ADVANCING INNOVATION: Recommendations for China’s High- and New-Technology Enterprise (HNTE) Program
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China has made notable advances in recent years in technology innovation. For example, in 2012, China’s State Intellectual Property Office (SIPO) received more than 650,000 applicants for invention patents, an increase of more than 26 percent from 2011 and the largest number received by any patent office in the world. Investment in research and development (R&D) activities is also growing, with spending on R&D in 2012 growing more than 17 percent, according to official Chinese statistics.

As a part of these efforts, Chinese authorities have recognized that nondiscriminatory tax policies and a robust legal and regulatory system for protecting intellectual property rights (IPR) play a vital role in fostering innovation. The US-China Business Council (USCBC) acknowledges the efforts of Chinese central and local government agencies to set fiscal and IPR protection policies and programs that advance innovation. USCBC also appreciates the ongoing dialogue between USCBC and various central government agencies to discuss the value of tax and IP protection policies that align with international best practices and the realities of corporate structures. Through this submission, USCBC hopes to continue this constructive conversation about best practices for tax and IP policies that benefit all stakeholders to promote China’s development as an advanced, high-tech industrial economy.

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 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 their jurisdictions. To qualify a facility for HNTE status, companies are required to own the proprietary IPR 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.

While China’s current HNTE program allows both domestic and foreign companies to apply for HNTE status, the structure of the HNTE program presents innovative global companies with three particular challenges, discussed below. These challenges limit the ability of these companies to participate in the HNTE program. The end result is that the innovative companies that officials aim to attract cannot fully contribute to China’s efforts to promote innovation. In addition to discussing these three challenges in greater detail, USCBC recommends potential solutions to address these challenges.

Challenge: HNTE Criteria Deviate from International Norms and Best Practices
Most foreign companies manage their IP portfolios globally based on commercial considerations, the legal environment, and accessing top talent and resources where they may be found, rather than on national borders. The result is a dynamic, globally integrated IP development structure, uniquely suited to each company’s needs and promoting innovation and technology development to the benefit of both businesses and consumers.

By contrast, China’s HNTE program requires companies to own or hold an exclusive global license for their IP in China to qualify for the preferential tax rate. Such a requirement prevents companies from fully utilizing their own IP throughout their company and in the most appropriate location for their business goals. As a consequence, companies must choose between benefits they can receive under HNTE by bringing IP to China and the benefit they may receive by using that IP in other markets. Faced with that choice, some companies may choose not to bring the IP to China, limiting their ability to innovate in China. Consequently, Chinese companies are closed off from the global innovation network. Both of these dynamics ultimately hinder central government innovation goals.
Recommendations

- Modify the current HNTE requirement that license rights held by the applicant must be global, exclusive rights (not merely the right to exploit the relevant IP in China) with a term of not less than 5 years. Options for such a change can be:
  - Eliminating the requirement for ownership of core proprietary IPR 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

Under existing HNTE rules, legal entities must have both a manufacturing and an R&D component and generate revenue to qualify for HNTE status, since eligibility criteria focus on sales of high-tech products and services as well as on R&D spending and employment of technical personnel. These requirements do not take into account modern international corporate structures that manage and promote joint corporate R&D activity, often by using single R&D centers to support multiple corporate units.

Under China’s framework, many entities that carry out innovative and high-tech activities are ineligible for HNTE. This includes R&D centers without manufacturing capabilities, manufacturing entities that use R&D innovations generated elsewhere in the products they sell, and companies whose innovative products are manufactured in China but not sold through their manufacturing entities. China’s government should allow all legal entities that develop, use and commercialize R&D, technology, IP, or high-tech products to qualify for the tax incentive.

Recommendations

- Revise existing HNTE rules—such as the Management Rules of High- and New-Technology Enterprises—to allow all legal entities that develop, use and commercialize R&D, technology, IP, and high-tech products to qualify. All entities that do so – including R&D centers without manufacturing capabilities, manufacturing entities selling products are commercialized using innovation generated elsewhere, and manufacturing entities that do not themselves sell in China the innovative products that they produce (e.g. a foreign-invested manufacturing enterprise whose products are sold by a separate foreign-invested commercial enterprise) – should qualify for HNTE status based on innovation and commercialization they are conducting.

Challenge: High Risk of Trade Secret Theft

The HNTE application process requires companies to disclose a significant amount of information that may be considered to be trade secrets or highly sensitive. These disclosures include the number of R&D projects a company is undertaking, names of personnel who work on them, types of activities taking place on the projects, and other confidential business information. The amount of information required by provincial authorities for these applications has been increasing. Fearing loss of trade secrets and other IP, qualified companies often do not apply for HNTE status because of these invasive procedures that put their IP at risk due to the lack of clarity about how such information will be protected.

Recommendations

- Revise 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 work with companies to limit required information disclosures to that which is truly necessary to evaluate a company’s high- and new-technology activities such as supporting evidence of R&D expenditure.

- 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, regardless of the nationality of the company that does it and regardless of where the company registers the IP connected to it. To that end, China can best advance its innovation and industrial modernization goals by adopting tax policies and programs to promote innovation that align with international best practices, including policies that do not explicitly or implicitly
link the location of IP ownership to incentives. 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.