



# Tax Newsflash

China

Deloitte Tohmatsu Tax Co.

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## SAT Issues Additional Guidance on Super Deduction for R&D Expenses

On 29 December 2015, China's State Administration of Taxation ("SAT") issued additional guidance (Bulletin 97<sup>1</sup>) on the super deduction for research and development ("R&D") expenses.

### (1) Background

Circular 119<sup>2</sup> was issued by China's Ministry of Finance and SAT on 2 November 2015 to encourage more businesses to invest in R&D; Circular 119 expands the scope of the super deduction for R&D expenses incurred by domestic enterprises and streamlines the administrative procedures relating to the super deduction, effective 1 January 2016<sup>3</sup>. Bulletin 97 provides further clarification on certain implementation issues and applies to enterprise income tax filings for 2016 and subsequent years.

### (2) Highlights of Bulletin 97

#### 1) Industries ineligible for the super deduction

Circular 119 provides a list of industries ineligible for the super deduction. To determine whether a company falls within the scope of the list for a specific year, Bulletin 97 provides a test to ascertain whether the company's revenue from industries on the list accounts for more than 50% of the company's total revenue in that year. The total revenue must be calculated according to article 6 of the enterprise income tax law, but must exclude nontaxable income and investment income.

#### 2) Contract R&D

For contract R&D arrangements where the contractor is an individual, Bulletin 97 requires the principal to obtain an invoice from the individual to support a claim for the super deduction.

For contract R&D arrangements where the contractor is a foreign party, Circular 119 provides that the super deduction will not be allowed. Bulletin 97 clarifies that the term "foreign parties" refers to enterprises or other organizations registered in a jurisdiction outside Mainland China and to foreign individuals (including individuals from Hong Kong, Macau and Taiwan).

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1 See [SAT Bulletin \[2015\] No. 97](#) (Chinese version)

2 See [Caishui \[2015\] No.119](#) (Chinese version)

3 See "[China Enhanced Super Deduction for R&D Expenses](#)" of Tax Newsflash dated 13 November 2015

3) Scope of R&D personnel

Bulletin 97 clarifies the scope of R&D personnel whose costs are eligible for the super deduction, by defining three subgroups: research, technical and support personnel. Staff who perform logistics functions will not qualify as support personnel.

Bulletin 97 further clarifies that R&D personnel may be either employees or nonemployees who are working for the company under an independent personal service agreement or a staff assignment arrangement.

4) Special issues

a) **Accelerated depreciation:** For R&D instruments or equipment to which accelerated depreciation was applied for tax purposes, the depreciation expense that is eligible for the super deduction will be the lesser of the tax depreciation or the depreciation recorded in the financial books.

b) **Expenses incurred for dual purposes:** For expenses incurred for both R&D and non-R&D purposes (e.g. costs of staff who perform both R&D and non-R&D activities, or equipment used for both R&D and non-R&D purposes), the company must reasonably allocate the expenses according to the relevant working hours (or other reasonable allocation criteria) and must maintain the usage/working information to support the allocation. The super deduction will not be allowed if dual-purpose expenses are not allocated between R&D and non-R&D costs.

c) **Limitation on other expenses directly related to R&D activities:** Circular 119 provides that "other expenses directly related to R&D activities" cannot exceed 10% of the total R&D expenses that are eligible for the super deduction. Bulletin 97 clarifies that the ceiling must be calculated on a project-by-project basis, as follows:

$$\text{R\&D expenses eligible for super deduction, excluding other expenses directly related to R\&D activities} \times 10\% / (1-10\%)$$

d) **Offsets to expenses:** Before a company calculates the amount of the super deduction, any income from selling scraps or certain test products resulting from the R&D activities must be deducted from the total amount of R&D expenses; however, this offset cannot reduce the R&D expenses below zero.

For situations where the R&D activities result in a single large machine that is immediately ready for sale, the cost of materials must be excluded from the R&D expenses eligible for the super deduction.

e) **Nondeductible expenses:** Bulletin 97 confirms that nondeductible expenses (e.g. expenses funded by certain government subsidies that are considered "nontaxable income") are not eligible for the super deduction.

5) Documentation and filing requirements

Bulletin 97 provides the following documentation requirements, accompanied with sample forms:

Documents	Taxpayer obligations	Information to be provided
<b>Supporting form for R&amp;D expenses</b>	Set up and maintain the form for each R&D project	Date, coding and detailed entries for relevant accounting vouchers; information in relation to each expense; etc.

<b>Form summarizing supporting forms for R&amp;D expenses</b>	Submit the form as an appendix to the financial statements to the tax authorities for each year	Annual breakdown of R&D expenses for each project; the amount to be capitalized; etc.
<b>Informational form for R&amp;D expenses eligible for super deduction for R&amp;D projects</b>	Submit the form with the annual income tax return filing to the tax authorities for each year	Annual total of R&D expenses (breakdown by each expense item, instead of by project); the amount of the super deduction; etc.

In addition, the following documents must be maintained by the company claiming the super deduction for R&D expenses:

- R&D project plans and relevant documents supporting internal decisions (e.g. board resolutions);
- Information in relation to the R&D taskforce, and a list of names of R&D personnel;
- R&D contracts registered with the government authorities in charge of science and technology (if required);
- Information in relation to the allocation of expenses (including records of working hours) where the personnel costs or other expenses (e.g. depreciation of instruments, amortization of intangibles) are incurred for both R&D and non-R&D purposes;
- Information in relation to the R&D expense allocation and benefits shared among parties that conducted R&D activities through a cost-sharing arrangement;
- Supporting form for R&D expenses;
- Written opinions from the government authorities in charge of science and technology regarding the R&D project (if any); and
- Other documents required by the tax authorities at the provincial level.

### **(3) Deloitte's comments and recommendations**

With the substantial expansion of the scope of the application of the super deduction by Circular 119, more businesses likely will be able to benefit from the incentive. Nevertheless, it appears that a company still must meet certain documentation requirements to claim the benefits of the deduction; for example, the supporting form for R&D expenses requires extensive accounting information in respect of R&D projects.

It also is worth noting that the tax authorities have been asked to enhance the post-event inspections of taxpayers that claim the super deduction, and at least 20% of companies claiming the super deduction will be audited for each year.

Affected businesses should consider the following actions:

- Review the current financial accounting system for R&D expenditures to assess whether it enables the company to meet the relevant documentation requirements effectively and efficiently, identify any weaknesses and make improvements accordingly; and
- Prepare and maintain the documents required to claim the super deduction, review the reasonableness of positions taken by the company, appropriately communicate with the tax authorities on unclear issues and seek professional advice where necessary.

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