

# The HNTE Program: Report of U.S. Experts\*



**BEIJING S&ED INNOVATION DIALOGUE**

**JULY 2014**

**\* ERIC CHUN, PETER COWHEY, JIMMY GOODRICH**

# The U.S. Experts Thank Our Chinese Colleagues for their Report and Comments



This presentation summarizes the U.S. experts report

- The U.S. report assumes that China and the United States continue to agree on the S&ED Innovation Dialogue commitments to innovation policies that are:
  - Non-discriminatory.
  - Support market competition and open trade and investment.
  - Leave the terms of technology transfer to agreement between individual firms.
  - Treat intellectual property (IP) developed or owned overseas the same as domestically owned or developed IP.
- This presentation also offers additional data and examples to answer the questions of our Chinese colleagues
  - U.S. experts reviewed documents of Chinese government and articles on tax incentive programs in the economic literature and various government documents.
  - U.S. experts discussed HNTE program personally with a number of firms and experts located in China and the U.S.
  - U.S. experts benefited from reviewing the results of a recent survey of around 60 U.S. multinational firms in a variety of industries about the HNTE program by a leading business association working on U.S-China commercial issues.

# Four Basic Conclusions of the U.S. Experts



- The HNTE program's goals are consistent with the policies of many countries, including the United States.
- The program's design may not be the most effective approach to achieve the goals of the Chinese government.
- The evolving rules and administrative practices of the HNTE program discourage participation by foreign funded enterprises in ways that prevent the HNTE program from fully achieving its stated goals.
- The HNTE program, as implemented, may unintentionally discriminate against foreign firms.

# Tax Incentive Programs to Accelerate Commercial Innovation in a Market Oriented Economy



- China seeks to become more “market oriented” while advancing innovation.
- Many market economies have tax incentive programs to encourage commercial innovation.
- The “market oriented” goals for these tax incentive programs:
  - Incent firms to create more innovation: New knowledge created by firms yields “externalities”, or knowledge spillovers, that benefits other firms even if a firm has extensive patents. Tax incentives compensate the firm financially for the spillover and therefore increases innovation by firms.
  - Achieve a global “win-win”: Creating new knowledge in one country can have “spillovers” that can benefit other countries. Therefore, it is desirable for all countries to create programs that are non-discriminatory.
- Four “market oriented” tests of effectiveness of these tax incentive programs:
  - Are they the lowest cost “tax expenditures” to achieve the desired innovation level?
  - Do they have the appropriate qualifying conditions, or do the qualifying conditions needlessly limit the firms participating in the program?
  - Do they distort market competition by inadvertently being discriminatory?
  - Do they encourage business confidence by being simple and predictable in their administrative system?

# There are Two Basic Approaches to Tax Incentive Programs for Innovation



- Front-loaded programs: Focus on providing tax incentives tied directly to the level of R&D spending by firms—examples include the United States and Australia.
- Back-loaded programs: Focus on providing tax incentives by reducing taxes on the total revenues of the firm—this is the HNTE approach (and some OECD countries also use this approach).

We believe that the front-loaded approach is more cost effective and less likely to either exclude firms unnecessarily or to unintentionally discriminate among firms.

If a country does adopt a back-loaded program, it needs to be very careful to make it cost effective, non-discriminatory, and administratively transparent and predictable.

# Case Study: The U.S. “Front-loaded” Incentive Program



- The U.S. tax incentives apply to all commercial R&D spending:
  - Full and immediate expensing of R&D costs as a deduction from corporate income.
  - A tax credit for qualified R&D spending that is above the baseline of the firm’s historic R&D spending (baseline calculation is defined by the program).
- Conditions for eligibility and administrative procedures:
  - Available automatically to all taxpaying subsidiaries of U.S. and non-U.S. firms.
  - No requirements about IP licensing.
  - No requirements that the firm has to manufacture (because the goal is to increase R&D).
  - Predictable and relatively simple administration: It is administered by the income tax service and is part of a firm’s corporate tax calculations.
  - Easy for U.S. Government to observe results of the program by analyzing spending on R&D.
- Consistent with market competition:
  - Because tied to R&D costs, there is no subsidy for other activities of the firm (in 2008 the tax expensing for firms were \$2.75 billion and the tax credits were \$8.4 billion – about 3.2% of all commercial R&D spending).
  - All firms are eligible based solely on their R&D spending, so unintentional discrimination is eliminated.
  - The program is consistent with the complex IP creation and management of global multinational firms, a key goal for all countries that are home or host to major multinational enterprises.

# As Implemented, the HNTE has Rules and Practices that Discourage Foreign Firms



- The Chinese expert report documents low participation by foreign firms, especially in recent years. While the report states that 15% of the HNTE enterprises are foreign funded, its closer look at the important Tianjin and Beijing regions after 2007 shows:
  - Tianjin appears to have between 3% (47 firms) based on Graph 3 and 7% foreign funded firms participation (based on 7% with exclusive worldwide IP) discussed in section 1.2.
  - Beijing has only 2% foreign funded enterprises out of 10593 total HNTE firms (based on Graph 7).
- A 2014 confidential survey of major foreign firms from a variety of industries documents skepticism and concerns about participation in the HNTE
  - Out of over 60 firms responding to the survey, over 65% have not applied:
    - About half the firms might apply in the future but worry about the program's rules (especially IP)
    - About half the firms plan never to apply for one of several reasons—the program rules, the qualification of their industry for the program, or a low priority on reducing their Chinese tax costs
    - Our personal interviews have confirmed the concerns of the firms reported in the survey.
  - In our view the HNTE program is missing a major opportunity to stimulate innovation by foreign firms because of the program's design.

# U.S. Experts Have Identified Three Big Reasons for Lower Participation by Foreign Firms



- Administrative changes beginning in 2008 and increasing with inspections in 2012 have raised uncertainty among foreign firms that hinders participation in the program.
- The IP rules for the program conflict with “best practices” for managing IP in global firms and hinder participation in the firm.
- The focus on “integrated firms” (e.g., requiring both innovation activities and manufacturing in the same firm) works against the innovation goal of the HNTE program.

# Greater Administrative Centralization since 2012 has Increased Uncertainty among Foreign Firms that Hinders Participation



- Different advice from provincial branches of MOST and provincial government officials often conflict and becoming unrealistic. Examples:
  - Company recently told its practices would qualify in one province and told it would not in another—no assurance that promises in one province would not be reversed by central administrative review.
  - Companies in several provinces report that they are being told that five-year exclusive global licenses will no longer be sufficient; must own/transfer the IP to China.
  - Company told that IP created in China had to be from last 3 years even though it takes more than 3 years to develop and patent new IP in its industry.
  - Company told that it cannot qualify for HNTe if it mixes its local IP and global IP on which it pays royalties in the same product—yet all of its products everywhere mix IP from its worldwide system.
- Worries by foreign firms about the protection of their business confidential information or personal information of employees have not been reduced
  - Firms report that the details required about R&D projects and personnel far exceed requirements in other countries.
- The HNTe program creates a complicated separate compliance process that discourages firms
  - Expensive and difficult to document (have to hire more staff for compliance). Firms often do not analyze their operations in ways measured by the rules (e.g., the percentage of revenue that is earned by a qualifying activity)
  - Do MOST, Finance and Tax Authorities give consistent advice?
  - Company told by MOST provincial officials that slightest mistake would lead to large fines, but other provincial officials say that flexibility to meet practical needs is still the rule.

# The IP Rules for HNTE Conflict with “Best Practices” for Managing IP in Global Firms and Hinder Participation in the Firm



- Multinationals manage IP and offer products and services based on a global division of labor in the creation and use of IP. Tax advantages in one country are weighed against total global cost, accounting practices and efficiency considerations.
  - HNTE treatment of “indigenous IP” advantages local Chinese firms: “Self-held IP” is usually interpreted to only mean IP created and registered by Chinese legal entities.
  - *HNTE Administrative Measures indicate IP registered outside of China does not qualify for HNTE status:* This better positions most local Chinese firms for qualifying for HNTE and may clash with Chinese commitments to treating foreign and domestic IP in a similar manner in its policies.
  - Alternative measure of qualification discourages participation: Qualifying through an exclusive 5 year worldwide license assigned to a Chinese subsidiary conflicts with integrated global management of IP by multinationals.
    - Two measures for licensing that would be more realistic: Multinational firms have said that allowing Chinese subsidiary to qualify for HNTE with a non-exclusive worldwide license or a China-exclusive IP license would be more consistent with global IP practice.

## The Focus on “Integrated Firms” (e.g., requiring both innovation activities and manufacturing in the same firm) Limits the Effectiveness of the HNTE Program



- Eligibility for the HNTE is determined on a legal entity basis, not on an innovation-related item of expenditure (or income). This discourages participation by innovative foreign firms.
- The rules effectively require a firm to conduct both manufacturing and R&D innovation activities in the same subsidiary, but many firms operate different subsidiaries with specialized roles (and in different provinces) as part of an integrated strategy for a country.
  - This discourages foreign firms with large separate R&D centers from joining the HNTE program.
  - The requirement also means that the back-loaded tax incentive (reducing the tax rate on all income of the firm) is subsidizing activities that are not related to innovation.

# Some Ideas for MOST to Consider



Based on the information provided by Chinese experts, we believe that MOST will not attempt to penalize firms who received benefits under the prior guidelines but may not qualify in the future. This is a good decision that raises foreign investor confidence.

## **Recommended Immediate Changes in the HNTE Program**

- Modify the requirement for ownership or a 5-year exclusive license: drop the IP requirement or allow the IP requirement to be fulfilled either by a non-exclusive worldwide license for the Chinese subsidiary or an exclusive IP license for China.
- Improve confidence in the confidentiality of business information: consider adopting the rules outlined in Article 41 of the Antimonopoly Law of China or clearly outline how current rules of MOST provide equivalent guarantees of confidentiality.

## **Recommended Actions in the Medium Term in regard to the HNTE Program**

- Improve transparency and realism of the rules governing intellectual property for global firms (whether U.S. or Chinese): Create an on-going multi-stakeholder consultation process on modern IP practices of global firms that includes domestic and foreign firms, legal/tax experts, and scholars. Use the results of the transparent consultation process to help redefine the rules for the HNTE.
- In addition to immediate changes in the existing HNTE program initiate an expert's review of economic gains from the HNTE program compared to other innovation policy tools.



**THANK YOU FOR THIS DIALOGUE!**