Scope of R&D Expenses Eligible for Super Deduction Enlarged

Regulations in this issue:

- *Circular of the MOF and the SAT on issues related to super deductions for R&D expenses* (Caishui [2013] No.70, issued on 29 September, 2013) (Circular 70)
- *Administrative measures on super deductions for R&D expenses (trial implementation)* (Guoshuifa [2008] No.116, issued by SAT on 10 December, 2008.) (Circular 116)

The Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued Circular 70 to broaden the scope of research and development (R&D) expenses that are eligible for super deduction.

Background

The SAT issued Circular 116 on 10 December 2008, which specifies definitions of R&D activities, eligible enterprises, scope of expenses, accounting requirements and tax administration for R&D expense super deduction purposes. Circular 116 outlines eight types of R&D expenses that are eligible for super deduction, but certain expenses that are directly related to R&D activities are excluded. To encourage enterprises to engage in R&D activities, Circular 70 broadens the scope of R&D expenses that are eligible for super deduction, allowing enterprises to benefit from greater tax savings under the super deduction regime.

Circular 70

The following aspects are included in the scope of R&D expenses for super deduction by Circular 70:

1. Basic pension insurance premiums, basic medical insurance premiums, unemployment insurance premiums, work injury insurance premiums, maternity insurance premiums and housing funds contributed by an enterprise for full-time employees exclusively engaged in R&D activities in accordance with the scope and standards stipulated by the state council or the provincial government.
2. Expenses incurred for the maintenance, tuning, inspection and repair of instruments and equipment used exclusively for R&D activities.
3. Expenses incurred for the purchase of samples, prototypes and general testing items that do not constitute fixed assets.
4. Clinical trial expenses for development of new medicine.
5. Expenses for evaluation of R&D results.

In view of the above, Circular 70 extends the scope of expenses to include certain ones that are directly relevant to R&D activities. As Circular 70 is retroactively effective to 1st January 2013, enterprises may wish to make adjustments accordingly in their annual Corporate Income Tax (CIT) filings for this year.

Additionally, Circular 70 states that enterprises can engage a qualified accounting firm or tax agent to issue a special audit report or verification report for super deduction claim purposes. It is therefore foreseeable that local tax authorities may utilise agency firms to ensure the authenticity and accuracy of super deduction claims, as well as to improve tax collection and management efficiency.

Furthermore, Circular 70 emphasises the role of the science and technology authorities in verifying R&D projects. The tax authorities may require R&D projects to be verified by a municipal science and technology authority when there are uncertainties regarding the eligibility of such projects.

KPMG's observations

In September 2012, the Central Committee of the Communist Party of China and China's State Council promulgated *Opinions on Intensifying Reform of the Science and Technology System and Expediting Development of the State Innovation System* (the *Opinions*), which emphasised the importance of technological innovation by enterprises during the 12^{th} Five-Year Plan period. The issuance of Circular 70 is very much in line with the *Opinions*, and demonstrates the government's ongoing support for enterprises that engage in R&D activities.

As Circular 70 broadens the scope for super deductions, enterprises should review their R&D expenses for 2013 and include eligible expenses in their declarations as soon as possible. However, enterprises should also be careful not to blindly expand the scope of their super deductions. Both Circular 116 and Circular 70 emphasise that relevant expenses should be directly related to R&D activities. For example, depreciation of equipment or amortisation of intangible assets that are not used exclusively for R&D activities cannot be counted as eligible R&D expenses for super deduction purposes. Although Circular 70 enlarges the scope of R&D expenses, there are still discrepancies between R&D expenses for High-New Technology Enterprises (HNTE) recognition purposes and those for super deduction purposes. For instance, expenses for HNTE recognition purposes include depreciation and rental of buildings used for R&D, and amortisation for the altering and repairing of R&D facilities, but these are not eligible R&D expenses for super deduction purposes.

R&D super deduction filing has to be completed before the CIT annual filing. Enterprises need to submit detailed information on their R&D activities to local science and technology bureaus and tax authorities within the prescribed period. Therefore, to ensure they are well prepared for filing and inspection, enterprises need to establish an R&D system, develop internal procedures and functional responsibilities for each department, and collect data on R&D activities in daily operations. Also, it is unclear whether the special audit report will replace the accounting requirement for R&D expenses (i.e. according to Circular 116, R&D expenses should be recorded in the company books under a special R&D account on a project by project basis). Enterprises should remain alert to local requirements in this regard, and make preparations as early as possible.

Moreover, as noted above, Circular 70 emphasises the role of science and technology authorities in verifying R&D projects. To qualify for super deductions, R&D projects must fall under either *High-New-Technology Areas with Key State Support* or *The Guideline Regarding Development of Key Hi-tech Sectors*. If enterprises are uncertain whether their R&D projects fall under these two catalogues, they should seek advice from a professional consultancy firm to mitigate the risks.

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