

The DIPN provides guidance and certain flexibility on deduction for R&D expenditure

News Flash
Hong Kong Tax
April 2019
Issue 3

In brief

The Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 55 – Deduction for Research and Development Expenditure (DIPN 55)¹ on 11 April 2019. The DIPN set out the IRD's views on various issues regarding the interpretation and application of the new research and development (R&D) tax deduction regime. The relevant legal framework of the new regime is provided by the Inland Revenue (Amendment) (No. 7) Ordinance 2018² (the R&D Ordinance) which was enacted on 2 November 2018. The DIPN not only provides guidance on the implementation of the revamped legislation but also adopts a liberal approach in granting a tax deduction for R&D expenditure in areas where there is flexibility. These areas include: (1) staff costs of seconded R&D staff, (2) fees paid to an overseas associate for subcontracted R&D, (3) use of a special purpose vehicle (SPV) to hold an intellectual property (IP) generated from the R&D activities and (4) R&D expenditure borne by an enterprise under a cost contribution arrangement (CCA) for R&D activities.

We welcome the issuance of DIPN 55 which explains the principles to be adopted by the IRD in assessing whether a given activity is a qualifying R&D activity with various illustrative examples. We also applaud the flexible approach adopted by the DIPN in applying the new R&D deduction regime. However, similar to other existing tax incentives, we urge the government to conduct a periodic review of the effectiveness of the R&D deduction regime and introduce further enhancements to the regime where necessary.

Companies wishing to claim a deduction for their R&D expenditures should take note of the guidance in DIPN 55. They should also be mindful that to enable them to lodge a correct R&D deduction claim (i.e. neither over-claim nor under-claim the amount of qualifying R&D expenditure), it is crucial to put in place a mechanism for effectively identifying the R&D activities eligible for deduction and an accounting system for keeping track of the correct amounts of R&D expenditure that qualify for the normal and enhanced deduction respectively throughout the different stages of a R&D project. In addition, there should be a proper documentation system to retain the relevant R&D documents and records so that these supporting documents can be readily produced to the IRD upon request to substantiate the deduction claims.

In detail

The R&D tax deduction regime

A new deduction regime for R&D expenditure has been introduced in Hong Kong effective from 1 April 2018 by the R&D Ordinance. Under the new regime, there are two types of tax deductible R&D expenditure, namely Type A expenditure (which qualifies for 100% normal deduction) and Type B expenditure (which qualifies for 300% deduction for the first HK\$2 million and 200% for the remaining amount, without any cap).

Type B expenditure is defined as (1) a payment made to a designated local research institution (DLRI)³ for a qualifying R&D activity or (2) staff costs (in the form of cash outlays) of employees engaged directly in a qualifying R&D activity (excluding directors' remuneration and benefits) and expenditure on consumables directly used in a qualifying R&D activity. Type A expenditure is defined as R&D expenditure other than Type B expenditure. Only R&D activities that meet certain criteria (e.g. the activities must be wholly undertaken and carried on in Hong Kong) are regarded as a "qualifying R&D activity". There are also various conditions that need to be fulfilled to qualify for the deduction (e.g. the R&D activities must not be taken for another person) and anti-avoidance rules that prevent abuse of the deduction.

For a more detailed discussion of the new R&D tax deduction regime, please refer to *Hong Kong Tax News Flash*, November 2018, Issue 13⁴.

Guidance and flexibility offered in DIPN 55

DIPN 55 set out the IRD's views on various issues regarding the interpretation and application of the new R&D tax deduction regime, with numerous illustrative examples and three appendices. More importantly, the DIPN indicates that the IRD is prepared to offer some flexibility in allowing a R&D tax deduction in certain circumstances. This should be welcome by taxpayers engaged in R&D activities.

Salient points and flexible treatments mentioned in the DIPN

- **Meaning of "R&D activity"** – the definition of "R&D activity" under the new regime is no different from that for "R&D" under the previous section 16B of the Inland Revenue Ordinance (IRO), the activities covered are in line with those that are regarded as "R&D" in the Hong Kong Accounting Standard 38, and "substantially improved" has a reasonably high threshold which represents a genuine and non-trivial improvement rather than a minor or routine upgrading.
- **Meaning of "qualifying R&D activity"** - qualifying R&D activities are those activities which seek to "achieve an advance in science or technology" by resolving scientific or technological uncertainty. The DIPN provides judicial guidance on the meaning of R&D as illustrated in *BE Studios Ltd v Smith & Williamson Limited [2006] STC 358*. Principles on "qualifying R&D activities" from a general perspective are explained in Appendix 1 of the DIPN whereas the application of such general principles to software creation, Fintech and drug development are explained in Appendix 2.
- A "qualifying R&D activity" must be **wholly undertaken and carried on in Hong Kong** – the DIPN explains that it does not mean the whole R&D project must be carried on in Hong Kong. If an R&D project is carried on partly in Hong Kong and partly outside Hong Kong, the R&D expenditure related to the part carried on in Hong Kong may still be eligible for the enhanced deduction.
- If a particular advance in science or technology has already been made or attempted but details are **not readily available (e.g. it is a trade secret)**, work to achieve such an advance can still be advance in science or technology.
- **Aborted R&D projects** can still be qualifying R&D activities, and registration of patents is not a prerequisite for an activity to be regarded as an R&D activity.
- Only staff costs of employees engaged directly and actively in a qualifying R&D activity can be a Type B expenditure that qualifies for enhanced deduction – if a group has one entity operating the payrolls for all of the entities in the group (the "group payroll entity"), it does not necessarily mean that all the employees are the staff of the **group payroll entity**. Whether an individual can be regarded as an employee of the enterprise conducting the R&D activities within the group is a question of fact and one key factor to consider is whether the employer and employee relationship subsists. In addition, staff costs borne by an enterprise for **R&D secondees or expatriates** sponsored by the enterprise can qualify for the enhanced tax deduction if the secondees or expatriates take instructions from the enterprise. Salaries of **expert consultants under a temporary employment contract and part-time R&D staff** can also qualify for the enhanced tax deduction.
- Remuneration of a director does not qualify as a Type B expenditure – however, in the absence of tax abuses and subject to transfer pricing rules, **apportionment** can be allowed where a person occupies a **dual role** of being a director and an R&D employee.
- The condition of "rights fully vested in the enterprise" can still be met in the case of **co-ownership of rights** since the definition of "rights" includes a share or an interest in rights.
- If a **SPV is used to hold an IP** generated from R&D activities and the SPV acts as a nominee for the enterprise performing the R&D activities (i.e. the SPV is not entitled to the economic interests of the rights generated from the R&D activities), the rights generated from the R&D activities would be regarded as fully vested in the enterprise provided that the enterprise is the "economic owner" of the rights and entitled to the returns therefrom.
- If an enterprise made a payment to an university or R&D institution for the university or institution to pursue its object of undertaking R&D activity related to the class of trade of business to which the enterprise belongs, there is no need for the R&D activity to be undertaken for the enterprise nor for the rights generated from such R&D activity be vested in the enterprise.

- R&D subcontracting fees paid to an overseas associate which is not an R&D institution as defined will not be deductible under section 16B. As a **concession**, the Commissioner of Inland Revenue is prepared to allow a 100% normal deduction of the subcontracting fee paid by an enterprise to an overseas associate for the R&D services provided if such fee is **not more than 20% of the total costs of the R&D project and the subcontracting fee is not more than HK\$2 million**. To enjoy the deduction, the enterprise will still need to be responsible for undertaking in Hong Kong the core part of the R&D project.

Tax treatments of CCAs for R&D

While section 16B of the IRO is silent on the tax treatments of a CCA entered into for R&D activities, the DIPN provides that the share of R&D expenditure borne by an enterprise under a CCA may be accepted as its in-house R&D expenditure and specifies the conditions that need to be met for applying this treatment. In particular, an enterprise must actively participate in the R&D project under the CCA and play a significant role in carrying on the R&D activities in order to be treated as a participant of the CCA. Mere monetary contributions without active participation will not qualify for any deduction under section 16B.

If an R&D project under a CCA is carried on partly in Hong Kong and partly outside Hong Kong, the contributions borne by an enterprise under the CCA for the part of the R&D project carried on in Hong Kong can qualify for the enhanced deduction whereas its share of contributions towards the part of R&D project carried on outside Hong Kong may qualify for the 100% normal deduction.

The DIPN also spells out the tax treatments of various common payments among participants in a CCA, such as charge-in payments made to other CCA participants, charge-out payments received from other CCA participants, balancing payments/charges due to changes in the allocation of CCA contributions, and buy-in/buy-out payments in relation to the rights generated from the R&D activities under a CCA.

R&D records to substantiate a deduction claim

Appendix 3 of the DIPN set out the approach taken by the IRD in assessing taxpayers' claims for deduction of R&D expenditure. All claims for deduction of R&D expenditure are subject to a risk assessment process. The DIPN also set out the records and documents of which an enterprise claiming a R&D deduction is expected to keep at different stages of the R&D project to substantiate the claim. Such records and documents include R&D project planning materials, documentation of review and search of the current state of knowledge, laboratory notes and project records, internal progress reports and minutes of project meetings, and R&D expenditure records for in-house and outsourced R&D activities. For a deduction claim in relation to a CCA for R&D activities, relevant information on the terms of the CCA, a copy of the CCA agreement and annual CCA transfer pricing audit report are expected to be provided to support the deduction claim. In the profits tax return for year of assessment 2018/19, there is a supplementary form (BIRS3)⁵ which requires taxpayers to provide details of the deduction claims on R&D.

The takeaway

We welcome the issuance of DIPN 55 which explains the principles to be adopted by the IRD in assessing whether a given activity is a qualifying R&D activity with various illustrative examples. We also applaud the flexible approach adopted by the DIPN in applying the new R&D deduction regime, such as allowing a Hong Kong company to subcontract an insignificant part of its in-house R&D project to an overseas associate and treating the subcontracting fees paid to the overseas associate as Type A expenditure eligible for the 100% normal deduction, subject to certain limits. However, similar to other existing tax incentives, we urge the government to conduct a periodic review of the effectiveness of the R&D deduction regime and introduce further enhancements to the regime where necessary.

Companies wishing to claim a deduction for their R&D expenditures should take note of the guidance in DIPN 55. They should also be mindful that to enable them to lodge a correct R&D deduction claim (i.e. neither over-claim nor under-claim the amount of qualifying R&D expenditure), it is crucial to put in place a mechanism for effectively identifying the R&D activities eligible for deduction and an accounting system for keeping track of the correct amounts of R&D expenditure that qualify for the normal and enhanced deduction respectively throughout the different stages of a R&D project. In addition, there should be a proper documentation system to retain the relevant R&D documents and records so that these supporting documents can be readily produced to the IRD upon request to substantiate the deduction claims.



Endnotes

1. DIPN 55 can be accessed via this link: <https://www.ird.gov.hk/eng/pdf/2019/dipn55.pdf>
2. The Inland Revenue (Amendment) (No. 7) Ordinance 2018 can be accessed via this link: <https://www.gld.gov.hk/egazette/pdf/20182244/es12018224429.pdf>
3. The Innovation and Technology Commission's guidelines and other relevant information on applying for the status as a DLRI for the purpose of the new R&D tax deduction regime can be accessed via this link: <https://www.itc.gov.hk/en/dlri/index.htm>
4. *Hong Kong Tax News Flash, November 2018, Issue 13* can be accessed via this link: <https://www.pwchk.com/en/hk-tax-news/2018q4/hongkongtax-news-nov2018-13.pdf>
5. The BIRS3 can be downloaded via this link: <https://www.ird.gov.hk/eng/pdf/ebirs3.pdf>



For a deeper discussion of how this issue might affect your business, please contact:

PwC's Corporate Tax Leaders based in Hong Kong

Charles Lee
China South and Hong Kong Tax Leader
+852 2289 8899
charles.lee@cn.pwc.com

Jeremy Ngai
China South Tax Leader
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

Jeremy Choi
Tax Partner
Industrial Products
+852 2289 3608
jeremy.choi@hk.pwc.com

Rex Ho
Tax Partner
Financial Services
+852 2289 3026
rex.ho@hk.pwc.com

Cecilia Lee
Tax Partner
Transfer Pricing
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Jenny Tsao
Tax Partner
Corporate Tax and Consumer Markets
+852 2289 3617
jenny.np.tsao@hk.pwc.com

Kenneth Wong
Tax Partner
Tax Controversy
+852 2289 3822
kenneth.wong@hk.pwc.com



One-stop tax information platform of Shui Jie 2.0 version

Your exclusive tax think tank



- For Android users, please scan the QR code to access to Tencent App store.
- Shui Jie web portal - <https://taxnews.pwchk.com>.



In the context of this News Flash, China, Mainland China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PwC's client service team or your other tax advisers. The materials contained in this publication were assembled on 30 April 2019 and were based on the law enforceable and information available at that time.

This China Tax and Business News Flash is issued by the **PwC's National Tax Policy Services** in China and Hong Kong, which comprises of a team of experienced professionals dedicated to monitoring, studying and analysing the existing and evolving policies in taxation and other business regulations in China, Hong Kong, Singapore and Taiwan. They support the PwC's partners and staff in their provision of quality professional services to businesses and maintain thought-leadership by sharing knowledge with the relevant tax and other regulatory authorities, academics, business communities, professionals and other interested parties.

For more information, please contact:

Matthew Mui
+86 (10) 6533 3028
matthew.mui@cn.pwc.com

Please visit PwC's websites at <http://www.pwccn.com> (China Home) or <http://www.pwchk.com> (Hong Kong Home) for practical insights and professional solutions to current and emerging business issues.

www.pwchk.com