



Working Guidelines for Assessment of New/High Tech Enterprises

In Issue 5 of our China Tax/Business News Flash, we reported on the new "Administrative Measures for Assessment of New/High Tech Enterprises ("NHTEs") ("Measures") and the appendix "Catalogue of New/High Tech Domains Specifically Supported by the State" ("Catalogue"), which were jointly issued by the Ministry of Science and Technology ("MOST"), Ministry of Finance ("MOF") and State Administration of Taxation ("SAT") on 14 April 2008. The Measures mentioned that there would be a set of working guidelines forming an important part of this new doctrine of NHTEs.

On 8 July, the three Central Ministries finally issued the "Working Guidelines for Assessment of New/High Tech Enterprises" ("Assessment Guidelines") by way of Circular GuoKeFaHuo [2008] No.362. The Assessment Guidelines supplement the Measures by setting out the details for the implementation of the Measures, namely the detailed application procedures, the requirements and responsibilities of intermediary agencies and experts, what constitutes qualified R&D expenditures and the detailed requirements for each of the assessment criterion.

The Assessment Guidelines are of 40 pages (including a few prescribed application forms) and provide very comprehensive details, including a complex structure and sophisticated logic, for this NHTe doctrine. We summarise below the key contents of the Assessment Guidelines, as well as our observations for your reference and consideration. Please refer to Issue 5 of our China Tax/Business News Flash for the details of the Measures, the Catalogue, and our analysis of the Corporate Income Tax ("CIT") incentives for NHTEs.

Key Contents of the Assessment Guidelines

The Measures have set out the six criteria for assessment of an NHTe but without sufficient details. Now the Assessment Guidelines provide further elaboration on some of these criteria.

(i). **Criterion 1:** Ownership of core proprietary intellectual property ("IP") right

The Assessment Guidelines clarify that an "exclusive license" refers to a license for sole use by the licensee exclusively on a worldwide basis. This geographical requirement will undoubtedly cause difficulty to many MNC groups which are not prepared to transfer IP ownerships or grant a worldwide exclusive right of these IP rights to their subsidiaries in China because of considerations such as legal protection, global IP management strategy or even their global transfer pricing strategy.

The Assessment Guidelines also define and limit "core proprietary IP rights" to include patents (invention, utility model and appearance design made by means of scientific and engineering methods and R&D process), copyright of software, IC layout design right and new plant species only.

(ii). **Criterion 2:** Products/services within the scope of the eight domains in the Catalogue

The Assessment Guidelines do not provide further explanation of the scope of the eight domains.

(iii). **Criterion 3:** Headcount of scientific technology personnel and R&D personnel

The Measures have provided the prescribed proportions of scientific technology personnel and R&D personnel to the total workforce of an NHTE. The Assessment Guidelines set out the definition of scientific technology personnel and R&D personnel and explain how the headcount is calculated.

It is worth-noting that although both scientific technology personnel and R&D personnel are covered in this criterion, it seems that only the wages and salary and associated costs of R&D personnel would be considered as qualified R&D expenditure under Criterion 4.

- (iv). **Criterion 4:** Qualified R&D expenditures should reach a certain percentage of total revenue for the last three years

The Assessment Guidelines set out the definition of R&D activities and R&D activities of high-tech services, and how to define R&D projects.

Further, the Assessment Guidelines set out the scope of qualified R&D expenditures, and requires enterprises to set up detailed accounts to capture the relevant expenses. There is a tabular schedule provided in the Assessment Guidelines for enterprises to follow in capturing their qualified R&D expenditures.

In general, qualified R&D expenditures are limited to and classified into the following eight categories:

- Salary and labour costs;
- Direct expenses;
- Depreciation expenses and amortization of deferred expenses;
- Design expenses;
- Equipment testing expenses (not including those relating to commercialisation of production line);
- Amortization of intangible assets acquired for R&D activities;
- Outsourcing R&D expenses; and
- Other expenses which are capped at 10% of the total qualified R&D expenditures.

It is important to note that outsourcing R&D expenses refer to arm's length fees paid on the outsourcing of R&D activities to other enterprises, colleges, technical service establishments and overseas R&D institutions, as long as the R&D outcomes are owned by the enterprise and closely associated with the main operation of the enterprise. However, only 80% of the expenses can be counted in calculating the qualified R&D expenditures. This is a reflection of the Chinese authorities' intention of not to encourage enterprises to outsource their R&D activities excessively.

The Measures have provided three ranges of total revenue in determining the respective ratios of qualified R&D expenditures. The lowest ratio is 3% where the total revenues in the preceding year is over RMB200 million. According to our intelligence collected, the Chinese authorities are of the view that the current ratio of qualified R&D expenditures to total revenue is set at a relative low level as compared to international standards. It is therefore unlikely that the Chinese authorities will add more levels to allow an even lower ratio for "mega sales companies".

We understand that as part of their global R&D management strategy, some MNC groups contract out the R&D work to their R&D subsidiaries in China and pay a service fee to them in return. In such situation, the R&D subsidiary in China undertaking the "contract R&D" activities for the other group companies will not own the outcome of the R&D effort. It only acts as a service provider. The relevant expenses for such R&D activities may not qualify as qualified R&D expenditures for the purpose of NHTEs' assessment. Even if they do qualify, that subsidiary will unlikely be able to meet the "ownership of core proprietary IP right" criterion as the outcome of the R&D effort does not belong to it. As a consequence, it will be difficult for the Chinese R&D subsidiary of an MNC group to qualify as an NHTE and obtain the relevant tax benefit under such contract R&D arrangement. MNC groups may consider changing this arrangement, transferring more IP rights to the Chinese subsidiary, and setting up the required accounting system to capture the relevant R&D expenditures.

- (v). **Criterion 5:** Income from sale of new/high tech products (services)

The Assessment Guidelines explicitly state that the "new/high tech products / service" cited in Criterion 5 in the Measures should fall into the encouraged domains in the Catalogue. Combining the requirements of the Measures and the Assessment Guidelines, it means that income from the new/high tech products/services must be more than 60% of the total annual income, and the new/high tech products/services generating the income should fall into the encouraged domains in the Catalogue.

The Assessment Guidelines specially provide further elaboration on "Income with Technology Content", which should include income from technology transfer, technology contracting, technical services and performing the R&D activities for other parties.

(vi). **Criterion 6:** The enterprises should gain a high rating in owning core proprietary IP rights, capability for converting R&D outcome, quality of R&D management, and growth of sales and total assets.

In order to assess the innovativeness of enterprises on using scientific technology, the Assessment Guidelines set out a 100-point score-card system based on the four parameters mentioned above. The applicant enterprise has to get a score of more than 70 in order to pass this criterion. The score-card system is not an overall assessment for the first five criteria mentioned above, but an additional requirement with the aim to guide enterprises to develop their own new/high technology.

	Parameter	Score Assigned
I	Core proprietary IP right	30 points
II	Capability for converting R&D outcome	30 points
III	Quality of R&D management	20 points
IV	Growth of sales & total assets	20 points

Further, there is a six-level grading system for each of the four parameters as follows:

- Level A: 80% - 100%
- Level B: 60% - 79%
- Level C: 40% - 59%
- Level D: 20% - 39%
- Level E: 1% - 19%
- Level F: 0

The grading for each of the parameters depends on the following performance in the last three years:

- Core proprietary IP rights: depending on the number of the core proprietary IP rights owned by the enterprise or the number of patented technology developed by the enterprise. However, it does not seem to include core proprietary IP rights obtained by the enterprise through a 5-year or more exclusive license;
- Capability for converting R&D outcome: depending on the average number of R&D outcomes converted;
- Quality of R&D management: depending on how the enterprise organises its R&D activities in terms of project management, expenditure management, cooperation with academic organization, equipment and function of R&D department and related personnel management;
- Growth of capital & sales: depending on the percentage of the growth of sales and total assets.

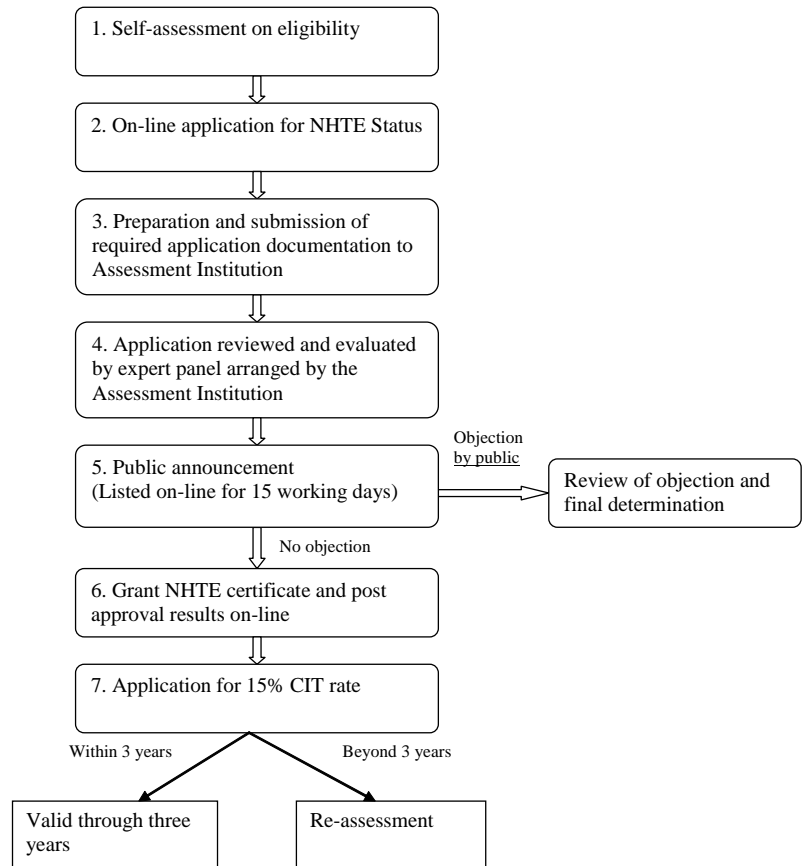
For example, if an enterprise is graded Level A in, say, core proprietary IP rights, it will be able to score 80% to 100% of the 30 points allocated to that parameter, and so on. However, whether the score is 80%, 100% or somewhere in between is a subjective call of the experts assigned to that assessment. The total score of the enterprise is the summation of the scores in each parameter.

Enterprises which are interested in applying for the designation of an NHTE should self-assess based on the criteria and detailed explanation of the criteria set out in the Measures, Catalogue and Assessment Guidelines. If they fail the self-assessment, they should consider restructuring their operations to try to meet the relevant criteria.

Where to apply?

(i). Assessment Institution, Experts and Qualified Intermediary Agencies

If the result of the self-assessment is positive, the enterprise should then apply for the assessment with the Assessment Institution in its locality. The Assessment Institution is comprised of officials from the local branches of MOST, MOF and tax bureau at the provincial or equivalent levels. It is responsible for the assessment of NHTEs by selecting an expert panel of not less than 5 experts in the Domain of the applicant to undertake the detailed assessment from a technical perspective. After receiving the required application documents from the applicant, the Assessment Institution will, after blocking out the name of the applicant, provide the electronic application material of the applicant to the expert panel. The expert panel is then responsible for assessing whether the R&D projects of the applicant meet the requirement of the Measures and the Assessment Guidelines and provide evaluations on an independent basis. Therefore, the judgement and evaluation made by the expert panel is crucial in the assessment process. The Assessment Guidelines also set out the requirements and responsibilities of the experts and the discipline which the experts have to follow, including independence, fairness, objectivity, confidentiality of application materials, etc. It further requires the Assessment Institution to establish an expert database. It is good to see that there are procedures in place to protect the confidentiality of proprietary information submitted by the applicants.



The Measures require the applicant to submit a detailed R&D expenditures report and financial statements for the last three years, both of which have to be audited by a qualified intermediary agency. The Assessment Guidelines further require a report of income from new/high tech products/services for the preceding year audited by a qualified intermediary agency to be submitted together with the application. The Assessment Guidelines set out the requirements and responsibilities of the intermediary agency, but it does not mention whether it is necessary for an intermediary agency (e.g. an accounting firm) to be verified and registered before it can provide the audit service to an NHTe applicant. In that respect, the applicant has to be very careful as to whom they choose for that service.

(ii). NHTe Certificate

The Assessment Guidelines stipulate that upon approval by the Assessment Institution, the enterprise will be awarded an NHTe certificate which is valid for a period of 3 years from the issuance date. Further, if an enterprise qualifies as an NHTe by virtue of a 5-year or more exclusive license, its NHTe status should only be valid within the term of that license. This implies that the tax incentives for NHTe would only be available during the term of the exclusive license.

When to apply?

According to the Measures and Assessment Guidelines, enterprises should log onto the "Assessment of NHTe Website (www.innocom.gov.cn)" set up by the relevant Assessment Institution to register as an

NHTE applicant. However, as it takes time for local authorities of each provincial or equivalent region to set out the detailed assessment process and database of assessment experts respectively, enterprises should watch out for circulars from the relevant Assessment Institutions in their localities on when they can commence their application process.

For enterprises newly set up in 2008, they have to be set up for at least one year before they can apply for the NHTE designation. As newly set up NHTEs in the 5+1 Special Zones in 2008 is eligible for a five-year tax holiday commencing from the first income generating year, we understand that the authorities are considering offering a special retrospective treatment to them so that they will be able to enjoy the tax holiday period in full. However, no final decision has been made yet.

What to consider for next step?

If an enterprise is successful in obtaining the NHTE status, since the NHTE certificate is only for a period of 3 years, we would suggest that management not only focus on the continuous R&D input but also pay attention to other 5 criteria aforementioned. Although both the Measures and Assessment Guidelines state that the emphasis on the first re-assessment is on Criterion 4, i.e. the ratio of qualified R&D expenditures to total revenue, the Assessment Institutions should still examine the status/progress of the other 5 criteria. It is also important for management to keep a close eye on any updates of the Domains supported by the State, which may be changed or adjusted at a later stage.

If an enterprise fails the NHTE assessment, there seems to be an opportunity for it to appeal as set out in the Assessment Guidelines. However, the language in the Assessment Guidelines is unclear. Even if there is an appeal, it would only serve to resolve conflicts on qualified R&D expenditures, but not the other criteria or issues. Also, it is silent on the actual procedures and timelines. We will bring this outstanding issue to the Chinese authorities for clarification.

PwC Observations

- On one hand, the Assessment Guidelines have clarified a large number of uncertainties after the Measures first came out in April 2008. On the other hand, the Assessment Guidelines seem to be adding more hurdles for enterprises to overcome in order to qualify as NHTEs than the Measures presented. According to our discussion with the relevant authorities, they are not expecting to see many enterprises qualifying as NHTE at the initial stage. We summarise below the possible difficulties faced by many groups, especially those MNCs group whose subsidiaries may fail to secure the NHTE status in light of the Assessment Guidelines:
 - The latest requirements brought about by the Assessment Guidelines on ownership of core proprietary IP rights seem discouraging to many enterprises, especially the 5-year or more exclusive licence on a worldwide basis.
 - Enterprises with mega sales revenues have to bear with the current high ratios (3% is the lowest) in terms of the qualified R&D expenditures, as the Central Ministries consider them to be quite low as compared to the worldwide standards.
 - As mentioned above, the subsidiary of an MNC which undertakes "contract R&D" for its overseas group companies may have difficulty qualifying as an NHTE. Therefore, those MNCs that wish to have their Chinese R&D subsidiaries to qualify as an NHTE may have to re-consider their global IP management strategy and change the contract R&D arrangement by injecting more IP rights to their China subsidiaries.
 - The NHTE assessment is based on what had already happened in the three years prior to the application. Therefore, enterprises may not have set up an accounting system which was able to capture the qualified R&D expenditures, and other necessary information required for the application. In that respect, applicant would likely have to engage a qualified intermediary agency to go over its books and records for the last three years to come up with the required R&D expenses report, financial statements and report of income from new/high tech products/services. In any event, for enterprises wishing to apply for an NHTE status, they should ensure that the accounting system is able to capture the required information going forward.

- Based on the latest requirements stated in the Assessment Guidelines, we note that the application for the NHTE status is not simply a task solely for the tax, accounting or finance department of an enterprise. To secure such status, it should also involve other functions, such as R&D, science and technology, IP management, legal, government affairs, human resource, etc. Management should consider pulling all the departments to form a taskforce to assess the current status of the enterprise, or work out the strategy to gain the NHTE status. If the self-assessment indicates that it does not qualify, then it should consider restructuring the current business model.
- NHTE doctrine is a brand new tax incentive concept for China. The issuance of the Assessment Guidelines, together with the Measures and Catalogues issued earlier this year, has now made the whole NHTE doctrine closer to complete. However, the local-level authorities, at the provincial or equivalent level, have not issued any further local implementation rules yet. They may be keen to help enterprises in their localities and may therefore be flexible in their interpretation and implementation of the Measures and Assessment Guidelines. Consequently, it is advisable for enterprises to check with their local authorities on a case by case basis to sort out their local positions, implementation policies, and application procedures.

In the context of this China Tax / Business News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PricewaterhouseCoopers client service team.

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