

Guideline 2.0 for Implementing the Policies on Super Deduction of R&D Expenditures and other new policies rolled out to spur enterprise-led innovation

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In brief

In recent years, Chinese authorities have been taking continuous efforts to champion the enterprises in carrying out research & development (“R&D”) and innovation activities with various tax incentives rolling out. In such a context, how the enterprises can legitimately enjoy the super deduction policies of R&D expenditures comes under the spotlight. To further stimulate the innovation vitality of enterprises, the Income Tax Department of the State Taxation Administration (“STA”) and the Department of Policy, Regulation and Innovation System of the Ministry of Science and Technology of China jointly issued the *Guideline for Implementing the Policies on Super Deduction of R&D Expenditures (Version 2.0)*¹ (the “*Guideline 2.0*”) in July 2023, which systematically and comprehensively clarifies the existing policies of R&D expenditures super deduction to help enterprises better understand and enjoy.

In September 2023, the *Public Notice Jointly Issued by the Ministry of Finance (“MOF”) and the STA regarding Input Value-added Tax (“VAT”) Super-Credit for Enterprises in Advanced Manufacturing Industry*² (the “Public Notice [2023] No.43”) and the *Public Notice Jointly Issued by the MOF, the STA, the National Development and Reform Commission and the Ministry of Industry and Information Technology of China Regarding Further Increasing the Super Deduction Ratio of R&D Expenditures for Corporate Income Tax (“CIT”) Purpose for Integrated-Circuit Enterprises and Industrial Mother Machine Enterprises*³ (the “Public Notice [2023] No.44”) were issued to further support and encourage advanced manufacturers, integrated circuits enterprises and industrial mother machine enterprises to invest more in R&D and accelerate technological innovation.

In this issue of News Flash, we will introduce the highlights in *Guideline 2.0* as well as the key points in the Public Notice [2023] No.43 and the Public Notice [2023] No.44 and share with you our observations accordingly.

In detail

Highlights and key changes of the *Guideline 2.0*

In 2018, several regulatory authorities jointly introduced the *Guideline for Implementing the Policies on Super*

Deduction of R&D Expenditures (Version 1.0) (the “Guideline 1.0”), which was widely welcomed by the taxpayers. Based on the *Guideline 1.0*, the *Guideline 2.0* comprehensively summarises and interprets the R&D expenditures super deduction policies from six aspects, including “the overview of the super deduction policies for R&D expenditures”, “the definition of R&D activities”, “R&D project management”, “highlights of R&D expenditures super deduction policies”, “accounting requirements for R&D expenditures under super deduction” and “the application for R&D expenditures super deduction and follow-up management”. Compared with the *Guideline 1.0*, the main changes in the *Guideline 2.0* include:

1. Updates on the types of R&D activities

The types of R&D activities have been updated in *Guideline 2.0*, specifically:

- The types have been updated according to the *Frascati Manual* with the “basic research” type added. The definition of “basic research” is consistent with the rules stipulated in the *Public Notice Jointly Issued by the MOF and STA Regarding the Preferential Tax Policies for Enterprises to Invest in Basic Research* (the Public Notice [2022] No.32);
- The main purposes of “applied research” and “experimental development” have been modified to clarify that “**direct application** of certain scientific research outcomes, and **repeated or simple changes** to the **existing** products, services, technologies, materials or processes”, and “**market research, quality control, repair and maintenance, and routine tests**” do not fall within the scope of R&D activities;
- The “substantive improvement” type has been deleted and integrated into “experimental development”.

2. Updates on the determining points and corresponding interpretations of R&D activities

In the *Guideline 2.0*, the determining points of R&D activities have been updated, i.e., the eligible R&D activities should be “with clear innovation objectives”, “with systematic organisational forms” and “with uncertain R&D results”. The corresponding interpretations have also been modified to make it easier for enterprises to assess whether their activities meet the relevant requirements.

Determining point 1 - “with clear innovation objectives”: the R&D activities with clear innovation goals are generally reflected in the acquisition of certain “new knowledge, new technology, new process, new materials, new products or new standards”;

Determining point 2 – “with systematic organisational forms”: the R&D activities with systematic organisational forms are generally carried out through “the organisational process of project establishment, implementation and conclusion”. The *Guideline 2.0* emphasizes the importance of project management in R&D activity assessment;

Determining point 3 - “with uncertain R&D results”: the R&D activities should go through “repeated experiments and tests” which reflects the uncertainty of the project’s R&D results.

3. Adding “assessment boundaries and description of R&D activities”

The *Guideline 2.0* adds the assessment regarding how to distinguish R&D activities from other industrial activities and other technological activities, as well as the assessment of software-related R&D activities and non-R&D activities. The addition provides a more specific basis by enumerating which helps better assess the eligible R&D activities for super deduction with certain special circumstances elaborated, for example:

- The design, manufacture and tests of prototypes are generally regarded as eligible R&D activities. However, the first batch of testing products for the purpose of later mass production should not be regarded as prototypes, and should **not** fall within the scope of R&D activities either;
- The routine tests even conducted by the R&D personnel should **not** be regarded as R&D activities;
- Technological activities themselves are not R&D activities, but those for the R&D purpose can be regarded as R&D activities under certain circumstances;
- Software development activities **may not** be R&D activities even if the software copyrights are acquired. However, they can be regarded as R&D activities only if they satisfy the criteria for R&D activities.

It should be noted that the assessment illustrated in this part requires expertise and is quite complicated and crucial for the enterprises to successfully apply for R&D expenditures super deduction. Although the *Guideline 2.0* provides some examples as a reference for assessments, it may still be difficult for the enterprises to conduct self-assessment in practice.

4. Adding “process management of R&D projects”

The *Guideline 2.0* underlines that “the two elements of applying super deduction are ‘assessment of R&D activities’ and ‘accurate calculation and allocation of R&D expenditures’, both of which are based on **R&D projects**.” Standardised R&D project management, is therefore, the basis and prerequisite for applying R&D expenditures super deduction, and enterprises are recommended to set up a management system covering the establishment, implementation and conclusion of projects.

It should be noted that this new addition has a direct impact on assessing whether a project is with a “systematic organisational form”.

Essentials in the Public Notice [2023] No.43 and the Public Notice [2023] No.44

For advanced manufacturing enterprises, the Public Notice [2023] No.43 stipulates that from 1 January 2023 to 31 December 2027, general taxpayers of high and new technology enterprises (“HNTes”) in the manufacturing industry can apply for the VAT-related incentives. These enterprises are allowed to have an extra 5 percent deduction on VAT payable based on their deductible input VAT for the current period. The new policy further brings the HNTes with more diversified tax benefits in terms of preferential CIT rate, super deduction of R&D expenditures, and VAT additional deduction.

For the integrated circuits enterprises and industrial mother machine enterprises, the Public Notice [2023] No.44 raises the super deduction ratio of R&D expenditures to 120%, valid from 1 January 2023 to 31 December 2027, which is expected to promote the high-quality development of the related industries. The industrial mother machine enterprises should refer to those that manufacture and sell products in accordance with the Appendix of the Public Notice [2023] No.44 – the *Basic Standards for Advanced Industrial Mother Machine Products*.

The takeaway

In recent years, Chinese authorities have been diligently providing a suite of favourable tax policies to support enterprises' R&D and innovation activities, such as continuously increasing the super deduction ratio of R&D expenditures, and rolling out new tax incentives for eligible HNTes, etc. Chinese authorities, on the other hand, are also tightening the related supervision and review. According to the latest public information, we found that more and more enterprises are being penalised due to their non-compliance in making use of additional deductions. According to the information released by the provincial and municipal departments, the number of HNTes being reconsidered as disqualified also maintains an upward trend.

Against the aforesaid intricate macro situation, we suggest considering the following countermeasures to ensure your eligibility for the maximum tax incentives:

- 1) Carefully review the R&D strategy; proactively respond to China's industrial policy orientation; fulfil social responsibilities in basic research, key technological breakthrough, energy saving, environmental protection, etc., while improving product competitiveness through technological R&D; align the R&D behaviours with the Chinese government's macro targets to legitimately enjoy R&D-related tax incentives.
- 2) Report the R&D behaviours truthfully without exaggeration and avoid using single templates. Prepare and archive documents illustrating the R&D features and strengths as well as the related supporting materials for future reference.
- 3) Focus on R&D management, set up and optimise the R&D management system and reward & punishment mechanism to reflect the authenticity of R&D activities, the rationality of data, and the completeness of documentation, to legitimately enjoy the tax incentives.

Preferential tax policies provide a growing impetus to spur innovation led by the eligible advanced manufacturers, the integrated circuits enterprises and industrial mother machine enterprises. Moreover, in addition to the advanced manufacturers, the integrated circuits enterprises and industrial mother machine enterprises can also apply for the VAT additional deduction according to relevant policies. For the detailed analysis, please refer to the China Tax/Business News Flash, [2023] Issue 24⁴.

Endnote

1. *Guideline for Implementing the Policies on Super Deduction of Research and Development R&D Expenditures (Version 2.0)*
<https://www.gov.cn/zhengce/202307/P020230713310076885421.pdf>
2. *Public Notice Jointly Issued by the MOF and STA Regarding Input VAT Super-Credit for Enterprises in Advanced Manufacturing Industry* (Public Notice [2023] No.43)
<https://fgk.chinatax.gov.cn/zcfgk/c102416/c5212095/content.html>

3. *Public Notice Jointly Issued by the MOF, STA, NDRC and MIIT Regarding Further Increasing the Super Deduction Ratio of R&D Expenses for CIT Purpose for Integrated-Circuit Enterprises and Industrial Mother Machine Enterprises* (Public Notice [2023] No.44)
<https://fgk.chinatax.gov.cn/zcfgk/c102416/c5213565/content.html>
4. *China Tax/Business News Flash, [2023] Issue 24 - Three Tax Incentives to Support the Technological Innovation and Development*
<https://www.pwccn.com/zh/china-tax-news/2023q3/chinatax-news-sep2023-24.pdf>

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