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R&D Super Deduction Regulation Update

Further to Premier Li Keqiang's announcement on 21 October regarding the R&D Super Deduction, the Ministry of Finance, the State Administration of Taxation, and Ministry of Science and Technology issued an important Notice on Policy Improvement of Research and Development Expenses Super Deduction, Cai Shui [2015] No. 119.

R&D Expenses Super Deduction Cai Shui [2015] No. 119

Cai Shui [2015] No.119 is the most important regulatory change to the R&D Super Deduction in years and it replaces Guo Shui Fa [2008] No. 116 and Cai Shui [2013] No. 70. It applies from 1 January 2016.

Key enhancements

- Retrospective 3 year claims: Companies will be able to deduct previously unclaimed R&D expenses for the preceding 3 year period. At this stage, the regulations are unclear as to how the retrospective claims will operate in practice.

- The encouraged R&D technical 'categories' specified in the original policy will no longer apply. This means that companies will need to satisfy the definition of R&D activities but will no longer need to match the activity to one of the categories.

- Companies can now use a set of auxiliary or supplementary accounts to capture eligible R&D expenses, rather than capture all eligible R&D expenses in one special account in the company's existing accounting system. This clarifies the interpretation of the regulations and simplifies the account keeping requirements, and accords with global best practice.

- All R&D expenses shall be eligible for the R&D super deduction, unless specifically listed as ineligible. The scope of eligible R&D activities and R&D expenditures will therefore expand. Specifically listed additional eligible items include "other related costs" such as: expert consulting fees, high-and-new technology R&D insurance fees, R&D output related fees (including information retrieval, analysing, discussion, evaluation, assessment, checking and acceptance), IP right related fees (including application, registration and agent), travelling fees, and meeting fees. However such costs are capped at 10% of total eligible R&D expenses and the precise nature of the 10% cap will need to be clarified.

- Creative design activities undertaken for obtaining creative, novel and innovative products, shall be eligible. This is, arguably, an extension of the existing rules and highlights the government's intention to support design related activities, and includes:
    - industrial design, and model designs
    - design of building construction (3 star Green Building standard)
    - development of multi-media software and animation game software, design and production of digital animation and game
    - landscape architecture

- This circular inserts the requirement for "systematic" activities to the definition of R&D activities but removes a paragraph that emphasised that the outcome of R&D activities needed to contribute to the development of related technologies/processes. The new definition is as follows: "R&D activities shall represent systematic activities with clear objectives consistently undertaken by the enterprise for the purpose of obtaining new knowledge in science and technology, creative application of new knowledge in science and technology or substantial improvement of technologies, products (services) and processes."

- R&D registration requirements will be simplified and certain registration requirements may be relaxed, but the nature and extent of the simplified procedures is not yet clear. However, 20% of R&D applications will be audited. As such, contemporaneous and post-filing record keeping will be important to manage tax compliance in case the authorities wish to investigate the activities or related expenses. Some local tax bureaus may still require some type of registration formality.

- The term "solely/exclusively" has been removed in respect of depreciation, rental and other relevant expenses regarding R&D devices and equipment, amortization of intangible assets and development/manufacturing expense for models and processing equipment. This indicates that a 'pro-rata' allocation of such R&D expenses may apply. Eg. If an asset is used for R&D purposes 50% of the year, then 50% of the depreciation expense may now be allowable in that year

- Costs for externally engaged R&D personnel are now eligible.

Impact assessment

The vast majority of companies will benefit from Cai Shui [2015] No.119. R&D activities and associated expenses are eligible unless they fall within the "negative list" (see below), so this will have a positive impact on most companies. The retrospective three year claim opportunity will represent a significant opportunity for companies to extract additional benefits from the R&D Super Deduction program.

Arguably, the scope of eligible activities has expanded to include industrial design and other creative design industries. Another key improvement is the specific reference allowing companies to use auxiliary or supplementary accounts to identify and capture relevant R&D expenses- it also includes references to the eligibility of other relevant support departments such as manufacturing.

Given that 20% of applicants will be audited, it is important that companies ensure that project identification and expense capturing protocols are well established. This will both maximise the value of the benefit, and protect the expenditure if questioned by the in-charge authorities.

As always, a key issue will be how companies determine whether projects qualify for the R&D Super Deduction. This requires case by case analysis on an annual basis.

Key restrictions

- Negative list as it applies to 'industries'. The circular specifically excludes certain industry sectors from R&D Super Deduction eligibility:

  1. Tobacco manufacturing industry
  2. Accommodation and catering industry
  3. Wholesale and retail industry
  4. Real estate industry
  5. Leasing and commercial service industries
  6. Entertainment industry
  7. Other industries as prescribed by ministry of finance and the state administration of taxation

- Negative list as it applies to 'activities'. The circular specifically excludes certain activities from R&D Super Deduction eligibility: if the activities are not listed below, it is likely the activities *will* be eligible if there is a direct connection to the R&D project/activity:

  - regular product upgrade
  - use of R&D results that are publicly available regarding new processes, materials, devices, products, services or knowledge
  - post-commercialization support
  - Repeat or simple update of existing products, services, technologies, materials or processes
  - Market research and studies, efficiency research or management studies
  - Industrial (services) processes or regular quality control, testing analysis, maintenance.
  - Humanities and social sciences related studies.

Impact assessment

The above list of 'activity' exclusions is not materially different to the existing provisions, will have minimal impact on companies, and is consistent with benchmark R&D tax inventive policies globally.

However, companies that fall within the negative list 'industry' sectors will find it difficult, if not impossible, to claim the R&D super Deduction. So even if a company in these sectors is undertaking highly innovative activities, it is likely such companies and projects will not qualify for the Super Deduction. For example:

- Catering industry: does this mean that innovative functional food formulas which enhance health and reduce obesity are no longer eligible? Does this mean that innovative manufacturing technology to pack, seal and fill products for longer shelf-life stability will no longer be eligible?

- Retail industry: (1) A large retailer may develop new distribution and logistics software functionality and systems to more efficiently manage the supply chain; and (2) according to the "Category and Code for National Economic Industry Classification", sales through the internet appear to belong to the retail industry – are these activities no longer eligible for companies in negative list industries?

- Real Estate industry: A real estate development company may also be involved in innovative construction techniques and related design – does that mean this company cannot claim the Super Deduction?

This concept of 'industry exclusions' is understandable in the context of China's historical requirement for activities to fall within approved categories. However, given the general trend in China, and globally, towards a services-consumption driven economy, it would be beneficial for the in-charge authorities to reduce the scope of these exclusions. This is because the services sector is a key component of knowledge based capital innovation, where companies increasingly invest in intangible assets such as software and technology to stay solvent and maintain a competitive edge in the market (as the above project examples demonstrate.)

Other items

- The circular removes the requirement: "unless otherwise stipulated by the law, the amortisation period shall not be less than 10 years". At this stage it is unclear how the in-charge tax authorities will treat amortisation for R&D tax purposes.

- Cai Shui [2015] No. 119 places a cap of 80% in relation to expenses incurred on a project paid to an external entrusted party. Currently no cap applies. The circular states that the entrusting party (payer) can claim the R&D deduction in respect of the contract expense. However, 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. This issue should be clarified in subsequent circulars/guidelines.

- R&D expenses carried out and paid to a foreign external organisation are not eligible.

- When claiming centralized R&D activities and expenses within a corporate group, companies should be mindful of any applicable transfer pricing regulations. The Cai Shui [2015] No. 119 also now no longer require written 'agreement' or 'contract' between members of the corporate group regarding R&D activities but it is possible the in-charge tax authority may nevertheless request such documentary evidence. The old provisions required an 'agreement' between related entities i.e. "Where the agreement or contract is not provided, R&D expenses shall not be allowed for deduction."

- Where payments are made to external parties in respect of eligible R&D activities, the entrusting party (payer) is no longer required to submit a breakdown of the expenses/invoices as prepared or issued by the entrusted party. In related party arrangements, the breakdown of expenses is still required for R&D Super Deduction purposes.

Summary

A major factor concerning a country's ability to drive innovation is its capability to undertake the work. When governments encourage R&D investment by companies, this 'innovation capability' increases exponentially. This is a key attraction for local Chinese and foreign companies looking to establish or expand operations in China, and, when combined with effective R&D incentives, such a combination may lead to stronger and sustainable inclusive economic growth.

Broadly, the Notice on Policy Improvement of Research and Development Expenses Super Deduction, Cai Shui [2015] No. 119 is a significant enhancement to the existing R&D incentive program and will help China achieve its economic growth objectives. However, a key R&D Super Deduction policy refinement for the future will be for the authorities to review the 'industry exclusions' list as described above.

Next steps for companies: The deadline for the R&D Super Deduction is fast approaching for the year ending 2015. Companies should start now to identify how these R&D benefits can drive innovation, improve processes and allow the company to reinvest the tax savings into future corporate growth.

KPMG will continue to liaise with the in-charge authorities to clarify areas of technical uncertainty and provide feedback regarding implementation and R&D tax compliance.

For further information regarding the R&D Super Deduction and other Chinese incentives for innovation, please contact your KPMG advisor and refer to the attached links for relevant KPMG R&D publications:

1. *R&D Incentives: Adding value across ASPAC*
2. *IP Tax Management in China - Navigating the thicket in a BEPS environment*
3. *[China Looking Ahead 4th Edition] Created in China: The fast pace of innovation, R&D incentives and economic development*

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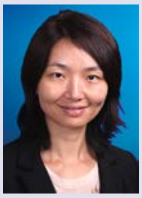

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