Departmental Interpretation and Practice Notes No. 55 - Deduction for Research and Development Expenditure (“DIPN 55”)

Summary

The Hong Kong Inland Revenue Department (“IRD”) released its practice note, DIPN 55, regarding the research and development (“R&D”) tax concession in Hong Kong, enabling taxpayers to claim a tax deduction of two or three times the actual cost on qualifying R&D expenditure. DIPN 55 sets out the IRD’s interpretation and practical application of the R&D tax concession, and documentation requirements.

While the R&D is very wide and the concessions may apply to all industry sectors provided that the necessary conditions are met, it is important for companies to identify qualified R&D activities ‘upfront’ and to understand the current state of the art, extension of knowledge and technical improvements involved in the project outcomes.

Companies undertaking any R&D should therefore assess eligibility and establish processes and procedures now to facilitate successful R&D claims.

The Hong Kong Inland Revenue Department (“IRD”) released its practice note regarding the research and development (“R&D”) tax concession in Hong Kong. DIPN 55 sets out the IRD’s interpretation of the R&D tax concession, the practical application of the concession and documentation requirements.

Commencing from the year of assessment 2018/19 (expenditure incurred from 1 April 2018), qualifying R&D activities are eligible for either Type A expenditure (100% tax deduction) or Type B expenditure (300% tax deduction for the first HK$2 million and 200% of the amounts exceeding HK$2m). Please refer to our Tax Alert – Enhanced tax deduction for R&D activities in Hong Kong for additional details relating to the legislative requirements.

DIPN 55 sets out the practical guidance, and we note the following:

Qualifying R&D activity

- The R&D enhanced deduction is available for all industries provided the necessary requirements are met.

- Key elements of the definition of qualifying R&D activities include: “an activity in the fields of natural or applied science to extend knowledge, application of research findings to introduce new or substantially improved materials, devices, products, processes, systems or services before they are commercially produced”.

- The IRD acknowledges that this definition has a wide scope but R&D needs to exceed minor or incremental upgrades. “R&D activity” can therefore be described as an activity working for tomorrow to develop new products, new lines and improvements to present production.

- Importantly, in cases where the science and technology has already been achieved, where such findings and outcomes are not readily available (e.g. trade secrets), R&D activities carried out to achieve a similar advance can still be an advancement in science and technology.

- DIPN 55 clarifies that the R&D activity is not required to be wholly carried on in Hong Kong, but only local Hong Kong expenditure may qualify for the enhanced deductions.

- Registration of patents is not a prerequisite for an activity to be regarded as an R&D activity.
Qualifying R&D expenditure

- Only expenditure relating to in-house direct staff, direct consumables and payments to designated local research institutions are eligible for the enhanced deduction. The IRD considers eligible R&D staff costs as those related to employees of the taxpayer.

- Employee costs of associated entities are not included as eligible R&D costs. That being said, where there is a “secondment arrangement”, such costs may be included. Payments to expert consultants which are not employees of the taxpayer cannot be claimed as enhanced R&D deductions.

- Payments to external contractors (other than designated local research institutions) are not eligible for the enhanced R&D deduction.

Documentation

- DIPN 55 sets out the requirement to maintain contemporaneous documentation. This includes project planning material covering:
  - R&D objective
  - Link between the outcome of the R&D project and commercial outcomes
  - Current state of knowledge
  - Foreseen technical difficulties of the project
  - Structure for the project
  - Notes on staffing and expertise of resources

- As the project develops, taxpayers shall maintain:
  - Documentation of findings
  - Notes on uncertainties and technical challenges encountered during the development
  - Details of patents filed (if any)
  - Internal progress reports

- Relating to the R&D expenditure, the IRD expects:
  - For outsourced activities, contracts entered and evidence of payments made
  - For in-house staffing costs, details of qualifications, employment contracts, payroll records and timesheets (for those which are not full time)
  - Invoices for consumables
KPMG observations

DIPN 55 clarifies both the nature of qualifying activities and associated R&D expenditure under the enhanced deduction regime. The IRD confirms that R&D is very wide and the concessions may apply to all industry sectors provided that the necessary conditions are met.

Notwithstanding this, it is important for companies to identify qualified R&D activities ‘upfront’ and to understand the current state of the art, extension of knowledge and technical improvements involved in the project outcomes. Companies should identify and segregate qualified R&D activities from routine “business as usual” and indirect activities that are not sufficiently connected to the main experiment(s).

Determining whether activities qualify under the R&D program depends on the facts associated with specific activities and must be assessed on a case by case basis. The documents companies maintain in respect of such activities will be critical to successfully defending a potential audit by the IRD. The case studies included in DIPN 55 are helpful for companies to determine their eligibility for enhanced deductions. Companies undertaking any R&D should therefore assess eligibility and establish processes and procedures now to facilitate successful R&D claims.

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