CHINA TAX ALERT

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150% Super Deduction Regulation Update

Regulation discussed in this issue:

- Announcement of the State Administration of Taxation regarding the Detailed Implementation on R&D Super Deduction Policy (SAT Announcement [2015] No. 97, hereinafter referred as "Announcement 97")

Cai Shui [2015] No.119 is the most important regulatory change to the R&D Super Deduction in years. In relation to this, the State Administration of Taxation released Announcement [2015] No. 97 to provide more detailed implementation standards in respect of Cai Shui [2015] No.119.

Announcement 97 states that Cai Shui [2015] No.119 will apply to Corporate Income Tax lodgements referable to the calendar year ending 31 December 2016 onwards, and therefore, the old rules apply in respect of the year ended 31 December 2015.

No. 97 Key Implementation Standards

- Three types of personnel can be involved as R&D personnel, including: R&D staff, technical staff and supporting staff. Logistics staff are excluded from the R&D activity loop if they are not directly involved in R&D activities and cannot be claimed under the 150% super deduction.

- Announcement 97 clarifies the enhanced depreciation treatment regarding equipment used for R&D purposes. The eligible depreciation expense related to equipment or devices used for R&D activities can be claimed for super deduction purposes if the accounting treatment has been followed, and in such a case the relevant depreciation amount is to be capped at the allowable amount deductible from a tax perspective.

- To the extent that expenses and/or personnel time are incurred which support the R&D activities, companies will need to record and track the usage and activity information for relevant equipment, intangible assets and personnel not fully engaged in the R&D activity.

- The Announcement details the calculation method to determine upper limit of 'other related R&D expenses'. Cai Shui [2015] No.119 stated that 'other expenses' are capped at 10% of total R&D expenses for the year.

- Any income / revenue gained from selling scraps, faulty, trial products and so on shall be used to offset the eligible R&D expense for super deduction purpose.

- If the output of R&D activities results in 'final products' or parts of final products, then the related material cost shall not be counted as an eligible R&D expense.

- The following items shall not be claimed as eligible expense for R&D super deduction purpose:

  - Expense or intangible asset amortization in relation to the non-taxable financial subsidies received by the company
  - Non-deductible expense for Corporate Income Tax (CIT) purpose
  - Intangible asset amortization which is not allowed for super deduction by Cai Shui [2015] No.119

- Expenses incurred on a project paid to an external entrusted party (external entities or personnel) are eligible for R&D super deduction but a cap of 80% applies to the external entrusted party payment.

- R&D expenses carried out and paid to a foreign external organization/personnel (including Hong Kong and Taiwan) are not eligible.

- Whether the company falls into the negative list of industries depends on its principle business. 'Principle business' means that revenue from such business is over 50% of total revenue (excluding non-taxable income and investment income.

- Auxiliary accounts for R&D expenses shall be established when the R&D project are set up. The company will need to maintain records for later validation.

- A summary sheet of auxiliary accounts for R&D expenses will need to be prepared each year and lodged with the in-charge tax authorities together with the income tax filing.

- Any agreement/contract in relation to contract R&D and cooperative R&D shall be registered with the in-charge science and technology authorities and companies shall maintain the documentation for later validation.

- Validation/audit review will be carried out after the annual corporate income tax filing period. The validation/ audit review rate will be 20% of all R&D super deduction applications.

Impact assessment

No. 97 Changes that may enhance the scope of claimable activities and expenses

The Announcement clarifies the definition of each type of R&D related personnel and includes 'supporting' staff but excludes logistics staff. For example, it appears that a project manager or engineering support team member that contributes to the R&D project may be eligible for inclusion as 'technical staff' or 'support staff'. We suggest applicants consider such individuals on a reasonable basis and allocate and record the time at least on a quarterly basis to prove the nexus to the R&D activity. In respect of logistics staff, it is unclear if logistics staff directly involved in the key experimental activities involving substantial improvement to technology can be included, for example, where the logistics team member is directly resolving complex R&D issues of a technical nature, rather than as a 'supporting' team member.

It is common industry practice that company staff, equipment and/or capitalized asset will take on multiple functions, including but not limited to R&D functions. The Cai Shui [2015] No.119 and Announcement 97 remove the term 'solely' in the regulation, thereby permitting a percentage 'pro rata' allocation to be included as eligible R&D expenses. This will therefore allow companies to include relevant supporting R&D expenses that may not have been claimed previously. Although this 'pro rata' allowance provides flexibility when capturing related R&D expenses, Announcement 97 requires applicants to track and keep a record of time spent on R&D related activities. This R&D time log allocation should then be used to calculate the final R&D expenses.

No. 97 Changes that may limit the scope of claimable activities and expenses

The Announcement implements a standard to calculate eligible R&D expenses by stating that if any income or revenue is received by the applicant in the form of R&D scrap, defects, faulty items, trial products etc, then such income/revenue shall be used to reduce or offset the total R&D expenses. This will decrease the total amount of eligible R&D expenses for R&D super deduction. For example:

<u>Preliminary R&D claim amount</u>
S&W = 100
Contract payment = 100
Other expenses = 20
Total = 220

Income from sale of defective/scrap items = 30

<u>Final R&D claim amount</u>
Preliminary R&D claim amount = 220
Less income from sale of scrap = (30)
Total = 190

In addition, material costs cannot be included as eligible R&D expenses if the output of R&D activities utilising such materials/parts etc results in the 'final' product or 'parts of final' products. For example, a company designs and develops improved robotics machinery for the automotive industry. It develops a prototype robot that is the first of its kind for the company, and it has additional functionality compared to the previous robot. The prototype does function reasonably well notwithstanding some technical defects. The company sells this initial prototype to a customer a few months later. In this case, the Announcement seems to suggest the following:

<u>Robot development costs</u>
S&W = 100
Materials = 150
Other = 10
Total development cost = 260

<u>Final R&D claim amount</u>
Robot development cost = 260
Less material cost = (150)
Total R&D claim = 110

Circular 119 expanded the scope of R&D expenses by adding a new R&D expense category called "Other related expenses" and lists a set of examples mainly concerning supporting R&D activities. This includes expenses relating to: search, analysis, evaluation, demonstration, identification, assessment and acceptance of R&D results, application fees, registration fees and agent fees for intellectual property etc. However, to control the scope of claimable 'other expenses', Cai Shui [2015] No.119 places a cap on the maximum allowable 'other' R&D expense amount, which is 10% of the total R&D expense. Announcement 97 clarifies the calculation method, stating that the total R&D expense is the sum of all captured expenses. For example, if the claimant originally calculated a total of RMB 100 million R&D expenses (including 'other expenses' of RMB 12 million and direct R&D expenses of RMB 88 million) the final R&D submission amount including the cap on 'other expenses' is as follows: RMB 88 million + 9.78 million (other expenses of RMB 12m subject to the 10% cap) = RMB 97.78 million.

No. 97 Changes that are neutral in respect of claimable activities and expenses

It is common for a company to have different tax and accounting depreciation rates. Announcement 97 stipulates a calculation regulation for applicants intending to claim capitalized assets as R&D expenses. For example, if the accounting treatment allows an annual allowable capitalized depreciation amount of RMB 2 million, but the tax treatment only allows RMB 1.5 million per annum, then the eligible 150% Super Deduction depreciation expense will be limited to the tax treatment, that is RMB 1.5 million for the specific capitalized R&D asset.

No. 97 Compliance Documentation

Given that 20% of R&D super deduction companies will be audited, it is important that companies ensure that eligible R&D 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.

However, at this stage, it is not clear what form such records may take, for example, it is common industry practice to allocate a fair and reasonable amount of expenses to the R&D project – and this is regularly evidenced by project reports, technical papers, emails, and correspondence which support the fact that the personnel time or expense was indeed incurred in relation to the R&D project. In such cases it is sometimes difficult to maintain precise time-sheets tracking the time and other expenses on a weekly basis. Cai Shui [2015] No.119 clarified the position that a separate 'R&D cost centre' is not required to claim the 150% Super Deduction and this was a positive point of clarification very well received by Chinese industry. However, Announcement 97 suggests that companies need to create auxiliary accounts for R&D expenses when the R&D projects are first set up – but this can lead to compliance challenges since some engineers / scientists and finance staff do not always create project specific accounts. This may be the case notwithstanding that such projects are undertaken on a very systematic basis. In this regard, the Announcement provides a standard template for auxiliary accounts which will help companies to record R&D related expenses in an 'authority-approved' way to reduce non-conformity risk. As such, it is important that companies establish an effective tracking system that captures the relevant expenses on a reasonable basis.

Announcement 97 indicates that the authorities would expect to see companies adopt a systematic approach when conducting R&D projects, and maintain relevant supporting documents and evidence to prove the nexus to R&D activity.

Summary

The rapid release of regulatory announcements by Premier Li Keqiang's and government authorities in respect of the 150% Super Deduction in the past 3 months reflects the government's focus on supporting Chinese companies to develop new knowledge and improve products and processes.

Cai Shui [2015] No. 119 enhances the existing R&D incentive program and should help China achieve its economic growth objectives if the local tax authorities adopt a fair and reasonable approach to compliance documentation. Announcement [2015] No.97 clarifies some points of uncertainty associated with Cai Shui [2015] No. 119, especially in relation to the effective date of the new provisions and around the scope of eligible activities and expenses.

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:

- KPMG: IP Tax Management In China – Navigating the thicket in a BEPS environment, August 2015
- International Tax Review, Tax Reference Library No 104, China: Looking Ahead, 5th Edition, Moving up the value chain – greater access to R&D incentives
- 2015 ASPAC R&D Guide – Overview of R&D Incentives

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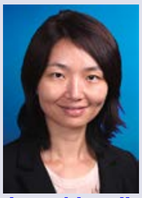

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