude towards allowing R&D claims will be an important factor in enabling taxpayers to access enhanced deductions. In some countries, overzealous tax authorities have effectively gutted these type of regimes. Finding the right balance is crucial to the success of the new regime.

For more information and assistance, please contact your usual tax advisor or one of our tax advisors below.

Contact us:



Lewis Y. Lu
National Head of Tax
Tel: +86 21 2212 3421
lewis.lu@kpmg.com



Curtis Ng
Head of Tax, Hong Kong
Tel: +852 2143 8709
curtis.ng@kpmg.com

Corporate Tax Advisory



Chris Abbiss
National Head of Real Estate Tax
Tel: +852 2826 7226
chris.abbiss@kpmg.com



Matthew Fenwick
Partner
Tel: +852 2143 8761
matthew.fenwick@kpmg.com



Stanley Ho
Partner
Tel: +852 2826 7296
stanley.ho@kpmg.com



Charles Kinsley
Partner
Tel: +852 2826 8070
charles.kinsley@kpmg.com



Alice Leung
Partner
Tel: +852 2143 8711
alice.leung@kpmg.com



Ivor Morris
Partner
Tel: +852 2847 5092
ivor.morris@kpmg.com



John Timpany
Partner
Tel: +852 2143 8790
john.timpany@kpmg.com



Eva Chow
Director
Tel: +852 2685 7454
eva.chow@kpmg.com



Elizabeth de la Cruz
Director
Tel: +852 2826 8071
elizabeth.delacruz@kpmg.com



Natalie To
Director
Tel: +852 2143 8509
natalie.to@kpmg.com



Michael Olesnick
Special Advisor
Tel: +852 2913 2980
michael.olesnick@kpmg.com

Deal Advisory, M&A Tax



Darren Bowdern
Head of Financial Services Tax, Hong Kong
Tel: +852 2826 7166
darren.bowdern@kpmg.com



Yvette Chan
Partner
Tel: +852 2847 5108
yvette.chan@kpmg.com



Sandy Fung
Partner
Tel: +852 2143 8821
sandy.fung@kpmg.com



Benjamin Pong
Partner
Tel: +852 2143 8525
benjamin.pong@kpmg.com



Malcolm Prebble
Partner
Tel: +852 2685 7472
malcolm.j.prebble@kpmg.com

China Tax



Daniel Hui
Partner
Tel: +852 2685 7815
daniel.hui@kpmg.com



Adam Zhong
Partner
Tel: +852 2685 7559
adam.zhong@kpmg.com



Travis Lee
Director
Tel: +852 2143 8524
travis.lee@kpmg.com



Wade Wagatsuma
Head of US Corporate Tax, Hong Kong
Tel: +852 2685 7806
wade.wagatsuma@kpmg.com



Becky Wong
Director
Tel: +852 2978 8271
becky.wong@kpmg.com

US Tax

Global Transfer Pricing Services



Karmen Yeung
Head of Global Transfer Pricing Services, Hong Kong
Tel: +852 2143 8753
karmen.yeung@kpmg.com



Lu Chen
Partner
Tel: +852 2143 8777
lu.l.chen@kpmg.com



John Kondos
Partner
Tel: +852 2685 7457
john.kondos@kpmg.com



Irene Lee
Director
Tel: +852 2685 7372
irene.lee@kpmg.com



Lachlan Wolfers
National Head of Indirect Tax & Tax Technology; Asia Pacific Regional Leader, Indirect Tax
Tel: +852 2685 7791
lachlan.wolfers@kpmg.com



Alexander Zegers
Director, Tax Technology
Tel: +852 2143 8796
zegers.alexander@kpmg.com

Global Mobility Services



Murray Sarelius
National Head of Global Mobility Services
Tel: +852 3927 5671
murray.sarelius@kpmg.com



Barbara Forrest
Partner
Tel: +852 2978 8941
barbara.forrest@kpmg.com



David Siew
Partner
Tel: +852 2143 8785
david.siew@kpmg.com



Kate Lai
Director
Tel: +852 2978 8942
kate.lai@kpmg.com

kpmg.com/cn

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