立法會
Legislative Council

LC Paper No. CB(1)957/17-18(04)

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Bills Committee on Inland Revenue (Amendment) (No. 3) Bill 2018

Background brief

Purpose

This paper provides background information on the Inland Revenue (Amendment) (No. 3) Bill 2018 ("the Bill"). It also summarizes the major views and concerns expressed by members of the Panel on Commerce and Industry ("the Panel") on the proposed legislative amendments.

Background

2. Section 16B of Inland Revenue Ordinance (Cap. 112) ("IRO") was enacted to allow expenditure incurred by a person carrying on a trade or business for scientific research related to that trade or business as a deduction. The deduction allowable includes capital expenditure on plant or machinery purchased by a taxpayer for research and development ("R&D") related to his trade, profession or business but excludes capital expenditure on land or buildings. In 1998, the section was extended to a person in a profession, and the definition of "scientific research" was expanded to include feasibility studies and market research. In 2004, the scope of the deduction was further extended to include expenses incurred on R&D,[1] which may be either in the form of a payment to an approved

[1] Under subsection (4)(a), section 16B of the Inland Revenue Ordinance (Cap. 112) ("IRO"), research and development ("R&D") means:

(a) any activities in the fields of natural or applied science for the extension of knowledge;
(b) any systematic, investigative or experimental activities carried on for the purposes of any feasibility study or in relation to any market, business or management research;
(c) any original and planned investigations undertaken with the prospect of gaining new scientific or technical knowledge and understanding; or
(d) the application of any research findings or other knowledge to a plan or design for the production or introduction of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of their commercial production or use.

research institute[2] or expenditure on in-house R&D undertaken by a person.

3. Under the prevailing tax regime, R&D expenditure incurred by enterprises can enjoy a 100% tax deduction. Having regard to relevant tax deductions in other countries, such as Singapore and the United States which are providing tax incentives on R&D ranging from 117% to 400% deduction,[3] the Administration considers that the existing practice in Hong Kong does not provide sufficient incentive for enterprises to carry out R&D activities.

4. The Chief Executive announced in her Policy Address delivered in October 2017 a goal to double the Gross Domestic Expenditure on R&D as a percentage of the Gross Domestic Product to about $45 billion a year (i.e. from 0.73% to 1.5%) by the end of the current Government's five-year term of office. The Administration would also step up its efforts to develop innovation and technology ("I&T") in eight major areas,[4] including increasing resources for R&D by providing additional tax deduction for expenditure incurred by enterprises on R&D.

Inland Revenue (Amendment) (No. 3) Bill 2018

5. The Bill was published in the Gazette on 20 April 2018 and received its First Reading at the Council meeting of 2 May 2018. The Bill seeks to amend IRO to implement an enhanced tax deduction regime for qualifying R&D and is divided into three parts. Part 2 of the Bill sets out the operational details of the basic tax deduction and enhanced tax deduction regimes;[5] as well as the

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[2] Under subsection (4)(a), section 16B of IRO, "an approved research institute" means any university, college, institute, association or organization which is approved in writing (for the purposes of section 16B) by the Commissioner of Inland Revenue ("CIR") as an institute, association or organization for undertaking R&D which is or may prove to be of value to Hong Kong.

[3] See Annex B to the Legislative Council Brief on the Bill (File Ref: ITC CR 5/1/2168/18).

[4] The Administration will step up its efforts to develop innovation and technology in the eight major areas below:

(a) increasing resources for R&D;
(b) pooling together technology talent;
(c) providing investment funding;
(d) providing technological research infrastructure;
(e) reviewing existing legislations and regulations;
(f) opening up government data;
(g) Government to lead changes to procurement arrangements; and
(h) strengthening popular science education.

[5] Including the definitions, scopes and rates of the basic tax deduction and the enhanced tax deduction, and provisions regarding proceeds from the sale of plant or machinery and rights generated from R&D activities.

safeguards and miscellaneous provisions.[6] Part 3 of the Bill provides an update on the changes in the respective roles of Commissioner for Innovation and Technology ("CIT") and Commissioner of Inland Revenue in the Specification of Public Offices Notice (Cap. 1 sub. leg. C) as a result of empowering CIT to designate certain entities as "designated local research institutions".

6. Details of the proposed enhanced tax deduction regime are set out in paragraphs 7 to 24 of the Legislative Council Brief on the Bill (File Ref.: ITC CR 5/1/2168/18).

Major views and concerns expressed by members of the Panel

7. The Panel was consulted on the proposed legislative amendments on 16 January 2018. The deliberations and concerns of members are summarized in the ensuing paragraphs.

<u>Discussion</u>

Definition of qualifying research and development activity and expenditure

8. Members noted that under the Administration's proposal, "qualifying expenditure" which would be eligible for 300% tax deduction referred to the expenditure attributable to the "qualifying R&D" incurred on direct staff costs and consumables employed directly in the "qualifying R&D" concerned, whereas the R&D expenditure such as testing expenses, fees paid for leasing or maintenance of plant or machinery, and fees paid for expert advice, etc. incurred would fall outside of the proposed definition of "qualifying expenditure". On the other hand, the relevant R&D activities outsourced to "designated local research institutions" (i.e. outsourced qualifying R&D) would also be eligible for 300% tax deduction. Some members expressed concern that such outsourcing requirement would discourage local enterprises from undertaking R&D activities on their own to build up the scale of their business, and it would be difficult to ensure that the outsourced R&D activities would not contain any non-qualifying elements.

9. Some other members pointed out that in the financial services sector, the regulatory authorities would generally require that testing be carried out and third party expert advice be sought before any new financial technology products were introduced. As such, they opined that testing expenses and fees paid for expert advice were vital and should not be excluded from the proposed definition of "qualifying expenditure". If the expenses on such activities were to be excluded, it would be difficult to encourage private R&D investment and achieve the policy

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6 Including empowering CIR to seek advice from Commissioner for Innovation and Technology ("CIT") for R&D and qualifying R&D claims and advance rulings applications; and empowering CIT to designate certain entities as "designated local research institution" for tax deduction purposes.

objective of doubling the Gross Domestic Expenditure on R&D as a percentage of the Gross Domestic Product to 1.5% by 2022.

10. The Administration advised that it would carefully examine applications for enhanced tax deduction and screen out any non-qualifying R&D, and would work out the operational details with the Inland Revenue Department ("IRD") in due course. The Administration also explained that testing was excluded as it could be carried out with existing testing systems, and might not have direct relevance to R&D which should involve the development of new technologies, materials or knowledge.

11. Some members enquired whether the expenses incurred in upgrading an enterprise's information technology ("IT") system or developing a new IT system both for the enterprise's own use and for sale to other enterprises would be eligible for the enhanced tax deduction. If so, whether the development cost should be deducted from the profit generated therein before calculating the tax deduction amount. The Administration advised that qualification for the enhanced tax deduction did not hinge on whether profits were made. Whilst the expenses incurred in the procurement of a new IT system or upgrading of an existing IT system were not "qualifying expenditure", the expenses incurred in developing new systems might be considered as "qualifying R&D". The expenses on non-qualifying R&D might still be eligible for 100% tax deduction as R&D capital expenditure under the existing IRO.

12. Noting that R&D investments were a risky venture, but would stand a better chance to succeed if accompanied by marketing promotion, some members suggested that the expenses incurred in marketing promotion should be considered as "qualifying expenditure" for enhanced tax deduction. The Administration advised that the policy intention was to assist enterprises in the commercialization of their R&D deliverables. As marketing promotion might not be limited to a single R&D deliverable, but could cover a range of products and even a brand name, the expenses in marketing promotion should not qualify for enhanced tax deduction.

Definition of designated local research institutions

13. Noting that for outsourced R&D activities to be eligible for the enhanced tax deduction, the R&D activities should be outsourced to "designated local research institutions", some members queried that the proposal might only benefit the existing R&D institutions already subsidized by the Innovation and Technology Fund, which might undertake R&D projects of lower innovative value only for the sake of being eligible for the enhanced tax deduction. They were concerned that some small and medium enterprises might invest in projects which they believed to be "qualifying R&D" but were eventually ruled out by IRD.

14. The Administration advised that one of the objectives of enhanced tax deduction was to encourage cooperation among government, industry, academia and the research sector, so as to contribute to I&T upgrading in local industries. Private enterprises meeting specified requirements (e.g. with R&Ds talents in the relevant technological fields employed, with relevant R&D equipment installed in premises, with proof of possession of relevant R&D experience and businesses) may apply to become "designated local research institutions". With reference to overseas experience, the Administration would work out detailed application procedures after the relevant legislative proposal was passed.

Motion passed by the Panel

15. The Panel passed a motion urging the Government to implement measures to improve the proposal on the enhanced tax deduction for R&D expenditure, including simplifying the application procedures and further clarifying the requirements of "designated local research institutions" for "qualifying R&D" and extending the coverage to private enterprises with R&D abilities, so as to encourage more enterprises to conduct R&D activities. In response to the above motion, the Administration advised that IRD would issue a Departmental Interpretation and Practice Note to assist the industry in understanding the relevant practices and documentation requirements. Enterprises might enjoy the enhanced tax deduction for R&D expenditure simply by submitting claims to IRD in their annual tax returns as usual.

Follow-up to the meeting

16. In response to the Panel's request for a comparison of the proposal for an enhanced tax deduction for R&D expenses with similar tax deduction arrangements in other countries such as Singapore (i.e. the Productivity and Innovation Credit Scheme ("PIC Scheme")) and Israel, the Administration advised that although Israel provided preferential tax regimes for high technology companies operating in specified locations, it did not provide enhanced deductions for R&D expenditures. In comparison with Singapore, the Administration advised that in respect of local R&D activities, the proposed rate for enhanced tax deduction was different, but more or less comparable, with that under the current PIC Scheme of Singapore or its new proposal to be effective in the year of assessment 2019.[7] However, as there was no cap on the qualifying R&D expenditures, the Administration's proposal was competitive in this regard. In respect of overseas R&D activities, the deduction rate under the current PIC Scheme of Singapore was more generous as compared to the Administration's proposal. However, such deduction rate in Singapore would be lowered to the same level of 100% as Administration's proposal starting from year of assessment

[7] As proposed in the Singapore 2018 Budget Speech, with effect from the year of assessment 2019 to the year of assessment 2025, the deduction rate for R&D activities carried out in Singapore would be increased from 150% to 250%. The deduction rate for overseas R&D activities would be 100%.

2019. Details of the Administration's response to the Panel's request are set out in LC Paper No. CB(1)954/17-18(01).

17. The Administration was also requested to clarify the following issues when the relevant legislative proposal was submitted to the Council for consideration: (a) whether the policy intent of the proposal was to encourage enterprises to outsource or undertake their own R&D activities; and (b) details of the provisions to be introduced to prevent artificially inflated claims to safeguard the public coffer and tie in with international tax rules.

Latest development

18. At the House Committee meeting held on 4 May 2018, Members agreed to form a Bills Committee to study the Bill.

Relevant papers

19. A list of relevant papers is in **Appendix**.

Council Business Division 1
Legislative Council Secretariat
17 May 2018

Appendix

List of relevant papers

Date of meeting	Meeting	Paper
16/1/2018	Panel on Commerce and Industry	Administration's paper on "Enhanced tax deduction for research and development expenditure" (LC Paper No. CB(1)449/17-18(05)) Background brief on the proposal for an enhanced tax deduction for research and development expenses prepared by the Legislative Council Secretariat (LC Paper No. CB(1)449/17-18(06)) Administration's follow-up papers on "Enhanced tax deduction for research and development expenses" (LC Paper No. CB(1)903/17-18(01)) (LC Paper No. CB(1)954/17-18(01)) Minutes of meeting (LC Paper No. CB(1)685/17-18)
18/4/2018 (issue date)	Legislative Council Brief	Legislative Council Brief on "Inland Revenue (Amendment) (No. 3) Bill 2018" issued by Innovation and Technology Bureau, Financial Services and the Treasury Bureau and Innovation and Technology Commission (File Ref.: ITC CR 5/1/2168/18)
4/5/2018	House Committee	Legal Service Division Report on Inland Revenue (Amendment) (No. 3) Bill 2018 (LC Paper No. LS55/17-18)