

## China Income Tax Preferences for High/New-Tech Enterprises (HNTE) (Combined Article)

The tax-preferred status of "high/new-technology enterprise" (HNTE) is one of very few means still available for companies (outside certain specially-supported industries) in the People's Republic of China (PRC) to enjoy preferential PRC income tax rates. The criteria and procedures that govern qualification for (and maintenance of) HNTE status are detailed and objective (largely numerical). HNTE status can be lost through interrupted compliance with HNTE qualification criteria, or through business changes including certain mergers or acquisitions.

HNTE qualification criteria include:

- Owning (with a narrow exception) core intellectual property.
- Maintaining detailed documentation of continuously high levels of employment and expenditure in research and development projects (along with similarly detailed documentation of related revenues).
- Complying with a broad range of tax and legal requirements.

Geographical location is being reduced, and foreign ownership is being phased out, as a factor in tax preference qualification. Corporate income tax holidays, which until 2008 were available to the many foreign-invested enterprises that qualified as "production-oriented", are now limited mainly to HNTEs, without regard to whether they are foreign- or domestic-invested. The Shenzhen, Zhuhai, Shantou, Xiamen and Hainan special economic zones and the (Shanghai) Pudong New Area (the Special Zones), which previously granted to foreign invested enterprises indefinite preferential income tax rates, now only grant temporary additional preferences to HNTEs.

A 15 percent corporate income tax rate is enjoyed by a HNTE, in comparison with the standard 25 percent rate. Additionally, a HNTE that is located in a Special Zone enjoys (for profits generated from business operations within the same or any other Special Zone) a two-year income tax exemption and a three-year preferential rate of 12.5 percent, starting from the first "revenue generating" year (as opposed to the first "profit generating" year).

### I. HNTE-Qualified Sectors

The supported industrial sectors in which an enterprise can qualify for HNTE status now expressly include service sectors, and have been reorganized and made more detailed, with 51 categories and 218 activities specified in eight sectors. The table below shows a comparison between supported sectors in the (still current) 2008-issued Support Catalogue and in the previous version that had been issued in 2000. The changes are an indication of changing

*This is a combined and updated version of two previously published articles: "High- and New-Technology Enterprises: Updated Preferences, Qualifications and Trade-Offs," published in the June 2008 issue of China Law & Practice, and "Tax Preference Guideline Provides Objective Scrutiny for High/New-tech Enterprises," published in the October 2008 issue of China Law & Practice.*

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development priorities, with the most dramatic change being the addition of "high-technology services".

<b>High/New-Technology Enterprises: Updated Preferences, Qualifications and Trade-Offs Table</b>	
2000--2007 Supported Sectors	2008-- Supported Sectors
N.A.	(New) High-technology services
Electronic and information technology	(Same) Electronic and information technology
Bio-engineering and new medical technology	(Same) Bio-engineering and new medical technology
New materials technology	(Same) New materials technology
Aviation and space technology	(Same) Aviation and space technology
Traditional industry transformation technology	(Same) Traditional industry transformation technology
New energy, efficient energy and energy conservation	Narrowed to: New energy and energy conservation technology
Environmental protection technology	Merged into (new category): Resources and environmental protection technology
Nuclear application technology	Merged (along with Hydrogen Energy) into (the above): New energy and energy conservation technology
Oceanic engineering technology	Merged (along with Oceanic Bio-technology) into (the above): Bio-engineering and new medical technology
Modern agricultural technology	Merged into (the above): Bio-engineering and new medical technology
Advanced manufacturing technology	Merged into (the above): Traditional industry transformation technology

## II. Governing Documents

The current HNTE regime, which became effective (retroactively) from January 1, 2008, and has been implemented starting in the last quarter of 2008, is based on the following key documents:

- Catalogue of High/New-Technology Industries Specifically Supported by the State (Support Catalogue), issued on April 14, 2008, containing an initial list (to be updated from time to time) of 51 categories and 218 activities specified in eight industry sectors.
- High/Technology Enterprise Assessment Administration Measures, also promulgated on April 14, 2008, containing twenty "Articles".
- Working Guideline for Recognition and Administration of High/New-Technology Enterprises, promulgated on July 8, 2008, containing six more-detailed sections and numerous sub-sections, along with appended forms.

- HNTE Recognition Special Audit Guideline, published on November 12, 2008, which contains nine chapters detailing principles, scope, procedures and form of report on HNTE audits.

### III. Players & Progress

Communications by applicants are mainly with a registered accounting firm (supervised by the China Registered Accountants Association) that the applicant engages to do an HNTE audit, and with the Recognition Authority formed jointly by the provincial (and equivalent) level departments of science and technology, finance and tax. The Recognition Authority selects experts to examine applications, and makes filings "for the record" with, and is supervised by, the national level authorities in charge of HNTE issues. These include the "Leading Small Group" (formed jointly by the Ministry of Science and Technology, the Ministry of Finance and the State Administration of Taxation), and the relevant Office (which is under the Leading Small Group, in the Ministry of Science and Technology). No communications are contemplated directly between applicants and reviewing experts or, except possibly in connection with a dispute, between applicants and the Leading Small Group or its Office.

Initial reports of progress in processing 2008 HNTE applications indicated that the greatest number of applications were received from Beijing, Guangdong and Shanghai, that applications from Special Zones were received only from Xiamen, and that processing was completed the fastest in Ningbo City and Jiangsu Province.

### III. Objectivity, Predictability & Scrutiny

The largely objective evaluation process, application contents and evidence format are very clear, but scrutiny of applicants is intense, and provisions for related dispute resolution are vague and troubling. It is only prudent for an HNTE application to be submitted by an enterprise that is able to withstand increased and sustained scrutiny of its qualifications and certain other aspects of its operations.

#### A. Objective evaluation criteria and process

Objective handling of applications is sought in various ways, notably through the following:

- Examination, of application documents without identifying information, by at least five randomly-selected experts, who are required "not to withhold different opinions".
- Emphasis on objective numerical calculations (subjective experts' views are converted into numerical values for sub-criteria, and then are run through a mathematical formula).
- A clear hierarchy of applicable technical standards, with priority given to standards issued by government departments, national or international industrial associations or other qualified institutions.
- Opportunity for the public to view online-published preliminary approvals and to raise objections before final approval.

#### B. Risks relating to compliance and changes

Heavy sanctions can result from a surprisingly broad range of circumstances. Potential circumstances that merit early and careful attention by companies considering applying for HNTE status, or acquiring an existing HNTE, including the following:

- HNTE status will be cancelled for five years if the enterprise (a) has a major safety- or quality-related accident, (b) is punished for environmental violations, (c) engages in tax evasion or (b) submits a false HNTE application. In view of this risk, a potential applicant should take care to verify that, for the foreseeable future, it can continuously comply with relevant standards in these areas.
- Any merger or reorganization that changes a HNTE's business, production or technology activities, etc, so that it ceases to meet HNTE qualification requirements, will lead to termination of HNTE status "beginning from that year" (that the merger or reorganization takes effect), apparently even if the change was implemented near the end of the year. In view of this risk, the safest timing of any relevant merger or reorganization would be shortly after the beginning of a new fiscal year.
- Partial-year fluctuations of expenses or income may be a basis for termination of disputed HNTE status, because disputes on the ratio of qualified expenses to qualified income are specified to be resolved through "verification of the ratio during the time period from the beginning of the qualification period and ending on the date the dispute arises".

### C. Disputes

Disputes relating to HNTE status are covered by only vague provisions in the High/Technology Enterprise Assessment Administration Measures. One of the Leading Small Group's primary responsibilities is "deciding major disputes arising in the course of the recognition of HNTEs". But there is no formal indication of which categories or sizes of dispute will be considered "major". All other disputes will be decided by the local Recognition Authority, but no decision timing, duties or procedures are specified. Of particular note, there is no formal indication of whether the reports of the first team of experts, after being disputed, must be re-examined by a different team or the same team (or any team).

## V. Criteria & Concepts

Specialized definitions apply to HNTE qualification criteria and related concepts, as discussed below.

### A. R&D definitions

Key definitions relating to "research and development" (R&D) include the following:

- An "R&D project" is defined as "non-repetitious R&D activity with independent financing and personnel deployment, and limited time".
- "R&D activity" is defined as "ongoing activity to acquire new scientific/technological knowledge (excluding humanities and social sciences), to utilize the same in an innovative way (excluding normal upgrades or direct utilization of a scientific results), or to substantially improve technologies, products or services".
- "Utilizing new scientific/technological knowledge in an innovative way or substantially improving technologies, products or services" is defined as "valuable progress an enterprise makes in technological, product or service innovations that promote technological progress in the local region, excluding normal upgrades or direct utilization of a scientific result, e.g., the direct use of new techniques, materials, equipment, products, services or knowledge, etc.".

## **B. Core IP definition**

The IP qualifying as "core" is interpreted flexibly, according to national officials' verbal interpretations, in order to enable a service-providing HNTE to satisfy the Core IP requirement by owning IP relating to its services without regard to any non-service deliverables. For example, the Core IP of an enterprise that develops software for customers under an outsourcing contract could relate to the enterprise's development activities rather than to the software that it develops and delivers to its customers.

The IP in "Core IP" is defined as "inventions, utility models, [certain designs,] software copyrights, integrated circuit layout design proprietary rights, and new plant varieties". The included designs are those "in which the pattern and shape of a product is changed in a non-simple manner (mainly meaning designs achieved through scientific and engineering technology methods in the course of R&D)". Other designs, along with unregistrable know-how and trade secrets, due to being omitted from this definition of Core IP, can only be used to satisfy HNTE criteria such as "capacity to convert R&D into products and services" or "management expertise to organize R&D", and cannot be used to satisfy the requirement that a HNTE own or hold an exclusive license of its Core IP.

## **C. Ownership v. License of Core IP**

Holding an "exclusive license" of Core IP, although formally permitted as a substitute for ownership, is not a practical alternative at present. It would be logical for more flexible interpretations or amendments to prevail eventually, but until then the license alternative is legally and commercially impractical, based on officials' verbal comments that the license must prohibit any other person from using the IP in any jurisdiction. Impractical prohibitions that appear to be required by this interpretation include the following:

- Prohibiting an owner/licensor from retaining a usage right in foreign jurisdictions.
- Prohibiting any other person, including a subsidiary of the HNTE, from receiving a sub-license from the PRC licensee.

It is commercially impractical for a HNTE applicant to obtain a license from an owner without allowing the owner to retain usage rights in some jurisdictions, not only because many owners will have a commercial need to continue usage in certain jurisdictions, but also because of the large amount of paperwork, administrative costs and potential tax liability that would result from filing license registrations in a large number of jurisdictions.

It is legally impractical for a HNTE to exploit the worldwide value of licensed IP without granting sub-licenses for usage in non-PRC jurisdictions, at least to the HNTE's own subsidiaries, and ideally to any person that contracts to pay reasonable sub-license fees, because the only other way to arrange such usage would be for the HNTE to establish foreign branch-type entities. Such entities, even where they are not subject to a restrictive scope of activities, can result in onerous legal consequences such as filing requirements, taxes, exposure to lawsuits in foreign courts and unlimited liability.

Higher taxes result from licensing (and sub-licensing) than from IP being jointly owned by more than one company, but such joint ownership appears not to be acceptable as a means to satisfy the requirement for HNTEs to own their core IP.

## **D. Numerical calculations of four criteria**

Four criteria for HNTE qualification are defined by a highly standardized numerical approach, in which a successful applicant must obtain at least 71 out of 100 points. The maximum number of points that can be obtained within each criterion is as follows:

- Through "Core IP sufficiency", a maximum of 30 points is available, and the highest grade within this criterion can be obtained by holding one core invention patent or six other Core IP items.
- Through "capacity to convert R&D into products and services", a maximum of 30 points can be obtained, based on the average annual number of "scientific and technological achievements being newly used in production". The highest grade within this criterion can be obtained by using "more than four achievements".
- Through "management expertise to organize R&D", a maximum of 20 points can be obtained by (i) formulating a project initiation report; (ii) establishing an accounting system; (iii) implementing combined production and R&D activities; (iv) establishing/ installing the enterprise's R&D institution, facilities or equipment; and (v) establishing an appraisal and award system for researchers' performance. The highest grade within this criterion can be obtained by completing five eligible actions.
- Through "growth of sales and total assets", a maximum of 20 points can be obtained (10 points for the sub-criterion of sales and 10 points for the sub-criterion of total assets) by achieving an average growth at or above 35% in each sub-criterion. The highest grade within each sub-criterion can be obtained by achieving an average growth at or above 35% in it.

#### **E. R&D Expenses**

R&D expenses of a HNTE must reach higher levels for smaller companies, must be maintained over rolling three-year period, and must be incurred at least 60 percent inside the PRC. Such expenses must, as a percentage of revenue over the most recent three fiscal years (or over the enterprise's entire operating history if shorter), exceed the following sliding scale:

- 6 percent if revenue is below RMB50 million.
- 4 percent if revenue is between RMB50 million and 200 million.
- 3 percent if revenue is above RMB200 million.

Potential applicants for HNTE status will need to clearly document all potentially eligible expenses and record them in "special HNTE recognition auxiliary accounting books", in accordance with a sample spreadsheet format. This format is designed to facilitate not only the calculation of eligible internal expenses (100% creditable for purposes of obtaining recognition) and external expenses (80% creditable for purposes of obtaining recognition), but also the allocation of expenses to the following categories:

- R&D personnel remuneration and related expenses.
- Direct expenses (including allocable overhead; excluding investment in fixed assets).
- Depreciation and long-term deferred expenses.
- Design expenses (including for conception, development or manufacture of new products or new techniques).
- Equipment testing expenses (excluding regular installation preparations for large-scale and commercial production and industrial projects).

- Amortization of intangible assets (the purchase price of exclusive technology rights used for R&D).
- Payments to other persons for R&D services (separately listing payments to entities outside China).
- Other expenses (including office expenses, communication expenses, patent application and maintenance costs, etc., generally limited to 10% of total R&D expenses).

#### **F. Revenue Source**

60% or more of total revenue must consist of "income derived from high-tech products ([or] services)" or presumably directly from intellectual property, that is generated through technological innovation or R&D activities.

#### **G. Personnel Qualifications Extended**

Employee qualifications now apply to all HNTEs (including the labor-intensive enterprises that previously enjoyed a relaxed standard). Accordingly, each HNTE must have a workforce that is at least 30 percent comprised of science and technology personnel possessing at least college or university academic qualifications, and is at least 10 percent comprised of science and technology personnel engaging in research and development of high/new- technology products or services. These calculations must be based on personnel who work in (and generally those who have an employment contract with) the enterprise for at least 183 days within the year of calculation.

### **VI. Procedures**

Procedures are mainly to be implemented by the applicant, the auditing firm that it engages, the local recognition authority, and experts engaged by the local recognition authority to handle technical examination. Procedures are detailed separately for first-time applications and renewal applications, while dispute resolution procedures are left relatively vague.

#### **A. Application and examination procedures**

A first-time application consists of the following key steps:

- The applicant must make an online submission of a registration form to the local recognition authority, which should then "confirm the identity of the applicant" and provide it with a username and password.
- The applicant must go online to submit a registration form in order to obtain a login ID and password from the local recognition authority.
- The applicant must go online again to fill out an application, and various data forms, attach evidence of the data, and attach the special audit report. The data and evidence required for submission includes those relating to technological innovation, IP ownership (or qualifying licenses) and "production approval documents, quality inspection reports, and other relevant certificates."
- Within 60 days of receiving the application documents, the local recognition authority will determine whether to reject or to grant preliminary approval.
- Online publication of the preliminary approval will take 15 days. Responsibility to implement the preliminary approval is not given to a specific department. Presumably the

local recognition authority is required to transmit a proposed publication to the website management department under the Leading Small Group, which will then post it online without further review.

To renew the application, an enterprise must submit a re-examination application form "within" three months before expiry of the three-year term. After this expiry date, any application will be regarded as a new application rather than a renewal application. The contents and procedures of a renewal application appear substantially identical to an enterprise's first application, except that the re-examination is expressly required to put emphasis on Article 10.4 of the High/Technology Enterprise Assessment Administration Measures, which sets out the minimum ratios of qualified R&D expenses to total income.

## VII. Trends

A variety of important trends are strengthened by the new HNTE regime. Local government officials will find it more difficult to subvert legislative intentions by using tax preferences to compete with other localities to attract investment, or to favor friends or locally influential players. PRC residents who previously considered injecting their intellectual property and other assets into offshore companies will find that the new HNTE regime, along with other legal changes, now encourage a more PRC-centered corporate structure. Foreign investors and multinational groups, having lost most tax preferences, have greater incentives to structure the role of a PRC affiliate to qualify for HNTE status and tax preferences, not only by conducting more R&D activities and owning more IP, but also by increasing efforts to comply with PRC laws on environmental protection, work safety, product quality and taxation. Resulting expenses will increase the importance of extracting maximum value from a HNTE. This entails integrating a HNTE into a global strategy that emphasizes protection and exploitation of an increasingly PRC-centered portfolio of R&D-generated technology and IP.

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