



Hong Kong Tax Updates

Report on Inland Revenue Board of Review Decisions

Volume 33 Second Supplement

D16/17 Source of Profits

The taxpayer claimed that it was engaged in OEM (Original Equipment Manufacturing) of watch cases, watch bands and straps. It purchased semi-finished goods from HK related entities, have them manufactured in the Mainland by Mainland entities and sold to HK related entities. It contended that it did not carry on business in HK. Even if it did carry on business in HK, the profits so derived were offshore. The taxpayer did not provide the information and documents to IRD as requested such as documents for sample transactions and details of services of its staff. The taxpayer failed to adduce any documentary evidence of sales and purchase. The Board dismissed the appeal.

D17/17 Subscription to Professional Bodies

A physicist claimed deduction of subscriptions to 4 professional bodies. The Board dismissed his appeal. The Board is not bound by DIPNs. The subscriptions were not necessarily incurred. S.12(1)(a) has not been fulfilled.

Report on Departmental Interpretation and Practice Notes (DIPNs)

Annuity Premium and Tax Deductible MPF Voluntary Contributions (TVC)

Departmental Interpretation and Practice Notes No. 57 (DIPN57)

Annuity premium (as.26N to 26R) and TVC (s.26S) are concessionary deductions allowable under salaries tax and personal assessment. The aggregate deduction for Annuity premium and TVC is limited to \$60,000 for 2019/20.



Annuity Premium

To be eligible for deduction, a taxpayer must purchase a qualifying deferred annuity policy (QDAP) which is certified by the Insurance Authority (IA). The QDAP must be purchased by the taxpayer or the taxpayer's spouse as a sole policy holder or the taxpayer and spouse as joint policy holders. The policy must cover the taxpayer or the taxpayer's spouse as a sole annuitant or the taxpayer and spouse as joint annuitants in the case of a joint policy. If the annuitant is any other person e.g. parent of the taxpayer, the taxpayer is not eligible for deduction.

The annuitant must be the holder of a HKID card at any time during the year of assessment. Deduction is granted in the year of assessment in which the premium is paid. Pre-paid premiums are not deductible in the year of payment. If any premium for which deduction has been granted is refunded, the taxpayer must notify the CIR within 3 months after the date of refund.

TVC

TVC, defined in section 11A of the Mandatory Provident Fund Scheme Ordinance (Cap 485) (MPFSO), is different from the employment-related voluntary contributions. The latter is not tax deductible. A taxpayer may open a TVC account in an MPF scheme and makes TVC directly to the TVC account without going through his employer. A taxpayer may make TVC to his TVC account at any time at any amount. He needs not be an employee or self employed person at that time. Deduction is not allowable to the spouse.



Retirement Scheme (DIPN 23 (Revised))

DIPN 23 (Revised) is published in May 2019 to update the practices as a result of the amendments to the IRO in the past years. MPF voluntary contributions made by employees and self-employed persons are not deductible for tax purposes. As from 1 April 2019, TVC paid into a TVC account is deductible under salaries tax or personal assessment. A TVC account holds TVC made by an account holder, accrued benefits from the TVC and TVC transferred from other TVC accounts. DIPN 23 (Revised) gives examples on taxability of accrued benefits, computation of proportionate benefits, setting off of severance payments and redundancy payments against accrued benefits etc under various circumstances, tax treatment of voluntary contributions by an employer which is not chargeable to profits tax e.g. charitable bodies and other issues in relation to retirement schemes. The DIPN also deals with transfer of benefits from one scheme to another without termination of services e.g. setting up of a new scheme to replace the old one or permanent departure from HK without termination of services. By concession the CIR will not tax the transferred benefit in the year of transfer if it is not part of a tax avoidance scheme. The chargeability will be determined upon termination of service. For defined benefit scheme (as contrast to defined contribution scheme), the defined benefit cost recognized in the income statement as required by HKAS19 is not deductible (s.17(1)(j)) but ordinary annual contribution paid is deductible subject to the 15% ceiling. Recognised retirement schemes which are funds within s.20AM may be eligible for exemption from Profits Tax effective from 1 April 2019. For the purpose of double taxation agreements (DTAs), pension is defined as including lump sum payments. The source of a pension (i.e. whether a pension is arising in Hong Kong) is the situs of the fund from which the pension is paid. This does not necessarily mean the place where the assets comprising the fund are physically situated but the place where the fund is managed and controlled. HK will try to reserve the taxing rights of payments made out of an MPF scheme but it depends on the terms of individual DTAs.



Deduction for Research and Development Expenditure s.16B

DIPN55

Amendments to the IRO in 2018 grant enhanced tax incentives to R&D activities. Type A expenditure qualifies for 100% deduction. Type B expenditure qualifies for 300% deduction for the first \$2 million and \$6 million plus 200% deduction for the remaining Type B expenditure. There is no cap on the amount of the deduction for Type B expenditure. The provisions relating to s.16B are now encapsulated in a new Schedule 45. DIPN55 has been issued in relation to the relevant provisions.

Schedule 45

Definitions:

Type A expenditure is an R&D expenditure other than a Type B expenditure.

An R&D expenditure is a payment to an R&D institution for an R&D activity related to the trade, profession or business or the class of trade, profession or business or other expenditure on an R&D activity related to the trade profession or business including capital expenditure except expenditure on or related to land or building. It does not include expenditure for the acquisition of rights from an R&D activity. (Expenditure for the acquisition of a patent right may qualify for deduction under s.16E).

An R&D institution refers to a local research institution. A payment to an overseas university or college may still qualify as an expenditure on an R&D activity related to the trade, profession or business and eligible as Type A expenditure provided that the other conditions for deduction are fulfilled.

R&D activity embraces scientific research, feasibility study and market, business or management research involving systematic, investigative or experimental activities and application of research findings to a new or substantially improved product, process, system or service.

R&D activity related to trade, profession or business means R&D activity that may improve the technical efficiency of the trade, profession or business and R&D activity of a medical



nature that is of particular relevance to the welfare of employees employed in the trade, profession or business.

Qualifying R&D activities means R&D activities which seek to directly contribute to achieving advance in science or technology through resolving scientific or technological uncertainty undertaken and carried on in HK. Feasibility study, market research or sales promotion are excluded. There is no need for the whole project to be carried on in HK. For a project carried on partly in and partly out of HK, only the expenditure attributable to the activities carried on in HK may qualify as Type B expenditure.

Qualifying expenditure relating to the trade, profession or business means:

- (i) expenditure in relation to an employee who is directly and actively engaged in qualifying R&D activities related to the trade, profession or business or
- (ii) expenditure on a consumable item that is used directly in a qualifying R&D activity related to the trade, profession or business.

Type B expenditure refers to:

- (i) R&D expenditure paid to an R&D institution for qualifying R&D activities related to the trade, profession or business or class of trade, profession or business to which the enterprise belongs; or
- (ii) Qualifying expenditure relating to the trade, profession or business. It can be seen that Type B expenditure only applies to qualifying R&D activities.

Key provisions of Schedule 45

No deduction is allowed:

- (1) if the right generated from the activity is not fully vested in the taxpayer;
- (2) the activity is undertaken for another person;
- (3) if the expenditure is reimbursed by a government or another person or
- (4) expenditure is incurred under an arrangement to enable to the taxpayer to obtain the deduction for which he would not otherwise be entitled.



If the plant or machinery the capital expenditure of which has been deducted under s.16B is subsequently sold, the proceeds will be treated as a trading receipt, limited to the total amount of deduction allowed under s.16B.

The proceeds from the sale of rights generated from the R&D activities where s.16B deduction has been granted are taxable.

Where application is made under s.88A for an advance ruling in relation to s.16B deduction, the CIR may seek advice from the Commissioner for I&T e.g. whether certain activity constitutes R&D activities or qualifying R&D activities.

DIPN55

R&D activities do not include quality control, routine testing, routine data collection or processing and distribution of goods or services. Minor or routine or cosmetic upgrading are excluded.

Qualifying R&D activities must seek to directly contribute to advancement in science or technology through resolving scientific or technological uncertainty. The crux is whether a competent professional in the field would regard the research as involving scientific or technological uncertainty.

Work in art, humanities and social sciences, including economics, are not sciences qualifying for Type B expenditure.

Activities can still be qualifying R&D activities even if the advance in science sought is not achieved.

Expenditure on commercial or financial steps, non-scientific or non-technological aspects, administrative and support services do not qualify as R&D expenditure.

Payments to R&D institutions qualify for deduction irrespective of whether the funds were actually used by the institutions for capital or revenue purposes. Thus payment for establishment, extension or administration of the institution qualifies so long as the conditions for deduction are fulfilled. Payments under s.16B should be distinguished from



donations which need not be made for any specific purposes. The latter may be deducted under s.16D if they qualify as approved donations.

Directors' fees, fees paid for licensing or maintenance of plant or machinery, consultancy fee paid for expert advice, licence fees paid for intellectual property rights do not qualify as Type B expenditure but may qualify as Type A expenditure.

No deduction under s.16B may be allowed if any right generated from the R&D activity is not fully vested, or would not be vested in the enterprise. Rights are not restricted to patent rights. They include unregistered know-how and work-in-progress intangibles. This condition does not apply to payments to R&D institution.

Cost contribution arrangement (CCA) may be entered into between associated companies in a multinational group for sharing of contributions and risks in R&D activities. Development CCAs are those entered into for the joint R&D activities to obtain intangibles or tangibles assets. Service CCAs are those entered into for the obtaining of services. The share of costs of development CCA may be deductible under s.16B provided that a number of conditions are fulfilled including the requirements that the enterprise derives benefit from the CCA and the enterprise actively participate in the R&D activity. Transfer pricing rules may be applied to determine the amount deductible.

R&D activity undertaken for another person does not qualify for relief under s.16B. For example, payment to a local institution to carry out R&D activities only confers an entitlement to deduction under s.16B to the enterprise. The local institution can only claim deduction of the actual expenses incurred by it under s.16(1). However, if the intellectual property generated from the R&D activity belongs to the local institution which carries out the R&D activity, the local institution may claim deduction for its costs under s.16B. This applies to a case where payment is made by an enterprise to a local institution to pursue the latter's object of undertaking R&D activities related to the class of trade, profession or business to which the enterprise belongs.

Where part of the R&D expenditure is reimbursed or met by any subsidy or grant whether from the HK Government or otherwise, only the net amount is eligible for s.16B deduction. Even though the enterprise may have received proceeds from sale of goods or contract



price of a project, expenditure incurred in respect of R&D expenditure may still qualify for deduction under s.16B. See Examples 14 and 15 of DIPN 55.

Deduction will be denied or restricted in case of tax avoidance arrangements. See Example 16 (inflated payments to local institution substantially financed by a non-recourse loan), Example 17 (using a partnership which is a sham) and Example 18 (R&D activity ostensibly out-sourced to an associate but is in fact conducted in-house).

Proceeds of sale of plant or machinery the expenditure of which has been allowed under s.16B are taxable. So is rights generated from the R&D activities. See para.109 to 111 and Example 19 for the apportionment of the sales proceeds if the amount previously deducted consists of both Type A and Type B expenditure.

S.15(1)(bc) is added to tax any sum received from the use or right to use outside HK of intellectual rights or know how generated from any R&D activity for which deduction under s.16B has been granted.

The CIR may apply S.61 and s.61A if an R&D regime is abused to secure a benefit which is not intended under s.16B. DIPN 55 cited two British cases, both of which involved partnerships claiming excessive deductions on research and development.

Advance Ruling may be applied on how s.16B and Schedule 45 may be applied to the applicant.

Appendix 1 DIPN 55 gives examples on various areas of science or technology illustrating the application of principles. Examples include HD Blu-ray Player, new drug, cooling system in a building, weed killer, new silver bonding wire, lower fat ice-cream, premixed flour formulation, concrete using plastic optical fibre, water breathable fabric for use in hiking.

Appendix 2 gives illustrations on the application of the practices of DIPN 55 - Software Creation, FinTech and Drug development



Appendix 3 explain how the Assessor may make inquiry into a claim for R&D deduction and the R&D records required to be kept.

Health Insurance Premiums – DIPN56

With effect from 2019/20, a new concessionary deduction for salaries tax and personal assessment is granted in respect of premium paid for insurance plans which comply with Voluntary Health Insurance Schemes (VHIS) (Certified Plans). A VHIS Office has been established by the Food and Health Bureau to certify insurance products which are in compliance with Certified Plans. Only premium paid in the year of assessment is deductible. The payment must be made by a taxpayer and his/her spouse as holder of a VHIS policy. The insured person must be the taxpayer or a specific relative of the taxpayer in the year of assessment. The insured person must be the holder of a HKID card at any time during the year of assessment or if the insured person is under 11, a natural or adoptive parent of the insured person must be a HKID card holder at the time of birth/adoption of the insured person. Premium in respect of other insurance plans e.g. accident, life or hospital cash plan is not a qualifying premium and not eligible for deduction. The DIPN gives examples illustrating the application of the law to different situations. S.26K(4) is an anti-avoidance provisions granting the power to the Commissioner to determine the amount of qualifying premiums if the Commissioner is of the opinion that the qualifying premiums paid for the insured person under a VHIS policy are not commensurate with the risk profile of the insured person.

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