Changes to China’s High and New Technology Enterprise (HNTE) Regime Both Sharpen its Focus and Make its Advantages More Broadly Available

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With the promulgation of the Corporate Income Tax (CIT) law in 2008, many preferential tax regimes (e.g. lower tax rates for foreign invested companies) were revoked. Under the CIT, the HNTE treatment, which reduces a qualified taxpayer’s applicable CIT rate from the standard 25 percent to 15 percent, is one of the few remaining tax preferences. As a result, any change to the HNTE rule attracts a great deal of attention.

On January 29, 2016, the Ministry of Science and Technology (MST), Ministry of Finance (MOF) and State Administration of Taxation (SAT) jointly released a notice revising the Administrative Measures for Recognition of HNTE (Guokefahuo [2016] No.32) (Circular 32).

Circular 32 does not radically transform the HNTE rules (Guokefahuo [2008] No.172) issued in 2008 (2008 Rules). Instead, it adjusts several aspects of the assessment standards to make HNTE status more attainable for small and medium sized companies while at the same time sharpening the focus of the rules in certain respects. This is consistent with the government’s efforts to transform the declining manufacturing and export-oriented economy into a technology and innovation-driven economy. Circular 32 also revised the scope of encouraged technologies for HNTE purposes, including a few state of the art technology areas such as encryption technology and cloud computing technology.

Key Changes

1. Assessment Criteria

Circular 32 institutes the following key changes to the assessment criteria for HNTE status:

1.1 Intellectual Property Ownership

Under the 2008 Rules, qualification for HNTE status required either (a) ownership of intellectual property rights (IPRs) in core technologies via self-development, grant, transfer, donation, or merger or acquisition in the last 3 years or (b) a global, exclusive license to use the core technologies for over 5 years.

Under Circular 32 qualification for HNTE status requires that “the company shall obtain the ownership of IPRs via its own R&D, grant or transfer, donation, and merger or acquisition, which make core technical contributions to its main products (services).” The option to acquire IPRs via license is eliminated as is any stated timeframes for acquisition or ownership of IPRs.

Circular 32 further emphasizes the correlation between IPRs and the main products (services) of an HNTE. The 2008 Rules provided that “the products (services) shall fall within the technology areas of the Catalogue of High and New Technology Areas Specifically Encouraged by the State (2008)” (the 2008 Catalogue). The 2008 Rules were more focused on whether the product (service) is included in the 2008 Catalogue, whereas Circular 32
provides that “the technology that made a core technical contribution to its main products (services) of the company shall fall within the technology areas of the Catalogue of High and New Technology Areas Specifically Encouraged by the State (2016)” (2016 Catalogue). Circular 32 and its catalogue stress the *technology* rather than the products (services). This change could be designed to address the situation where a company purchases IPRs unrelated to its products (services) solely for the purpose of meeting the requirement for HNTE status.

### 1.2 R&D Personnel

The 2008 Rules stipulated that “the number of technology personnel with a college diploma or above shall be over 30 percent of total employees, and R&D personnel shall be over 10 percent of total employees.”

Circular 32 provides that “technology personnel participating in the R&D and related technology innovation activities shall not be less than 10 percent of the total number of employees of the current year.”

Companies in labor-intensive industries should benefit from the removal of the 30 percent college degree requirement since higher education is not a prerequisite for fulfillment of much of their labor needs. Companies who acquire IPRs via contract R&D arrangements also could benefit from the lowered requirement for technology personnel.

### 1.3 R&D Expense Ratio

Circular 32 lowers the R&D expense ratio from 6 percent to 5 percent of the total revenue for companies with sales revenues of up to RMB 50 million in the preceding year. For companies with revenues over RMB 50 million in the preceding year, the R&D expense ratio remains unchanged at 4 percent (if annual revenue exceeds RMB 50 million but is not over RMB 200 million) or 3 percent (if annual revenue is over RMB 200 million).

The reduced threshold of the R&D expense ratio is believed to help small and medium sized enterprises achieve HNTE status.

### 1.4 Indicator Requirements

According to the 2008 Rules, a company shall meet the requirements in the Guidelines on the Administration of Determination of HNTE with respect to several indicators which include the organization and management of R&D activities, the ability to convert R&D results into productivity, the number of self-developed IPRs, and the growth of sales and the total assets. The 2008 Rules applied a scoring system to assess the HNTE applicant’s performance under each indicator. Out of a total score of 100, a company must achieve a score of over 70 to be qualified as an HNTE company.

Circular 32 replaces the complicated indicators with a requirement that the company “satisfy the requirement for innovation capability evaluation.” It is expected that new guidelines will be formulated to guide taxpayers through the HNTE application process. Currently, “innovative capability evaluation” is undefined.

### 1.5 Compliance Record

Circular 32 states that “the company shall not have any serious security or quality accidents, or incidents which seriously violate environmental laws in the preceding year before the application for HNTE status.” If an HNTE company commits such a violation after attaining HNTE status, its status will be revoked and it will be required to pay back all the taxes that it saved as a result of attaining HNTE status.

This compliance record test is new. The 2008 Rules mainly focused on requirements regarding IPRs and the company’s growth potential. The emphasis on the compliance record of an HNTE company stresses the importance of a “green” operation. HNTE status also hinges on the operation of a safe and stable company. However, it is unclear how the authorities will determine a “serious” accident or incident.

### 2. Application Procedure and Follow-up Supervision

Circular 32 shortens the application process for HNTE status. However, once the HNTE status is obtained, the company faces a heavier information disclosure burden than it previously had under the 2008 Rules. Moreover, the company will be continuously supervised by the authorities.

#### 2.1 Application Procedure

The application procedure for HNTE status is as follows:
The applicant company registers on the HNTE Company Assessment and Administrative Website (Website) and prepares and submits application documents. The required documentation includes a special audit report on R&D expenses, audited financial statements, corporate income tax returns for the last three years, and information regarding revenues derived from high-tech products (services) from the prior year.

The HNTE Assessment Committee reviews the application documents.

The HNTE Assessment Committee posts a public notice on the Website for ten working days for public comments.

The HNTE Assessment Committee grants the HNTE Certificate if the committee does not receive any objections within the ten-day period.

The new application procedure adopts the old practice except that the public notice time period is reduced from 15 to 10 working days. This will surely be good news for HNTE applicants. However, Circular 32 requires applicants to provide certain documents from the last three years. This may indicate, though Circular 32 is not clear, that companies established for less than three years may not qualify for HNTE status.

2.2 Follow-up Supervision

An HNTE company will have new reporting obligations under Circular 32:

- Upload annual development forms to the Website by the end of May of each year on information regarding IPRs, technology personnel and R&D expenses and revenues for the preceding year.
- Report a change to the company name or significant changes to the company relevant to the HNTE assessment criteria within 3 months of the change.
- Report any relocation of the HNTE company. Complete relocation of a company does not affect its HNTE status. Partial relocation (e.g. relocation of a functional unit) may require re-evaluation of a company's HNTE status.

Under Circular 32, HNTE status will be revoked and the tax authority will claw back tax benefits if the HNTE commits any of the following acts:

- Substantial fraud during the application and assessment process.
- Serious security or quality accidents, or incidents seriously violating environmental laws.
- Failure to report significant changes relating to the assessment criteria in a timely manner or to submit the annual development forms for two years.

3. New Encouraged Industry Areas

The 2016 Catalogue adds new encouraged industries to the industry catalogue that will qualify for HNTE purposes:

- Cloud computing technology
- Mobile internet
- Encryption technology
- E-commerce and modern logistics
- Inspection certification and standardized services
- Supportive technologies for cultural and creative industries
- Natural disaster monitoring
- Alert and emergency solutions

Conclusion

In some respects, Circular 32 loosened the assessment criteria for HNTE status. However, in other respects, the HNTE regime has been tightened. Enterprises should pay close attention to the following matters in the
application for HNTE status and to assure HNTE status is maintained:

- The revision to the IPR requirements implies that the authorities will be placing more emphasis on the quality of the technology and the connection between IPRs and R&D activities, core technologies, and the main products (services). An HNTE applicant should have this in mind and demonstrate its qualifications.

- An HNTE will have to invest more effort than in the past to maintain its status. It will need to attend to keeping proper documents to demonstrate its capabilities, reporting significant changes relating to the assessment criteria and updating information on an annual basis.

- HNTE companies and prospective HNTE applicants should review their compliance record with a focus on product quality and environmental protection.

Circular 32 states that MOST, MOF, and SAT will be issuing additional guidance. It is expected that additional guidance will address some of the ambiguities in Circular 32 and flesh out the framework for coming within the regime and complying with its ongoing requirements.

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