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Panel on Commerce and Industry

Meeting on 16 January 2018

**Background brief on the proposal for an enhanced tax deduction for
research and development expenses**

Purpose

This paper provides background information on the Administration's proposal for an enhanced tax deduction for expenditure incurred by enterprises on research and development ("R&D") and gives a summary of the views and concerns expressed by members on the issue during previous discussions.

Background

2. Section 16B of the 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 included capital expenditure on plant or machinery but excluded capital expenditure on land or buildings. In 1998, the section was extended to a person in a profession. At the same time 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 Section 16B of IRO is in **Appendix I**.

¹ Under subsection (4)(a), section 16B of the Inland Revenue Ordinance (Cap. 112), 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.

3. Under the prevailing tax regime, R&D expenditure incurred by enterprises can only enjoy a 100% tax deduction. Compared with other countries which provide more than 100% tax deductions for R&D activities conducted by their local enterprises, the existing practice in Hong Kong does not provide sufficient incentive for enterprises to carry out R&D activities.

4. To catch up in the innovation and technology ("I&T") race, the Chief Executive announced in her Policy Address ("the PA") delivered in October 2017 that the Administration would step up its efforts to develop I&T in eight major areas,² including increasing resources for R&D by providing additional tax deduction for expenditure incurred by enterprises on R&D. The Administration has set a goal to double the Gross Domestic Expenditure on R&D as a percentage of the Gross Domestic Product to about HK\$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.

5. To give private companies an incentive to increase investment in technological R&D, the Administration will provide additional tax deduction for expenditure incurred by enterprises on R&D, namely the first HK\$2 million eligible R&D expenditure will enjoy a 300% tax deduction and 200% for the remainder. With this measure, the Administration hopes to reverse the ratio of public sector versus private sector expenditure on R&D from government-led to public-private participation, which would make R&D funding more sustainable. The Administration also considers that this has a positive effect on attracting overseas scientific research personnel to Hong Kong and nurturing local R&D talents.

6. According to the Administration, it has started the relevant law drafting work. Should the proposal be supported by the Legislative Council, the initiative is expected to be rolled out as soon as in the third quarter of 2018.

² 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 legislation and regulations;
- (f) opening up government data;
- (g) Government to lead changes to procurement arrangements; and
- (h) strengthening popular science education.

Previous discussions

7. The Administration briefed the Panel on Commerce and Industry ("the Panel") at the policy briefing-cum-meeting on 17 October 2017 on the policy initiatives in respect of promotion of I&T featured in the PA, including the Administration's proposal to enhance tax deduction for expenditure incurred by enterprises on R&D. Members' views on the subject matter are summarized below.

8. Some members enquired whether there would be a designated panel set up for the vetting of the tax returns filed by enterprises under the proposal to provide enhanced tax deduction for expenditure incurred by enterprises on R&D.

9. In response, the Administration said that it would submit a legislative proposal to amend IRO to provide enhanced tax deduction for expenditure incurred by enterprises on R&D. The Inland Revenue Department ("IRD") would consult the Innovation and Technology Commission on uncertain cases of tax deduction for expenditure on R&D.

10. Some members enquired whether the unused portion of the R&D expenditure deduction could be carried forward for use in future financial years; and if so, whether it could be accumulated for an unlimited period as a form of tax credit. The Administration said that it would work closely with the Financial Services and the Treasury Bureau and IRD on the relevant taxation arrangements.

Latest position

11. The Administration will seek the Panel's support for the proposal to amend relevant sections of IRO so as to provide companies with enhanced tax deduction for their spending on "qualified R&D activities".

Relevant papers

12. A list of relevant papers is in **Appendix II**.

16B. Expenditure on research and development*

- (1) Notwithstanding anything in section 17, in ascertaining the profits from any trade, profession or business in respect of which a person is chargeable to tax under this Part for any year of assessment there shall, subject to subsection (2), be deducted the following payments made, and expenditure incurred, by such person during the basis period for that year of assessment (other than any amount which is allowable as a deduction apart from this section), namely—
 - (a) payments to—
 - (i) an approved research institute for research and development related to that trade, profession or business; or
 - (ii) an approved research institute, the object of which is the undertaking of research and development related to the class of trade, profession or business to which that trade, profession or business belongs; and
 - (b) expenditure on research and development related to that trade, profession or business, including capital expenditure except to the extent that it is expenditure on land or buildings or on alterations, additions or extensions to buildings.
- (2) Where any payment or expenditure to which this section refers is made or incurred outside Hong Kong and the trade, profession or business in relation to which it is so made or incurred is carried on partly in and partly out of Hong Kong, the deduction allowable under this section shall be such part of the amount which would otherwise be allowable as is reasonable in the circumstances. (*Amended 7 of 1986 s. 12*)

- (3)(a) Where any plant or machinery, representing research and development expenditure of a capital nature which pursuant to subsection (1)(b) has been allowed as a deduction in ascertaining the profits from a trade, profession or business, ceases to be used by the person carrying on the trade, profession or business for research and development related to that trade, profession or business and is then or thereafter sold by him, the proceeds of sale shall, to the extent that they are not otherwise chargeable to tax under this Part and do not exceed the amount of the deduction, be treated as a trading receipt arising in or derived from Hong Kong of the trade, profession or business accruing at the time of the sale or, if the sale occurs on or after the date on which the trade, profession or business is permanently discontinued, accruing immediately before the discontinuance.
- (b) Where any such plant or machinery is destroyed, it shall for the purposes of paragraph (a) be treated as if it had been sold immediately before the destruction thereof and any insurance moneys or other compensation of any description received by the person carrying on the trade, profession or business in respect of the destruction and any money received by him in respect of the remains of the plant or machinery shall be treated as if they were proceeds of that sale.
- (c) The reference in paragraph (a) to the time of sale shall be construed as a reference to the time of completion or the time when possession is given, whichever is the earlier.
- (d) Where, prior to the commencement[#] of section 2 of the Revenue Ordinance 2004 (9 of 2004), expenditure represented by any plant or machinery has been allowed as a deduction in ascertaining the profits from a trade, profession or business pursuant to the provisions of subsection (1)(b) in force immediately before that commencement[#], then, for the purposes of paragraph (a)
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- (i) such plant or machinery shall be treated as plant or machinery representing research and development expenditure of a capital nature which had been allowed as a deduction in ascertaining the profits from the trade, profession or business pursuant to subsection (1)(b); and

(ii) the reference in that paragraph to the amount of the deduction in respect of expenditure represented by such plant or machinery shall be construed as a reference to the aggregate of—

(A) the amount of the deduction allowed in respect of expenditure represented by such plant or machinery pursuant to the provisions of subsection (1)(b) in force immediately before that commencement[#]; and

(B) the amount of the deduction allowed in respect of research and development expenditure of a capital nature represented by such plant or machinery pursuant to subsection (1)(b) after that commencement[#]. (*Added 9 of 2004 s. 2*)

(3A)(a) Notwithstanding the exclusion relating to the sale of capital assets contained in section 14, where any rights in, or arising out of, research and development the expenditure on which has been allowed as a deduction under this section in ascertaining the profits of any person from a trade, profession or business for the year of assessment commencing on 1 April 1998 or any subsequent year of assessment are thereafter sold by him— (*Amended 9 of 2004 s. 2*)

(i) subject to subparagraph (ii), the proceeds of sale;

(ii) if the deduction has been allowed in accordance with subsection (2), such part of the proceeds of sale as is proportionate to the extent to which the expenditure on the research and development to which the rights relate has been allowed as a deduction in accordance with that subsection,

shall, to the extent that the proceeds of sale or the part of the proceeds of sale, as the case may be, is not otherwise chargeable to tax under this Part and does not exceed the amount of the deduction, be treated as a trading receipt of the trade, profession or business accruing at the time of the sale or, if the sale occurs on or after the date on which the trade, profession or business is permanently discontinued, accruing immediately before the discontinuance.

(b) For the purposes of this subsection—

- (i) without prejudice to subsection (3), a reference to the proceeds of sale shall be construed as a reference to such part of the proceeds of sale as is not attributable to the sale of plant or machinery;
 - (ii) the reference to the time of the sale, in relation to any rights, shall be construed as a reference to the time of completion of the sale of the rights. (*Added 32 of 1998 s. 7*)
- (c) Where, prior to the commencement[#] of section 2 of the Revenue Ordinance 2004 (9 of 2004), expenditure to which any rights relate has been allowed as a deduction in ascertaining the profits from a trade, profession or business under the provisions of this section in force immediately before that commencement[#], then, for the purposes of paragraph (a)—
- (i) such rights shall be treated as rights in, or arising out of, research and development the expenditure on which had been allowed as a deduction in ascertaining the profits from the trade, profession or business under this section; and
 - (ii) the reference in that paragraph to the amount of the deduction in respect of expenditure to which such rights relate shall be construed as a reference to the aggregate of—
 - (A) the amount of the deduction allowed in respect of expenditure to which such rights relate under the provisions of this section in force immediately before that commencement[#]; and
 - (B) the amount of the deduction allowed in respect of expenditure on research and development to which such rights relate under this section after that commencement[#]. (*Added 9 of 2004 s. 2*)

(4)(a) In this section—

an approved research institute (認可研究機構) means any university, college, institute, association or organization which is approved in writing for the purposes of this section by the Commissioner as an institute, association or organization for undertaking research and development which is or may prove to be of value to Hong Kong; (*Amended 7 of 1986 s. 12; 24 of 1996 s. 5; 9 of 2004 s. 2*)

research and development (研究和開發) 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. (*Added 9 of 2004 s. 2*)
- (b) An approval for the purposes of paragraph (a) may—
- (i) operate as from a date, whether before or after the date of approval, specified in the instrument of approval; and
 - (ii) be withdrawn at any time.

(Amended 9 of 2004 s. 2)

(5) In this section—

- (a) references to expenditure incurred on research and development do not include any expenditure incurred in the acquisition of rights in, or arising out of, research and development, but, save as aforesaid and subject to subsection (1)(b), include all expenditure incurred for the prosecution of, or the provision of facilities for the prosecution of, research and development; and

- (b) references to research and development related to a trade, profession or business or class of trade, profession or business shall be read as including a reference to— (*Amended 9 of 2004 s. 2*)
- (i) any research and development which may lead to or facilitate an extension, or an improvement in the technical efficiency, of that trade, profession or business, or, as the case may be, of trades, professions or businesses of that class; and
 - (ii) any research and development of a medical nature which is of special relation to the welfare of workers employed in that trade, profession or business or, as the case may be, in trades, professions or businesses of that class; and
- (c) a reference to rights shall be construed as including a reference to a share or interest in such rights. (*Added 32 of 1998 s. 7*)
- (6) For the purposes of this section—
- (a) expenditure shall not be regarded as incurred by a person in so far as it is, or is to be, met directly or indirectly by the Government of Hong Kong or by any government or public or local authority, whether in Hong Kong or elsewhere, or by any person other than the first-mentioned person; and (*Amended 7 of 1986 s. 12; 19 of 1996 s. 5*)
 - (b) any expenditure of a capital nature incurred on research and development related to any trade, profession or business by a person about to carry on that trade, profession or business shall be treated as if it had been incurred by that person on the first day upon which he does carry on that trade, profession or business.
- (7) The same sums paid, or expenditure incurred, shall not be taken into account for any of the purposes of this section in relation to more than one trade, profession or business.

(Added 35 of 1965 s. 10. Amended 32 of 1998 s. 7; 9 of 2004 s. 2)

Editorial Note:

* The amendments made to this section by 9 of 2004 apply in relation to the year of assessment commencing on 1 April 2004 and to all subsequent years of assessment. (Please see 9 of 2004 s. 1(2))

Commencement date: 21 May 2004.

List of relevant papers

Date of meeting	Meeting	Paper
17/10/2017	Panel on Commerce and Industry	<p>Administration's paper on "2017 Policy Address - Policy initiatives of Commerce, Industry and Tourism Branch, Commerce and Economic Development Bureau Innovation and Technology Venture Fund" (LC Paper No. CB(1)20/17-18(01))</p> <p>Administration's paper on "2017 Policy Address - Policy initiatives of Constitutional and Mainland Affairs Bureau in relation to Mainland co-operation and Taiwan affairs" (LC Paper No. CB(1)20/17-18(02))</p> <p>Administration's paper on "2017 Policy Address - Policy initiatives of Innovation and Technology Bureau" (LC Paper No. CB(1)32/17-18(03))</p> <p>Minutes of meeting (LC Paper No. CB(1)341/17-18)</p>