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RSM Tax Advisory (Hong Kong) Limited

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

RECORDING R&D COSTS APPROPRIATELY FOR DIFFERENT TAX INCENTIVES IN CHINA

If your enterprises in China have incurred research and/or development (“R&D”) expenditure, please record them appropriately in order to secure different tax incentives in China.

The major preferential treatments in relation to R&D activities for Enterprise Income Tax (“EIT”) purpose include:

- If an enterprise is qualified as a High-and-New-Technology Enterprise (“HNTE”), the applicable EIT rate will be reduced from 25% to 15%. In confirming the HNTE status, the R&D costs to turnover ratio is one of the critical factors to be considered by the government authorities.
- A taxpayer can claim super-deduction at 150% (or 175% for high-tech small and medium sized enterprise) of the qualified R&D costs actually incurred in the calculation of its EIT payable for the

relevant tax year. If the enterprise results in a tax loss situation for the year after the super-deduction, the tax loss can be carried forward for a maximum of five tax years to set off against future taxable profits of the enterprise.

In daily operations, it is not uncommon that taxpayers have mixed up the scope of R&D costs for (1) statutory financial reporting, (2) HNTE status recognition, and (3) tax super-deduction claim. When the R&D costs are determined and recorded inappropriately, it may not only jeopardize the eligibility for tax incentives but also result in financial and reputational risks upon tax examinations and audits.

The major differences in the scope of R&D costs for different usages have been highlighted in Appendix 1 of this Tax Flash for your preliminary information.

In brief, for financial accounting purpose, a company may include any costs and expenses that the company considers incurred in relation to its R&D activities. For HNTE recognition purpose, the candidates will be evaluated to see if the intensity of R&D investment and the strength of science and technology of the candidate are up to the standards of HNTE. The scope and requirements of R&D costs for tax super-deduction purpose are the most stringent one as it is to encourage enterprises to focus on their core R&D investments.

Taxpayers' Next Steps

- Tax super-deduction for R&D costs is not confined to enterprises in manufacturing and technology industries. Defined R&D activities (e.g. creative design activities such as architectural and landscape design; industrial design; model design; development of multi-media, animation and game software, etc.) of enterprises in certain service industries can also be qualifying costs. If your enterprises in China have not yet considered the tax super-deduction for R&D costs or the reduced tax rate of 15% for HNTE, management may revisit its current operations and eligibility in light of the relaxation of the requirements over the years.
- If your enterprises have already adopted any of the tax incentives, management

may wish to conduct annual “health check” by independent internal or external reviewers to check on the recording of R&D costs, compliance of other qualifying conditions as well as the quality and strengthening of the supporting documents.

- Since cross-border sub-contracting of R&D activities has now become acceptable for the super-deduction claim in China, companies in China may consider working with Hong Kong or overseas business partners (including affiliated entities) for R&D projects to benefit from the expertise and resources not readily available in the mainland China, especially in view of the Bay Area cooperation, and Hong Kong’s establishment of international innovation centre. In addition, Hong Kong is planning to introduce super-deduction of up to 300% of relevant R&D costs of qualified taxpayers for Hong Kong Profits Tax purpose. Enterprises may map out different options on possible arrangements, analyse and evaluate them to arrive at the most suitable and overall cost-efficient model and arrangement.

Highlight of the Major Differences in the Scope of R&D Costs

R&D costs	For PRC financial accounting purpose	For HNTE recognition purpose	For tax super-deduction purpose
Staff costs	<i>Including wage, bonus, allowance, subsidy, social security premiums, housing provident fund</i>	<i>Wage, salary, basic pension insurance premium, basic medical insurance premium, unemployment insurance premium, industrial injury insurance premium, birth insurance premium, housing provident fund</i>	
	<i>R&D employees</i>	<i>Limited to science and technology employees</i>	<i>Limited to employees directly engaged in R&D activities</i>
	<i>Labour costs of external R&D personnel</i>		
Direct costs	<i>Directly consumed materials, fuel and power costs (Note: For accounting and tax super-deduction purposes, the costs should be directly related to R&D activities.)</i>		
	<i>Development and manufacturing cost of mould and process equipment for intermediate test and product trial manufacture</i>		
	<i>Sample, prototype and general testing method purchase costs, inspection fees for trial products</i>	<i>Same as the left provided that they do not constitute any fixed assets</i>	
	<i>Rental fee for fixed assets (such as instrument, equipment and premises) for R&D activities</i>	<i>Operating lease rental fee for leased fixed assets used in R&D activities</i>	<i>Operating lease rental fee for leased instrument and equipment used in R&D activities</i>
	<i>Equipment adjustment and inspection fees, and the costs of operation, maintenance and maintenance of the related fixed assets</i>	<i>Costs of operation, maintenance, adjustment, inspection and maintenance of instrument and equipment for R&D activities</i>	

R&D costs	For PRC financial accounting purpose	For HNTE recognition purpose	For tax super-deduction purpose
Depreciation charges on fixed assets	<i>Fixed assets (including premises) for R&D activities</i>	<i>Instrument, equipment and premises in-use for R&D activities</i>	<i>Instrument and equipment for R&D activities</i>
Deferred expenditure amortisation charges	<i>Not applicable</i>	<i>Alteration, modification, decoration and repair of R&D facilities</i>	<i>Not applicable</i>
Intangible asset amortisation charges	<i>Intangible assets (including software, patent, etc.) for R&D activities</i>	<i>Software, intellectual property and non-patentable technology for R&D activities</i>	<i>Software, patentable and non-patentable technology for R&D activities</i>
Design and testing expenses	<i>Not mentioned</i>	<i>Qualifying costs for design, equipment commissioning and testing</i>	<i>Costs of new product design, formulation of new process regulations, clinical trials for new drug development, and on-site test fees for exploration and development technology</i>
Other expenses directly relating to R&D activities	<i>No limit in amount</i>	<i>Normally not more than 20% of the total amount of the above R&D costs</i>	<i>Not more than 10% of total amount of the above R&D costs</i>

RSM Tax Advisory (Hong Kong) Limited

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- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- 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
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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