Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email (bc_08_17@legco.gov.hk) and by hand

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Hon. Kenneth Leung
Chairman
Bills Committee on Inland Revenue (Amendment) (No.3) Bill 2018
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Mr Leung,

Inland Revenue (Amendment) (No. 3) Bill 2018

The Taxation Faculty ("TF") of the Hong Kong Institute of Certified Public Accountants has considered the Inland Revenue (Amendment) (No.3) Bill 2018 ("the Bill") and would like to submit its views on the Bill, which are explained further below.

While we welcome the aims of the Bill to support the future development of research and development ("R&D") in Hong Kong, particularly in the fields of innovation and technology, we consider that further changes may need to be made to the Bill to enhance Hong Kong's ability to attract R&D activities.

1. Qualifying research and development (R&D) expenses

The proposed definition of "qualifying R&D activity" in relation to type B expenses, which qualify for enhanced deductions, is based upon the definition of "research and development" in the current section 16B(4)(a) of the Inland Revenue Ordinance ("IRO"), and includes the following activities conducted in Hong Kong:

a) An activity in the fields of natural or applied science to extend knowledge;
b) an original and planned investigation carried on with the prospect of gaining new scientific or technical knowledge and understanding; or
c) the application of research findings or other knowledge to a plan or design for producing or introducing new or substantially improved materials, devices, products, processes, systems or services before they are commercially produced or used.

Paragraph 13 of the Legislative Council Brief on the Bill and paragraph 6 of the Inland Revenue Department ("IRD")'s Departmental Interpretation and Practice Notes No. 5 (revised) ("DIPN 5") state that the definition is in line with the definition of Hong Kong Accounting Standard 38 ("HKAS38"). However, "technical knowledge", "system" or "services" are not further defined in HKAS38. Therefore, professional accountants are required to exercise judgment as to whether expenditure incurred should be regarded as R&D expenses under HKAS38 and should qualify for a tax deduction under section 16B of the IRO.

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For example, some entities may include the expenses incurred for development of a new online game, based on the existing available programming language, as development expenditure, and expenses incurred in a process seeking advancement of the existing technology of artificial intelligence, as research expenditure, under HKAS38. However, it is not certain whether the IRD would consider such activities to be "qualifying R&D activity".

We note that section 18 of schedule 45 to the IRO empowers the Commissioner of Inland Revenue ("CIR") to seek advice from the Commissioner for Innovation and Technology ("CIT") when processing section 16B claims or advance ruling applications, given CIT's expertise in relation to what constitutes R&D activities that would extend scientific or technical knowledge and understanding. While it may be difficult to provide a comprehensive list on what business activities would be regarded as fulfilling the conditions laid down in (a) - (c) above, it is highly desirable for CIR/CIT to provide some further principles and practical guidance to which taxpayers could refer in determining whether their business activities would satisfy any of the requirements of (a) - (c) above. IRD could then consider incorporating these guiding principles into a revised DIPN 5.

2. ***Information confidentiality***

As mentioned above, section 18 of schedule 45 empowers CIR to seek advice from CIT when processing section 16B claims or advance ruling applications. This means that claimants' information may be passed to CIT for review. It is not made clear whether, beyond this, CIT may seek further input from external experts, but it highlights the need for taxpayers' information to be kept confidential and for CIT and staff of the Innovation and Technology Commission to be bound by the same confidentiality obligations as currently apply to the IRD.

3. ***R&D expenses paid to third parties***

Under the Bill, expenditure qualifying for any type of section 16B tax deductions is limited to direct expenses incurred by taxpayers and payments made by taxpayers to R&D institutions for R&D activities. An "R&D institution" is defined as:

(a) a designated local research institute or;
(b) a university or college that is not a designated local research institute.

Under section 19 of schedule 45, CIT may designate certain types of Hong Kong-based institutions as "designated local research institutes". While no principles or procedures for designating a particular institution are provided in the Bill, the Legislative Council Brief (paragraph 17) indicates that detailed conditions and application procedures will be drawn up separately.

Payments made in relation to subcontracted R&D activities to parties other than R&D institutions will not be tax deductible under section 16B and it is also uncertain whether such payments will be permitted as general deductions under section 16(1) of the IRO, or otherwise be deductible.

It is worth noting that it is not uncommon for multinational corporations to centralise their R&D functions in certain specific locations, so as to achieve economies of scale and make use of the advantages of those particular locations, such as the presence of talent pools.

For example, the Hong Kong subsidiary of a multinational software company, which takes care of the group software distribution in Hong Kong, might ask the group's research laboratory in Mainland China to develop additional innovative software to address issues specific to the Hong Kong market. The additional software and the original software run together would aim to serve the needs of the Hong Kong market and would be sold as a package to customers in Hong Kong. The Hong Kong subsidiary may take up the relevant costs for developing the software through a group cost-sharing arrangement. Also, the Hong Kong subsidiary may co-own the intellectual property ("IP") rights of the software.

Based on the existing and proposed deduction rules for R&D expenses, the Hong Kong subsidiary would not be able to deduct the relevant cost incurred for developing the software under section 16B, as the payment would not be made to an R&D institution.

The above example illustrates that the scope for deducting subcontracted R&D expenses is still very restrictive under the Bill, which will impede the objective of developing Hong Kong as a regional IP hub. In addition, this restrictive approach renders Hong Kong less competitive relative to other relevant markets, including the Mainland, which permits R&D expenses under cost-sharing arrangements within a group as allowable tax deductions.

While we appreciate the need to have controls in place to avoid abuse of incentives, it is important to strike an appropriate balance and not to disqualify taxpayers who incur genuine R&D expenses from being able to claim tax deductions for those expenses.

Unlike the procedure for CIT to designate local research institutes, there seems to be no equivalent arrangement for research institutes to seek to be recognised as an "R&D institution", or for taxpayers to otherwise seek deductions for payments made to such institutes. In order to address this gap, we suggest that the government consider expanding the definition of "R&D institutions", which as currently drafted would appear to allow R&D to be subcontracted to, or commissioned from, relatively obscure universities and colleges outside of Hong Kong, but not from renowned research institutes.

We suggest that the definition be expanded or a mechanism be provided in the Bill, to allow (i) group entities (including those located in Hong Kong and overseas); and (ii) other local and overseas R&D research institutes, to seek "R&D institution" status; or, alternatively, that CIT be empowered to determine that payments made to specific institutes or entities should qualify for deduction, upon application by taxpayers to the IRD or CIT. The aim would be to enable Hong Kong entities to be able to claim a 100 percent tax deduction on legitimate R&D expenses paid to other research organisations, which may be outside of Hong Kong and which undertake the R&D work, or part of the R&D work, on behalf of the Hong Kong entity.

4. Group cost sharing arrangements where IP rights are not fully vested to the Hong Kong entities

In the example quoted in item 3 above, it would appear that a deduction under section 16B would be denied because the payment would not be made to an R&D institution. However, even if the Hong Kong entity, together with other overseas group companies, were to engage an overseas R&D institution to conduct the R&D activity, the Hong Kong entity might not be able to claim a deduction for the expenses incurred where the IP related to the R&D activity was co-owned by the participating group entities. This is so because section 14(a)(i) of schedule 45 added by the Bill requires that any rights generated from an R&D activity falling within the description in section 6(1)(a) or (c) of the schedule must be "fully vested" in the taxpayer, in order to be deductible under the amended section 16B of the IRO. Therefore, in this case, it is uncertain whether the condition of being "fully vested" would be satisfied.

If the outcome under the Bill would be denial of a deduction to the taxpayer in the circumstances referred to above, on the grounds that the IP is co-owned, we would urge the government to relax the requirement that IP must be "fully vested". Guidelines could be drawn up to provide for circumstances in which deductions would be allowed under a co-ownership arrangement.

5. Startup companies

During consultations conducted last year by the Innovation and Technology Commission, we expressed the view that startup companies that engage in R&D activities may not be able to get the benefit of the new enhanced deductions, because they may be in a tax loss position in the early stages of their operations. We suggested that tax credits, which are offered in a number of other jurisdictions, be made available to startups as a more practical and valuable incentive for them. We take this opportunity to repeat the proposal. Given that a fundamental aim of the new provisions is to encourage more R&D to be conducted in Hong Kong, any tax credit arrangements could be limited to qualifying R&D activities and Type B expenditure, i.e., only expenditure eligible for the enhanced deductions.

Should you have any questions on this submission, please contact me at 2287 7084 or peter@hkicpa.org.hk

Yours sincerely,

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