Tax incentives for high technology industries in China

New circulars on the taxation of new and high technology companies sweep away some previous uncertainties but also bring along new ones, write Amy Cai, Steven Wong and Charles Leung

The unification of China’s corporate income tax from 1 January 2008 features a noteworthy change. The focus of tax incentives shifted from geographically-oriented to industry-oriented, targeting projects encouraged and supported by the country. Here are a few incentives that reflect the Chinese government’s effort to encourage technological developments:

- Reduced corporate income tax rate of 15 percent for new and high technology enterprises
- Super deduction of research and development expenses for corporate income tax purpose
- Corporate income tax exemption or reduction on income derived from qualified technology transfer
- Different corporate income tax holidays for software and integrated circuit enterprises
- “Immediate levy, immediate refund” value-added tax policy for software and integrated circuit enterprises

However, uncertainties arose when some of these incentives expired last year. For the decade up to the end of 2010, a general VAT payer needed to pay a stipulated VAT rate of 17 percent for software products it developed and sold. With an “immediate levy, immediate refund” policy however, the portion of effective VAT burden in excess of 3 percent of the sales revenue was immediately refunded to the payer. If the enterprise uses the VAT refund for research and development of software products or to increase production, the refunded amount would be exempt from corporate income tax.

On 28 January, the State Council issued Guofa [2011] No.4 officially extending the VAT refund policy following its expiration at the end of last year, providing various incentives for the software and integrated circuit industries as listed below. Circular 4 took effect from the date of issue.

Tax incentives under Circular 4

The circular also unveiled other new incentives, such as providing flexible treatments in financing arrangement, research and development, import and export procedures, supporting human resources and protecting intellectual property. Relevant authorities such as the State Authority of Taxation, the Ministry of Finance and the National Development and Reform Commission will formulate the detailed implementation rules.

Software and integrated circuit enterprises are encouraged to carefully assess their own qualification for existing tax incentives now honoured by the State Council. They should also closely communicate with relevant local authorities to keep abreast of the latest practices, especially for new incentives that have yet to be clarified.

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*Corporate income tax

The corporate income tax holidays for qualified software and integrated circuit enterprises shall begin from the first profit-making year prior to the end of 2017. As long as the tax holiday is triggered before 31 December 2017, the enterprise would be entitled to it until expiry.

In addition, if a software or integrated circuit enterprise qualifies for more than one corporate income tax incentives, it can choose the most favourable one but cannot apply for more than one. In order to maximize their benefit, software or integrated circuit enterprises should analyze and plan for the applicable tax incentives against the relevant criteria, where commercially viable, by reviewing their financial forecasts and operation plans.

Provisional rate subject to renewal

In late 2008, many new and high tech enterprises for the first time obtained certificates that allowed them to apply the confirmed existing tax incentives.

New tax incentives to be introduced

- Business tax exemption for qualified software or integrated circuit-related services, for example, development, design, consultancy, etc.
- Reduced CIT rate for key integrated circuit enterprises under the state’s plan
- Policy to solve the cash flow issue of a large amount of input VAT for significant integrated circuit projects, which could not be credited in a timely manner
- CIT incentives for qualified enterprises engaging in integrated circuit packaging, testing, manufacturing of key integrated circuit materials and manufacturing of specialized integrated circuit equipment
In order to maximize their benefit, software or integrated circuit enterprises should analyze and plan for the applicable tax incentives against the relevant criteria, where commercially viable, by reviewing their financial forecasts and operation plans.

preferential corporate income tax rate of 15 percent. Based on the administrative measures and working guidelines governing new and high tech enterprises, a certificate is valid for three years and enterprises are required to renew within three months before the expiry.

Certificates obtained in late 2008 will expire in late 2011. It is not clear whether these enterprises would be allowed to continue to enjoy the preferential corporate income tax rate of 15 percent for the quarterly provisional tax filings for 2011 before they pass the renewal process.

On 10 January, the SAT issued “Public Notice [2011] No.4” confirming that prior to the approval of the renewal application and within the validity of the previously approved qualified period, new and high tech enterprises are allowed to file and pay their 2011 quarterly provisional corporate income tax using 15 percent.

From a cash flow perspective, the SAT’s announcement prior to the renewal result is helpful to those enterprises renewing their certificates this year. However, since corporate income tax is filed annually, if an enterprise fails to pass the renewal process and is no longer qualified for the new and high tech enterprise status, it should file income tax at 25 percent for the whole year of 2011. This means it will have to make up for the shortfall between the provisional rate of 15 percent and the 25 percent rate to be
adopted during its annual corporate income tax filing.

New and high tech enterprises should refer to the procedural and documentation requirements for renewal set out in the 2008 new and high tech enterprise rules. But they have to bear in mind that these requirements and processes might be subject to changes in the detailed renewal guidelines to be issued later this year. They are recommended to self-assess whether they will continue to qualify as a new and high tech enterprise this year and onwards and to prepare for the changing renewal requirements and process in order to secure the reduced corporate income tax rate.

Exemption and reduction for technology transfer

According to Article 27(4) of the Corporate Income Tax Law and Article 90 of Detailed Implementation Rules, the first five million yuan of qualified income derived by tax resident enterprises from the transfer of patented technology, which refers to legally granted exclusive ownership of invention, utility model and layout-design that is not a simple change of outlook of the product design, shall be exempted from corporate income tax and the portion that exceeds five million yuan shall be entitled to a 50 percent reduction.

In April 2009, the SAT issued Guoshuihan [2009] No.212, clarifying the criteria, procedural matters and calculation method for technology transfer income to qualify for the corporate income tax exemption and reduction. One of the criteria is that the technology transfer has to be within the scope prescribed by the MOF and the SAT. However, it was not until recently that the authorities jointly issued Caishui [2010] No.111 to address this prescribed scope among other things. Circular 111 took effect retroactively from 1 January 2008.

Clarification made by Circular 111

Circular 111 clarifies the uncertainty in the scope of qualified technology transfer for corporate income tax exemption and reduction. However, it apparently limits the scope to certain types of technology transfers. The technology transfer also has to be one of ownership or global exclusive licensing right of the qualified technology for a period of five years or more, which might not be easily accomplished in reality.

Since the circular was made effective retroactively from 1 January 2008, enterprises that have already enjoyed this corporate income tax incentive for technology transfer in 2008 and 2009 should review whether they meet the criteria in this new circular. They should see if it is necessary to revoke the enjoyed tax exemption and reduction through the upcoming 2010 annual tax filing or other means that are agreeable to the relevant tax bureaus.

Circular 111 excludes technology transfer income from related parties under the enterprise’s 100 percent control (direct or indirect) from the corporate income tax exemption and reduction. This restriction aims to prevent some group companies from abusing the preferential tax treatment. However, a transfer between related parties with genuine business purpose (assuming all other criteria are met) will suffer from a higher corporate income tax cost compared with a transfer to an unrelated third party, which could be entitled to the preferential tax treatment.

Different local tax bureaus may interpret the vague wording of “related party under 100 percent control (directly or indirectly)” differently and cause practical uncertainties. For example, should the phrase refer to the transfer from a parent company to its 100 percent direct or indirect subsidiary, from a 100 percent-owned subsidiary to its parent or ultimate parent company, or even a transfer between sister companies under the same parent company? The SAT is expected to clarify this uncertainty and new and high tech companies should keep monitoring tax developments.

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