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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited’s Newsletter Covering Technical Development in Taxation

CHINA REFINES R&D SUPER DEDUCTION POLICY

Further to Premier Li Keqiang’s announcement during last October’s State Council executive meeting on refining the super deduction policy for Research and Development (“R&D”) expenses, the Ministry of Finance, State Administration of Taxation and Ministry of Science and Technology jointly promulgated Circular Caishui [2015] No.119 (“Caishui 119”) on 3 November 2015 to provide details on the expanded scope of R&D super deduction policy and the simplified administrative procedures.

In this Tax Flash, we aim to provide you with the salient points of Caishui 119.

1. BACKGROUND

Super deduction policy for R&D expenses was first introduced under the Corporate Income Tax Law (“CIT Law”) in 2008. According to the Implementation Rules of the CIT Law, enterprises developing new technology, new products and new processes can claim deduction on qualifying R&D expenses incurred during the year by 150% of the actual amount if intangible assets are not created. If the R&D expenses were incurred for developing intangible assets, instead of pre-tax super-deduction, the companies may amortize the capitalized intangible assets based on 150% of the actual cost incurred. The applicable scope and detailed administrative procedures of the incentives were covered by Circular Guoshuifa [2008]116 and Circular Caishui [2013]70.

Although the super deduction policy has played an important role in boosting R&D activities, the benefits have been available only for certain specified industries and expenses. To speed up innovation and to encourage growth and development, there was a need to refine the R&D incentive regime.

2. KEY ENHANCEMENTS OF CAISHUI 119

Caishui 119 applies to China tax resident enterprises. It was effective 1 January 2016, and Circular Guoshuifa [2008]116 and Circular Caishui [2013]70 are superseded.

Scope of Eligible R&D Industries and Activities

According to the former regulations, R&D activities eligible for super deduction should fall under the “Categories of Key High & New Technology Sectors Supported by the State” and the “Guidelines for Key High & New Technology Industrialization Fields for Prioritized Development”. Caishui 119 now further expands the scope of eligible R&D activities. It defines “R&D Activities” as activities with clear defined purposes on a continuous basis and systematically carried out in order to derive new science/technology knowledge:

- Applying new science /technology knowledge in an innovative manner; or
- Improving current technologies, products/services or techniques substantially

For qualifying applicable scope, Caishui 119 adopts the “Negative List” approach, meaning that all industries and activities are eligible for R&D super deduction unless they fall within the following “Negative List”:

Industries not eligible for Super Deduction	Activities not eligible for Super Deduction
Tobacco manufacturing	Routine upgrades of products/services
Hospitality and catering	Simple application of publicly available R&D results e.g. new techniques, materials, devices, products, services or knowledge
Wholesale and retail	Technical support activities following commercialization of a product
Real estate	Repetitive or simple changes to existing products, services, technology, materials or processes
Leasing and commercial services	Market research and studies, efficiency studies or management research
Entertainment	Quality control, testing and analysis, repair and maintenance activities that are related to industrial (service) process or are performed regularly
Other industries as prescribed by MOF and SAT	Humanities, arts and social sciences related studies

Creative Design Activities

R&D expenses incurred on creative design activities¹ carried out to obtain creative, novel and innovative products are now eligible for super deduction treatment.

¹ Creative design activities may include:

- development of multi-media, animation and game software;
- design and production of digital animation and games;
- industrial design, multi-media design, animation and derivative product design and model design; and
- architectural and landscape design.

Outsourced R&D Activities

Caishui 119 also provides some clarifications on outsourced R&D activities²:

Outsourced R&D Activities	Implications
Entrusts the R&D activities to unrelated local organizations or individuals	<p><u>Entrusting Party (Service Recipient)</u></p> <ul style="list-style-type: none"> ➤ 80% of the actual R&D expenses incurred is eligible for super deduction <p><u>Entrusted Party (Service Provider)</u></p> <ul style="list-style-type: none"> ➤ Not mandatory to provide the Entrusting Party (Service Recipient) with detailed R&D expenditures of the project for Entrusting Party (Service Recipient) super deduction purpose ➤ Not allowed to claim the super deduction
Entrusts the R&D activities to related local organizations or individuals	<p><u>Entrusting Party (Service Recipient)</u></p> <ul style="list-style-type: none"> ➤ 80% of the actual R&D expenses that are on arm's length terms incurred is eligible for super deduction <p><u>Entrusted Party (Service Provider)</u></p> <ul style="list-style-type: none"> ➤ Required to provide the Entrusting Party (Service Recipient) with detailed R&D expenditures of the project for Entrusting Party (Service Recipient) super deduction purpose ➤ Not allowed to claim the super deduction <p>If R&D activities were carried out through cost sharing agreements, each party can only super-deduct its share of expenses under the allocation parameters</p>
Entrusts the R&D activities to overseas organizations or individual	<p><u>Entrusting Party (Service Recipient)</u></p> <ul style="list-style-type: none"> ➤ R&D expenses super deduction is not allowed

² The circular does not clarify whether the intellectual property needs to be owned by the entrusting party (payer) or whether it can be owned by the entrusted party, or whether it can be shared.

Scope of Eligible R&D expenses

In addition to expenses listed in Circular Guoshuifa [2008] No.116 and Caishui [2013] No.70, Caishui 119 expands the scope of qualified R&D expenses to include expenses such as service fee for external R&D personnel and expenses for testing trial products. It also allows other directly related expenses (such as expert consultation, insurance expenses for high/new technology research and development, intellectual property application and registration costs, business travel and conference expenses costs) to be eligible for super deduction purpose as long as the amount of these expenses does not exceed 10% of the total R&D expenses.

The following is a summary of the full list of qualifying expenditures:

Qualifying Expenditures	Details
Labour Cost	<ul style="list-style-type: none"> ➤ For employees directly and entirely engaged in the R&D activities: Salaries, basic pension insurance, basic medical insurance, unemployment insurance, work injury insurance, maternity insurance and housing fund paid by enterprises ➤ Service fee for external R&D personnel
Direct Investment Cost	<ul style="list-style-type: none"> ➤ Materials, fuel and power directly consumed in the R&D activities ➤ Expenses for development and production of moulds and technique equipment used for intermediate experiment and trial production of products ➤ Expenses for samples and prototypes that do not constitute fixed assets ➤ Expenses for general testing solutions ➤ Expenses for testing trial products ➤ Expenses for operation, maintenance, adjustment, examination, repair and rental cost of devices and equipment that are used especially for R&D activities
Depreciation	<ul style="list-style-type: none"> ➤ Depreciation expenses of devices and equipment used for R&D activities
Amortization expenses of intangible assets	<ul style="list-style-type: none"> ➤ Amortization expenses of software, patents and non-patented technologies (licensing, know-how, design and calculation method, etc.) used for R&D activities
Design expenses for new products etc.	<ul style="list-style-type: none"> ➤ Design expenses for new products ➤ Expenses for formulating new technique procedures ➤ Clinical testing expenses for new medicine ➤ Field experiment expenses for exploration and development technologies
Other costs directly related to R&D activities (capped at 10% of the total qualifying R&D expenses)	<ul style="list-style-type: none"> ➤ Expenses for technical books and information ➤ Translation fees ➤ Expert consultation fees ➤ Insurance premium for R&D of high and new technology ➤ Expenditures for research, analysis, review, verification, identification, evaluation, assessment and inspection of R&D results ➤ Application, registration and agency fees for intellectual property ➤ Travel and meeting expenses, etc.
Other expenses as prescribed by the MOF or the SAT	

Caishui 119 no longer requires equipment and intangible assets to be “exclusively used” for R&D activities for the corresponding depreciation and amortization expenses to qualify for super-deduction, which indicates that a ‘pro-rata’ allocation of R&D expenses may apply

Accounting Requirement

Pursuant to the former policy, enterprises have to set up a special account to record R&D expenses separately for super deduction purposes. Caishui 119 now specifies that companies may use an auxiliary or supplementary account to capture the R&D expenses that are eligible for super deduction treatment. Managing R&D expenses in a special account is no longer required.

Administrative Procedure

According to Caishui 119, R&D registration requirements will be simplified and certain registration requirements will be relaxed:

- Caishui 119 replaces the current prior record filing procedure with a post monitoring procedure. Advance approval from the relevant tax authorities is not required.
- Tax authorities will intensify their administration of super deduction claims filed by taxpayers through regular inspections and monitoring.
- Not less than 20% of all R&D super deduction cases will be audited annually. Accordingly, contemporaneous and post-filing record keeping and auxiliary account management will be important to manage tax compliance.

Authentication/Verification

In case the competent tax authority has any disagreement on the R&D project for super deduction purpose, Caishui 119 indicates that now it is the tax authority, instead of the enterprise, to request authentication opinion from the in-charge science and technology authority. It also clarifies that for companies undertaking R&D projects at the provincial or ministerial level or above, or projects that span over multiple years and that already have been verified, annual verification by the competent science and technology authorities is no longer required.

Retrospective Claims

By completing the relevant record-filing procedures, company can deduct previously unclaimed qualified R&D expenses (incurred on or after 1 January 2016) for the preceding 3-year period.

3. OUR COMMENTS

The Central Government would like to provide tax incentive as a fiscal policy to encourage companies in China to engage in more R&D activities, with a view the policy would enhance the productivity and competitiveness of Chinese companies. However, the Central Government officers would not be able to think of potential negative side effect of this type of policy during implementation. With the substantial expansion of the applicable scope for R&D activities and expenses, vast majority of companies will benefit from Caishui 119 and very likely, the annual tax revenue of each tax bureau would drop significantly. To catch up with the annual budgeted revenue, each tax bureau would scrutinize the super deduction claim and/or to collect additional tax revenue via other means. Given that at least 20% of applicants will be audited [tax officers may raise other issues such as transfer pricing issue, payment of services fee to non-Chinese companies, etc.], companies will have to be extra careful in managing the R&D expenses recorded under each auxiliary account and maintaining sufficient supporting documentations. Under the record-filing and post monitoring system, taxpayers would now assume the responsibilities if found to have failed to prove themselves qualified for the R&D super deduction.

RSM Tax Advisory (Hong Kong) Limited

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- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
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- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
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