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For discussion on
16 January 2018

Legislative Council
Panel on Commerce and Industry

Enhanced Tax Deduction for Research and Development Expenditure

PURPOSE

This paper introduces to the panel the proposed amendment to the Inland Revenue Ordinance (Cap. 112) ("IRO"). The proposal aims to provide companies with enhanced tax deduction for their spending on qualifying research and development ("R&D") activities.

BACKGROUND

2. R&D is the fountain of innovation and technology. Commercialisation of R&D results and development of new products and services will help create wealth, bring about quality jobs, and support the development of new industries in Hong Kong. The Government has set a goal to double the Gross Domestic Expenditure on R&D as a percentage of the Gross Domestic Product to 1.5%, equivalent to about $45 billion, by 2022. We also hope to gradually reverse the ratio of public sector expenditure versus private sector expenditure on R&D from government-led to public-private participation, which is more sustainable.

3. At present, IRO provides 100% deduction for expenditure on R&D, as well as 100% deduction for capital expenditure incurred on the purchase of plant and machinery for R&D in the year during which it was incurred. In the 2017 Policy Address, the Chief Executive announced to substantially increase the tax deduction, providing enhanced tax deduction for expenditure incurred by enterprises on qualifying R&D activities, in order to encourage more enterprises to conduct R&D activities in Hong Kong.

KEY LEGISLATIVE PROPOSALS

4. With reference to tax arrangements in many countries, R&D tax incentives are generally only applicable to those R&D activities that seek to achieve scientific or technological advancement and involve the resolution of some scientific or technological uncertainty. In alignment with this common model, we suggest the following proposed framework.

Enhanced deduction

5. We propose a two-tier rate of deduction. The deduction will be 300% for the first $2 million of the aggregate amount of “qualifying expenditure incurred” by the enterprise (i.e. expenditure incurred by enterprises for in-house qualifying R&D) and payments made to “designated local research institutions” (i.e. out-sourced qualifying R&D) (see paragraph 8 below), and 200% for the remaining amount. There is no cap on the amount of the relevant tax deduction.

Qualifying R&D

6. The proposed definition of “qualifying R&D” is primarily built on the definition of “R&D” in the present IRO. However, several activities which are not generally regarded as innovative activities involving advancement in science and technology, such as feasibility studies or market, business or management researches, will not be regarded as “qualifying R&D” to be eligible for enhanced deduction (however, expenditure incurred on these kinds of activities may still be eligible for 100% tax deduction). This definition is in line with international practices.

7. The objectives of the proposed tax deduction are to attract enterprises to invest more in R&D in Hong Kong, promote local R&D activities, and groom local R&D talents. We propose that only “qualifying R&D” activities carried out in Hong Kong will be eligible for the enhanced deduction.

8. Furthermore, we also propose to replace the references to “approved research institutes” in the current IRO by “designated local research institutions” which means any local university, college, institute, association or organisation in Hong Kong designated by the Commissioner for Innovation and Technology (“CIT”). Upon passage of the proposed amendments, enterprises may still engage overseas universities or colleges to conduct R&D and enjoy the existing 100% basic deduction under the current IRO. However, to be eligible for the enhanced tax deduction, the relevant R&D activities must be outsourced to “designated local research institutions”.

Qualifying R&D expenditure

9. At present, expenditure arising from R&D is widely defined in 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.

10. Making reference to international practices, we propose to define "qualifying expenditure" as expenditure attributable to the "qualifying R&D" that is incurred on direct staff costs (director's fees and other emoluments such as salaries, bonus or share options, etc. excluded), and consumables employed directly in the "qualifying R&D" concerned.

11. R&D expenditure not meeting the above proposed definition (e.g. director's fee and other emoluments including salaries, bonus, or share options, etc., testing expenses, fees paid for leasing or maintenance of plant or machinery, fees paid for expert advice, licence fees paid for use of intellectual property rights etc.) may still qualify for 100% deduction under the existing IRO.

Other safeguarding and miscellaneous amendments

12. Legislative amendments are proposed to empower the Commissioner of Inland Revenue ("CIR") to consult CIT in ascertaining whether any particular activity constitutes "R&D" or "qualifying R&D", and whether the payment or expenditure was made or incurred in the carrying out of the "R&D" or "qualifying R&D" concerned. CIR may disclose to CIT any details which he considers necessary for the purposes of such consultation.

13. To safeguard the public coffer and to tie in with relevant international tax rules, we will also introduce other provisions and amendments with regard to the following matters, including:

(a) sale of rights in or arising out of qualifying R&D;

(b) treatment of government grants and subsidies;

(c) preventing artificially inflated claims;

(d) vesting of rights in or arising out of "R&D" or "qualifying R&D"; and

(e) royalties from licensing intellectual property rights or know-how created as a result of "R&D" or "qualifying R&D".

STAKEHOLDERS ENGAGEMENT

14. We have consulted the Committee on Innovation, Technology and Re-industrialisation in August 2017 and major trade/industrial associations and professional bodies in accountancy/tax in the fourth quarter of 2017. They generally welcome the proposed amendments.

LEGISLATIVE TIME TABLE

15. We aim to introduce the amendment bill into the Legislative Council within the first half of this year and plan to launch the initiative in the third quarter.

ADVICE SOUGHT

16. Members are invited to note and give views on the legislative proposals.

Innovation and Technology Bureau
Financial Services and the Treasury Bureau
Innovation and Technology Commission
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