

Interpretations on the Notice Regarding Certain Policies Related to the Pre-tax Super Deduction of Research and Development Expenses for Corporate Income Tax Purposes

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On 29 September 2013, the Ministry of Finance (the “MOF”) and the State Administration of Taxation (the “SAT”) jointly released the *Notice Regarding Certain Policies Related to the Pre-tax Super Deduction of Research and Development (R&D) Expenses for Corporate Income Tax (CIT) Purposes* (《关于研究开发费用税前加计扣除有关政策问题的通知》) (Caishui [2013] No. 70, hereinafter referred to as “Circular 70” or the “Notice”) to supplement the scope of R&D expenses which are able to enjoy a Super Deduction for CIT purposes. The Notice takes retroactive effect from 1 January 2013.

Extracts from Circular 70

Circular 70 expanded the scope of super deduction on the following five aspects:

- (1) Basic pension fund, basic medical insurance, work-related injury insurance, unemployment insurance, maternity insurance and housing funding contributed by a company for its employees directly engaging in R&D activities in accordance with regulations set by the relevant department of the State Council or relevant provincial-level government authorities (the “Insurance and Housing Fund”);
- (2) Costs of operational maintenance, adjustment, testing and repair of tools and equipment incurred exclusively for R&D activities;
- (3) Costs of samples, prototypes that do not constitute fixed assets, and expenses for general testing solutions;
- (4) Clinical test costs for R&D activities for new drugs;
- (5) Certification costs for R&D results.

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In addition, Circular 70 states that companies may engage a qualified accounting firm or tax agent firm to issue special purpose audit reports or verification reports to claim a super deduction. If the tax authority has any doubt regarding the validity of the R&D projects claimed, it can request opinion letters issued by the science and technology authorities at the municipal level or above.

Background of Releasing Circular 70

On 10 December 2008, the SAT released the *Notice Regarding Trial Administrative Measures Related to the Pre-tax Super Deduction of R&D Expenses*(《企业研究开发费用税前扣除管理办法(试行)》) (Guoshuifa [2008] No. 116, hereinafter referred to as “Circular 116”), which provides detailed stipulations regarding what qualifies as R&D activities, the scope of qualified R&D expenses, financial accounting treatment for the super deduction, application materials, and provisional and annual filing procedures. As background information, the original scope of qualified R&D expenses provided under Circular 116 for super deduction purposes contains the following eight categories:

- (1) Design fees for new products, expenses for formulating procedures relating to new skills, and expenditures for technical books and information and translation fees etc. directly related to R&D activities;
- (2) Costs of materials, fuel and power consumed directly for R&D activities;
- (3) Salaries, wages, bonuses and allowances of employees directly engaging in R&D activities;
- (4) Depreciation expenses or rentals for tools and equipment exclusively used for R&D activities;
- (5) Amortization expenses of intangible assets such as software, patents, non-patented technologies exclusively used for R&D activities;
- (6) Development and manufacturing costs of molds and process equipment exclusively used for intermediate testing and trial manufacture;
- (7) Expenditures for on-site testing of technology for prospecting and exploitation;
- (8) Expenditure for verification, assessment and inspection of R&D results.

Compared to the actual R&D expenses incurred for R&D activities in different industries, the expenses covered by the super deduction scope under Circular 116 is narrower.

On 8 October 2010, the MOF and the SAT released the *Notice on Pilot Policy of Super Deduction of R&D Costs Related to Zhong Guan Cun Science and Technology Park's Building of the National Demonstration Zone for Independent Innovation*(《对中关村科技园区建设国家自主创新示范区有关研究开发费用加计扣除试点政策的通知》) (Caishui [2010] No. 81), which provides that, from 1 January 2010 to 31 December 2011,

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high-tech enterprises acknowledged by the High-tech Enterprise Acknowledgement Management Agency in Beijing, and registered in the Demonstration Zone of the Science and Technology Park of Beijing Zhong Guan Cun, which are taxed based on an actual profit basis, can enjoy pre-tax super deduction for five more items (the same as listed in Circular 70) of R&D costs than those set forth in Circular 116.

On 26 February 2013, the MOF and the SAT released the *Notice on Pilot Policy of Super Deduction of R&D Costs related to Zhong Guan Cun, Dong Hu and Zhang Jiang National Demonstration Zone for Independent Innovation and He Wu Bang General Innovative Pilot Zone*(《关于中关村、东湖、张江国家自主创新示范区和合肥自主创新综合试验区有关研究开发费用加计扣除试点政策的通知》)(Caishui [2013] No. 13), which provides that, from 1 January 2012 to 31 December 2014, high-tech enterprises acknowledged by the provincial High-tech Enterprise Acknowledgement Management Agency, managing respective pilot zones and registered in the pilot zones which are taxed based on an actual profit basis, can enjoy pre-tax super deduction for five more items (the same as listed in Circular 70) of R&D costs than those set forth in Circular 116.

As a consequence of Circular 70, the five added items of super deductible R&D costs will spread to a nationwide level for those qualified enterprises. Therefore, they are no longer limited to high-tech enterprises in certain regions.

Interpretations

Among the five items of super deductible R&D costs under Circular 70, three of them are supplemental to certain super deductible R&D costs under Circular 116, and the remaining two are completely new. Following is a brief analysis of these newly added super deductible R&D costs under Circular 70:

- (1) On the basis of Circular 116, which provides “salaries, wages, bonuses and allowances of employees directly engaging in R&D activities” as super deductible R&D costs, Circular 70 adds the Insurance and Housing Fund. Because the Insurance and Housing Fund is legally required for every employee, its impact on qualified enterprises would be greater compared to other added items. It is worth noting that super deduction of the Insurance and Housing Fund shall satisfy the following conditions: (i) super deduction only applies to the Insurance and Housing Fund that is actually paid according to the legal standard, which does not cover the accrued amount; (ii) the Insurance and Housing Fund covered by super deduction must be paid for personnel directly engaging in R&D activities, and whether a particular staff belongs to personnel directly engaging in R&D activities will be analyzed and determined by the competent tax authority, based on actual circumstances.
- (2) Based on Circular 116, which provides “depreciation expenses or rentals for tools and equipment exclusively used for R&D activities” as super deductible R&D costs, Circular 70 adds “costs of operational maintenance, adjustment, testing and repair of tools and equipment incurred exclusively for R&D activities”. As these costs are also normal and substantial in R&D activities, such an addition can significantly reduce the tax burden on qualified enterprises.

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- (3) Based on Circular 116, which provides “expenditures paid for verification, assessment and inspection of R&D results” as super deductible R&D costs, Circular 70 adds “certification costs for R&D results”. Certification is an important step for acknowledgement of an R&D result. Based on the whole process for R&D result acknowledgement, Circular 70 permits super deduction of the certification cost of the R&D result.
- (4) Circular 70 adds “costs of samples, prototypes that do not constitute fixed assets, and expenses for general testing solutions” to super deductible R&D costs. Circular 116 only permits super deduction of development and manufacturing costs of molds and process equipment exclusively used for intermediate testing and trial manufacture. However, during R&D activities, enterprises not only need to develop and manufacture relevant equipment itself, but also needs to purchase relevant equipment. Circular 70 takes the actual need for the R&D activities into consideration and adds the relevant part.
- (5) Circular 70 adds “clinical costs for R&D activities for new drugs” to super deductible R&D costs. For the pharmaceutical industry, clinical testing for R&D activities for new drugs is an essential and important step in the R&D activities. In order to support R&D innovation in pharmaceutical industry, Circular 70 permits super deduction for clinical costs for R&D activities for the purpose of manufacturing new drugs.

Notes

Given that Circular 70 expands the scope of super deduction for R&D cost, enterprises should review their R&D costs incurred from 1 January 2013 as soon as possible, and include qualified costs to its scope of filing. It is worth noting that pre-tax super deduction for R&D cost involves various different costs and multiple steps, and enterprises should pay attention to the reasonableness of the accounting system, communicate with the competent tax authority frequently in applying the Notice, and try to understand the competent tax authority’s requirements in respect of the financial accounting of R&D costs. The following points are provided for reference purpose:

- (1) Enterprises shall determine whether their R&D projects belong to projects specified in the *New and High Tech Sectors Receiving Primary Supports from the State*(《国家重点支持的高新技术领域》) and the *Guide to Key Fields of High-Tech Industrialization under the Current Development Priority (2007)*(《当前优先发展的高技术产业化重点领域指南(2007 年度)》) promulgated by the National Development and Reform Commission and other departments. Although Circular 116 and Circular 70 do not make it a condition precedent to provide a R&D project certification letter issued by the science and technology authorities of municipal government for the filing of pre-tax super deduction, if the competent tax authority has an objection to the project declared by the enterprise, it can request such enterprise to provide the certification letter. In addition, enterprises should pay attention to the collection, organization and maintenance of internal R&D materials in order to prepare for tax declaration and inspection.

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- (2) Enterprises should conduct independent financial accounting and establish special accounting systems to collect *and* document their R&D costs via an appropriate method. Please note that: (i) if the enterprise has not established a separate R&D institution yet or the R&D institution is responsible for operational activities at the same time, R&D costs and operational costs should be accounted for separately and the enterprise shall calculate different R&D costs accurately and reasonably; (ii) if the separation of accounts is inaccurate, the costs under such accounts will not be covered by super deduction; and (iii) if the enterprise is conducting multiple R&D activities in one tax year, it should collect R&D costs for super deduction separately, based on different development projects.
- (3) Given that the filing of super deduction for R&D costs should be completed before CIT payment is settled, enterprises should ensure that *they* submit all detailed materials on their R&D projects to the local science and technology authority and tax authority within the prescribed time limit. Therefore, it is recommended that enterprises establish an R&D system, develop internal procedures and functional responsibilities for each department, and collect data on daily R&D activities, so as to ensure they are well prepared for the filing procedures.

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