



Tax Newsflash

China

Deloitte Tohmatsu Tax Co.

November 13, 2015

China Enhanced Super Deduction for R&D Expenses

On 3 November 2015, China's Ministry of Finance, the State Administration of Taxation and the Ministry of Science and Technology jointly issued new guidance (Caishui [2015] No.119 (Circular 119)) that expands the scope of the super deduction for research and development (R&D) expenses incurred by domestic enterprises and streamlines the related administrative procedures relating to the super deduction. Circular 119, which is designed to encourage more businesses to invest in R&D, will enter into effect on 1 January 2016, and replace the current rules (i.e. Guoshuifa [2008] No.116 and Caishui [2013] No.70).

(1) Background

The Enterprise Income Tax (EIT) Law grants a generous super deduction for qualifying R&D expenses incurred by enterprises for the development of new technology, new products and new techniques. Qualifying companies are allowed to deduct 150% of R&D expenses actually incurred (i.e. an additional 50% deduction on top of the normal expense deduction) if the expenses do not result in the production of an intangible asset. If intangible assets are developed, companies can capitalize 150% of the actual costs incurred for amortisation purposes.

Although the super deduction rules aim to encourage R&D activities in general, the intended benefits have not been fully realized because the super deduction has been available only for select industries and expenses. Accordingly, in the State Council executive meeting on 21 October 2015, a decision was made to expand the scope of the applicability of the super deduction as from 1 January 2016, to encourage more businesses to invest in R&D. Circular 119 clarifies the details for the implementation of this decision.

(2) Major changes made by Circular 119

1) Significant expansion of scope of eligible industries and activities

Under current rules, only R&D activities listed in the Categories of High and New Technology Sectors Specifically Supported by the State and the Guidelines on Priority Areas for High Technology Industrialization are eligible for the super deduction. Circular 119 introduces a "negative list," so that any activities or industries that are not included on the list will be eligible for the super deduction, which will substantially broaden its applicability.

Circular 119 includes the following industries and activities on the negative list:

Industries that are not eligible for the super deduction	Activities that are not eligible for the super deduction
<ul style="list-style-type: none"> ➤ Tobacco; ➤ Hospitality and catering; ➤ Wholesale and retail; ➤ Real estate; ➤ Rental and commercial services; and ➤ Entertainment. 	<ul style="list-style-type: none"> ➤ Normal upgrades of products (services); ➤ Direct application of research findings; ➤ Support activities following commercialization of a product; ➤ Duplication or simple alteration of existing products, services, technology, materials or processes; ➤ Market research, efficiency studies or management research; ➤ Quality control, testing and analysis or repair and maintenance activities that are related to industrial (service) processes or are routine in nature; and ➤ Research in the social sciences, the arts or humanities.

Circular 119 specifically provides that expenses incurred during innovative, creative and “break-through” product design activities will be eligible for the super deduction. Such activities may include the development of multimedia and animation game software; digital animation and game design; architectural and landscape design; industrial design; multimedia design; animation and derivative product design, model design, etc.

2) Expansion of scope of eligible expenses

Additional types of expense: Circular 119 will expand the scope of expenses eligible for the super deduction to include the following types of expense:

- Labor costs of external R&D personnel;
- Testing expenses for trial products; and
- Other expenses directly related to R&D activities (such as expert consultation, “high and new technology” R&D insurance, intellectual property application costs, travel and meeting costs), up to 10% of the total R&D expenses that are eligible for the super deduction.

Clarification of "depreciation related to equipment and instruments": The current rules may be interpreted as providing that only depreciation expense related to equipment and instruments that are used solely for R&D activities is eligible for the super deduction. In practice, the relevant wording in the current rules has given rise to disputes, and depreciation of equipment and instruments that have been used for both R&D and non-R&D purposes (even if primarily used for R&D purposes) may be disqualified from the super deduction.

Circular 119 will revise the relevant wording to “depreciation related to equipment and instruments that are utilized for research and development,” which should reduce the possibilities for disputes and should facilitate companies claiming the super deduction for their actual R&D expenses.

3) Amendments to rules on contract R&D

The current rules provide that, in contract R&D arrangements, the contractor must provide the principal with a detailed list of its R&D expenses; otherwise, the principal may not claim the super deduction. This requirement is not always commercially practicable when the contracting parties are not related, and

there have been differing opinions with regard to whether the profits the contractor earns from its services provided to the principal may be included within the scope of the super deduction.

Circular 119 clarifies that, where the principal and the contractor are related parties, the contractor must provide the principal with a detailed list of R&D expenses; in other words, it appears that where such an arrangement is not between related parties, a detailed expense list no longer will be required. The circular also specifies that the principal may recognize up to 80% of the total actual R&D expenses that are on arm's length terms (which means that the profits earned by the contractor may be considered part of the principal's total R&D expenses) for purposes of claiming the super deduction. This new approach may, to some extent, help simplify the super deduction calculation and reduce the number of tax disputes.

Circular 119 also specifically provides that expenses related to R&D activities carried out by foreign organizations or individuals are not eligible for the super deduction.

4) Streamlined approval and administrative procedures and other relevant provisions

Circular 119 provides guidance on a number of additional issues, including the following:

- Based on Circular 119 and recent State Council decisions, taxpayers must follow the applicable filing procedures to claim the super deduction; it is not necessary to obtain advance approval from the relevant tax authorities.
- Companies undertaking R&D projects at the provincial or ministerial level or above, or projects that span multiple years and that already have been verified, no longer will require annual verification by the competent science and technology authorities.
- For expenses incurred on or after 1 January 2016, a company is allowed to apply for super deduction retroactively, within three years after the expenses are incurred.

5) Taxpayer obligations and post-event inspections

Companies no longer will be required to set up special accounts for R&D expenses; however, Circular 119 emphasizes that, in addition to complying with the standard accounting treatment under the prevailing financial accounting rules, companies must prepare supplementary financial records to accurately track the actual expenses that are eligible for the super deduction in the current year.

Circular 119 requires the tax authorities to intensify their administration of super deduction claims filed by taxpayers, through regular inspections and monitoring, with audits to cover no less than 20% of all cases annually.

(3) Deloitte's comments

With the substantial expansion of the scope of the application of the super deduction, more businesses likely will be able to benefit from the incentive. Companies should begin to examine their R&D activities to determine whether any adjustments are needed; enhance their expense tracking and monitoring for compliance and external inspection purposes; and monitor regulatory developments regarding the super deduction to position themselves to fully capture the potential tax benefits.

Relevant circular:

[Notice on Further Enhancing Policy on Super Deduction for Research and Develop Expenses \(Caishui \[2015\] No.119\) \(Chinese version\)](#)

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