

# Tax Analysis

PRC Tax

Authors:

Clare Lu  
Partner  
Qinli \*  
Tel: +86 21 6141 1488  
Email: [clu@qinlilawfirm.com](mailto:clu@qinlilawfirm.com)

Roger Zhou  
Senior Manager  
Deloitte Shanghai  
Tel: +86 21 6141 1381  
Email: [rozhou@deloitte.com.cn](mailto:rozhou@deloitte.com.cn)

\* Clare Lu is from Qin Li Law Firm, which is a Chinese law firm and forms part of the international Deloitte network.

For more information, please contact:

Research & Development and  
Government Incentives

Vivian Jiang  
Partner  
Deloitte Shanghai  
Tel: +86 21 6141 1098  
Email: [vivjiang@deloitte.com.cn](mailto:vivjiang@deloitte.com.cn)

Clare Lu  
Partner  
Qinli  
Tel: +86 21 6141 1488  
Email: [clu@qinlilawfirm.com](mailto:clu@qinlilawfirm.com)

Finny Cao  
Partner  
Deloitte Beijing  
Tel: +86 10 8520 7525  
Email: [fcao@deloitte.com.cn](mailto:fcao@deloitte.com.cn)

Lisa Li  
Director  
Deloitte Shenzhen  
Tel: +86 755 3353 8527  
Email: [lisali@deloitte.com.cn](mailto:lisali@deloitte.com.cn)

## 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.

### 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.

### 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 enterprises	Major issues	Consequences
6	Submission of false applications to obtain HNTE status	HNTE status revoked, with recapture of relevant tax benefits that had been granted
36	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	HNTE status revoked and preferential tax treatments terminated
124	Submission of incomplete applications to obtain HNTE status or inadequate governance that would not result in disqualification as an HNTE	Rectifications ordered

### 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.

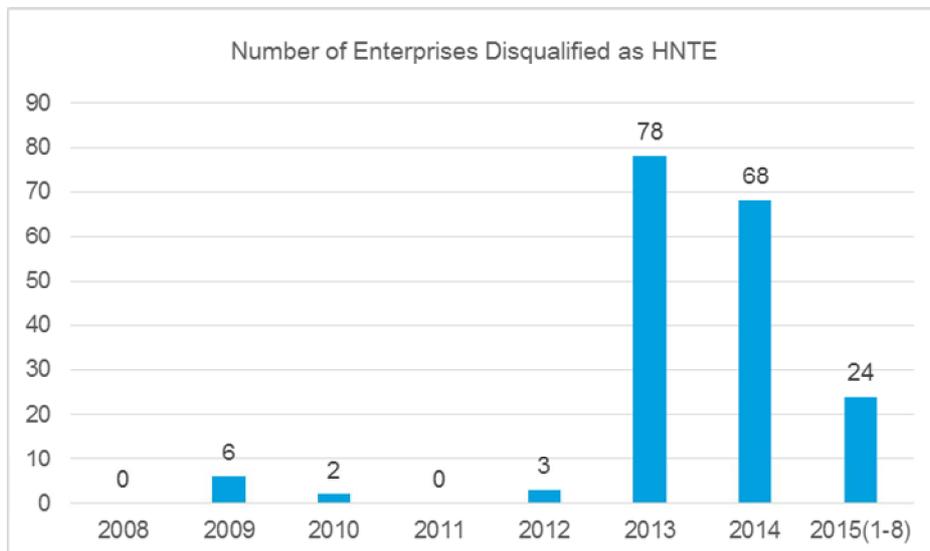
Even if an enterprise satisfies the relevant criteria, retaining HNTTE status is dependent on ongoing compliance with the HNTTE rules, as well as other laws and regulations. The imposition of fines or penalties, however insignificant, will cause the enterprise to have its HNTTE status revoked, resulting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

The stringent requirements to qualify for, and maintain, HNTTE 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 HNTTE 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 HNTTEs were found to be noncompliant in these areas.

With respect to IP rights, it appears that some enterprises were granted HNTTE 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 HNTTE 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 HNTTE 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, HNTTE 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<sup>1</sup> indicate that during the period 2013 to August 2015, 170 enterprises have been disqualified as HNTTEs, far exceeding the total number of enterprises that were disqualified in the period 2008-2012 (11 in total). Going forward, verification of HNTTE status likely will become increasingly pervasive and regular.



### 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 HNTTE status was denied or revoked. Potential action items for consideration include the following:

- Enterprises that have not yet decided whether to apply for HNTTE status should evaluate the pros and cons from a business perspective and the feasibility of HNTTE 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 HNTTE status.

<sup>1</sup> Source: Deloitte analysis of information published on the official government website relating to HNTTEs, [www.innocom.gov.cn](http://www.innocom.gov.cn)

- 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.

Deloitte's team of R&D and Government Incentives professionals can assist enterprises with the following:

- [Applying for preferential treatment \(e.g. HNTE status and the R&D super deduction\)](#): maximizing the financial benefits of applicable preferential policies.
- [Process re-engineering, system transformation and knowledge transfer](#): implementing necessary amendments to processes and systems by leveraging Deloitte's proprietary tools, and transfer knowledge by training.
- [Assistance with tax audits and dispute resolution](#): responding appropriately to challenges and disputes using effective communications approaches and leveraging rich experience from prior cases.
- [R&D structuring and planning for group companies](#): enhancing corporate governance efficiency.
- [End-to-end advisory services](#): assisting enterprises in investor attraction, operations and exit strategies.

If you have any questions regarding preferential policies for technology innovation, please contact members of the Deloitte R&D and Government Incentive services team.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

#### Beijing

Andrew Zhu  
Partner  
Tel: +86 10 8520 7508  
Fax: +86 10 8518 1326  
Email: [andzhu@deloitte.com.cn](mailto:andzhu@deloitte.com.cn)

#### Hong Kong

Sarah Chin  
Partner  
Tel: +852 2852 6440  
Fax: +852 2520 6205  
Email: [sachin@deloitte.com.hk](mailto:sachin@deloitte.com.hk)

#### Shenzhen

Victor Li  
Partner  
Tel: +86 755 3353 8113  
Fax: +86 755 8246 3222  
Email: [vicli@deloitte.com.cn](mailto:vicli@deloitte.com.cn)

#### Chongqing

Frank Tang  
Partner  
Tel: +86 23 6310 6206  
Fax: +86 23 6310 6170  
Email: [ftang@deloitte.com.cn](mailto:ftang@deloitte.com.cn)

#### Jinan

Beth Jiang  
Director  
Tel: +86 531 8518 1058  
Fax: +86 531 8518 1068  
Email: [betjiang@deloitte.com.cn](mailto:betjiang@deloitte.com.cn)

#### Suzhou

Frank Xu / Maria Liang  
Partner  
Tel: +86 512 6289 1318 / 1328  
Fax: +86 512 6762 3338  
Email: [frakxu@deloitte.com.cn](mailto:frakxu@deloitte.com.cn)  
[mliang@deloitte.com.cn](mailto:mliang@deloitte.com.cn)

#### Dalian

Bill Bai  
Partner  
Tel: +86 411 8371 2888  
Fax: +86 411 8360 3297  
Email: [bilbai@deloitte.com.cn](mailto:bilbai@deloitte.com.cn)

#### Macau

Raymond Tang  
Partner  
Tel: +853 2871 2998  
Fax: +853 2871 3033  
Email: [raytang@deloitte.com.hk](mailto:raytang@deloitte.com.hk)

#### Tianjin

Jason Su  
Partner  
Tel: +86 22 2320 6680  
Fax: +86 22 2320 6699  
Email: [jassu@deloitte.com.cn](mailto:jassu@deloitte.com.cn)

#### Guangzhou

Victor Li  
Partner  
Tel: +86 20 8396 9228  
Fax: +86 20 3888 0121  
Email: [vicli@deloitte.com.cn](mailto:vicli@deloitte.com.cn)

#### Nanjing

Frank Xu  
Partner  
Tel: +86 25 5791 5208  
Fax: +86 25 8691 8776  
Email: [frakxu@deloitte.com.cn](mailto:frakxu@deloitte.com.cn)

#### Wuhan

Justin Zhu  
Partner  
Tel: +86 27 8526 6618  
Fax: +86 27 8526 7032  
Email: [juszhu@deloitte.com.cn](mailto:juszhu@deloitte.com.cn)

#### Hangzhou

Qiang Lu  
Partner  
Tel: +86 571 2811 1901  
Fax: +86 571 2811 1904  
Email: [qilu@deloitte.com.cn](mailto:qilu@deloitte.com.cn)

#### Shanghai

Eunice Kuo  
Partner  
Tel: +86 21 6141 1308  
Fax: +86 21 6335 0003  
Email: [eunicekuo@deloitte.com.cn](mailto:eunicekuo@deloitte.com.cn)

#### Xiamen

Jim Chung  
Partner  
Tel: +86 592 2107 298  
Fax: +86 592 2107 259  
Email: [jjchung@deloitte.com.cn](mailto:jjchung@deloitte.com.cn)

#### About the Deloitte China National Tax Technical Centre

The Deloitte China National Tax Technical Centre ("NTC") was established in 2006 to continuously improve the quality of Deloitte China's tax services, to better serve the clients, and to help Deloitte China's tax team excel. The Deloitte China NTC prepares and publishes "Tax Analysis", "Tax News", etc. These publications include introduction and commentaries on newly issued tax legislations, regulations and circulars from technical perspectives. The Deloitte China NTC also conducts research studies and analysis and provides professional opinions on ambiguous and complex issues. For more information, please contact:

#### National Tax Technical Centre

Email: [ntc@deloitte.com.cn](mailto:ntc@deloitte.com.cn)

#### National Leader

Leonard Khaw  
Partner  
Tel: +86 21 6141 1498  
Fax: +86 21 6335 0003  
Email: [lkhaw@deloitte.com.cn](mailto:lkhaw@deloitte.com.cn)

#### Northern China

Julie Zhang  
Partner  
Tel: +86 10 8520 7511  
Fax: +86 10 8518 1326  
Email: [juliezhang@deloitte.com.cn](mailto:juliezhang@deloitte.com.cn)

#### Southern China (Hong Kong)

Davy Yun  
Partner  
Tel: +852 2852 6538  
Fax: +852 2520 6205  
Email: [dyun@deloitte.com.hk](mailto:dyun@deloitte.com.hk)

#### Southern China (Mainland/Macau)

German Cheung  
Director  
Tel: +86 20 2831 1369  
Fax: +86 20 3888 0121  
Email: [gercheung@deloitte.com.cn](mailto:gercheung@deloitte.com.cn)

#### Eastern China

Kevin Zhu  
Director  
Tel: +86 21 6141 1262  
Fax: +86 21 6335 0003  
Email: [kzhu@deloitte.com.cn](mailto:kzhu@deloitte.com.cn)

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at [wanluk@deloitte.com.hk](mailto:wanluk@deloitte.com.hk) or by fax to +852 2541 1911.

#### About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see [www.deloitte.com/cn/en/about](http://www.deloitte.com/cn/en/about) for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte has in the region of 200,000 professionals, all committed to becoming the standard of excellence.

#### About Deloitte in Greater China

We are one of the leading professional services providers with 22 offices in Beijing, Hong Kong, Shanghai, Taipei, Chengdu, Chongqing, Dalian, Guangzhou, Hangzhou, Harbin, Hsinchu, Jinan, Kaohsiung, Macau, Nanjing, Shenzhen, Suzhou, Taichung, Tainan, Tianjin, Wuhan and Xiamen in Greater China. We have nearly 13,500 people working on a collaborative basis to serve clients, subject to local applicable laws.

#### About Deloitte China

The Deloitte brand first came to China in 1917 when a Deloitte office was opened in Shanghai. Now the Deloitte China network of firms, backed by the global Deloitte network, deliver a full range of audit, tax, consulting and financial advisory services to local, multinational and growth enterprise clients in China. We have considerable experience in China and have been a significant contributor to the development of China's accounting standards, taxation system and local professional accountants.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the "Deloitte Network") is by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.