



Tax Analysis

China

Deloitte Tohmatsu Tax Co.

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Results of High and New Technology Enterprise Status Verification Announced

China's Ministry of Science and Technology ("MOST"), the Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT") recently published the results of inspections conducted in 2014 in eight provinces and municipalities that focused on verifying the status of high and new technology enterprises ("HNTEs") (Circular Guokefahuo [2015] No. 299 ("Circular 299")). The inspections were designed to identify enterprises that had been classified as HNTEs and were benefiting from incentives granted to HNTEs, but that failed to meet the requirements for HNTE status. Of the 1,723 enterprises inspected, 166 were found to be in violation of relevant rules, and 42 of these enterprises were disqualified as HNTEs.

The issues identified in Circular 299 warrant the attention of enterprises that are in the process of applying for HNTE status, as well as those that currently enjoy HNTE status.

(1) Background

According to the Enterprise Income Tax Law, HNTEs are entitled to a preferential tax rate of 15%, a clear advantage over taxpayers subject to the normal 25% rate. The government continues to encourage technology innovation and has been granting more preferential tax treatment to HNTEs (e.g. a higher deduction ceiling for staff training costs and allowing qualifying technical personnel to pay individual income tax on certain stock-based compensation in installments), further enhancing the attractiveness of HNTE status. At the same time, the government wants to ensure that only qualifying enterprises benefit from the incentives.

The 2008 Administrative Measures for the Recognition of HNTE Status require resident companies applying for HNTE status to satisfy certain criteria, including the following:

- The enterprise must have independent ownership of core intellectual property (IP).
- The products or services the enterprise provides must be listed in the Categories of High and New Technology Sectors Specifically Supported by the State.
- The enterprise must have a certain percentage of employees who have at least a junior college degree and employees who work on research and development (R&D).
- The enterprise's R&D expenses must reach or exceed a certain percentage as compared to its

total sales revenue.

- The enterprise's revenue from high and new technology products or services must account for a certain percentage of the annual total sales revenue.

Once an enterprise is granted HNTE status, it is awarded a certificate that will be valid for three years, during which time the enterprise still must fulfill certain compliance obligations (notably, annual filings of supporting documentation demonstrating that the above percentage requirements are met at all times). HNTE status may be revoked in certain cases, such as where the enterprise has major safety or quality issues or has been fined for violation of environmental protection laws and regulations.

(2) Overview of the 2014 inspections

In January 2013, the MOST, the MOF and the SAT jointly announced that they were launching inspections to verify the HNTE status of enterprises across the country. The inspection was rolled out in two phases: self-inspection and focused inspections. The self-inspection was carried out in 2013.

The MOST, the MOF and the SAT formed joint taskforces in the period March to May 2014, and then based on the results of the self-inspections, carried out independent targeted inspections of HNTEs located in Anhui, Beijing, Hubei, Liaoning, Shaanxi, Shandong, Shenzhen and Zhejiang.

As noted above, out of the 1,723 companies inspected, 166 enterprises, or about 10% of the enterprises inspected, were found to be in violation of the rules. Forty two of these enterprises were disqualified as HNTEs. The following table details the violations discovered during the inspection process:

Number of enterprise	Major issues	Consequences
6	<ul style="list-style-type: none"> • Submission of false applications to obtain HNTE status 	<ul style="list-style-type: none"> • HNTE status revoked, with recapture of relevant tax benefits that had been granted
36	<ul style="list-style-type: none"> • Expired core and proprietary IP rights; • R&D expenses failed to meet the required percentage; • Sales revenue from high and new technology products and services fell short of the required percentage; and • Fines imposed by environmental protection authorities 	<ul style="list-style-type: none"> • HNTE status revoked and preferential tax treatments terminated
124	<ul style="list-style-type: none"> • Submission of incomplete applications to obtain HNTE status or inadequate governance that would not result in disqualification as an HNTE 	<ul style="list-style-type: none"> • Rectifications ordered

(3) Deloitte's comments

Many enterprises are interested in HNTE status because of the significant potential tax savings, and some have falsified or manipulated their operational data to qualify as HNTEs. If an enterprise is found to have applied for HNTE status using fraudulent information, HNTE status will be revoked, it will be

required to pay back the tax benefits that has been granted, as well as interest and penalties and its reputation will be negatively impacted.

Even if an enterprise satisfies the relevant criteria, retaining HNTE status is dependent on ongoing compliance with the HNTE rules, as well as other laws and regulations. The imposition of fines or penalties, however insignificant, will cause the enterprise to have its HNTE status revoked, resulting in the loss of the preferential tax treatment. An enterprises that is disqualified because it submitted a fraudulent application or violated environment protection laws and regulations will be unable to obtain HNTE status for five years.

The stringent requirements to qualify for, and maintain, HNTE status create challenges for enterprises, with respect to their day-to-day management, especially in areas relating to R&D expense data collection and the management of IP rights. For example, the R&D expense criteria that must be satisfied to apply for and maintain HNTE status is different from the criteria that applies in the accounting standards and from the requirements to qualify for the R&D super deduction; as a result, enterprises must be able to accurately capture and account for R&D expenses for multiple purposes. During the course of the 2014 inspections, nearly 50 HNTEs were found to be noncompliant in these areas.

With respect to IP rights, it appears that some enterprises were granted HNTE status based on a claim that the enterprise had core and proprietary IP, but in fact the IP was of a peripheral nature and had low economic value. Such enterprises likely are structured to bear only limited risks within a group, a position that may be at variance with HNTE status in a transfer pricing analysis. It also appears that during the course of the government's inspections, the authorities stated that the claimed core and proprietary IP must "play a critical role for the primary products or services of the enterprise," a requirement that is expected to be formalized by revising the Administrative Measures for the Determination of High and New Tech Enterprises.

The authorities have been carrying out inspections to verify HNTE status since the Administrative Measures became effective. As early as 2009, the National Audit Office (NAO) and the MOF were conducting inspections and publishing their findings. As regulators continue to gain experience, HNTE status has become an area of focus for regular inspections by regulators at all levels. The 2014 national inspection campaign was considered to have the most extensive inspection conducted to date.

Statistics indicate that during the period 2013 to August 2015, 170 enterprises have been disqualified as HNTEs, far exceeding the total number of enterprises that were disqualified in the period 2008-2012 (11 in total). Going forward, verification of HNTE status likely will become increasingly pervasive and regular.

(4) Deloitte's recommended steps

As the authorities intensify their inspection efforts, enterprises should take steps to raise their awareness of tax risks and potential exposure, and to learn from the results of the 2014 inspection campaign, specifically from cases where HNTE status was denied or revoked. Potential action items for consideration include the following:

- Enterprises that have not yet decided whether to apply for HNTE status should evaluate the pros and cons from a business perspective and the feasibility of HNTE status from a technical perspective, taking into account their overall IP rights management and value chain positioning, as

well as the strategic rationale and the requirements to qualify and maintain HNTE status.

- Enterprises that are considering applying for HNTE status should conduct self-evaluations before filing the application to determine whether all of the relevant criteria is met, and if not, conduct a gap analysis to assess the possibility of making adjustments and meeting the requirements.
- Enterprises that are in the process of applying for HNTE status should ensure that their application materials provide a true and accurate representation of the business in order to facilitate the process and avoid any challenges to the data. Particular attention should be paid to the soundness of internal systems that account for R&D expenses and sales revenue from high and new technology products (services) and to ensure that an appropriate mechanism is in place to capture and report relevant data in a timely manner.
- Enterprises that already have HNTE status should set up or enhance systems that monitor the major risk points that could result in revocation of HNTE status. Such enterprises also should review prior year information and be prepared for potential future inspections and verifications.
- All enterprises should monitor future developments relating to HNTEs and consult authorities or professional services for guidance and support, where needed.

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