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## Legal flash | Shanghai office - October 2015: notice of the Ministry of Finance, the State Administration of Taxation and the Ministry of Science and Technology on improving the super-deduction policy for R&D expenses (Caishui [2015] No. 119) (财政部、国家税务总局、科技部关于完善研究开发费用税前加计扣除政策的通知)

### Cuatrecasas

**China** | November 12 2015

On October 21, 2015, the State Council convened an executive meeting in which Chinese Premier Li Keqiang announced the extension of enterprise income tax (“EIT”) benefits to promote innovation in China, including expanding the scope of R&D expenses qualified for super-deduction.

The super-deduction policy for R&D expenses was first introduced under the EIT Law in 2008 and developed through the implementing guidelines under Circular Guoshuifa [2008] No. 116 and Circular Caishui [2013] No. 70. This incentive allows enterprises developing new technology, new products and new processes to deduct before tax the R&D expenses incurred by 150% of their actual amount. Also, if intangible assets are created as a result of these activities, the tax base for their amortization is 150% of their accounting cost.

Further to the meeting, on November 2, 2015, the Ministry of Finance (“MOF”), the State Administration of Taxation (“SAT”) and the Ministry of Science and Technology (“MOST”) jointly issued Caishui [2015] No. 119 (“Circular 119”).

Highlights of Circular 119:

#### 1. Wider scope of qualified R&D activities

The former regulations required enterprises to engage in qualified R&D activities provided under the Catalogue of Key National Supported High and New Technology Fields and the Guidelines for Key High-Tech Industrialization Fields for Prioritized Development.

Circular 119 takes a “negative list” approach, providing that R&D activities (generally defined as those carried out on an ongoing basis with the purpose of obtaining new knowledge relating to science and technology to use it creatively or to innovate and substantially improve its products) qualify for super-deduction, unless they fall under the following categories:

#### a. Unqualified activities:

- Regular upgrade of products or services
- Direct application of technology results (e.g., directly using new processes, materials, devices, products, services or knowledge available to the public)
- Technical assistance to clients after commercialization
- Repeated or simple changes to existing products, services, technology or processes
- Market research and studies, efficiency research and management studies
- Regular quality control, test analysis, repair and maintenance
- Studies in social science, arts or humanities

b. Unqualified industries:

- Tobacco manufacturing
- Hospitality (hotels and catering)
- Wholesale and retail
- Real estate
- Leasing and commercial services
- Entertainment
- Other industries prescribed by MOF and SAT

2. Wider scope of qualified R&D expenses

Circular 119 expands qualified R&D expenses by adding fees for external R&D personnel, inspection fee for trial production, expert consulting fee, insurance fee for high and new technology development, expenses on retrieval, analysis, appraisal and assessment of results, intellectual property application fee, registration fee, agent fee, and travel and conference expenses. It no longer requires equipment and intangible assets to be exclusively used for R&D activities for the corresponding depreciation and amortization expenses to qualify for super-deduction.

Circular 119 categorizes qualified R&D expenses into several groups: (i) personnel costs, (ii) direct inputs, (iii) depreciation, (iv) intangible assets amortization, (v) design fee for new product, fee for developing new process rules, clinical trial for new drug development, and field test for exploration and development of technology, (vi) other relevant expenses, and (vii) other expenses provided by MOF and SAT. Although it does not provide an exhaustive list of “other relevant expenses,” it limits them to a maximum of 10% of the total R&D super-deducted expenses to avoid abusive use of this category.

3. Outsourced R&D activities

While the former regulations did not cap super-deduction of outsourced R&D projects, Circular 199:

- a. Limits super-deduction to 80% of the amount paid domestically by the commissioning party (in line with the high and new technology enterprise regime).
- b. Denies super-deduction of the amount the commissioning party paid overseas.

If the outsourcing is to a related party, the commissioned party must provide the expense details to the commissioning party as a condition for super-deduction. When carried out through cost sharing agreements, each party can only super-deduct its share of expenses under the allocation parameters.

4. Creative design activities

Circular 119 allows super-deduction for expenses incurred in creative design activities carried out to obtain innovative, creative and breakthrough products. These activities refer to software development for multi-media, animation and games, design and production of digital animation and games, engineering design for buildings

and garden scenery, industrial design, multi-media design, animation design, derivative product design and model design.

#### 5. Accounting and management

Managing R&D expenses in a special account is no longer required. Enterprises will book R&D expenses under China's accounting principles and then set up a subsidiary account for R&D expenses qualified for super-deduction.

#### 6. Retroactive effects

Starting January 1, 2016, enterprises will be able to apply super-deduction retroactively to qualified R&D expenses going back a maximum of three years.

#### 7. Simplified procedures

Circular 119 replaces the current prior record filing procedure with a post monitoring procedure. However, companies still need to keep supporting documents available for tax authorities' review, as regular tax audits will be performed on at least 20% of taxpayers applying the tax incentive.

Circular 119 largely expands the scope of R&D activities that may benefit from super-deduction and improves administration of super-deduction to reduce the burden associated with formal requirements, which will greatly benefit enterprises engaging in R&D activities. However, the tax authorities' lack of prior monitoring could create a higher burden on enterprises; they will have to be extra careful in managing R&D expenses and preparing supporting documents on time, which could increase the risk of enterprises facing adjustments to the super-deduction through tax audits.

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