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Hon Kenneth Leung
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Bills Committee on Inland Revenue (Amendment) (No. 3) Bill 2018
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Submission on the Inland Revenue (Amendment) (No. 3) Bill 2018 (the Bill)

Dear Hon Kenneth Leung,

We are writing to submit our comments on the Bill, which seeks to implement an enhanced tax deduction regime for qualifying research and development (R&D) expenditure.

We welcome the HKSAR Government's proposal of offering an enhanced tax deduction for qualifying R&D expenditure (i.e. 300% deduction for the first HK$2 million and 200% for the remaining amount) in Hong Kong to encourage more Hong Kong enterprises to engage in R&D activities. Though the policy move is in the right direction, it seems that not many businesses may be able to benefit from the proposed regime as there are inherited limitations in the existing deduction rules for R&D expenditures based upon which the proposed enhanced R&D tax deduction regime is built. We are of the view that a number of issues concerning the existing R&D tax deduction regime need to be addressed before Hong Kong businesses can truly take advantage of the tax incentives of the overall (i.e. both existing and enhanced) R&D tax deduction regime when investing in innovation and technology (I&T) in Hong Kong.

The issues are elaborated below and we also provide our suggestions on the Bill for the Bills Committee's consideration.

1. Expanding the scope of deduction for outsourced R&D activities

The Bill proposes that payments made by a Hong Kong company for outsourced R&D activities will be eligible for an enhanced tax deduction only if *the payments are made to a designated local research institution* and the *R&D activities* are *performed in Hong Kong*.

Currently, the list of approved research institutes for purposes of the existing section 16B is relatively short with only five institutes. While it is understood that the Commissioner for Innovation and Technology intends to expand the current list to a wider list of designated local research institutions which may also include private institutions, the eligibility criteria, application and approval procedures and time required are still unknown. It may take some time before the list reaches a level that can enable more taxpayers to obtain the benefit.

Meanwhile, it is common business practice for companies to either (1) set up a designed company within the corporate group to perform the R&D work that benefits the whole group for various commercial reasons (e.g. pooling of R&D resources and risk management) or (2) outsource the R&D activities to an unrelated third party that possesses the expertise in the particular area concerned due to lack of resources or expertise within the group. In addition, due to insufficient R&D talents in Hong Kong at the moment, it may not be feasible for Hong Kong companies to perform all their R&D in Hong Kong and they may need to outsource part or all of the R&D activities to a related or unrelated party outside Hong Kong.

The potential non-deductibility of the R&D payments (if paid to entities other than R&D institutions or designated local research institutions) is inconsistent with the usual business practice. This will inevitably increase the effective tax rate and cause significant barrier to these Hong Kong companies to locate their R&D centres in Hong Kong through which the R&D activities will be conducted. In most case, if the R&D are conducted in Hong Kong, the resulting IP will be owned in Hong Kong. Excluding the R&D payments from both the enhanced tax deduction and normal tax deduction regimes apparently is not in alignment with the HKSAR Government's policy initiative of developing Hong Kong into a regional R&D centre and I&T hub.

For this reason, we propose that the requirement for the R&D activities to be outsourced to a designated local research institution (for enhanced deduction) or a R&D institution (for normal deduction) be relaxed. In particular, we propose that outsourced R&D payments made to any company conducting qualifying R&D activities or R&D activities be entitled to (1) the enhanced R&D tax deduction (300%/200%) if the relevant qualifying R&D activities are carried out in Hong Kong and (2) the existing R&D tax deduction (100%) if the R&D activities are carried out in Hong Kong, or if the qualifying R&D activities or R&D activities are carried out outside Hong Kong.

We believe that the proposed provisions that restrict the R&D activities / qualifying R&D activities eligible for the normal or enhanced tax deduction contained in the Bill should be sufficient to prevent any possible abuse of the proposed incentives, and thus it is not necessary to limit the tax deduction to R&D activities outsourced to an R&D institution or designated local research institution. Furthermore, with the impending enactment of the Inland Revenue (Amendment) (No. 6) Bill 2017, any excessive R&D payments to related parties can be denied pursuant to the transfer pricing rules contained in the proposed section 50AAF.

The economic integration of the Greater Bay Area (GBA) is an opportunity for Hong Kong companies to set up their R&D centers in the GBA. To encourage such economic integration, we propose that R&D payments made to companies conducting qualifying R&D activities in the GBA be entitled to an enhanced R&D tax deduction of 150%.

In summary our proposed tax deduction for outsourced R&D activities are as below:

Payments to any related or unrelated party for	Location of activities	Tax deduction allowed
1. Qualifying R&D activities	Hong Kong	A 300%/200% enhanced tax deduction
2. Qualifying R&D activities	GBA	A 150% enhanced tax deduction
3. R&D activities	Hong Kong	A 100% normal tax deduction
4. Qualifying R&D activities or R&D activities	Outside Hong Kong (except for qualifying R&D activities conducted in GBA)	A 100% normal tax deduction

We would also like to point out that under the current super R&D tax deduction regime in the Mainland China, 80% of the payments made for R&D outsourced to an organisation in the Mainland China is eligible for super deduction without the need for the service provider to be a designated or an approved organisation. In addition, the State Council of the PRC has announced in March 2018 that the scope of super tax deduction for R&D expenditure will be further expanded to cover R&D activities outsourced to overseas organisations.

2. Allowing deduction for payments made under a cost sharing arrangement

Corporate groups often enter into cost sharing arrangements (CSA) on R&D, where different group companies participate and contribute to the R&D projects for the benefit of the group.

Under a CSA, cost sharing payments made by a Hong Kong company to the other group companies participating in the CSA are unlikely to be deductible under both the existing regime as well as the enhanced regime because the other group companies under the CSA are unlikely to be R&D institutions or designated local research institutions. Unable to get tax deduction in Hong Kong will discourage a Hong Kong company from entering into a joint R&D project with the other group companies and co-owning the resulting IP with the other group companies. In this regard, we would like to point out that super tax deduction is currently granted in the Mainland China for cost sharing payments made by an enterprise participating in a group CSA.

Similar to the rationale discussed in point 1 above regarding payments made for outsourced R&D activities, we are of the view that payments made by a Hong Kong company to another group company in Hong Kong or in the GBA under a CSA should be eligible for enhanced deduction whereas payments made by a Hong Kong company to an overseas group company under a CSA should be eligible for normal deduction.

The Bill also requires that any rights generated from the relevant R&D activities be fully vested in the person claiming a tax deduction for the R&D expenditure incurred. Normally rights created under a CSA are jointly owned by the participants. In this regard, we propose that the Bill clarifies that the relevant rights generated from the R&D activities under a CSA by a Hong Kong company together with the other group companies participating in the CSA be regarded as "fully vested" in the Hong Kong company.

3. Expanding the scope of in-house R&D expenditure eligible for enhanced deduction

The Bill proposes that for in-house R&D activities performed by a Hong Kong company, only the direct costs (e.g. salaries, MPF contributions) incurred by the company for employees engaged directly and actively in the R&D activities and consumables used directly in the R&D can qualify for the enhanced deduction. Other R&D related expenditures will not be eligible for the enhanced deduction.

We urge the HKSAR Government to consider expanding the scope of in-house R&D expenditure eligible for the enhanced deduction to cover other R&D related expenditures, such as overhead costs, costs of engaging independent contractors to participate in the R&D and capital expenditure on plant and machinery (P&M).

In the I&T world, it is common for individuals to work as independent contractors rather than employees for various reasons. Some contractors are engaged to work on a specific project only. Besides, there is also a trend towards a "gig economy", where Millennials prefer working as independent contractors to enjoy the flexibility rather than as full-time employees of a particular company. Excluding their costs from expenditures qualifying for the enhanced deduction would be ignoring commercial reality.

P&M is integral to many R&D activities conducted by Hong Kong companies in various industries. For example, in the biotechnology and biomedical sectors, R&D activities involve significant usage of specialised equipment for scientific research and investigations. In the manufacturing sector, R&D projects require the use of industrial devices and mechanical equipment for producing new materials and products. In the financial services and information technology (IT) sectors, significant expenditure is spent on IT and computer-related equipment in Fintech, Insurtech and IT projects. It is obvious and common that capital expenditure on P&M is also a major component of R&D expenditure. Excluding capital expenditure on P&M from the scope of in-house expenditure for enhanced deduction will make it difficult to achieve the policy objective of increasing private R&D expenditure.

In this regard, we note that other R&D related expenditures, such as capital expenditures on P&M and intangibles, are also eligible for super tax deduction in the Mainland China. Although no enhanced tax deduction is allowed for capital expenditure on P&M used in R&D in some other jurisdictions (such as Singapore and the UK), we believe that granting such enhanced deduction in Hong Kong can help increase the competitiveness of the regime in Hong Kong and thus, attract more companies to relocate their R&D activities to Hong Kong.

We consider that as long as the P&M have been acquired and used for qualifying R&D activities as a primary purpose, the capital expenditure should be eligible for the enhanced deduction. Therefore, the potential concern that the P&M may not be solely used for R&D and are subsequently used for other purposes such as production is not a relevant reason to limit the scope of enhanced deduction.

4. Clarification on the definition and scope of R&D activities qualifying for enhanced deduction

The definition and scope of R&D activities qualifying for the enhanced deduction as currently proposed in the Bill mainly covers R&D activities in the fields of *natural or applied science*, investigations undertaken for gaining *new scientific or technical knowledge* and application of research findings for producing *new or substantially improved materials, devices, products, processes, systems or services* before they are commercially produced or used.

a) Meaning of "new scientific or technical knowledge" and "new or substantially improved materials, devices, products, processes, systems or services"

We are of the view that in applying the above definition to assess whether the R&D activities conducted by an enterprise qualify for the normal or enhanced deduction, the word "new" should be interpreted more liberally to cover any knowledge, materials, devices, products, processes, systems or services that are not available in the public domain. For example, a technology may have already been privately developed by Company A but Company B is not able to access such technology in the public domain and therefore has to conduct its own R&D activities to develop such technology. Or both Company A and Company B are developing a similar technology on their own separately, but it just happens that Company A succeeds in achieving a positive result earlier than Company B. In the above situations, both Company A and Company B should be entitled to the normal or enhanced deduction for the R&D expenditure incurred by them to develop the said technology, provided that the other specified conditions for obtaining the deduction are met.

b) Ensuring the scope of qualifying R&D activities can cover the common R&D activities that are or will likely be conducted in different industries

We urge the HKSAR Government to thoroughly consult the various industries (e.g. the financial services, information technology, textile and garment, and other manufacturing industries) to ensure that the proposed scope of qualifying R&D activities can cover the common R&D activities that are or will likely be conducted in these different industries. We set out below some examples of specific concerns of manufacturing, financial services and IT sectors in respect of the scope of qualifying R&D activities:

Manufacturing

The meaning of R&D activity in the proposed legislation covers, *inter alia*, 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. However, in reality, it is not possible to wait for the "perfect" version before a product is launched. A new product may contain deficiencies, and continual R&D is needed on an ongoing basis for improvement. The improvements may not be substantial from one stage to the next, but on a cumulative basis they can be significant. It is therefore necessary to broaden the definition of R&D activities in Schedule 45 to cover R&D activities for improving existing products.

Financial Services

There may be a misconception that financial services companies are not involved in R&D, when in fact it is almost a must for them to engage heavily in R&D in order to facilitate their operations in this fast-changing world. Fintech and Insurtech projects involve further development, modification, upgrade and/or integration of third party systems / technology. Such technology may include facial recognition for online banking, electronic bond trading, robotic investment planner, new trading algorithm to reduce latency, new reporting systems for compliance and financial reporting, new systems to detect cybersecurity risk, automation and online sales and support for insurance products and claims, artificial intelligence initiative that will allow insurance companies to settle hospital claims on the same day, and application of blockchain technology, etc. It is necessary to ensure that the proposed scope of R&D activities can cover the above common R&D activities.

IT

The scope of R&D activities focuses a lot on sciences, and it is unclear whether IT-related activities, such as development of software / apps, building of blockchain protocols, writing of algorithms for e-Commerce platforms, design of robotics controls systems, development of virtual reality / augmented reality hardware, etc. are covered or not. Since IT development plays a critical role in innovation and technological advancement, clarification as to whether it is covered by the scope of qualifying R&D activities is important.

5. Option to convert the R&D tax deduction into refundable tax credit

Finally, many start-ups and SMEs engaging in R&D activities may not generate profits for a considerable number of years from the beginning of their business operations. Although the HKSAR Government has already established a number of different funding schemes to help start-ups and SMEs in carrying out R&D activities, many taxpayers are not benefitting from the Government's funding due to limitations of these schemes, administrative burden and trade secrecy concerns. Therefore, the HKSAR Government is recommended to consider providing an option for these companies to convert a portion of their deductible R&D expenditures into refundable tax credits as a financial support for them to continue investing in R&D.

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We would be pleased to provide further comments if necessary. If you have any questions on our submission, please feel free to contact me (charles.lee@cn.pwc.com) or Gwenda Ho (gwenda.kw.ho@hk.pwc.com).

Yours sincerely,
For and on behalf of PricewaterhouseCoopers Limited

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