



**THE US-CHINA BUSINESS COUNCIL**

美中贸易全国委员会

## **ADVANCING INNOVATION: Recommendations for China's High- and New-Technology Enterprise (HNTE) Tax Incentive Program**

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China's leadership has made innovation one of its top priorities as it seeks to rebalance and upgrade the Chinese economy. As a part of these efforts, Chinese authorities are revamping innovation incentive policies and have engaged with international counterparts to discuss the need for pro-innovation tax policies. The US-China Business Council (USCBC) has been pleased to be a part of the dialogue with Chinese and US government agencies about improving innovation policies in China so that they better align with international best practices, provide incentives to encourage participation by domestic and foreign stakeholders, and more effectively 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 applicants a 15 percent tax rate based on their R&D and technology activities. HNTE status is granted by provincial branches of the Ministry of Science and Technology (MOST) for company facilities located within their jurisdictions. For a facility to qualify for HNTE status, its parent company must own the proprietary intellectual property rights (IPR) of the core technology used in their products and services at that facility. Alternately, the company must give its Chinese subsidiaries a global exclusive license for that IP for at least five years. Companies also must meet other criteria related to personnel qualifications, R&D expenses, and high-technology product sales.

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 a series of challenges that limit the ability of these companies to participate in the HNTE program. These structural challenges do not only impact foreign companies, but will also increasingly challenge innovative Chinese companies as they expand and create intellectual property both in China and abroad. The end result is an incentive program that excludes many of the most innovative companies operating in China, companies whose participation would be most likely to contribute to the program's success. This outcome harms China's ability to attract valuable investment, as companies may seek to find more competitive innovation-related tax incentives in other markets.

The US and Chinese governments have made progress in their innovation policy discussions. That progress includes a pledge by MOST at the 2013 US-China Innovation Dialogue to review its HNTE policies to ensure consistency with previous commitments, with the review designed to see if revisions would need to be made to HNTE policies. At the 2014 US-China Innovation Dialogue, MOST committed to design a pilot project to address certain US company concerns, such as the global exclusive license requirement for applicants.

Despite both governments' efforts, however, challenges remain that limit companies' abilities to participate in the HNTE program. These challenges are explained below, along with potential solutions.

### **Challenge 1: HNTE Criteria Deviate from International Norms and Best Practices**

Many companies have large, complex intellectual property portfolios. One technology product may involve thousands of patents with different component parts being produced in countries around the world. As a result, most foreign companies manage their IP portfolios globally based on commercial considerations – not national borders. Key considerations that determine where a company holds its IP include a country's legal environment, its pool of skilled labor, and the availability of other resources. The result is a dynamic, globally integrated IP development structure in which the market determines proper allocation of IP. This structure allows each company to make innovation decisions based on its own needs, and it promotes innovation and technology development to the benefit of both businesses and consumers.

By contrast, China's HNTTE program requires companies to own or grant an exclusive global license for their IP to their China-based subsidiaries to qualify for a preferential tax rate. Such a requirement prevents companies from fully using their own IP in the ways and locations that are most appropriate for their business goals. As a consequence, companies must choose between the benefit they can receive under HNTTE and the benefit they may receive by using the same IP in other markets. Faced with that choice, some companies have chosen not to bring their IP to China, limiting their contribution to China's innovation environment. 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 HNTTE requirement that license rights held by the applicant must be global, exclusive rights (not merely the right to utilize the relevant IP in China) for no less than 5 years. To create a more competitive HNTTE program that better promotes investment and innovation, regulators should:

- Eliminate the requirement for ownership of core proprietary IPR in China;
- Expand the criteria to include legally acquired, non-exclusive license or usage rights; or
- Narrow the licensing criteria to allow exclusive license rights in China only.

### **Challenge 2: Inadequate Coverage of HNTTE Incentives for Corporate Innovation Structures**

Under existing HNTTE rules, eligible companies must not only own core IP, but they must also meet specific targets for high-tech product sales, percentage of overall expenses spent on R&D, and technical personnel employment. In practice, these criteria mean that companies must have both a manufacturing and an R&D component at the same facility in China. These requirements do not consider modern international corporate structures that manage and promote joint corporate R&D, often by using single R&D centers to support multiple corporate units or by contracting R&D to individual business units. Put simply, companies cannot possibly invest in both R&D and manufacturing facilities in every location they create or use IP, as is currently required under HNTTE. However, this fact does not limit the important contribution these facilities make in fostering more competitive innovation environments locally and nationally.

Under China's current HNTTE framework, many entities that carry out innovative and high-tech activities are thus ineligible. This includes R&D centers without manufacturing capabilities, manufacturing entities that use IP generated outside China, and companies whose innovative products are produced but not sold through their manufacturing entities in China. 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. Doing so would allow more investors to take part in the program, promoting China's international IP competitiveness and potentially increasing government revenues.

To address these challenges, some companies have sought to make other arrangements that might allow them to qualify for HNTTE status, such as outsourcing technical personnel or providing contracted funding from a business unit to a R&D facility. Such arrangements would better allow a manufacturing entity to qualify for HNTTE. These arrangements, however, run into other legal and practical limitations. For example, they may conflict with provisions under the Labor Contract Law that govern how companies can outsource labor. Any such arrangements are, at best, an incomplete solution to a problem that could be addressed more fully by reconsidering the structure and nature of HNTTE criteria.

### **Recommendations**

- Revise existing HNTTE rules, such as the Management Rules of High- and New-Technology Enterprises, to explicitly allow all legal entities that develop, use, and commercialize R&D, technology, IP, and high-tech products to qualify. Revisions should also ensure that these criteria do not bar any legal entities that develop, use, and commercialize R&D, technology, IP, and high-tech products to qualify because they use a different operational structure. Entities that should be able to qualify for HNTTE tax benefits based on their innovation and commercialization work include R&D centers without manufacturing capabilities, manufacturing entities selling products that use IP generated overseas, and manufacturing entities that do not sell their innovative products in China, but instead outsource China sales to a separate entity (e.g. a foreign-invested manufacturing enterprise whose products are sold by a separate foreign-invested commercial enterprise).

- Review and revise other tax-related laws and regulations to eliminate location-specific IP ownership and registration requirements. These requirements not only hinder a company's ability to move IP freely, but they also create conditions that hurt China's innovation environment.
- Review and clarify other policies that may affect company efforts to promote innovation and qualify for HNTE, including policies that define R&D expenditures or human resource arrangements for technical personnel.

### **Challenge 3: High Risk of Trade Secret Theft**

The HNTE application process requires companies to disclose a significant amount of information that may be considered trade secrets or highly sensitive. These disclosures include confidential business information such as the number, details, and scope of a company's R&D projects and the names of personnel who work on them. Many companies believe these requirements put their IP at risk due to the lack of clarity about how such information will be protected.

The amount of information required by provincial authorities for these applications has been increasing in recent years, and companies have found it difficult to renew their HNTE status. Fearing the loss of trade secrets and other IP, qualified companies often don't apply for HNTE status because of these invasive procedures.

### **Recommendations**

- Revise existing HNTE rules, including the Management Rules of High- and New-Technology Enterprises, to clearly list company reporting requirements, and to limit the amount of sensitive information that companies are required to submit with their applications. These include project details and employees' personal information.
- Require government official to work with companies to limit required information disclosures to what is truly necessary to evaluate a company's high- and new-technology activities. For example, required documentation might focus primarily on R&D expenditures.
- Release specific guidelines outlining the responsibilities of officials involved with HNTE certification to protect confidential business data gathered during the application process. Such guidelines should include ramifications for officials who fail to protect confidential data.

### **Conclusion**

Innovation that happens in China benefits China, regardless of the nationality of the company or the location of its IP registration. To that end, China can best advance its innovation and industrial modernization goals by adopting tax policies and innovation programs that align with international best practices, including those 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.