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# China's Indigenous IP Policies – Here to Stay?

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# China's indigenous IP policies - here to stay?

When China dropped its indigenous IP requirements from central government procurement policies, foreign rights holders applauded. However, **Dan Prud'homme** warns that preferences for indigenous IP are still pervasive

In 2010 and 2011, foreign businesses and governments welcomed measures believed to dramatically reform a highly controversial branch of China's indigenous innovation policy which provided government procurement preferences to applicants who can meet restrictive indigenous intellectual property rights requirements. However, recent research finds that what can be labelled China's "indigenous IP policy" is still very much in force and, for several reasons, not likely to be overhauled anytime soon.

## The history of indigenous IP

The concept of "indigenous innovation" (自主创新), also sometimes translated as "independent innovation," forms the basis of what has become known as China's indigenous innovation policy (IIP). The Science & Technology Medium and Long-term Plan (2006-2020) (S&T MLP), promulgated in 2006, often thought to have established the main framework for the concept, defines "indigenous innovation" as innovation achieved via original innovation (原始创新), integrated innovation (集成创新), and assimilated innovation (引进消化吸收再创新). The concept also specifies that these approaches to innovation should not result in over-reliance on foreign technologies. The concept now serves as the basis for China's innovation strategy at large.

The term "indigenous intellectual property rights" (自主知识产权), also translated as "independent intellectual property rights", originated not in the S&T MLP but in the mid-1990s in policy advice to build domestic IP in the Chinese automobile industry. There is solid evidence – from specific definitions of indigenous IP in multiple government measures, secondary sources, and consultations with ex-Chinese-government officials and other insiders in China – that the term typically means IP owned by a Chinese entity in China, excluding entities with majority foreign ownership. In some atypical cases, the term encompasses restricted IP licensing. This specific concept is *per se* more nationalistic and extreme than the larger concept of indigenous innovation, which advocates assimilation of foreign technology as one method to boost domestic innovation, while indigenous IP pertains to exclusively Chinese inventions with as little foreign input as possible.

After an outcry from foreign stakeholders against measures tying indigenous IP to government procurement preferences, the Chinese government issued measures in 2010 and 2011 thought to dramatically reform the system. In April 2010, a notice was issued that was subsequently interpreted as revising the restrictive IP requirements within the prior indigenous innovation product accreditation framework to allow licensed foreign IP for use in China, even if owned abroad. Central-level public statements were issued in July 2011 invalidating several indigenous innovation product accreditation measures, and a notice from November 2011 required de-linking of indigenous IP requirements from government procurement preferences. It seemed that the most controversial components of the IIP had been nullified or otherwise reformed, including the indigenous IP component.

## China's indigenous IP policies are still in force

However, contrary to conventional understanding, China's indigenous IP system is far from abolished. First, the April 2010 Draft Notice is not currently and was never binding. Second, there are questions as to if indigenous IP requirements have been fully de-linked in practice from government procurement at all levels of government across China. Third, unbeknownst to many, there are a host of indigenous IP requirements explicitly linked or in the process of being linked to financial and other

## One-minute read



After the delinkage between China's central government procurement requirements and its indigenous IP policies, foreign rights holders

thought that the policies were gone for good. However, a number of other policies still explicitly or implicitly give preference to indigenous IP. Furthermore, provincial and local programs continue to subsidise the local production of IP.

## The HNTE tax programme: tax cuts for indigenous IP

Under the HNTE scheme, qualifying enterprises pay a 15% tax rate, a 10% reduction from the normal Enterprise Income Tax rate. Qualifying enterprises also receive a 150% ‘super deduction’ for R&D expenses and a potential business tax deduction.

According to the Administrative Measures for the Recognition of Hi-tech Enterprises, the Key High-tech Fields With State Support along with the Working Guidance on the Recognition of Hi-tech Enterprises promulgated by the Ministry of Science and Technology, Ministry of Finance and the State Administration of Taxation, qualifying enterprises must own “core” IP in China or have “worldwide rights to the exclusive use” of IP for five or more years. The guidance explicitly states that “No enterprise that does not have any independently developed core intellectual property will be recognised as a high-

tech enterprise”. Further, the HNTE Guidance and application form stipulate that on a 100 point scale for assessing enterprises for HNTE status, IP is worth 30 points with a minimum qualifying score of 70.

In practice, these clearly restrictive IP-related conditions are even more difficult to meet. Specifically, while “worldwide rights to exclusive use” is stipulated in the measures as a substitute for ownership of IP, this exception is difficult to practically meet because the rules effectively prohibit owners and licensors from retaining IP usage rights in a foreign jurisdiction and also prohibits any other person, including a subsidiary of an HNTE, from receiving a sublicense from the China licensee. This has led some tax advisors to conclude it will be difficult for China affiliates of multinational companies to obtain HNTE status.

Utility models, certain inventive design patents and some other types of IP can be used to meet the IP requirements for HNTE status. There are certain restrictions on the types of IP in achieving HNTE status, and criterion in the application form in annex 4 of the HNTE Guidance has been interpreted to mean that six utility model patents constitute one invention patent for the purposes of applying for HNTE status. Consultations with the Chinese government suggest that given this allowance, many enterprises simply use utility models instead of invention patents for the purpose of applying for HNTE status.

HNTE status is also a precondition for qualifying for important government S&T funding, like the Innovation Fund for Small Technology-based Firms, a branch of the Torch Program.

incentives outside the realm of government procurement in currently effective measures in China. A non-exhaustive list of these includes:

- Measures setting indigenous IP requirements linked to significant financial grants for developing domestic standards. For example, a program in Beijing that provides subsidies of Rmb 1 million (\$163,000) per standard developed with indigenous IP.
- Science and technology related funds at the sub-central level tied to indigenous IP. Various provincial governments have policies stating funding from their key technology invention project fund, S&T invention fund, technology invention fund for SMEs, amongst others, should be preferentially given to enterprises with indigenous IP.
- Often intertwined with the S&T funds, policies to stimulate China’s strategic emerging industries (SEI) provide funding from “special funds” and other monetary mechanisms for development of indigenous innovation, explicitly including indigenous IP.
- The High and New Technology Enterprise (HNTE) tax scheme provides a lower tax rate for qualifying enterprises. The IP requirements in the scheme are not as restrictive as the typical ones found in other policies, although they often make it difficult for non-local enterprises to qualify [see boxout].
- Policies that provide financial support to enable exports of products with indigenous IP, particularly patents and trade marks, to reach specific targeted percentages of total export volume by 2015. Some measures require meeting indigenous IP requirements as an exclusive precondition for qualifying for export-based subsidies from China’s Central Foreign Trade Development Fund (CFTDF), a fund worth over Rmb 37.7 billion (\$6.16 billion) according to available estimates.
- Many sub-central level patent filing and award subsidies continue to have indigenous IP requirements. A number of provinces provide funding specifically for registering

patents abroad, Rmb 500,000 (\$81,500) awards for “China Patents”, among numerous other patent-specific financial incentives that likely often incorporate de facto indigenous IP requirements.

### Why indigenous IP ‘thought’ will likely not radically change anytime soon

It is unlikely that the logic underlying China’s indigenous IP policies will radically change in the near term. There are several reasons for this.

First, there is intense nationalism that underlies the concept of indigenous IP. The logic behind the concept appears to be deeply ingrained in the system, an idea started at the upper echelons of the Chinese government, and over time not just implemented but justified by certain government officials and certain academics.

The timelines and parameters of Chinese policy makers also factor into the entrenchment of indigenous IP. There is a focus on long-term goals sometimes despite less-than-optimal short-term consequences. Because many scholars and government officials appear to be convinced that policies linking indigenous IP requirements to government incentives will succeed in building indigenous innovation in China, at least in the mid- longer-term, any waste of resources incurred in this process is viewed as worthwhile.

The third reason is that the concept of indigenous IP is reinforced by the exigency associated with cultivating SEIs. Indigenous IP is a core tenant of the SEI initiative. And development of SEIs is viewed by Chinese leaders as the way to leap frog the country to the forefront of the world economy, all while addressing economic, social and environmental challenges at home.

The fourth reason is that some view the ability to institute indigenous IP policies as a matter of fairness. For example, some equate them to the “Buy-American” programme of US government procurement preferences for American products and argue China should be allowed to follow similar policies.

While the applicability of this argument to China's current indigenous IP policies can be questioned, it is nonetheless often used around China to justify the policies.

The fifth reason is that many are unaware of the extent indigenous IP policies existed or exist currently. As mentioned, some foreign businesses and governments appear largely unaware of the types of indigenous IP policies and nuances within China's indigenous innovation system described hereto.

Sixth, those questioning IIPs have difficulty finding a forceful enough forum in which to challenge them. Certain governments have challenged China's indigenous IP requirements in discussions in the past, or at least the policies that linked to government procurement preferences, but indigenous IP requirements are still linked to governmental financial support in China. It is unclear how much impact further government discussions will have in this area. In terms of legal dispute mechanisms, while certain financial components of the policy such as export subsidies clearly violate WTO rules and the underlying IP requirements themselves might violate the TRIPs Agreement, a variety of factors make a successful WTO case difficult.

Finally, if China wants to appease certain critics yet keep this controversial policy, it may choose to only reform some applications of the policy while maintaining other discriminatory aspects. It is also always possible that reforms to the policy, even if made on paper, will not be thoroughly instituted in practice.

### What can international rights holders do?

Indigenous IP policy is more deeply ingrained in the Chinese system than conventionally thought and it is unlikely that the logic underpinning the policy will be radically rethought anytime soon.

This presents a number of important implications for inventors in the Chinese market. Despite questions about the overall effectiveness of the policy to build healthy innovation, it will inevitably cultivate *some form* of inventions in China at some point. And it will spur Chinese entities to build up portfolios of IP, which they will use as strategic assets. The policy provides some Chinese entities opportunities in the near-term, and while in some rather indirect ways may afford opportunities to foreign innovators as well, first and foremost presents a number of threats to foreign innovators.

**Plant red flags.** While the simple mention of "indigenous innovation" is not worth getting excited over (and, in fact, *healthy* stimulation of domestic Chinese innovation can directly, and via knock-on effects, provide numerous opportunities for foreign firms), the frequent mention of indigenous IP should raise some red flags. Companies should incorporate policy monitoring of mentions of indigenous IP into their IP management strategy. This would include monitoring of industrial development policies frequently mentioning the term. For example, amongst SEI policies, biotech industry policies mention the term far more than those for the energy conservation industry. One can expect Chinese counterparts in those industries to receive not insignificant amounts of government support for IP cultivation, and thus these areas will see a faster rise in domestic firms' holdings of IP than expected in lieu of such incentives. This IP can of course be used in a variety of ways to limit foreign firms' market opportunities, such as patents being used to limit freedom to operate. Foreign companies should incorporate this analysis into their larger IP management strategy.

**Calculate the costs of the policy.** This calculation should capture as much as possible of the IP-specific advantage the

mechanisms might provide to domestic firms. It would incorporate the type of red flag analysis mentioned above as well as a wider calculation of direct and indirect benefits the policy affords Chinese competitors in the short, medium and longer term, including access to tangible resources and intangible networks.

**Do not be fooled.** Familiarise yourself with how Chinese universities, research institutes and companies might appear innovative without actually innovating. Understand that patents in China may not be filed with the intention of protecting an invention that will be transformed into something useful, thus becoming an innovation, but simply to claim government financial support. This is something to consider when conducting due diligence on a partner for research and development or otherwise seeking an investment target in China.



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© Dan Prud'homme 2013. Prud'homme is an IP and innovation policy analyst based in Beijing. Formerly of the EU Chamber of Commerce in China, he is the author of "Dulling the Cutting Edge: How Patent-Related Policies and Practices Hamper Innovation in China"