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Global Tax Alert

Hong Kong passes new legislation to grant increased tax deductions for qualifying R&D activities

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Executive summary

On 24 October 2018, Hong Kong's Legislative Council passed the bill (the Bill) for the new legislation (the New Law) to grant an increase in tax deductions for qualifying research and development (R&D) activities. The New Law is expected to be enacted on 2 November 2018.

The Bill retains the original form, other than one amendment.[1]

In addition, the Hong Kong Government has clarified certain provisions of the New Law during the legislative process.

Detailed discussion

Overview

Under the New Law, effective for expenditure incurred on or after 1 April 2018, qualifying R&D expenditure on a qualifying R&D activity will be eligible for a 300% deduction for the first HK$2 million, and the remainder, deductible at 200% without limitation.

R&D expenditure that does not qualify for the above deduction will continue to be eligible for the normal 100% deduction.

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With respect to subcontracted out qualifying R&D activities, the payments must be made to a "designated local research institution" to qualify for the additional deductions.

For in-house qualifying R&D activities, the R&D activities must be undertaken and carried on by a taxpayer wholly within Hong Kong to be eligible for the additional tax deductions.

Amendment

The amendment relates to a payment made by a taxpayer to another institution for a subcontracted out R&D activity. It provides that if an institution is designated by the Commissioner for Innovation and Technology in Hong Kong as a designated local research institution within six months after the payment was made, the payment will retroactively qualify as a payment to a designated local research institution.

Clarification by the Government

Qualification of certain expenditures in connection with a cost-sharing arrangement (CSA) as in-house R&D expenditures

The New Law states that, if a Hong Kong enterprise shares the costs of R&D activities performed by a separate group company under a CSA, the R&D activities would be regarded as being outsourced to that group company.

However, the Government has clarified that expenditures incurred by a company in Hong Kong on its own account and for its own benefit for the pooled R&D activities may be regarded as in-house R&D expenditures of the taxpayer and therefore would generally qualify for either the normal or additional tax deductions.

Treatment of pro rata joint ownership of intellectual property rights (IPRs) from R&D

The New Law requires that any IPRs from R&D activities must be fully vested in a taxpayer before any payments or expenditures incurred by the taxpayer for the R&D activities can be deductible.

However, the Government has clarified that a taxpayer's pro rata joint ownership with other CSA participants of any IPRs generated as a result of pooled R&D activities would be sufficient to make the payment or expenditure as deductible, provided that the other conditions for deduction are satisfied.

Criteria of a group company as a designated local research institution

The Government indicates that to obtain a designation, the entity must have the capability, capacity, experience and competency to undertake R&D activities in the relevant technology area.

Definition of a qualifying R&D activity

Pursuant to the Government, key considerations in determining whether an activity is a qualifying R&D activity include the state of knowledge and technology at the commencement of an R&D project and the scientific or technological uncertainties involved, among others. If an R&D project seeks to directly contribute to achieving an advance in science or technology by resolving scientific or technological uncertainty, it would be regarded as a "qualifying R&D activity."

Endnote

1. See EY Global Tax Alert, *Hong Kong proposes increased tax deductions for qualifying research and development activities*, dated 10 May 2018.

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