

China's High and New-Technology Enterprise (HNTE) Program

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The most innovative economies in the world typically use non-discriminatory tax incentives and research and development (R&D) support programs to foster innovation. These incentives include R&D tax credits, tax deductibility for R&D expenditures, and open-bid innovation projects.

Current Chinese tax policies do not provide R&D-related tax credits – credits to reduce the amount of taxes owed based on R&D expenses – but instead offer a wide range of tax deductions – reductions in the amount of taxable income –and preferential tax rates for R&D activities. These incentives are generally in the Corporate Income Tax Law, Value-Added Tax (VAT) Law, and their related implementing documents. These innovation incentive programs frequently include requirements for locally owned intellectual property. These requirements limit the ability of many innovative foreign companies to participate and work in China, and thus run counter to China's goals of creating an innovative economy. Such programs also contradict commitments made by senior Chinese officials in multiple bilateral dialogues not to discriminate against IP based on the location of ownership.

Until China implements a better approach to promoting innovation, the United States will have to continue fighting battles over specific central, provincial and local policies and practices that favor domestic Chinese companies over foreign ones.

High and New Technology Enterprises

One of China's core innovation tax policies, the High and New Technology Enterprise (HNTE) program, offers qualified company locations a 15 percent tax rate (versus the standard 25 percent tax rate), regardless of the company's investment type and where the company is headquartered. HNTE status is granted by provincial tax authorities for company facilities located within those provinces.

However, to qualify their facilities for HNTE status, companies are required to own the proprietary IP rights of the core technology used in their products and services in China, or they must give their Chinese subsidiaries a global exclusive license for that IP for at least five years. Generally, the HNTE certificate is valid for three years once it has been approved and can be renewed every three years.

Because of this structure the HNTE program has a *de facto* bias against foreign companies because it forces them to manage their global corporate IP structure according to Chinese industrial policy goals. Innovative companies around the world prefer to manage their IP according commercially based considerations and international best practices.

Foreign companies that have sought to attain HNTE status, however, have had mixed success in doing so. While some companies have been able to work with provincial regulators to meet the IP qualification criteria and achieve HNTE status, others have not, or have been unable to transfer ownership of patents that are used globally to their Chinese subsidiaries in ways that would allow them to get HNTE status. Some companies report significant differences between how local government officials in different provinces implement the HNTE accreditation process.

Additionally, those applying for HNTE often find the process invasive and burdensome because of high information disclosure requirements and the substantial costs associated with the application procedures. For example, the HNTE application process requires companies to disclose the number of R&D projects, names of personnel who work on them, types of activities taking place on the projects, and other confidential business information that some companies find too sensitive to share. Furthermore, many companies believe the HNTE incentives (namely the 15 percent corporate income tax reduction) will not fully offset the cost associated with managing all the data necessary to meet the criteria. As a consequence, qualified companies – the types of companies that this program is designed to identify and support – sometimes choose not to apply for HNTE status because of these concerns.

Even those companies that do prevail in qualifying for HNTE point to another challenge posed by how these policies are crafted and implemented. While the central government may determine the general policy direction, it is up to local governments to actually put them into practice. Local government interpretations are wide-ranging and inconsistent. In recent months, some USCBC member companies have reported significant “tightening” of the application process, with some provinces applying criteria above and beyond those laid out in China’s HNTE guidebook. This has made it even more difficult for qualified foreign companies to gain HNTE status and some companies who previously qualified have subsequently been denied renewal based on these revised rules.

Qualifying for High- and new-technology enterprise (HNTE) status

China’s HNTE program provides a reduced tax rate for innovative companies that meet specific qualification criteria. The reduced rate is 15 percent compared with the overall corporate tax rate of 25 percent. To qualify for HNTE status, a company must:

- Be established for over one year in China;
- Continuously conduct research and development (R&D) activities and transform intellectual property (IP) developed into products or services;
- Obtained proprietary intellectual property rights of core technology of its main product (service) in the last three years through self research and development, transfer/purchase, donation, merger and acquisition, etc., or through an exclusive license with a term of more than five years;
- Conduct business in a qualified high- and new-technology sector (such as aviation and aerospace, biological and medical, electronic information, new-energy and energy conservation, new-materials, high-tech services, or resources and environmental technology, as well as high and new technologies that transform traditional sectors);
- Engage 10 percent of employees in R&D work, with 30 percent or more having at least an associate degree;

- Invest 3-6 percent of total revenue on R&D and make 60 percent of R&D expenses in mainland China; and
- Earn more than 60 percent of total revenue from high- and new-technology products and services.

Companies must apply for HNTE status through the provincial branch of the Ministry of Science and Technology, and the annual application season varies depending on the specific city or province. Once an application is approved, HNTE certificates are valid for three years from the date of issue.

HNTE-related challenges and recommendations

While HNTE has several aspects that should be modified to treat domestic and foreign companies equally, an improved HNTE program could create the type of innovation incentives that are used around the globe by innovative economies. USCBC recommends changes in the following areas:

Challenge: HNTE Criteria Deviate from International Norms and Best Practices

Most foreign companies manage their IP portfolios globally based on accessing top talent and resources where they may be found, without respect to national borders. The result is a dynamic, globally integrated IP development structure in which companies make decisions about developing, utilizing, licensing, and selling their IP based on commercial considerations, legal environment, and access to talent. China's HNTE incentive system raises costs and disadvantages all companies, foreign and domestic, because it requires companies to own the IP in China and prevents them from developing the IP in the most appropriate location.

Recommendations

- Modify the current HNTE requirement that exclusive license rights held by the applicant be the worldwide rights (not merely the right to exploit the relevant IP in China) with a term of not less than 5 years by:
 - Eliminating the requirement for ownership of core proprietary intellectual property rights in China; or
 - Expanding the criteria to include legally acquired, non-exclusive licensee or usage rights; or
 - Narrowing the criteria to be exclusive license rights in China only.

Challenge: Limited applicability of HNTE incentives

The practical impact of existing HNTE rules is that legal entities must contain both a manufacturing and R&D component to qualify for HNTE status. This requirement ignores the realities of modern international corporate structures that manage and promote joint corporate R&D activity, often by using R&D centers to support multiple corporate units. Under China's framework, R&D centers without manufacturing capabilities and manufacturing entities that use R&D innovations generated elsewhere may be ineligible for HNTE tax incentives, even though their collective outcomes contribute to the central government's goal of increasing innovative and high-tech manufacturing activity. China's government should allow all legal entities that develop and use R&D, technology, IP, or high-tech products – and thus make meaningful contributions to China's innovation goals – to qualify for the tax incentive.

Recommendations

- China should revise existing HNTE rules – such as the *Management Rules of High and New Technology Enterprises* – to allow all legal entities that develop and use R&D, technology, IP, or high-tech products to qualify.¹ In particular, language should be added to permit R&D centers without manufacturing capabilities or manufacturing entities whose products are commercialized using R&D innovations generated elsewhere to qualify for HNTE status based on the innovative research they are carrying out.
- As necessary, China should revise other tax-related laws and regulations to eliminate IP ownership and registration requirements that hinder innovation.

Challenge: Invasive and burdensome HNTE application procedures

Qualified companies often put off applying for HNTE status because of the invasive and burdensome HNTE application procedures. The HNTE application process requires companies to disclose the number of R&D projects, names of personnel who work on them, types of activities taking place on the projects, and other confidential business information that some companies find too sensitive to publicize. Furthermore, many companies believe the HNTE incentives (namely the 10 percent corporate income tax reduction) will not fully offset the cost associated with managing all the data necessary to meet the criteria.

Recommendations

- Revise China's existing HNTE rules, including the *Management Rules of High and New Technology Enterprises*, to limit the amount of sensitive company information that companies are required to compile and submit with their application, including project details and personal information about employees. Officials should limit such required information to information that is truly necessary to evaluate a company's high- and new-technology activities such as supporting evidence of R&D expenditure.
- Additionally, MOST should release specific guidelines outlining the responsibilities of officials involved with HNTE certification to protect confidential business data gathered during the application process, including ramifications for officials that fail to protect such data.

Conclusion

Innovation that happens in China benefits China, no matter what the nationality is of the company that does it and regardless of where they register the IP connected to it. To that end, China should adopt international approaches to promote innovation, rather than continuing to use incentives linked to IP ownership and government procurement.

Improving the HNTE program and similar tax programs that reward innovative activities regardless of the location of IP ownership would be an important step in that direction.

¹ *Management Rules of High and New Technology Enterprises*,
www.most.gov.cn/tggw/zfwj/zfwj2008/200804/t20080428_61006.htm