

Tax Analysis

PRC Tax

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Transfer Pricing and ‘High and New Technology Enterprises’ in China: What you need to know

The local management of some Chinese subsidiaries of multinational corporations often seeks to qualify the company as a "high and new technology enterprise" (HNTE). HNTE status, which requires ownership of technology by the company, entitles it to the favorable local enterprise income tax rate of 15 percent (versus the standard 25 percent statutory enterprise income tax rate) and a branding impact viewed by the local government as a contribution to the local industry upgrade.

However, the implications of HNTE status could create concerns for the headquarters management regarding the company's global transfer pricing policies. As a result, from time to time we have observed conflicting tension between local management and the company's headquarters on whether the local Chinese entity should apply for HNTE status.

Why and to what extent, do the conflicts arise? How does a company develop a defensible transfer pricing policy and also take into account the tax incentives offered under HNTE status for companies in China? This article provides a high-level analysis of the above questions by examining the Chinese HNTE conditions and the latest trends in transfer pricing audit practice by the Chinese tax authorities.

Conditions for HNTE Qualification

The Enterprise Income Tax Law grants HNTEs a reduced income tax rate of 15 percent (compared to the statutory rate of 25 percent). Now that some tax holidays have been substantially reduced (for example, the traditional two-year exemption and the three-year half rate incentive have been eliminated), such a tax incentive becomes an appealing tool for a multinational with substantial operations in China. However, an HNTE must meet the criteria set forth below:

- The enterprise must have developed or acquired independent ownership of its core IP ownership within the prior three years, when the ownership of core IP rights associated with its core business and/or services;
- At least 30 percent of all employees must be technology personnel holding college diplomas or higher degrees, and at least 10 percent of all employees must be engaged in research and development; and
- The ratio of qualifying R&D expenditures to sales revenue for the enterprise must meet relevant levels for the most recent three financial years (for example, no less than 3 percent for an enterprise with revenue greater than RMB 200 million).

Why there are conflicting views between local and HQ management?

The conflicting views of local and headquarters management on applying for HNTE status may arise initially from the different priorities and goals of financial and tax management. Local management is often attracted by the lower income tax rate, the prestigious HNTE status, and the prospect of maintaining a good relationship with the local government. The headquarters management, conversely, may be more concerned about the potential implications to the multinational's global transfer pricing policy and the global effective tax rate.

Local governments tend to encourage enterprises to apply for HNTE status, because the number of HNTEs in a given area may be used as an indicator of local economic development. Local management usually prefers to maintain a good relationship with local governmental authorities because they may play an important role in approving various business applications.

HNTE status could also help the company build up its image with customers and other stakeholders as an owner of advanced technology.

However, HNTE status (in particular, the core IP ownership) may potentially affect the characterization of the local company under the group's global arrangement.

The table below summarizes the different focuses of HQ and local management:

	Local Chinese Management	HQ Management
Good relationship with local government	Significantly concerned	Less concerned than local management
Honorable status	Significantly concerned	Less concerned than local management
Reduced local income tax rate	Significantly concerned	Local income tax rate is only one of the factors affecting the global effective tax rate
Global TP policy	Less concerned	Significantly concerned

Because of the benefits from HNTE status mentioned above, local Chinese management is often motivated to move forward with the necessary organizational changes and documentation preparation to qualify for HNTE status. However, in practice, the application for HNTE status is not a clear-cut exercise, and could potentially generate ambiguity.

For example, for the core IP ownership:

- Circular 362 provides guidance on core IP, whereby core IP includes inventions, new models, new appearance designs that are not a mere change in pattern and shape, software copyrights, patents of integrated circuit design, and new plant species.
- At a glance the requirement appears to mean that know-how and other non-registerable IP may not be recognized during the application process evaluation of the primary requirements. Technical know-how, however, will be recognized in the secondary requirement's index for "capability of technology result transformation" within the score-card system during the HNTE application.
- To maximize the chance of qualification, local management tends to state in the application documentation that the IP owned is "core" technology, even though it may not be core technology from a global group perspective. For example, a manufacturing process that may qualify as a local patent (and thus could be considered "core IP" for purposes of the HNTE application) may not necessarily be as valuable as the foundation technology owned by its global affiliate.

In addition to the core IP requirement, other parts of the HNTE qualification require judgment calls and thus could lead to potential ambiguity, including the qualified personnel/R&D projects, R&D expense composition, and the calculation of qualified revenue.

Given the ambiguity of the HNTE qualification standards and the potential judgment call by the government agencies involved in the review process, it is possible that a company could obtain HNTE status, and be deemed to own the core IP for purposes of HNTE qualification, but may not own the core IP from a group transfer pricing arrangement

standpoint. From a group perspective, the China entity may still be positioned as a routine company without nonroutine IP; hence, the global transfer pricing policy may reward the Chinese entity based on a routine profitability, which is normally determined based on a transactional net margin method (TNMM) benchmarking against routine comparables without nonroutine IP.

However, when the anti-avoidance department of the Chinese tax authorities examines the HNTE's transfer pricing compliance (at a later time after the HNTE application¹), the routine entity characterization and HNTE status could potentially cause serious challenges to the group's transfer pricing policy.

The OECD transfer pricing guidelines make it clear that the TNMM may be applicable only when the tested party, as the less complex party to the transaction, makes no unique contribution.² As the value of unique IP may not be easily identified and there may not be ideally comparable IP owned by the comparable companies, normally TNMM would capture only the return of routine functions and risks, but not the return for unique IP.

Chinese transfer pricing regulations, like the OECD transfer pricing guidelines, indicate that the use of a transfer pricing method should take into account the functions, risks, and assets assumed in the transactions, and China's State Administration of Taxation (SAT) mentioned the study of IP as a focus in its annual anti-avoidance reports in recent years. As provided in the UN's Transfer Pricing Practical Manual for Developing Countries, the SAT thinks that over time the local entity "acquires the skill and experience from operations in China, and may even contribute to the improvement of the MNE's original intangibles".³ In general, local tax authorities often hold the view that in return for the preferential HNTE treatment, the taxpayer should earn a profit margin higher than a routine margin.

SAT officers have indicated that they will pay extra attention to a company with HNTE status and examine whether a cost-plus remuneration is appropriate for its related-party transactions. We have also seen cases whereby the local tax authorities challenge the deduction of royalty payments from an HNTE to its overseas affiliate, arguing that the HNTE is supposed to own the core IP and should not pay technology royalty.

On the other hand, headquarters management must maintain global consistency regarding the group's transfer pricing policies, and it might be concerned about the impact on the global business model if a local subsidiary is considered the core IP owner. Naturally, headquarters might be hesitant about any potential "deemed" change of a subsidiary's functional and risk profile, and the potential associated challenges. Because of the potential ambiguity of the HNTE application and potential uncertainties, headquarters management is usually unwilling to proceed with the HNTE application, which local management may not always fully understand.

Developing a Defensible Transfer Pricing Policy and Taking Advantage of HNTE Status

In principle, a company's transfer pricing policy should be based on the facts and a thorough functional and risk analysis. When assessing the economic ownership of IP, special attention should be paid to whether evidence or analyses support the assertion that the local entity in fact contributes to the group core R&D. Taxpayers must balance the local HNTE benefits with the potential transfer pricing exposure.

If the local entity does indeed contribute to the group core R&D, the taxpayer should consider adopting a transfer pricing policy that allocates a proper return to the local entity, and apply for HNTE status to take advantage of the preferential tax treatment. In that situation, regardless of whether the company secures HNTE status, the local entity possibly would be expected to earn a higher return than a TNMM routine return. Of course, the increased attention from the tax authorities due to the local contribution on IP necessitates a careful review of the documents such as the HNTE submission documents (which should not overstate the importance and role of the local R&D activities and IP) and its alignment with the group's transfer pricing policy.

If local involvement in R&D is more routine than group core R&D, it is recommended that the taxpayer carefully weigh the potential risk from a transfer pricing perspective before proceeding with the HNTE application, regardless of its likelihood of success in the application process, because of the ambiguity of the conditions for HNTE status. While the possibility that an entity may qualify for HNTE status and also avoid any contradictions of the global functional and risk allocation cannot be ruled out, special care would need to be taken to mitigate the risk to the global transfer pricing arrangement.

Note: Contents discussed in this Tax Analysis pertain to Deloitte Transfer Pricing Services

¹ In China, the statute of limitation for transfer pricing audits is 10 years.

² OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, Para 2.4 and 2.59

³ UN TP Manual: Chapter 10.2 China Country Practices

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