創新科技署
Innovation and Technology Commission

香港特別行政區政府
The Government of the Hong Kong Special Administrative Region

Our Ref. : ITC CR 6/1/2168/18

(By Fax 2869 6794)
21 Jun 2018

Mr Derek LO
Clerk to Bills Committee
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Mr LO,

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

I refer to your email dated 14 June 2018 on the follow-up items arising from the meeting on 12 June 2018. Our responses are as follows:

(a) elaboration on the provisions in the Inland Revenue Ordinance and/or the Inland Revenue (Amendment) (No.3) Bill 2018 ("the Bill")which serve to prevent abuses or tax evasion which may arise under the enhanced tax deduction regime for research and development ("R&D") expenditures proposed by the Bill

The provisions which serve to prevent tax abuses arising from the enhanced tax deduction regime under the Inland Revenue Ordinance ("the IRO") and the Inland Revenue (Amendment) (No. 3) Bill 2018 are as follows:

(1) Section 14(c) of Schedule 45 in the Bill provides that no deduction is to be allowed under section 16B for an R&D expenditure incurred by a person if the expenditure is incurred under an arrangement the main purpose, or one of the main purposes, of which is to enable the person to obtain—

(i) a deduction to which the person would not otherwise be entitled under section 16B; or

(ii) a deduction of a greater amount than the amount to which the person would otherwise be entitled under section 16B.

This specific provision is to forestall artificially inflated claims or other tax avoidance arrangements involving tax deductions under section 16B. For example, a taxpayer has artificially inflated the fee paid to a designated local research institution for undertaking an R&D activity whereas the excess fee can be returned to the taxpayer by other means. In such circumstances, no deduction under section 16B would be allowed in respect of the inflated fee.

(2) Section 61 of the IRO specifies that where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly. This is a general anti-avoidance provision which serves to nullify artificial or fictitious transactions that avoid tax.

(3) Section 61A of the IRO stipulates that where a transaction has, or would have had but for this section, the effect of conferring a tax benefit on a person (referred to as "the relevant person"), and, having regard to the seven matters listed in the section, it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit, an Assistant Commissioner of Inland Revenue ("the Assistant Commissioner") shall assess the liability to tax of the relevant person as if the transaction or any part thereof had not been entered into or carried out or in such other manner as the Assistant Commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained. This general anti-avoidance provision empowers the Assistant Commissioner to disregard or restructure any tax avoidance transaction with the sole or dominant purpose of conferring a tax benefit on a taxpayer.

(b) response to views on the Bill expressed by deputations attending the meeting and in their written submissions

The Administration's response to the views of the deputations is set out at **Annex**.

(c) in due course after the passage of the Bill, the draft Departmental Interpretation and Practice Note regarding the eligibility of claims for tax deductions under the enhanced tax deduction regime or draft guidelines, if any, for that purpose for Legislative Council's information/consideration

The Inland Revenue Department is now drafting a Departmental Interpretation and Practice Note ("DIPN") which would elaborate its interpretation and practices regarding the deduction claims under proposed section 16B. After the passage of the Bill, the DIPN will be submitted to the Legislative Council for information in due course.

Yours sincerely,

(Miss Joyce CHAN)
for Commissioner for Innovation and Technology

c.c. Hon Kenneth LEUNG (Chairman)
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Annex

The Administration's responses to the views of deputations

Organisation	The Deputations' Views	The Administration's Reponses
Association of Chartered Certified Accountants Hong Kong ("ACCA") Capital Markets Tax Committee of Asia ("CMTC") Federation of Hong Kong Industries ("FHKI") The Tax Institute of Hong Kong ("TIHK")	**<u>R&D activities carried out outside Hong Kong</u>** The enhanced tax deduction should also be provided to the qualifying research and development (R&D) activities carried out outside Hong Kong, e.g 150% for those qualifying R&D activities carried out in Greater Bay Area (GBA).	The key policy objective of the Bill is to encourage more local R&D activities. Granting enhanced deduction to R&D activities outside Hong Kong would run contrary to this objective. It would be difficult for Inland Revenue Department ("IRD") to verify the overseas R&D expenditure in the absence of cross-border tax audits.
FHKI Plover Bay Technologies Limited ("PloverBay") PricewaterhouseCoopers ("PwC")	**<u>Scope and definition of R&D activities</u>** The scope and definition of R&D activities and expenditure is unclear. The Administration should adopt a broad or liberal interpretation to the definition of qualifying R&D activity, particularly with regard to what constitutes an "advance in technology' or a "new scientific or technical knowledge".	In determining whether an R&D activity is a qualifying R&D activity, IRD will have to consider all the relevant facts, including the state of knowledge and technology at the commencement of the project, the scientific or technological uncertainties involved, etc. If an R&D project seeks to directly contribute to achieving an advance in

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	IRD should provide more clarification in cases whether they could eligible for enhanced tax deduction. For example: - commercialization and application of technologies by the financial services sector - system development by enterprises - new features to an existing proprietary product	science or technology by resolving scientific or technological uncertainty, it would be regarded as a qualifying R&D activity. An advance in science or technology means an advance in overall knowledge or capability in a field of science or technology (not a company's own state of knowledge or capability alone). A material, device, product, process, system or service does not become an advance in science or technology simply because science or technology is used in its creation. After enactment of the amendment bill, IRD will issue a Departmental Interpretation and Practice Note ("DIPN") at a suitable juncture to elaborate its interpretation and practices regarding the R&D enhanced deduction regime. Examples of R&D activities in the field of software engineering will also be covered in the DIPN.

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ACCA, CMTC, FHKI, PloverBay, PwC	**<u>Types of expenditure eligible for enhanced tax deduction</u>** The Administration is urged to consider expanding the scope of in-house R&D expenditure eligible for enhanced tax deduction to cover (i) capital expenditure on plant and machinery (e.g. computers, servers etc.), (ii) cost of acquiring, designing and related legal and application fees on intellectual properties, (iii) fees paid to independent contractors/ consultants, (iv) R&D/ employee related overhead costs or expenses, especially when it is infeasible for some companies to out-source R&D owing to concerns over protection of trade secrets and know-how, and (v) dual role for a person who is a director as well as employee directly contributed to the R&D activities.	The current 100% upfront deduction for expenditure incurred on plant or machinery is already generous by international standards. Enhanced deduction in respect of R&D staff costs would normally cover situations where there is an employer-employee relationship, including an employee under a secondment. In the absence of tax abuses and subject to transfer pricing rules, apportionment can be allowed to address situations where a person occupies a dual role in being both a director and an employee directly and actively engaged in qualifying R&D activities. If R&D staff are seconded to help a fellow group company carry out qualifying R&D activities, their remuneration may be treated as the latter's in-house R&D expenditure and qualify for 100% deduction or enhanced deduction. IRD will elaborate this in the

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		DIPN.
PwC, TIHK	**Option to convert the amount of R&D tax deduction into refundable tax credit or cash allowance** The Administration should provide taxpayers who are in a tax loss position an option to convert the amount of normal or enhanced tax deduction into cash allowance or refundable tax credit, up to a cap of HK$100,000 (or 50% of the amount of tax savings, whichever is lower) in each year of assessment.	Any deduction not absorbed by assessable profits can be carried forward as losses to set off assessable profits in future years. ITC administers a number of funding schemes to assist and support start-ups and SMEs in undertaking R&D activities.
CMTC, PwC	**Applicability of the definition of R&D activity to particular business/industry sectors** The definition fails to address many of the specific concerns of the (i) textile/garment and other manufacturing industries, (ii) financial services, and (iii) information technology sectors.	The definitions for "R&D activity" and "qualifying R&D activity" are applicable to all trades and sectors and are based on international R&D definitions. They do not focus on any particular industries. Paragraphs (c) and (d) of the definition of "R&D activity" are based on local accounting standards.
ACCA, FHKI, PwC, Liberal Party Youth Committee	**Outsourcing to "Designation Local Research Institute"** Regardless of whether the R&D activities are undertaken by a DLRI or a non-DLRI, enhanced tax deduction should be given	DLRIs will cover local private service providers. To designate a local research institute is to ascertain that it has the capability, capacity and experience and

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	so long as the qualifying R&D activity is carried out in Hong Kong. R&D activity or qualifying R&D activity carried out overseas should be eligible for 100% deduction. The Administration should take a liberal approach in assessing DLRI applications.	is competent to undertake R&D activities in the relevant technology areas. To protect the public coffer, it is necessary to ensure that payments are made to competent DLRIs. An expert panel comprising members from relevant industries, professions and the academia will be set up to advise on the assessment of DLRIs.
FHKI, PloverBay, Democratic Alliance for the Betterment and Progress of Hong Kong	**<u>Procedures on claiming the enhanced tax deduction</u>** The procedures for claiming enhanced tax deduction and the documentation requirements should be as streamlined and simple as possible without tedious or burdensome audit or reporting requirements to be fulfilled.	Practical guidance and documentation requirements will be included in the DIPN to be issued by IRD.
ACCA, PwC, TIHK	**<u>Cost Sharing Arrangement (CSA)</u>** The Administration should clarify whether payments made for R&D activities outsourced to other entities, including a private company within a business group under a group CSA, will be deductible if the private company concerned is not a DLRI. Clarification is needed on whether "rights" generated from the	If the claimant has undertaken part or all of the underlying R&D activities under a CSA, the share of R&D expenditure borne by the claimant under the CSA may be treated as its in-house R&D expenditure and qualify for 100% deduction or 300%/200% enhanced deduction. IRD will provide further explanations in the DIPN.

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	R&D activities under a CSA is to be regarded as "fully vested" in the Hong Kong company which makes CSA payments.	Co-ownership of intellectual property ("IP") rights is covered by the proposed section 1(2) of Schedule 45 which defines "rights" as including a share or an interest in rights.
ACCA, PwC	**Provisions on preventing the tax abuse** The general anti-avoidance provisions are sufficient. New provisions (i.e. "one of the main purposes" test) may not be required. Section 50AAF of the impending enactment of Inland Revenue (Amendment) (No. 6) Bill 2017 and the restrictive definition of "qualifying R&D activity" are sufficient to prevent abuse of the proposed incentives. The DLRI mechanism can be relaxed.	The adoption of a "main purpose test" reflects the current international practice of using the test as one of the anti-avoidance measures. In practice, all relevant facts of the case have to be considered before reaching a conclusion under the test. In effect, the "main purpose test" is no more stringent than the "sole or dominant purpose test". The anti-abuse provision is to prevent artificially inflated claims, and not for defining "qualifying R&D activity".
PwC TIHK	**Deeming provision on royalties received** Section 15(1)(bb) of the amendment bill should be removed as it seems to contradict the territorial source principle of taxation	According to the new international tax rules, income should be taxed at the place where the value is created and returns from intangibles should accrue to

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	and is not necessary.	the entities that carry out the development, enhancement, maintenance, protection, and exploitation (DEMPE) functions. So if an IP or know-how is created or developed through an R&D activity of a taxpayer carrying on a trade or business in Hong Kong, the royalties derived from licensing such IP or know-how should be regarded as Hong Kong sourced income and hence should be subject to Hong Kong profits tax. The proposed section 15(1)(bb) clearly conforms to the territorial source principle and the new international tax rules on intangible assets.
CMTC	**Attractiveness of the enhanced tax deduction regime** The proposed enhanced tax deduction regime should be simple, easy to apply, business friendly and competitive. The Administration should provide a more attractive tax deduction regime rather than simply benchmarking to those of other tax jurisdictions.	The proposed regime has balanced the interest of taxpayers and the need to protect tax revenue. Overall, the regime is simple and not difficult to apply. The definition of "qualifying R&D activity" is based on the international definition of R&D. Adopting

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		too broad a definition of "qualifying R&D" will be out of line with the international practice and to run contrary our attempt to encourage R&D in Hong Kong.
CMTC	**Registration of patents as a prerequisite of deduction** IRD should clarify in the DIPN that registering a patent is not a prerequisite for benefitting from the enhanced tax deduction regime.	Registration of patents is not a legal requirement for claiming tax deduction under the new section 16B. IRD will clarify this point in the DIPN.