BFAC Paper 5/18

Thirty-eighth Meeting of
the Business Facilitation Advisory Committee

Agenda Item 3: Enhanced Tax Deduction Measure for Research and Development

Purpose

This paper briefs Members on the enhanced tax deduction regime for Research and Development ("R&D").

Background

2. At present, section 16B(1) of the Inland Revenue Ordinance (Cap. 112) ("IRO") allows 100% deduction for payments to approved research institutes[1] (i.e. out-sourced R&D) and expenditure on R&D (i.e. in-house R&D). On the other hand, many other jurisdictions, such as Mainland China, Singapore, the United Kingdom and the United States ("US"), are providing tax incentives on R&D activities ranging from 117% to 400% deduction to promote domestic R&D. The current rate of R&D tax deduction in Hong Kong is by comparison less than competitive. There have been calls from the business community, in particular the technology sector and industry federations, for the Government to provide a higher rate of tax deduction on R&D expenditure.

3. In her first Policy Address of October 2017, the Chief Executive announced that we would provide additional tax deduction for expenditure incurred by enterprises on R&D. The CE has set a goal to double the Gross Expenditure on Research and Development as a percentage of the Gross Domestic Product to 1.5%, equivalent to about $45 billion, by 2022. We also aim to gradually reverse the ratio of public sector expenditure versus private sector expenditure on R&D from government-led to private-led, which is more sustainable.

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[1] The term "an approved research institute (認可研究機構)" as defined in section 16B(4)(a) of the IRO means any university, college, institute, association or organisation which is approved in writing (for the purposes of section 16B) by the Commissioner of Inland Revenue ("CIR") as an institute, association or organisation for undertaking research and development which is or may prove to be of value to Hong Kong.

<u>The Amendment Ordinance</u>

4. Under the Amendment Ordinance, R&D expenditures eligible for deduction under section 16B of the IRO are now classified into either **"Type A expenditures"** which qualify for 100% deduction or **"Type B expenditures"** which qualify for the enhanced tax deduction. The enhanced tax deduction for Type B expenditures will be a two-tiered deduction regime. The deduction will be 300% for the first $2 million of the aggregate amount of payments made to "designated local research institutions" for "qualifying R&D activities" (i.e. out-sourced qualifying R&D) and "qualifying expenditures" incurred by the enterprises (i.e. in-house qualifying R&D), and 200% for the remaining amount. There is no cap on the amount of enhanced tax deduction.

5. The definition of a "qualifying R&D activity" is primarily built on the definition of "research and development" in the current section 16B(4)(a) of the IRO (save for paragraph (b) of that definition) and is defined as -

(a) an activity in the fields of natural or applied science to extend knowledge;

(b) an original and planned investigation carried on with the prospect of gaining new scientific or technical knowledge and understanding; or

(c) 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.

A qualifying R&D activity should be wholly undertaken and carried on in Hong Kong.

6. The objectives of the enhanced tax deduction are to encourage enterprises to invest more in R&D in Hong Kong, promote local R&D activities and groom local R&D talents. Regardless of whether the expenditures are spent for out-sourced or in-house qualifying R&D, R&D expenditures on **"qualifying R&D activities"** would be eligible for enhanced tax deduction as Type B expenditures. For R&D expenditures on **"R&D activities"** conducted outside Hong Kong, they may still be eligible for the existing 100% tax deduction as Type A expenditures for "R&D activities".

Out-sourced R&D activities

7. Currently, a payment to "an approved research institute" qualifies for 100% deduction if the payment is made for R&D activities related to the person's trade, profession or business, or if the object of the institute is the undertaking of R&D activities related to the class of trade, profession or business to which the person's trade, profession or business belongs. As part of the new scheme, a payment to a "designated local research institution" (which is any university or college located in Hong Kong, or any other institute, association, organisation or corporation located in Hong Kong that undertakes qualifying R&D activities in Hong Kong, designated by the Commissioner for Innovation and Technology ("CIT")), qualifies for the enhanced tax deduction as a Type B expenditure if the payment is made for a qualifying R&D activity related to the person's trade, profession, or business, or if an object of the institution is the undertaking of a qualifying R&D activity related to the class of trade, profession or business to which the person's trade, profession or business belongs and the payment is used for pursuing that object.

8. On the other hand, a payment to an "R&D institution"[2] qualifies for 100% deduction as a Type A expenditure if the payment is made for an R&D activity related to the person's trade, profession, or business, or if an object of the institution is the undertaking of an R&D activity related to the class of trade, profession or business to which the person's trade, profession, or business belongs and the payment is used for pursuing that object and is not a Type B expenditure. R&D service providers which provide R&D services in Hong Kong and are competent to provide such services may apply to Innovation and Technology Commission (ITC) for designation. The detailed conditions and application procedures for designation would be drawn up separately.

In-house R&D activities

9. At present, expenditure incurred on R&D is widely defined in section 16B(5)(a) of the IRO to include all expenditure incurred for the prosecution of or the provision of facilities for the prosecution of R&D, but exclude any expenditure incurred in the acquisition of rights in, or arising out of, R&D. Capital expenditure incurred on the purchase of

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[2] We define R&D institution as (a) a designated local research institution; or (b) a university or college that is not a designated local research institution. In other words, it covers all designated local research institutions as well as universities/colleges that have not been designated by CIT.

plant or machinery for R&D is also fully deductible in the basis period during which it was incurred.

10. According to European Union's and US's empirical studies, the major components of R&D expenditure are labour (60% to 70%), consumables (15%) and contract research expenses (15%). These three components adopted in most jurisdictions provide a useful pointer as to what should be the target expenditure of the two-tiered tax deduction regime.

11. Accordingly, we define "qualifying expenditure related to trade, profession or business" which would be a Type B expenditure as –

(a) an expenditure in relation to an employee who is engaged directly and actively in a qualifying R&D activity related to the trade, profession or business; or

(b) an expenditure on a consumable item that is used directly in a qualifying R&D activity related to the trade, profession or business.

12. No additional deduction will be given for an expenditure incurred on the purchase of plant or machinery used in carrying out qualifying R&D activities. The current 100% upfront deduction for an expenditure incurred on plant or machinery provided under section 16B(1)(b) is generous by international standards, in that many jurisdictions only allow such capital costs to be written off over a number of years by accelerated depreciation allowances.

13. R&D expenditures not falling within the above definition of "qualifying expenditure related to trade, profession or business" (e.g. director's remuneration, fees paid to non-designated local research institutions, fees paid for leasing or maintenance of plant or machinery, consultancy fees paid for expert advice, licence fees paid for the use of intellectual property rights, etc.) may still be eligible for 100% deduction as Type A expenditures.

14. As there were concerns about the processing time required by ITC to designate local institutions as "designated local research institutions", we will allow a taxpayer to claim tax deduction or enhanced tax deduction for a payment made to a local institution if the institution is designated as "designated local research institutions" within six months after the date of payment.

Implementation Timetable

15. The Ordinance was enacted on 24 October 2018 and gazetted on 2 November 2018. The arrangement is applicable to R&D expenditure incurred by enterprises on 1 April this year and thereafter.

Advice Sought

16. Members are invited to note the content of the paper.

Innovation and Technology Commission
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