

China Tax Alert

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New 'Working Guidance of Administrative Measures for Recognition of High and New Technology Enterprise (HNTE)' Released

Regulation discussed in this issue:

On 29th of June, 2016, the Ministry of Science and Technology (MOST), Ministry of Finance (MOF) and State Administration of Taxation (SAT) jointly released an announcement on the revision of "Working Guidance of Administrative Measures for Recognition of High and New Technology Enterprise" (Guokefahuo [2016] No. 195)

Background

On 29th of June, 2016, the Ministry of Science and Technology (MOST), Ministry of Finance (MOF) and State Administration of Taxation (SAT) jointly released an announcement regarding the revision of "Working Guidance of Administrative Measures for Recognition of High and New Technology Enterprise" (Guokefahuo [2016] No. 195, 'New Guidance').

The New Guidance sees significant change concerning HNTE compliance thresholds, for example, by establishing a higher HNTE requirement with respect to intellectual property (IP) and innovation assessment capability. It also shows that the government will continue to strengthen its supervision of HNTE status.

The Administrative Measures for Recognition of High and New Technology Enterprise (Guokefahuo [2016] No.32) was originally announced by MOST, MOF and SAT on 29th of January, 2016. Please refer to our issue 5 of China Tax Alert for more details.

Main contents

1 Higher benchmark for intellectual property

The criteria for assessing 'innovation ability' are tighter under the New Guidance. A notable change is the enhanced benchmark concerning IP, which is also reflected in other aspects of this qualification requirement.

The New Guidance puts IP into the following categories:

Type I	Type II
Invention patents (including defence technology), new plant varieties, national-level crop varieties, national-level new drugs, national-level traditional Chinese medicine protection varieties, exclusive rights of integrated circuit layout design, etc.	Utility model patents, design patents, software copyrights, etc. (excluding trademarks)

Importantly, IP in Type II can only be included in a HNTE application once. (I.e. cannot be used again for HNTE renewal).

Main products and IP ownership

The New Guidance specifies that an applicant should own the core technological IP required of its main products. The old guidance did not emphasize the point of 'core technological' IP.

Quantitative and qualitative assessment of IP

Unlike the old guidance that only focused on the number of IP, the New Guidance requires a more comprehensive assessment of IP when reviewing a company's innovation ability. In addition to the number of IP, it now requires an assessment of the quality of the IP:

- disruptiveness or technological advancement of the IP; (Note there is no definition or explanation of this term in the New Guidance)
- technological impact of the IP on main products (services); (Note there is no definition or explanation of this term in the New Guidance)
- and
- how the IP was acquired (or source of the IP right).

IP resulting from self-developed R&D activities will generate more points than those through acquisition, merger or donation etc.

Furthermore, a 'bonus score' is offered to those participating in the preparation of national / industry standards, testing methods or technical specifications.

The changes in respect of IP and the transformation of research achievements can be seen as part of the government's intention to promote proprietary and industry leading R&D within HNTEs, with an overarching objective to push China to the technological forefront of the wider-industry.

Ownership and application requirements

In the situation that IP is jointly owned by multiple stakeholders, only one entity is entitled to use the IP for HNTE purposes. IP would be considered valid for HNTE purposes upon the receipt of the authorization certificate and/or authorization notice from the State Intellectual Property Authority, together with the proof of payment

2 Clarification of the innovation ability assessment criteria

Overall, the assessment quadrants under the old guidance continue in the New Guidance i.e. intellectual property, the ability to transform (capitalize on) the scientific and technological achievements, organizational excellence and enterprise growth.

Intellectual property

Please refer to the section above.

Transformation of scientific and technological achievements

Deriving from the 'Law for Promotion of Scientific and Technological Achievement Transformation', the New Guidance provides more detail regarding the definition of scientific and technological achievements, and the development and transformation method of the achievements.

According to the New Guidance, 'scientific and technological achievements' refers to the achievements with practical value which resulted from scientific research and technological development (e.g. patent, copyright and integrated circuit layout design, etc.)

The assessment criteria have also been raised, such that a maximum score can only be achieved with more than five successful transformations of a company's research achievements. In the past only four successful transformations were required to achieve maximum points.

Due to the limited IP requirements description in the old guidance it was sometimes difficult for applicants to establish a clear procedure when assessing IP. The New Guidance seeks to rectify this by focusing on the significance, quality and disruptiveness/transformational nature of the IP in respect of the applicants' main products and services, and how the IP is an advancement in technology from a technical perspective.

The additional detail regarding the definition of scientific and technological achievements, and the development and transformation method of the achievements place more emphasis on the specific nature of technological advancement and level of technology and the correlation to R&D activities, core technology and enterprises' main products (services).

Therefore, under the New Guidelines, an enterprise will need to highlight its own leading, disruptive technology in its industry, and file IP for its own protection. Applicants are encouraged to carefully consider the quality of the IP and describe how the IP is an advancement of technology as compared to peers in the industry, as well as specifically how the IP is used and applied to its R&D activities, core technology and main products (services).

R&D management (organizational excellence)

This section includes a number of indicators such as the organization and management of the company's R&D activities, in-house R&D cost centre, auxiliary accounting for R&D, co-operation with external bodies, and overall R&D competence. The New Guidance has added a new requirement on technical staff training as part of the assessment criteria, although this is not detailed.

Enterprise growth

The assessment of the growth of total assets has been replaced by the assessment of 'net assets'; the assessment of the growth rate of sales revenue remains unchanged.

3 Clarification of HNTE criteria definitions

The New Guidance provides more detailed definitions for some key application requirements, including:

— Definition of year(s)

"Established for more than a year" means enterprises should be registered and established for more than 365 calendar days;

"Current year", "recent one year" and "past one year" all mean the same as the accounting year prior to the application date;

"The past three accounting years" means three continuous accounting years prior to the application date (excluding the application year).

"In one year before application" means 365 days before application date (include application year).

— High-tech products (services)

The New Guidance states that high-tech products (services) are those in which the core technology falls under the scope of "Areas of Advanced Technologies Strongly Supported by the State".

— Total Revenue

'Total revenue' is to be based on the total revenue less the non-taxable revenue. Total revenue includes operating revenue, non-operating revenue and investment returns. Both total revenue and non-taxable revenue should be determined according to 'PRC Corporate Income Tax Law' and 'PRC Corporate Income Tax Implementation Rules'.

The old guidelines previously defined revenue from a different perspective, i.e. sales revenue equals product sales revenue and technical services revenue. As such, it may now be more challenging for some enterprises to meet the 60% HNTE revenue as a percentage of total revenue.

— Main products (services)

'Main products (services)' refers to high-tech products (services) for which the enterprise owns the IP of the core technology, and the revenue from which accounts for more than 50% of revenue of all high- tech products (services) during the same financial period.

— *R&D expenses*

The New Guidance includes a slight adjustment concerning the R&D expense rules. The key change is that the ratio for the upper limit ratio of 'other expenses' has increased from 10% to 20%. This change allows enterprises to include some expenses that may previously have been disregarded because of the lower ratio under the old guidance.

4 **Strengthened supervision and administration**

- Supervision: The New Guidance sets out clear guidelines with respect to annual reporting, re-examination, enterprise name amendment, changes on major issues, cross-city relocation, application errors and violation of the law pertaining to HNTE status.
- This is a tighter review policy as compared to the old guidance. During the assessment process, auditors may undertake a site visit to review HNTE eligibility at the company's premises. Also, more stringent requirements now apply to agent and experts.
- Administration: The New Guidance demonstrates that an expert panel will continue to be utilized for HNTE assessment purposes. The expert appointment system is retained, and financial specialists will be engaged to review income tax and other relevant financial data. Technical experts on the panel must comprise at least 60% of the total number of panelists.
- The changes regarding strengthened supervision highlight that the government will undertake more regular and focused review of all HNTE applications. We note that, in prior years, some regions across China had issues with HNTE compliance. More recently however, there has been an overall improvement in HNTE compliance across most regions. This is likely to have resulted from better education and understanding of the HNTE regulations by both claimant companies and local authorities. The New Guidance seeks to build on this recent improvement and align applicants more closely to the overall policy objectives of the HNTE program. The modifications to the administration of the HNTE program also reflect the government's focus on the nature and quality of the IP and overall integrity of the system from a technical perspective.

Next steps and action points: KPMG recommendations

- Companies should perform a comprehensive self-assessment in the context of the New Guidance, and identify potential HNTE compliance risks. Key areas to examine are:
 - Nature and quality of the IP, including potential disruptiveness of the IP; and the technological impact of the IP on main products (services) and its transformative impact and technological advancement as compared to current state of the art.
 - Ownership of the IP rights, including scope of IP, frequency of use and IP classification into Type I or Type II.

- R&D expenses and determine if additional expenses can now be included in the R&D expense calculation.
- HNTE revenue calculations with respect to high-tech product revenue to check if the relevant revenue threshold target is still achievable.
- HNTE score-card analysis to determine if the company still achieves the points target.
- Group enterprises may wish to not only assess a single entity but consider the R&D activities in the group as a whole, and make necessary arrangements to enhance HNTE compliance.
- Given the PRC's ongoing focus on supervision of HNTE status, enterprises are encouraged to enhance ongoing reporting, substantiation, and record-keeping and thereby improve R&D management systems in case of audit.

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