

Further clarification on tax incentives for software and integrated circuit enterprises – new opportunities and challenges

May 2016
Issue 14

In brief

Since 2000, the Chinese government introduced a series of tax incentives for software and integrated circuit (IC) enterprises¹, aimed at promoting the growth of these industries, motivating enterprises to enhance their capacity in technological innovation and self-development, optimising the industrial chain, boosting technological innovation and the upgrading of industrial structure. These tax incentives did facilitate the rapid development of these industries in China.

Since 2015, in response to the move of the government to streamline administrative power, the State Council has promulgated various circulars to abolish relevant administrative approval for the qualification assessment, product registration and other administrative / non-administrative licensing examination and approval of software and IC enterprises, paving the way for such enterprises to enjoy relevant tax incentives via simplified procedures.

To implement the aforementioned simplified procedures after the removal of the administrative approval, on 4 May 2016, the Ministry of Finance (MOF), the State Administration of Taxation (SAT), the National Development and Reform Commission (NDRC) and the Ministry of Industry and Information Technology (MIIT) jointly released the *Notice Regarding Certain Matters of Corporate Income Tax (CIT) Preferential Treatment for Software and IC Industries* (Caishui [2016] No.49, hereinafter referred to as Circular 49), which further clarified tax incentives for software and IC enterprises.

Highlights of Circular 49 include: 1) implementation of the record-filing system; 2) clarification on certain criteria for tax incentive entitlement; and 3) establishment of a post-record filing examination mechanism and enhancement of post-administration. Among them, 1) and 3) require relevant enterprises to have a higher compliance level. In this regard, enterprises should strengthen their internal management and control on the relevant criteria (such as core technology, accurate calculation of the research and development (R&D) expenditures) to secure their tax incentives and mitigate compliance risk.

In detail

Background

Software and IC industries are strategic industries in China. They serve as one of the foundations of the national economy and the digitalisation of information in the modern

society. In order to accelerate the development of these industries, the State Council promulgated two notices, i.e. Guofa [2000] No.18 and Guofa [2011] No.4 in 2000 and 2011 respectively to cement the supportive initiatives for these industries.

Under such favourable environment, the software and IC industries have blossomed with significant improvement in

technical capacity, and contributed to the digitisation of information in China's modern society. For the software and information technology service industries, the 2015 national revenue derived from software business was RMB 4.3249 trillion. As for the IC industry, the annual production volume of IC units in 2015 reached 108.72 billion; the 2015 national sales hit RMB 360.98 billion with an annual growth rate of 19.7%,

accounting for 21.08% of the total sales globally (increased by 9.07% from 12.01% in 2011)².

Meanwhile, pursuant to the government's call to streamline administration, the State Council has released Guofa [2015] No.11 and Guofa [2015] No.27 on 24 February and 10 May 2015 respectively to abolish the administrative approval for qualification assessment, product registration and other administrative / non-administrative licensing examination and approval of software and IC enterprises. While the cancellation of the administrative approval for the qualification assessment for software and IC enterprises has been clarified, the change has adversely resulted in a temporary suspension of the CIT incentives for software and IC industries at the local level as there was no clear guidance on how to grant tax incentives with the lack of approval.

The issuance of Circular 49 reassures the software and IC enterprises that relevant tax incentives will still be implemented. The circular is expected to help promote industrial restructuring and upgrading, and encourage innovations under the 'New Normal'.

Highlight 1: implementation of the record-filing system

With the pushing ahead of the streamlining of administrative approval, decentralised administration and optimisation of services by the State Council as a backdrop, Circular 49 clarifies the detailed implementation measures for software and IC enterprises to enjoy the tax incentives after the approval mechanism has been replaced by a record-filing system.

1. Self-assessment on the eligibility for tax incentives

According to Circular 49, software and IC enterprises wishing to enjoy the relevant CIT incentives should perform a record-filing with their in-charge tax authorities during the annual CIT filing in accordance with the provisions in the *Public Notice Issued by the SAT Releasing the Administrative Measures for CIT Preferential Treatments* (SAT Public Notice [2015] No.76, hereinafter referred to as Public Notice 76). It means that relevant enterprises should self-assess as to whether they are

eligible for the tax preferential treatment before performing the record-filing.

2. Clarification on record-filing documents to ensure implementation

Enterprises should follow the requirement provided in the *List of Record-filing Documents for Software and IC Enterprises to Enjoy the CIT Preferential Treatment* attached to Circular 49 (instead of the relevant documents stipulated in Public Notice 76) to prepare and submit the relevant documents to the in-charge tax authorities. Moreover, enterprises should be mindful of the difference between the record-filing documents and those documents retained internally for post-examination. Overall, relevant documentation requirements under Circular 49 are more specific than before, which provide more guidance for enterprises to prepare the documents and enjoy the relevant tax incentives. Meanwhile, more detailed documentation requirement also requires the enterprises to improve their internal control on their eligibility for the tax incentives.

Highlight 2: clarification on certain criteria for tax incentive entitlement

Circular 49 further clarifies the criteria that various types of software and IC enterprises should fulfil in order to claim the tax incentives.

1. Substantial criteria remain unchanged

Except for more stringent criteria for qualifying as 'key IC design enterprises and key software enterprises within the National Plan' (Key IC Design and Key Software Enterprises), the criteria for other types of software and IC enterprises have basically followed those stipulated in the *Notice Jointly Issued by the MOF and SAT Regarding CIT Policies to Further Encourage the Development of the Software and IC Industries* (Caishui [2012] No.27).

2. Criteria clarified for Key IC Design and Key Software Enterprises

Circular 49 further clarifies the criteria for enterprises to qualify as Key IC Design and Key Software

Enterprises. Apart from the general criteria for qualifying as IC design enterprises and software enterprises, enterprises should also meet at least one of the additional requirements set forth in Circular 49 to qualify. The requirements are a combination of criteria based on sales, annual taxable income, percentage of R&D personnel and percentage of R&D expenditures incurred in China, with different thresholds depending on whether the relevant business falls in the key software / IC design domain. These additional requirements are more stringent than those stipulated in the *Administrative Measures on the Assessment of Key Software Enterprises and IC Design Enterprises within the National Plan* (Fagaigaoji [2012] No.2413).

It is noteworthy that Circular 49 introduces two new terms, i.e. 'key IC design domain within the National Plan' and 'key software domain within the National Plan'. NDRC and MIIT will work with MOF and SAT to jointly publish the details of the two domains according to the national industry development plan and make adjustment actively. The concept of technology 'domain' in Circular 49 will be similar to the relevant requirements for high/new tech enterprises (HNTEs)³. Enterprises should pay particular attention to their core technology, the technological substance of their R&D activities as well as the compliance requirement.

3. Inclusion of safety, quality and environment violations as one of the criteria

Compared with the previous regulation, Circular 49 has now included safety and quality incidents as well as violation of environment-related regulations as a qualifying criterion for software and IC enterprises to enjoy the tax incentives.

4. Further guidance on the calculation of R&D expenditures

The percentage of the R&D expenditures over annual sales is one important qualifying criterion for software and IC enterprises. In 2015, the MOF, SAT and MIIT jointly released the *Notice on Refining the Super Deduction of R&D Expenditures for CIT purpose* (Caishui [2015] No.119,

hereinafter referred to as Circular 119) to introduce a new approach of calculating R&D expenditures for the purpose of claiming super deduction of R&D expenditures. Circular 49 now clarifies that software and IC enterprises should also follow Circular 119 to calculate their R&D expenditures incurred in and after 2016 for the purpose of entitlement to the tax incentives in relation to software and IC industries.

It is important to note that Circular 119 has expanded the scope of R&D expenditures. Meanwhile, it emphasised the fundamental role of technical analysis during the assessment of R&D activities, which would also impact the calculation of R&D expenditures for software and IC enterprises accordingly.

Highlight 3: establishment of the post-record filing examination mechanism and enhancement of post-administration

One noteworthy change in Circular 49 is the post-filing administration of the relevant tax incentives. The provincial-level tax authorities will forward the relevant information submitted by the enterprises to the equivalent departments of NDRC and MIIT at the provincial level for examination. If the enterprises are assessed not to be eligible for the tax incentive, the relevant reduced or exempted tax will be clawed back and the enterprises could be subject to tax surcharges and penalties according to the *Tax Collection and Administration Law*.

In particular, Circular 49 requires various provincial-level departments of MOF, SAT, NDRC and MIIT to closely collaborate with one another to enhance the post-administration of software and IC enterprises through the establishment of the aforementioned examination mechanism and the effective use of the examination results. Under the examination mechanism, provincial-level tax authorities should submit the list of enterprises which have already filed a record for claiming the tax incentives during the annual CIT filing period as well as their record-filed documents to the following authorities in two batches (i.e. by 20 March and by 20 June of each year):

- The provincial-level MIIT is responsible for examining the

eligibility of software and IC design enterprises on the list via the work of experts or third-party agencies;

- The provincial-level NDRC is responsible for examining the eligibility of other enterprises on the list via the work of experts or third-party agencies.

As to the timeline, the provincial-level NDRC and MIIT should provide their examination results to the provincial-level tax authorities within two months of receiving the relevant documents. The examination result for the first-batch of enterprises should be provided before the due date of annual CIT filing.

The takeaway

With the new procedures and interpretations in relation to the tax incentives for software and IC enterprises introduced in Circular 49, enterprises are suggested to pay attention to the following matters:

1. **Self-assessment:** While the record-filing system significantly facilitates software and IC enterprises to enjoy the relevant tax incentives, it also put forward higher requirements for enterprises to perform self-assessment of their eligibility, which might be difficult as the misconception of technology-driven approach, misinterpretation of the core technology, inaccurate calculation of the R&D expenditures as well as the misunderstanding of the relationship between the R&D personnel and enterprises' R&D department, etc., may result in misjudgement of the eligibility and lead to compliance risk. Now that Circular 49 is strengthening the post-administration of such incentives and setting out the time frame of the examination, enterprises shall consider how to address the aforesaid issues and establish a mechanism to monitor their tax incentive eligibility so as to avoid the non-compliance risk.
2. **R&D expenditures:** How to satisfy the percentage of R&D expenditures threshold continues to be a challenge for many enterprises. Generally speaking, it is fundamental to start with a technology-driven approach to accurately identify and calculate R&D expenditures. Enterprises should identify the R&D projects

and calculate the R&D expenditures accurately based on the determination requirements for R&D expenditures set out in the relevant accounting and tax regulations. To this end, enterprises are recommended to build a team equipped with both technology and tax experts in order to ensure the accurate and reasonable calculation of R&D expenditures and mitigate risks of non-compliance.

3. **Documentation:** Circular 49 refines the documentation requirement for record filing, which provides more clarity for software and IC enterprises to claim tax incentives. Enterprises should note the connection and difference between the technical documents and accounting/tax documents therein, prepare relevant documents at an early stage, and leverage expertise in both technology and tax areas. In short, both the substantive criteria and the compliance requirement are equally vital for software and IC enterprises to enjoy the tax incentives.

It can be anticipated that Circular 49 will benefit more enterprises in claiming the relevant tax incentives and has profound impact on the development and restructuring of the software and IC industries. On the other hand, Circular 49 also requires enterprises to improve their capabilities in self-assessment, monitoring the eligibility for the incentives, and integrating technology and accounting / tax expertise, etc. Enterprises should consider these factors so as to mitigate the relevant risks.

Endnote

1. *The software and IC enterprises in this News Flash refer to IC manufacturing enterprises, IC design enterprises, software enterprises, as well as key IC design enterprises and key software enterprises within the National Plan.*
2. *Data source: Official website of MIIT and China Semiconductor Industry Association.*
3. *For the detailed analysis on the latest CIT preferential treatments for HNTes, please refer to China Tax News Flash [2016] Issue 4.*

Let's talk

For a deeper discussion of how this issue might affect your business, please contact a member of **PwC's China Research and Development Services Team**:

China R&D Tax Services Market Leader

Roger Di
+86 (10) 6533 2268
roger.di@cn.pwc.com

Landa Guo
+ 86 (21) 23233016
landa.guo@cn.pwc.com

Vicky Au
+86 (21) 2323 1269
vicky.au@cn.pwc.com

Kevin Huang
+86 (755) 8261 8239
kevin.j.huang@cn.pwc.com

Chen Gang
+86 (20) 3819 2566
gang.chen@cn.pwc.com

Syd Lin
+852 2289 5610
syd.lin@hk.pwc.com

PwC's China Research and Development Services Team is an important member of PwC global Research and Development service network and a full time service team specializing in Research and Development related tax incentives. The team is formed by engineers and scientists as well as finance, tax and management experts in order to accommodate the requirements for businesses to obtain research and development incentives from technology and finance & tax perspectives.

In the context of this News Flash, China, Mainland 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 PwC's client service team or your other tax advisers. The materials contained in this publication were assembled on 9 May 2016 and were based on the law enforceable and information available at that time.

This China Tax and Business News Flash is issued by the **PwC's National Tax Policy Services** in China and Hong Kong, which comprises of a team of experienced professionals dedicated to monitoring, studying and analysing the existing and evolving policies in taxation and other business regulations in China, Hong Kong, Singapore and Taiwan. They support the PwC's partners and staff in their provision of quality professional services to businesses and maintain thought-leadership by sharing knowledge with the relevant tax and other regulatory authorities, academics, business communities, professionals and other interested parties.

For more information, please contact:

Matthew Mui
+86 (10) 6533 3028
matthew.mui@cn.pwc.com

Please visit PwC's websites at <http://www.pwccn.com> (China Home) or <http://www.pwchk.com> (Hong Kong Home) for practical insights and professional solutions to current and emerging business issues.