



Inland Revenue Department  
Hong Kong

## **DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES**

### **NO. 5 (REVISED)**

#### **PROFITS TAX**

##### **DEDUCTIONS FOR EXPENDITURE ON –**

- (A) RESEARCH AND DEVELOPMENT**
- (B) TECHNICAL EDUCATION**
- (C) PATENT RIGHTS, ETC.**
- (D) BUILDING REFURBISHMENT**
- (E) PRESCRIBED FIXED ASSETS**

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in October 2003.

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Commissioner of Inland Revenue

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## No. 5 (REVISED)

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## **INTRODUCTION**

It is a canon of taxation that capital expenditure is not normally an allowable deduction in ascertaining the assessable profit of any trade, profession or business. The introduction in 1965 of section 16B and section 16C respectively relating to scientific research and technical education marked an important change from the normal principle of allowing tax deductions. This was followed successively by the enactments in 1983 of section 16E (relating to patent rights), in 1996 of section 16F (relating to hotel refurbishment), which, in 1998, was extended to all non-domestic buildings, and in 1998 of section 16G (relating to prescribed fixed assets).

### **(A) RESEARCH AND DEVELOPMENT – SECTION 16B**

2. Section 16B was enacted in 1965 to allow expenditure incurred by a person carrying on a trade or business for scientific research related to that trade or business as a deduction. The deduction allowable included capital expenditure on plant or machinery but excluded capital expenditure on land or buildings. In 1998, the section was extended to a person in a profession. At the same time the definition of scientific research was expanded to include feasibility studies and market research. In 2004, the scope of the deduction was further extended to include expenses incurred on “research and development”. The term “research and development” has a wide meaning and embraces all the activities that were previously classified as scientific research, as well as the new original investigation and design-related activities.

3. Expenditure on research and development may be in the form of a payment to an approved research institute, or expenditure on in-house research and development undertaken by a person, or expenditure incurred by a person for acquiring technology in relation to his trade, profession or business.

#### ***Meaning of research and development***

4. For the years of assessment from 1965/66 to 1997/98, the term “scientific research” was defined to mean “any activities in the fields of natural or applied science for the extension of knowledge” [the then section 16B(4)(a)]. Scientific research is generally regarded as embracing the application of new

scientific principles in an existing area of research, or the application of existing principles in a new area of research. This covers research work to develop new products, new lines and also the improvement of existing products.

5. With effect from the year of assessment 1998/99, the definition of “scientific research” was expanded to cover any systematic, investigative or experimental activities carried on for the purposes of any feasibility study or in relation to any market, business or management research [section 16B(4)(a), definition as amended in 1998].

6. From the year of assessment 2004/05 and onwards, the references to “scientific research” are replaced by the references to “research and development”, and deduction is allowed on expenses incurred on research and development. The term “research and development” has a wider scope. It embraces all the activities that are referred to as scientific research. In addition, it includes original and planned investigations into new scientific or technical knowledge and understanding, as well as the application of any research findings or knowledge to a plan or design for production or introduction of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of their commercial production or use. The activities newly included are in line with those that are regarded as “research” and “development” in the accounting standards currently adopted by the accountancy bodies in Hong Kong [section 16B(4)(a), definition as amended in 2004].

***Research and development related to a trade, profession or business***

7. Research and development is to be treated as related to a trade, profession or business if it may lead to or facilitate an extension, or an improvement in the technical efficiency, of that trade, profession or business [section 16B(5)(b)(i)], or is medical research which has a special relation to the welfare of workers employed in that trade or class of trade [section 16B(5)(b)(ii)].

8. Thus research and development undertaken by a trader with the object of branching out into a new line of business or of improving the technical efficiency of his existing business will be treated as related to the

trade; also expenditure by a trader for research into an occupational disease peculiar to his industry would be treated as related to his trade. “Research and development” can therefore be described as working for tomorrow to develop new products, new lines and improvements to present production. It does not, however, cover “quality control” which is more aptly described as working for today and today’s production to ensure that what has been produced is up to standard [see *Australian Board of Review Decision in 12 CTBR (NS) Case 5*]. Deductibility of expenses relating to quality control activities should be tested under the normal rules for deduction under sections 16(1) and 17, that is, the expenses are deductible if they are incurred in the production of chargeable profit of the taxpayer and that they are not capital in nature.

### ***Payments to approved research institutes***

9. Payments to approved research institutes are allowable if the payments are for specific research and development related to that person’s trade, profession or business, or for general research if the object of the institute is the undertaking of research and development related to the class of trade, profession or business to which that person belongs.

10. An approved research institute is defined in section 16B(4)(a) as (a) any university or college; or (b) any institute, association or organization which is approved in writing for the purposes of this section by the Commissioner as an institute, association or organization for undertaking research and development which is or may prove to be of value to Hong Kong. Prior to 1 April 1996, the Director of Education was responsible for granting the approval. An approval operates from a date, whether before or after the date of approval, specified in the instrument of approval, and can be withdrawn at any time. A list of approved institutes is provided in the **Appendix**.

11. The deduction is allowed irrespective of the actual usage of the funds by the approved institute for either capital or revenue purposes. Thus, payments for establishing or extending an approved research institute, payments towards the administration of the approved research institute and payments for the actual carrying out of the research and development are allowable as long as the object of the approved institute is the undertaking of research and development related to the class of trade, profession or business to which that person belongs.

### ***Capital expenditure on plant and machinery***

12. Capital expenditure on plant or machinery purchased by a taxpayer for research and development related to his trade, profession or business is allowable in full as a deduction for the basis period during which it was incurred. If the expenditure is incurred before the trade commences, it should be treated as incurred in the first basis period.

13. Under section 16B(3)(a), when such plant or machinery ceases to be used for research and development and is then sold, the sale proceeds, to the extent that they are not otherwise chargeable to Profits Tax and do not exceed the amount of deduction previously allowed, are treated as a trading receipt accruing at the time of the sale or the date immediately preceding the cessation of business if the sale occurs on or after the date of cessation. The time of sale is the time of completion of the sale or the time when possession is given, whichever is the earlier.

14. Where any such plant or machinery is destroyed, it shall for the purposes of section 16B(3)(a) be treated as if it had been sold immediately before the destruction. Any insurance money, compensation money or money received shall be treated as if it were the proceeds of that sale and be assessed as a trading receipt.

### ***Capital expenditure on land or buildings***

15. No deduction is allowable under section 16B in respect of any capital expenditure incurred by a taxpayer on land or buildings or on alterations, additions or extensions to buildings. Where such expenditure results in a relevant interest in a building, then Industrial Building Allowances under section 34 can be granted on the capital expenditure on a building used for research and development purposes, irrespective of the nature of trade carried on [section 40].

### ***Capital expenditure in acquiring rights in, or arising out of, research and development***

16. It is specifically provided in section 16B(5)(a) that no deduction is allowed for any expenditure incurred in acquiring rights in, or arising out of,

research and development. Effective from the year of assessment 1998/99, a reference to rights includes a reference to a share or interest in such rights. However, if the rights acquired are patented rights, the expenditure can amount to an allowable deduction under section 16E.

### ***Expenditure outside Hong Kong***

17. Where any payment or expenditure, which qualifies for deduction under section 16B, is made or incurred outside Hong Kong, it is necessary to consider whether it is allowable in full. If the trade, profession or business is carried on solely in Hong Kong, then the full amount of the expenditure is allowable as a deduction in arriving at the chargeable profits.

18. Where the trade, profession or business is carried on partly in and partly out of Hong Kong, it is necessary to consider the whole of the activities of the trade, profession or business to arrive at a reasonable deductible proportion of such expenditure, which relates to the production of chargeable profits. This is a question of fact to be determined in the light of the circumstances of each case.

### ***Subsidies and grants received***

19. Where a person incurs expenditure on research and development and part of such expenditure is, or is to be, met directly or indirectly by the Government of Hong Kong, or by any government or public or local authority, or by any other person, only the net amount qualifies for deduction under section 16B.

### ***Sale of rights in or arising out of research and development***

20. With effect from the year of assessment 1998/99, where any rights in, or arising out of, research and development, the expenditure on which has been allowed as a deduction under section 16B, are sold, the sale proceeds not otherwise chargeable to Profits Tax shall be treated as trading receipts. Where the scenario in paragraph 18 applies, the sale proceeds will be restricted to such part as proportionate to the extent of the deductible proportion of the expenditure on research and development. The amount assessable shall not exceed the amount of deduction previously allowed.

21. The sale proceeds accrue as income at the time of sale, which is the time of completion of the sale of the rights. If, however, the sale occurs on or after the date of permanent cessation of the trade, profession or business, the sale proceeds accrue as income immediately before the cessation.

## **(B) TECHNICAL EDUCATION – SECTION 16C**

22. Section 16C was introduced as from the year of assessment 1965/66 to allow payments made by a person carrying on a trade or business for technical education. Effective from the year of assessment 1998/99, the section was extended to a person carrying on a profession.

23. Under section 16C, a person carrying on a trade, profession or business in Hong Kong is allowed a tax deduction for any payment to be used for the purposes of technical education related to that trade, profession or business at (a) any university, university college or technical college; or (b) any other similar institution which is approved by the Commissioner. The recognition of the institution for this purpose shall start from whatever date is specified in the approval. This may be before or after the date of approval [section 16C(3)(a)]. Prior to 1 April 1996, the approval was given by the Director of Education. The approval given can be withdrawn at any time. A list of approved institutions is provided in the **Appendix**.

### ***Deductible payments***

24. For the purposes of section 16C, technical education is deemed to be related to a trade, profession or business if and only if it is of a kind specially requisite for persons employed in that class of trade, profession or business.

25. The deduction applies to any payment to an approved institution to be used for the purposes of technical education related to a particular trade, profession or business. It does not have to be directly for the education of any person or persons actually employed in the particular business at the time of payment. The deduction extends to a payment to establish a unit or for the general maintenance of a unit at an approved institution so as to provide technical education of a kind specially suited or requisite to a particular class of trade, profession or business. However, contributions in response to appeals

made for funds to be used on purchase of capital equipment would not be allowable.

26. Where payments are made for the technical education of particular persons, the payment may be made to either such persons or the approved institution.

27. The intention of section 16C is to broaden and not to restrict what would ordinarily be allowable deductions. So expenditure by an employer on the technical training or education of any of his employees may be allowed under section 16(1) even if the institution is not an approved institution.

### **(C) PURCHASE AND SALE OF PATENT RIGHTS, RIGHTS TO KNOW-HOW – SECTION 16E**

28. Section 16E was introduced to provide an incentive to promote technological progress in local industry by allowing as a deduction the capital cost of acquiring patent rights, trademarks or designs. The deduction is effective from the year of assessment 1982/83 and onwards. This deduction is additional to that for the royalty or recurrent payment in connection with the use of the patent right, trademark or design which continue to be allowable under section 16(1).

29. As a measure to prevent exploitation, section 16E was amended on 12 March 1992 by the Inland Revenue (Amendment) Ordinance 1992. One amendment was to substitute the term “trade mark or design” by “know-how” so as to restrict the deduction to expenditure on industrial information and techniques on manufacturing of goods. Another amendment was to deny a deduction for transactions between associated parties. The amendments apply to contracts entered into on or after 18 April 1991.

#### ***Meaning of patent rights, know-how***

30. The terms “patent rights” and “know-how” are defined in section 16E. “Patent rights” means “the right to do or authorize the doing of anything which would, but for that right, be an infringement of a patent”. “Know-how” means “any industrial information or techniques likely to assist in the manufacture or processing of goods or materials”.

### ***Allowable deduction***

31. Under section 16E, any expenditure incurred by a person on the purchase of patent rights or rights to any know-how is deductible if –

- (a) the rights are for use in Hong Kong in the trade, profession or business carried on by the person;
- (b) they are incurred in the production of that person's chargeable profits; and
- (c) the rights are not purchased wholly or partly from an associate.

32. A deduction is allowed when the expenditure is incurred. There is no requirement that the patent or know-how, once acquired, must be used in the production of profits chargeable in the year of purchase. It is sufficient if the person claiming the deduction can show that at the time of purchase the purpose of acquiring the right was for use solely in Hong Kong. However, adjustment of the deduction may have to be considered if the subsequent facts prove otherwise.

### ***For use in Hong Kong***

33. The phrase “for use in Hong Kong” is not defined in section 16E. According to the Shorter Oxford English Dictionary, the word “use” means “the act of using the thing for any purpose, the fact, state or condition of being so used; utilization or employment for or with some aim or purpose; application or conversion to some end”.

### ***Apportionment of the expenditure***

34. If the patent right or the right to the know-how is purchased for use partly in and partly outside Hong Kong, the expenditure shall be allowable to the extent of the use in Hong Kong on a basis reasonable and appropriate in the circumstances of the case. Such basis is clearly one of fact, to be determined on all the relevant facts including the terms of the agreement relating to the rights acquired, the manner and the use to which the patent is immediately put,

the range and scope of the activities both within and outside Hong Kong and whether the whole of the profit is subject to tax.

### ***Purchase of rights from associate***

35. No deduction is allowable under section 16E(2A) if the patent rights, etc. are purchased wholly or partly from an associate, irrespective of whether or not the price was at an arms-length. The meaning of “associate” is widely defined in subsection 4 of section 16E. It covers natural persons, partners in a partnership, or corporations under common control and trusts.

36. In the case of a trust, and for the purpose of section 16E(2A) the purchase or sale of a patent right etc. by the trustee of the trust or a corporation controlled by the trustee would be regarded as the purchase or sale, as the case may be, by each trustee, the corporation and the beneficiary under the trust [section 16E(2B)].

### ***Subsequent disposal***

37. If the whole or part of the cost of the patent rights or rights to know-how has been allowed as a deduction from the assessable profits, then the proceeds not otherwise chargeable to Profits Tax on the subsequent disposal of such rights are to be treated as a trading receipt. In other words, the sale proceeds of such sale, although capital in nature, are subject to tax.

38. Where only part of the cost of such rights has been allowed (see paragraph 34), only that part of the proceeds as is attributable to the relevant cost of the patent shall be assessed as a trading receipt. The basis of apportionment of the sale price will again have to depend on the facts of each case.

39. The sale proceeds shall be treated as a trading receipt accruing at the time of sale, or immediately before the discontinuance if the sale occurs after the business has been permanently discontinued.

40. The 1992 Amendment Ordinance referred to in paragraph 29 provides that the provisions of section 16E, in force immediately before the commencement of that Ordinance, continue to apply to patent rights etc.

purchased under contracts entered into before 18 April 1991 and also to sale proceeds received from the disposal of such rights whether before or after 18 April 1991, as if the amendments had not been enacted.

**(D) CAPITAL EXPENDITURE ON HOTEL / BUILDING  
REFURBISHMENT – SECTION 16F**

41. Section 16F was introduced as from the year of assessment 1996/97. For the years of assessment 1996/97 and 1997/98, a deduction is allowed on capital expenditure on the renovation or refurbishment of a hotel. With effect from the year of assessment 1998/99, the deduction was extended to the renovation or refurbishment of buildings other than domestic buildings. Any expenditure allowed under this section will not qualify for depreciation allowances under Part VI of this Ordinance.

42. The term “domestic building or structure” is defined in section 16F. It means any building or structure used for habitation, but does not include any building or structure used as a hotel or guesthouse. It is the actual use or intended use of the building, not the type of the building, that counts. “Hotel” and “guesthouse” have the same meaning as in the Hotel and Guesthouse Accommodation Ordinance (Cap. 349). Thus, the deduction does not apply to buildings used for letting for residential purposes or as directors’ or staff quarters.

***When allowable***

43. Capital expenditure meeting the requirements under section 16F is allowed as a deduction by five equal instalments, the first of which is allowed in the basis period during which the expenditure was incurred and the remaining four instalments in the basis periods of the four succeeding years of assessment. If the relevant property is sold before the instalments are fully granted, the person entitled to the instalments is still granted the instalments as if the property had not yet been sold.

### ***Qualifying expenditure***

44. To qualify for deduction, the expenditure incurred must be a renovation or refurbishment in nature. The words “renovation” and “refurbishment” are not defined in the Ordinance.

45. According to the Shorter Oxford English Dictionary, “renovation” means renewal or restoration, and “refurbishment” is renovation. Renovation or refurbishment expenditure can be either capital or revenue in nature, depending on whether the expenditure results in improving or repairing the building or structure concerned. Renovation expenditure of a capital nature is deductible in the manner specified under section 16F while renovation expenditure of a revenue nature is deductible under section 16(1)(e).

46. The Shorter Oxford English Dictionary defines “repair” as “Restoration of some material thing or structure by the renewal of decayed or worn out parts by refixing what has become loose or detached”. It should be noted that in the *Privy Council case of Auckland Gas Co. Ltd. v CIR in 2000*, (STC 527), Lord Nicholls of Birkenhead stated that “the solution is not to be found by any rigid test or description. The answer depends upon a consideration of all the circumstances. They may not all point in the same direction. Then it may be temptingly easy to say the answer is a question of fact and impression. That would be a mistaken approach.... The distinction between repair and replacement is not so unascertainable that it must be placed in the category of an unformulated question of fact.” Thus the question of improvement or repairs to a building or structure is one of fact and degree and close examination of the facts of the particular case is required. The commonly used test for this purpose is the “entirety” test. If the entirety of a building or structure is replaced, it is improvement; and if part of the entirety is replaced, it is repair.

### ***Non-qualifying expenditure***

47. The deduction under section 16F does not apply to capital expenditure incurred –

- (a) on a building which is used or intended to be used as a domestic building;

- (b) to enable the building to be first used substantially by the person for the production of chargeable profits;
- (c) to enable the building to be used for a purpose different from that for which it was used immediately before the capital expenditure was incurred.

48. Thus, capital expenditure incurred on the initial construction, decoration or fitting out of a commercial building or structure, and expenditure on alteration of a building to enable a different usage do not qualify for the deduction under section 16F but they may qualify for commercial building allowance under section 33A.

**(E) EXPENDITURE ON THE PROVISION OF PRESCRIBED FIXED ASSET – SECTION 16G**

49. Section 16G was effective from the year of assessment 1998/99 and onwards to allow a deduction for specified capital expenditure incurred by a person for the provision of a prescribed fixed asset. The section also offered, for the year of assessment 1998/99, a one-off, irrevocable option to elect the write-off of the reduced value of prescribed assets already owned and in use prior to 1998/99.

***Specified capital expenditure***

50. The term “specified capital expenditure” is defined in section 16G(6). It means any capital expenditure incurred by a person on the provision of a “prescribed fixed asset”, but does not include –

- (a) capital expenditure that may be deducted under any other section;
- (b) capital expenditure incurred under a hire-purchase agreement.

***Prescribed fixed asset***

51. “Prescribed fixed asset” in turn is defined in section 16G(6) to mean –

- (a) the following items of machinery or plant specified in the First Part of the Table annexed to Rule 2 of the Inland Revenue Rules as is used specifically and directly for any manufacturing process –

Item	Nature of the assets
16	Type and blocks
20	Bleaching and finishing machinery and plant
24	Electronics manufacturing machinery and plant
26	Plastic manufacturing machinery and plant including moulds
28	Silk manufacturing machinery and plant
29	Sulphuric and nitric acid plant
31	Textile and clothing manufacturing machinery and plant
33	Weaving, spinning, knitting and sewing machinery
35	Any other machinery or plant, not specified in items 1 to 34

- (b) computer hardware, other than that which is an integral part of any machinery or plant;
- (c) computer software and computer systems;

but does not include an “excluded fixed asset”.

52. “Excluded fixed asset” means a fixed asset in which any person holds the rights as a lessee under a lease [section 16G(6)].

***Manufacturing process***

53. To qualify for a deduction under section 16G, the machinery or plant must be used specifically and directly for any manufacturing process. As the

term “manufacturing process” is not defined in the Ordinance, we have to refer to its ordinary meaning. According to the Shorter Oxford Dictionary, it means a series of activities or operations, usually carried out inside a factory or any other similar premises, for the creation of any new product.

54. Though the term “manufacturing process” is capable of a wide interpretation, it does not include construction. In fact, bulldozers and graders commonly used in construction works are not included in the definition of prescribed fixed asset in section 16G(6).

### ***Computer hardware***

55. Prescribed fixed asset includes computer hardware which is not an integral part of any machinery or plant. In other words, stand-alone computer hardware qualifies for deduction but computer hardware forming an integral part of an item of machinery or plant will not be granted the section 16G deduction unless the machinery or plant containing the computer hardware happens to be a prescribed fixed asset.

### ***Computer software and computer system***

56. Capital expenditure incurred on computer software and a computer system used in the production of chargeable profits is deductible under section 16G. This includes the relevant consultancy fees and associated costs.

### ***Prescribed fixed asset used partly in the production of chargeable profits***

57. Where a prescribed fixed asset is used partly in the production of chargeable profits, the deduction under section 16G shall be such part of the specified capital expenditure as is proportionate to the extent of the use of the asset in the production of the chargeable profits. On sale of such a prescribed fixed asset, the proportionate amount of sale proceeds attributable to the portion used in the production of chargeable profits, limited to the amount of deduction previously allowed under section 16G, shall be treated as a trading receipt.

### ***Sale of the prescribed fixed asset***

58. Where the prescribed fixed asset in respect of which a deduction has been allowed under section 16G is sold, the sale proceeds, not otherwise chargeable to Profits Tax and not exceeding the amount of deduction previously allowed, shall be treated as a trading receipt.

59. The relevant trading receipt shall accrue and be assessable at the time of sale, or the date immediately before the discontinuance of business if the sale occurs on or after the date on which the trade, profession or business is permanently discontinued.

60. The time of sale shall be construed as a reference to the time of completion of the sale, or the time which possession of the asset is given, whichever is the earlier.

### ***Controlled sale***

61. Where the prescribed fixed asset is sold, the seller has control over the buyer, or vice versa, or both are under the common control of some other person, or the buyer and seller are husband and wife, the Commissioner may determine the true market value of the asset if he is of the opinion that the sale price does not represent its true market value.

### ***Destruction of the prescribed fixed asset***

62. Where a prescribed fixed asset is destroyed, the asset shall be treated as if it had been sold immediately before the destruction. Any insurance money or other compensation of any description received and any money received in respect of the remains of the asset shall be treated as if it were the sale proceeds.

### ***Prescribed fixed asset already owned and in use prior to 1998/99***

63. For the year of assessment 1998/99 only, where a person owned and had in use any prescribed fixed asset prior to the year of assessment 1998/99, he may elect to claim as a deduction the reduced value of such asset as at the beginning of the basis period for 1998/99.

64. The reduced value of the prescribed fixed asset as at the beginning of the basis period for 1998/99 shall be the amount of capital expenditure incurred on the provision of that asset as reduced by the depreciation allowances granted on that asset in accordance with Part VI of the Ordinance in all years of assessment prior to 1998/99.

65. The election shall be in writing and shall be lodged before the expiration of one month after the date of the notice of assessment for the year of assessment 1998/99. Such an election, once made, is irrevocable.

**Approved Institutes under Sections 16B and 16C  
of the Inland Revenue Ordinance**

**Approved Research Institutes under Section 16B(4)(a)**

Sir Sik-nin Chau Foundation for Industrial Development  
The Chinese Language Press Institute Ltd.  
Federation of Hong Kong Industries (Testing Centre)  
Hong Kong Plastics Technology Centre Co. Ltd.

**Approved Institutes under Section 16C(1)**

**A. University and Technical Institutes**

The Hong Kong Polytechnic University  
Hong Kong Institute of Vocational Education (Morrison Hill)  
Hong Kong Institute of Vocational Education (Kwun Tong)  
Hong Kong Institute of Vocational Education (Lee Wai Lee)  
Hong Kong Institute of Vocational Education (Haking Wong)  
Hong Kong Institute of Vocational Education (Kwai Chung)

**B. Training Centres**

Automobile Industry Training Centre  
Electrical Industry Training Centre  
Electronics Industry Training Centre  
Textile Industry Training Centre  
Plastics Industry Training Centre  
Printing Industry Training Centre  
Machine Shop and Metal Working Industry Training Centre  
Welding Training Centre  
Hospitality Industry Training & Development Centre  
(formerly known as Hotel Industry Training Centre)  
Seamen's Training Centre  
The Management Development Centre of Hong Kong

**Note** – Please check the web site of the Inland Revenue Department  
([www.ird.gov.hk](http://www.ird.gov.hk)) for the latest update of the lists.