

Equipment Tax Break for R&D Centres

By David Yu and Clare Lu

On 10 October 2009, the Ministry of Finance (Mof), the General Administration of Customs (GAC) and the State Administration of Taxation (SAT) issued the *Circular on Taxation Policies on Purchasing of Equipment by Research & Development Institutions* (财政部 海关总署 国家税务总局关于研发机构采购设备税收政策的通知 (财税[2009]115号)) (Cai Shui [2009] No. 115) (Circular 115). Circular 115 stipulates that qualified foreign-invested research and development (R&D) centres are eligible for tax exemption on relevant items imported for scientific and technological R&D purposes. They can also enjoy a full value-added tax (VAT) refund when purchasing domestic-made equipment.

Furthermore on 22 March 2010, the Ministry of Commerce (Mofcom), Mof, GAC and SAT jointly issued the *Measures for the Approval on the Qualifications of Foreign-invested R&D Centres for Tax Exemption or Tax Refund on Purchasing of Equipment* (商务部 财政部 海关总署 国家税务总局关于外资研发中心采购设备免/退税资格审核办法的通知 (商资发[2010]93号)) (Shang Zi Fa [2010] No. 93) (Circular 93). Circular 93 clarifies in detail the tax exemption on relevant items imported for scientific and technological R&D purposes, and the VAT refund for purchasing domestic-made equipment by foreign-invested R&D centres.

Background

➤ Tax policies for equipment importation prior to VAT reform

Prior to the PRC VAT reform, the authorities issued the Notice of the GAC concerning Import Tax Policies Relevant to Further Encouraging Foreign Investment Circular (海关总署关于进一步鼓励外商投资有关进口税收政策的通知) (Shu Shui [1999] No.

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791) and the Notice of the Ministry of Foreign Trade and Economic Cooperation concerning the Establishment of Foreign-invested R&D Centres (Wai Jing Mao Zi Fa [2000] No. 218) (对外贸易经济合作部关于外商投资设立研发中心有关问题的通知 (外经贸资发[2000]第 218 号)). These allowed foreign-invested R&D centres to enjoy exemptions from Customs Duty (CD) and importation taxes on imported self-use equipment, relevant technologies, accessories, and parts, when meeting certain criteria.

➤ Tax policies for equipment importation after VAT reform

One of the key issues of the VAT reform was that ordinary VAT payers could claim input VAT credit against output VAT on purchased equipment. Thus, the preferential import VAT policy foreign-invested R&D centres (being foreign-invested enterprises, or internal departments of foreign-invested enterprises) enjoyed for over ten years was no longer applicable. In this regard, after the VAT reform, most foreign-invested R&D centres cannot fully claim input VAT credit against output VAT for imported goods (including equipment) either because they are Business Tax (BT) taxpayers or because they rarely conduct VAT-related activities. As such, those foreign-invested R&D centres have to bear an extra cost on purchasing equipment, which also has a negative impact on the cashflow of R&D centres.

In considering foreign-invested R&D centres can take advantage of foreign funds to perfect the domestic industrial and foreign investment structure, Circular 115 was issued. Consequently, various problems arose during implementation due to a lack of approval measures, which nearly led to the suspension of the process of tax exemption and refund. In order to encourage and attract more foreign-invested R&D centres, and to effectively implement Circular 115, relevant government authorities issued Circular 93 on 22 March 2010.

Overview of Circular 93

Circular 93 makes further clarifications on the applicants' eligibility requirements and application formalities mentioned in the Circular 115. Below are some noteworthy points Circular 93 clarifies or determines:

➤ The examination and approval authority

The establishment of a qualified legal-person foreign-invested R&D centre requires approval by the local branch of Mofcom and should be based on relevant regulations. A non-legal-person foreign-invested R&D centre should provide the approval documents of its foreign-invested enterprise and relevant governmental confirmation documents regarding encouraged foreign investment projects.

➤ The concepts of "total investment" and "total R&D investment"

Circular 93 stipulates that the "total investment" of a legal-person foreign-invested R&D centre shall be recorded on the Certificate of Approval. The total R&D investment of a non-legal-person foreign-invested R&D centre covers all assets and amounts invested for the establishment and construction of the R&D centre (including the assets to be invested, as supported by executed purchase agreements).

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➤ The calculation of “annual amount of R&D expenditures”

Circular 93 stipulates that the “annual amount of R&D expenditures” refers to average annual R&D expenditures during the past two-year period. R&D centres which have been fully operating for less than two years may calculate its annual R&D expenditures based on the amount incurred in any consecutive 12-month period after its establishment. In addition, assets invested in the form of cash or tangible goods shall not be less than 60% of the annual amount of R&D expenditures. In practice, the definition of “annual R&D expenditures” is also an accounting issue. As a copy of the audited report must be provided as part of the application package, how the scope of “annual R&D expenditures” is defined depends on active and effective communications with auditors.

➤ The definition of “full-time staff”

Circular 93 provides that “full-time R&D staff” refers to full-time scientific and technological personnel who are engaged in any of three types of activities: 1) basic research activities 2) applied research activities, and 3) experimental development activities. Full-time staff includes those persons that are directly involved in the above-mentioned activities, as well as relevant full-time technological management personnel, and direct project service providers. These full-time staff must enter into employment contracts with the foreign-invested R&D centre or the foreign-invested enterprise for an employment period of no less than one year. The number of full-time staff is determined as of the date directly prior to the submission of the application by the R&D centre.

➤ The definition of “original value of purchased equipment”

As stipulated in Circular 115, an eligible foreign-invested R&D centre needs to meet certain “original value of purchased equipment” requirements, which increases the threshold for preferential tax treatment for foreign-invested R&D centres. Applicants should take care of the calculation method of the accumulative value of purchased equipment.

➤ The scope of examination, formalities, and timeframe for approval

Circular 93 provides that the local provincial level branch of Mofcom, in conjunction with the local provincial level branches of the Mof, SAT, and GAC (collectively, the “Approval Authorities”) are in charge of the examination and approval of the applications by foreign-invested R&D centres. For eligible R&D centres, the Approval Authorities shall issue a name list by public notice. For those who are not qualified as R&D centres, the Approval Authorities should provide a written opinion. All notices and opinions should be issued within 60 working days from the acceptance date of the application. These provisions clearly stipulate the approval procedures and timeframe, which provide more predictability for the applicants.

➤ Implementation rules on the “transitional period”

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Circular 93 states that for qualified equipment purchased between 1 July 2009 and 22 March 2010, the applicants may apply for a refund with the local customs office for taxes already paid. Applicants should note that necessary conditions for obtaining the tax refund include submitting the VAT payment certificates in connection with the equipment.

➤ Measures on “supervision”

Circular 93 provides that the Approval Authorities have the right to re-examine foreign-invested R&D centres that have obtained a tax exemption or refund every two years. If the foreign R&D centre cannot meet relevant conditions, its qualification for the VAT exemption or refund will be cancelled immediately.

Points Requiring Careful Consideration

For import tax exemption treatment of foreign-invested R&D centres, applicants should pay special attention to the following issues:

- Circular 115 clarifies that eligible foreign-invested R&D centres are exempted from import taxes on “items imported for scientific and technological R&D purposes”, and can enjoy full VAT refund for purchasing “domestic-made equipment”. The circular provides a catalogue of qualified “items that are imported for scientific and technological R&D purposes” and “domestic-made equipment”. However, Circular 93 does not strictly distinguish between the two. Therefore, an applicant should effectively communicate with the relevant tax authority and customs office in relation to the implementation of such tax policies.
- Foreign-invested R&D centres may use the import tax exemption policy to effectively reduce the purchasing cost of imported equipment and lowers its cash flow pressure. However, the tax rules do not clarify, within the “transitional period”, how R&D centres should treat the input VAT that has been claimed credit against output VAT within the “transitional period”. The applicant should note that, on the one hand, it is not feasible to apply for both a VAT refund and a VAT credit; but on the other hand, the VAT liability amount which has been refunded or exempted may not be included in the original value of the equipment for depreciation or amortisation.
- As stipulated in Circular 115, an eligible foreign R&D centre may be in the form of an independent legal person, a branch of an enterprise, or an internal department of an enterprise. In addition to the tax exemption on imported equipment, R&D centres should also consider their qualification for other preferential tax policies. For instance, super-deduction in computing Corporate Income Tax, tax incentives for high-tech enterprises, and preferential tax policies for service outsourcing arrangements among others to optimise the overall tax burden.
- Equipment exempted from import taxes is subject to customs supervision for a certain period of time. During this period the applicant may not transfer, sell, divert, or otherwise dispose of the equipment without obtaining prior permission from the customs office. In case of any violation, the applicant is

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disqualified from enjoying the tax exemptions or refunds for one to three years. In light of this, enterprises must strictly comply with the listed rules. The implementation of Circular 115 will end on 31 December 2010, so the aforementioned rules seem to indicate that the relevant government authorities may issue further rules in relation to tax exemption/refund treatments for foreign-invested R&D centres.

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