

CHINA FOCUS

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Driving Innovation in China

Innovation is at the core of China's current development plans. 'Made in China 2025' and the 13th Five Year Plan (2016-2020) set out to steer the economy away from mass manufacturing and unsustainable industries, through technologically driven growth. The foreign companies we support share mixed views on what this innovation push will mean for their business in China: Will it boost demand for foreign know-how or will it favour domestic players? Since the ultimate goal of 'Made in China 2025' is to make China's own industry competitive in new and high-tech sectors,

its policies often favour domestic and foreign companies asymmetrically.

In this issue of China Focus, Fiducia takes a pragmatic approach to the matter. We look at how foreign companies are already benefiting from China's innovation push and its related tax incentives, especially the 'High and New Technology Enterprise' (HNTE) program.



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- First-Hand Experience with HNTE
- Applying for HNTE Status
- Business Opportunities for Foreign Innovators

China's Innovation Incentives

Since 2015, when Made in China 2025 was launched, China has strengthened its tax incentive programs to encourage the development of new knowledge, products, and processes among domestic and foreign enterprises. These incentives are an opportunity for innovation-driven foreign companies to generate savings and value. Yet this opportunity is often foregone due to a lack of understanding of available programs, their requirements, and how to meet them. Fiducia's tax professionals provide support in assessing a company's eligibility for tax reductions, preparing successful applications, and ensuring compliance.

Made in China 2025: Implications for Foreign Companies

Opportunities

- ▶ Growing demand for foreign equipment and expertise
- ▶ Opportunities for collaborative R&D
- ▶ Government prioritisation of Intellectual Property (IP) rights enforcement
- ▶ **Tax savings for innovation-driven companies**

Threats

- ▶ Rising competitiveness of Chinese companies
- ▶ Government funding, regulations, and public tender procedures favouring domestic competitors in key industries
- ▶ Growing cybersecurity and IP infringement risks

Available Tax Incentives

Advanced Technology Service Enterprise (ATSE) Status

Qualified enterprises with eligible business scopes - such as IT, industrial design, or supporting services for the film industry - which are located in designated pilot cities, can benefit from:

- ▶ A reduced Corporate Income Tax rate of 15%, as opposed to the standard rate of 25%
- ▶ Tax deductible education fees

R&D Super Deduction

Companies in traditional and new industries can benefit from:

- ▶ 150% tax deduction on eligible R&D expenses incurred during the year
- ▶ Amortisation of capitalised intangible assets developed through R&D based on 150% of their total value

High and New Technology Enterprise (HNTE) Status

Qualified companies in government encouraged sectors can benefit from:

- ▶ A reduced Corporate Income Tax rate of 15%, as opposed to the standard rate of 25%

(See page 3 for more details on HNTE eligibility criteria and application process)

First-Hand Experience with HNTE

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China's leap forward in regards to innovation, efficiency, and quality is an opportunity for all foreign companies providing sophisticated technology

For over a century, Schenck has been enhancing manufacturing processes through its now market-leading balancing and diagnosis equipment. Today, the company's strong China arm, Schenck Shanghai Machinery (SSM), develops and produces solutions for the Chinese and international market, employing over 600 people in China and achieving sales of RMB 600M in 2016.

Peter Legner, CEO and President of SSM, shared with China Focus the company's first-hand experience with the HNTE program, as well as his take on what China's innovation push means for multinational high-tech manufacturers.



I understand these concerns, as IP is not thoroughly protected by law in China. However, IP protection is improving and with China pursuing its 'Made-in-China 2025' program, we certainly can expect the government to focus on this subject.

What would be your advice to other SMEs considering to apply for HNTE status?

It is absolutely crucial to work together with an external consultant who is familiar with the certification requirements and able to guide the applicant through the complex approval process – especially the preparation of all necessary documentation.

Which benefits is "Made in China 2025" likely to generate for innovation-leading foreign enterprises like yours?

In order to achieve its ambitious goals within the set time frame, China will depend on foreign technology and aid for a certain time to come. China's leap forward in regards to innovation, efficiency, and quality is an opportunity for all foreign companies providing sophisticated technology for plant equipment, software, and system integration. We are technology leaders precisely in equipment and systems designed to enhance efficiency and quality in manufacturing, so we are optimistic about the future.

Will China's innovation push pose new challenges for foreign technology leading companies?

If China is able to realise its goals, it will have a firm position as a high-tech solutions provider and will become a serious competitor in the world market. "Made-in-China 2025" has the full attention and support of the Chinese government, which is subsidising all promising technology trends in China. This should be a wake-up call for other countries, especially Germany, whose economical backbone lies precisely in the technologies targeted by "Made-in-China 2025". Even today, one should never underestimate the dynamics of the Chinese market and competition.

At the same time, the requirements of our customers will continue increasing and we will have to adapt accordingly. But I am confident that we will achieve this - we are market and technology leaders worldwide in all our segments, and we have access to the broad and constantly evolving knowledge basis of our headquarters and competence centres. ☺

Technological Highlights



Schenck's new fully automated tire assembly line features three technological highlights: the VENTUO inflation system, a fully-automated unbalance correction (top) and a robot-based "marrying" of tires and rims.

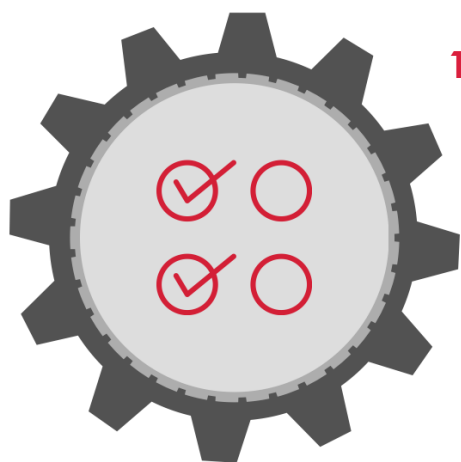
Tell us about the R&D efforts you are spearheading in China.

We have R&D activities in all business segments: balancing and diagnosis systems, cleaning and filling technology, and testing and assembly products. In China, we focus on developing solutions tailored to the specific market requirements, such as easy-to-handle automation systems and solutions for higher through-put quantities. Our Chinese R&D also jointly works with our headquarters and competence centres in Germany and Denmark to develop "world solutions": machines and systems built in China and sold to the world.

How complex was the application process to obtain HNTE status?

The biggest challenges are registering six patents in China every three years and proving on paper that the company invests 3% of the annual turnover into R&D activities. Ongoing government supervision to ensure compliance with HNTE criteria has also intensified, but this is not necessarily a setback and will depend on how cooperative local authorities are. For us, this experience has been quite positive so far.

Some foreign SMEs worry about the IP implications of the HNTE program, since it requires certain inventions to be registered locally. What is your opinion on this?



1. Determine Eligibility

Assess whether your business:

- ▶ Has been registered as a resident enterprise for 1+ years
- ▶ Offers innovative products/services within the government's encouraged industries
- ▶ Owns the intellectual property of its core technology
- ▶ Has a large enough R&D expenditure (3-5% of the company's total annual sales income, depending on annual income level)
- ▶ Has high-tech related operations that account for 60% or more of total revenue
- ▶ Has 10% or more of its staff dedicated to R&D



2. Prepare Documentation

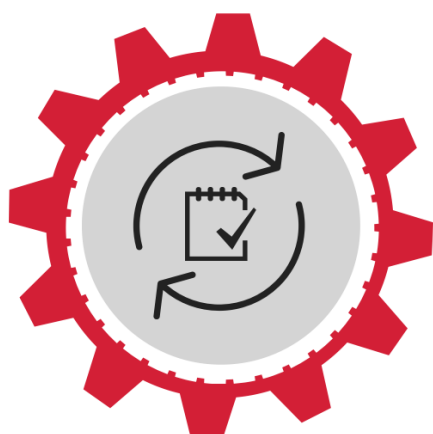
Collect all necessary records to prove that your enterprise meets the requirements mentioned in Step 1, such as:

- ▶ Audited financial statements for the last 3 years, including a special audit report on R&D expenses
- ▶ CIT returns for the last 3 years
- ▶ Proof of revenues derived from high-tech products/services in the last year



3. Submit Application

- ▶ Apply through the HNTE Company Assessment and Administrative Website
- ▶ Wait for the HNTE Assessment Committee's revision and approval



4. Ensure Ongoing Compliance

Once certified:

- ▶ Report information such as IP Status and R&D expenses annually
- ▶ Report relevant company changes - such as relocation or restructuring - within 3 months of the change
- ▶ Submit at least 5 R&D project reports annually to the Science and Technology Bureau for approval
- ▶ Be prepared for random investigations
- ▶ Set up a specialised R&D account in your books
- ▶ Be informed about revisions to the HNTE Working Guidance
- ▶ Liase with local authorities



5. Reapply After 3 Years

- ▶ HNTE licenses expire after 3 years, so reapplication is a must
- ▶ Reassess your enterprise's eligibility according to the most updated criteria
- ▶ Start preparing reapplication documents ahead of time

If you need support at any stage during your HNTE application, or wish to assess your company's eligibility for other tax incentives, please contact our experts at contact@fiducia-china.com.

A commitment to constant research and testing underpins FUCHS' success as a market leading producer of high-performance lubricants. In China, its innovations are in line with the market's growing appetite for high-quality, efficient, and environmentally sustainable industrial solutions. Bernd Siegel, CFO at FUCHS China, spoke to China Focus about the business opportunities that arise from this alignment and how FUCHS is seizing them.



FUCHS is headquartered in Mannheim, Germany, but has 50 companies and 24 laboratories internationally, including two advanced labs in China. How do you deal with the challenges of innovating on a global scale?

FUCHS' global R&D strategy employs a decentralized network of laboratories organised into "key working groups". Together with Germany and the USA, our labs in China collaborate to develop global technology platforms that can be tailored to local market needs. The resulting advantage is that local requirements are already considered in the design phase, instead of relying on late-stage adaptation of centrally developed products.

How is "Made in China 2025" affecting your innovation initiatives in China?

Our innovations are in line with the government's push for environmental protection. For instance, our lubricants and greases reduce fuel consumption and lower emissions in the automotive industry.

Our R&D focuses strongly on greases for e-mobility and we run a grease plant in Northern China. We are also a market leader in the wind-power industry, where demand for specialised lubricants is high. With regard to metal-working fluids and their additives, we produce lubricants that allow our customers to waste-optimize their operations.

From which R&D related tax incentives do you benefit?

FUCHS is a qualified HNTTE. Furthermore, some municipalities support our qualified staff with direct subsidies in their real estate acquisitions. This helps employees with a higher level of education, especially in technical areas.

How complex was the HNTTE approval process?

From beginning to end, the process took almost 1.5 years. The majority of this time was spent working on the application documents and putting together the report for the relevant authorities. Once we had completed that, we still had to explain our business model during the auditing process.

Documenting our R&D work was the biggest challenge. Various departments in our company had to work together to meet the requirements of the approving authorities. The technical, chemical, and financial documents must all be complete and consistent.

What would be your advice to other SMEs considering to apply for HNTTE status?

I think companies need to assess their company's situation carefully with regard to the HNTTE criteria and application requirement before making a decision on whether or not to apply, as the process itself is time consuming. Additionally, we recommend talking to the authorities and doing a preliminary check. At all stages, the involvement of a qualified consultant is advisable.



ECOCOOL GLOBAL is a metal-working fluid developed by FUCHS in response to tightening chemical, environmental labeling requirements.

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Innovative foreign enterprises that are committed to China and ready to establish their full value chain there will benefit from the direction in which industry is developing

How do you anticipate the changing market in China to influence innovation-driven companies like yours in the future?

FUCHS is already seeing a shift from low cost products towards those that affect total operating cost. For example, producers of machined components usually see a less than 1% decrease in cost per manufactured part even with a significant price reduction. By using a product that is better at protecting cutting tools, they can optimize their machining process and achieve productivity increases that deliver higher savings. Therefore, instead of using innovative technology to develop efficiently designed low cost products, the new focus is on developing high performance technologies that customers can employ with the help of a team of knowledgeable application engineers.

In general, I believe innovative foreign enterprises that are committed to China and ready to establish their full value chain there will benefit from the direction in which industry is developing. The Chinese market is open to innovations. ☺

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