



## **II. REPORT**

The date of First Reading of the Bill is 2 May 2018. Members may refer to the Legislative Council ("LegCo") Brief (File Ref.: ITC CR 5/1/2168/18) issued jointly by the Innovation and Technology Bureau, the Financial Services and the Treasury Bureau, and the Innovation and Technology Commissioner on 18 April 2018 for further details.

### **Object of the Bill**

2. The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) to:
- (a) provide for enhanced tax deductions for certain expenditures incurred in relation to research and development ("R&D") activities;
  - (b) introduce further safeguards to prevent the abuse of tax deductions in respect of R&D activities;
  - (c) deem certain sums to be trading receipts chargeable to tax; and
  - (d) provide for related matters and minor textual amendments.

### **Background**

3. At present, section 16B of Cap. 112 allows expenditure incurred by a person carrying on a trade, profession or business on R&D related to that trade, profession or business as a deduction. Section 16B(1) of Cap. 112 allows 100% deduction for expenditure on R&D and for capital expenditure incurred on the purchase of plant and machinery for R&D in the year of assessment during which it was incurred.

4. According to paragraph 5 of the LegCo Brief, in her first Policy Address of October 2017, the Chief Executive 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. The Government also aims 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.

5. According to paragraphs 3, 4 and 6 of the LegCo Brief, the Administration has studied the relevant tax practices in major jurisdictions,<sup>1</sup> and noted that their R&D tax incentives mainly target at activities that seek to achieve scientific or technological advancement and involve the resolution of some scientific or technological uncertainties. In alignment with this common model, the Administration proposes to introduce an enhanced tax deduction regime for qualifying R&D activities.

### **Provisions of the Bill**

6. The Bill seeks to amend Cap. 112 to implement the enhanced tax deduction regime. The proposed amendments are summarized in the following paragraphs.

#### The enhanced tax deduction regime

7. The Bill seeks to implement the enhanced tax deduction regime by, among other things:

- (a) replacing the existing 16B of Cap. 112 with the proposed new section 16B; and
- (b) adding Schedule 45 to Cap. 112 which provides for the operational details.

8. The new section 16B provides for the deduction of expenditures on R&D activities and the treatment of the proceeds of sale of plant or machinery for, and rights generated from, R&D activities as trading receipts. The total amount of deduction to be allowed under the new section 16B would be determined in accordance with the new Schedule 45.

9. Under section 4 of the new Schedule 45, a "qualifying R&D activity" is defined as an activity wholly undertaken and carried on in Hong Kong including one in the fields of natural or applied science to extend knowledge and the carrying on of an original and planned investigation with the prospect of gaining new scientific or technical knowledge and understanding. Under section 5 of the new Schedule 45, a "qualifying R&D activity related to a trade, profession or business" includes a qualifying R&D activity that may lead to or facilitate an extension, or an improvement in the technical efficiency, of

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<sup>1</sup> Including Australia, Canada, France, Ireland, Mainland China, Singapore, the United Kingdom and the United States.

the trade, profession or business; and a qualifying R&D activity of a medical nature that is of particular relevance to the welfare of employees employed in the trade, profession or business.

10. Section 13 of the new Schedule 45 provides for the calculation of the total amount allowed to be deducted under the new section 16B for R&D expenditures during the basis period for a year of assessment. In gist, Type A expenditures (i.e. expenditures on R&D activities related to a trade, profession or business including a payment to an R&D institution<sup>2</sup> and expenditure other than Type B expenditures) would qualify for 100% deduction. As for Type B expenditures (i.e. expenditures on qualifying R&D activities related to a trade, profession or business including a payment to a designated local research institution<sup>3</sup> and a qualifying expenditure related to the trade, profession or business<sup>4</sup>), it is proposed that they would qualify for the enhanced tax deduction, i.e. 300% for the first \$2 million of the total amount of expenditures and 200% for the remaining amount.

#### Further safeguards to prevent the abuse of tax deductions in respect of R&D activities

11. Sections 14 and 15 of the new Schedule 45 seek to provide for safeguards to prevent the abuse of tax deductions under the new section 16B of Cap. 112. The proposed safeguards are set out below:

- (a) under section 14 of the new Schedule 45, no deduction would be allowed for certain R&D expenditures. These include (i) expenditure that is, or is to be, met directly or indirectly by the Government, the government of any place outside Hong Kong, any public or local authority in Hong Kong or elsewhere, or another person; (ii) expenditure on an R&D activity related to a trade, profession or business but the rights generated from the activity are not, or will not be,

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<sup>2</sup> Under section 6(4) of the new Schedule 45, "R&D institution" means (a) a designated local research institution; or (b) a university or college that is not a designated local research institution.

<sup>3</sup> Section 19 of the new Schedule 45 seeks to empower the Commissioner for Innovation and Technology to designate any university or college located in Hong Kong or any other local institution that undertakes qualifying R&D activities in Hong Kong as a designated local research Institution.

<sup>4</sup> Under section 12 of the new Schedule 45, a "qualifying expenditure related to a trade, profession or business" includes an expenditure in relation to an employee who is engaged directly and actively in, or an expenditure on a consumable item that is used directly in, a qualifying R&D activity related to the trade, profession or business.

fully vested in the person claiming for a deduction; and (iii) expenditure incurred under an arrangement which would enable the person concerned to claim a deduction to which he would not otherwise be entitled under the new section 16B of Cap. 112; and

- (b) under section 15 of the new Schedule 45, an R&D expenditure may only be deducted for one trade, profession or business.

#### Deeming certain sums to be trading receipts chargeable to tax

12. Clause 5 of the Bill seeks to amend section 15(1) of Cap. 112 to deem the following sums as taxable receipts arising in or derived from a trade, profession or business carried on in Hong Kong:

- (a) sums received by or accrued to a person for the use, or the right to the use, outside Hong Kong of any intellectual property or know-how generated from any R&D activity in respect of which a deduction is allowable under the new section 16B of Cap. 112 in ascertaining profits of the person; and
- (b) sums received by or accrued to a person for imparting or undertaking to impart knowledge directly or indirectly connected with the use outside Hong Kong of any such property or know-how.

#### Other amendments

13. Section 18 of the new Schedule 45 seeks to empower the Commissioner of Inland Revenue to seek advice from the Commissioner for Innovation and Technology on matters related to claims and applications made by a person in relation to a deduction under the new section 16B of Cap. 112.

14. Other amendments relate to transitional, consequential and textual amendments.

#### **Commencement**

15. The Bill, if passed, would come into operation on the day on which it is published in the Gazette as an Ordinance.

## **Public Consultation**

16. According to paragraph 28 of the LegCo Brief, the Administration had consulted the Committee on Innovation, Technology and Re-industrialisation in August 2017 and major trade and industrial associations and professional bodies in accountancy or tax in the fourth quarter of 2017, and they generally welcomed the proposed amendments.

## **Consultation with LegCo Panel**

17. As advised by the Clerk to the Panel on Commerce and Industry, the Panel was briefed on 16 January 2018 on the legislative proposal. The Panel supported in principle the legislative proposal and expressed views and concerns on a number of issues, including that the proposed arrangement would discourage local enterprises from undertaking R&D activities on their own, or might only benefit the existing R&D institutions already subsidized by the Innovation and Technology Fund. The Panel also passed a motion to urge the Government to implement specific measures to improve the proposal of the enhanced tax deduction for R&D expenditure.

## **Conclusion**

18. The Legal Service Division is scrutinizing the legal and drafting aspects of the Bill. In view of the concerns expressed by members of the Panel on Commerce and Industry, Members may wish to consider whether a Bills Committee should be set up to study the Bill in detail.

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