KPMG

China Tax Alert

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Tax incentives for VC and angel investment in technology start-ups

Regulations discussed in this issue:

- Notice on tax collection pilot policies related to venture capital investment enterprises and angel investment individuals (Cai Shui [2017] No. 38, hereinafter referred as to "Circular 38"), issued by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) on 28 April 2017.

Background

In the first half of 2017 China rolled out a range of new tax reduction measures to facilitate the development of the Chinese economy. In particular, Premier Li Keqiang set out, in the April 2017 *Report on the Work of the Government* to the State Council, plans for VAT rate bracket consolidation, enhanced research and development (R&D) expense super deductions for certain small and medium enterprises (SMEs), personal income tax deductions for private health insurance, and new venture capital (VC) tax incentives.

Focusing on the latter, effective from 1 January 2017 a new tax incentive is provided to VC enterprises investing in science and technology enterprises at seed capital or start-up stage (referred to here as "technology start-ups"). The incentive had already been flagged as early as September 2016 in State Council Circular 53. The details are provided in Circular 38, issued by MOF and SAT on 28 April 2017.

Under the incentive, 70% of the investment amount can be offset against the taxable income of the VC enterprise for Corporate Income Tax (CIT) purposes. Furthermore, from 1 July 2017 equivalent Individual Income Tax (IIT) treatment will be provided for individuals investing through VC partnerships, as well as in an individual capacity as 'business angels'. The new rules will initially be piloted in eight designated locations, including Beijing-Tianjin-Hebei, Shanghai, Guangdong, Anhui, Sichuan, Wuhan, Xian, Shenyang, as well as Suzhou Industrial Park. The details of the incentives are set out in this Alert.

Main contents

The new incentive treatment applies in the following circumstances.

- **VC enterprises taking corporate form**: Investments made in technology start-ups by way of equity investment benefit from special tax treatment. Where the investment is held for at least two years, 70% of the investment amount can be offset against the taxable income of the VC enterprise. The deduction may be taken once the two year holding period has elapsed. The balance of any deduction, not used immediately for offset, may be carried forward to subsequent tax years.

- **VC enterprises taking limited partnership form**: Investments made in technology start-ups by way of equity investment similarly benefit from the incentive treatment. Where the investment is held for at least two years, legal person and/or natural person partners in the VC partnership enterprise may offset 70% of the investment amount (as apportioned) against the taxable income amount allocated to them from the partnership. Once the two year period has elapsed, a deduction for CIT/IIT purposes may be taken, as appropriate, and unused balances may be carried forward to subsequent tax years.

- **Individual 'business angel' investors**: Where individual investors (business angels) make an investment in their own personal capacity the incentive is also available. In such cases, 70% of the investment amount can be offset for IIT purposes against taxable gains arising from disposals of equity in the technology start-up in which the investment has been made. Any unused balance may be carried forward and used against further future disposal gains from equity in the same invested technology enterprise.

  A special treatment may apply where an individual investor makes investments in several technology start-ups in the pilot area, and the de-registration/ liquidation of one of the invested technology start-ups limits the degree to which the 70% investment deduction for that start-up can be utilized against gains arising from disposals of equity in that start up. In such cases, the investment deduction may also be offset against taxable gains arising from disposals of equity in other invested technology start-ups. It is yet to be clarified whether these technology start-ups need to be within the same pilot area for this offset to be allowed, or whether this treatment could cover invested start-ups in all pilot areas. This offset must be used within 36 months of the de-registration/liquidation of the invested technology start-up.

Qualifying conditions:

- For technology start-ups (investees) these must:
  - ❖ Be a tax resident enterprise registered in Mainland China which is subject to CIT on an accounts assessment basis;
  - ❖ Have fewer than 200 employees, at least 30% of whom must have a university degree. In addition, the investee's assets and annual revenue must not exceed RMB 30 million at the time of investment;
  - ❖ Have been in business for no more than 5 years (i.e. 60 months) at the time of investment;
  - ❖ Not be listed in the year in which the investment is made or in the following 2 years; and

- Have incurred at least 20% of total costs and expenses on research and development (R&D) in the year in which the investment is made and the following tax year.

The technology start-ups do not need, from an incentive application perspective, to be in one of the eight designated zones where they are invested in by VC enterprises or partnerships (in such case the VC enterprises or partnerships must themselves be registered in one of the eight designated zones). However, where a business angel investment is in point then the technology start-up does need to be located in one of the eight designated zones (for this version of the incentive, the business angel investor need not be in any of the zones.

- For VC enterprises (both corporate and limited partnership form) these must:
  - Be tax resident enterprise registered in Mainland China which is subject to CIT on an accounts assessment basis (except for VC enterprises in limited partnership form), and who is not the founder of the invested technology start-ups.
  - Register and operate in compliance with the regulations on venture investment stipulated in 10 Departments Order No. 39 or CSRC Order No. 105;
  - May (with their related parties) only hold equity interests in technology start-ups which are less than 50% of the share capital of the technology start-ups; and
  - Be registered in the designated areas (i.e., one of the eight pilot innovation areas).

  For this form of the incentive, the invested technology start-ups themselves do not need to be located in one of the eight zones.

- For individual 'business angel' investors these must:
  - Not be the founders or employees of the invested technology start-ups and not supply staff to the technology start-ups. The same restriction applies to family members of individual investors. These limitations are linked to the definition of 'business angel' set out in the rules;
  - Not (together with their family members) hold more than 50% of the share capital in such technology start-ups within 2 years after the investment was made;
  - Invest in technology start-ups registered in one of the designated areas (i.e., the eight pilot innovation areas).

  For this version of the incentive, the business angels themselves do not need to be located in any of the eight zones.

The tax incentive treatment only applies to equity investments are made in technology start-ups by way direct cash subscription for new equity. It does not apply where an investment is made in existing equity transferred from other existing shareholders of the technology start-ups.

Where an investment is made within the two years prior to the implementation of the new rules (i.e. January and July 2017), and where the investment is held for at least two years after the implementation date, the incentive treatment can also be applied to this investment.

KPMG Observations

In recent years, the Chinese VC industry has undergone rapid development. The emergence of new channels for financing "mass entrepreneurship and innovation" is supportive of the Chinese government's wider initiatives to foster innovation and upgrade the Chinese economy to avoid the 'middle income trap". However, to-date, VC investment, particularly where it used a corporate vehicle, faced double taxation. CIT at 25% applies at entity level on dividends and gains and IIT at 20% applies to dividends received by the investors in the VC entity, as well as to gains on disposals of interests in the VC entity.

Already, for close to a decade, the 2008 CIT law and the subsequent Guo Shui Fa [2009] No.87 provided that VC enterprises investing in non-listed small and medium high and new technology enterprises (HNTE) by way of equity investment could obtain a tax incentive. This was, as with the new VC incentive, a 70% tax deduction based on the value of the investments. The incentive had also been expanded to cover corporate investors in VC partnerships from 1 October 2015, with the issuance of Cai Shui [2015] No.116 and SAT Announcement [2015] No. 81.

However, the usefulness of these incentives was limited by the fact that the threshold for investee enterprises to obtain HNTE status is relatively high. In fact such threshold may be hard to reach for most technology start-ups. In addition, the existing incentives did not cover investments by individual, whether investing through a VC partnership or in their own right.

Circular 38 exhibits the following key aspects:

1. **Lower investee threshold to access incentive:**

   The new tax incentive treatment expands the scope of eligible investees insofar as no HNTE status is required. It is noted though that the criteria for an investee to be regarded as a technology start-up map fairly closely to those for enterprises looking to access the small and medium HNTE enterprise incentives. Variations from these criteria for technology start-ups are noted here:

   - Requirements are set for technology start-ups in relation to the number of employees (i.e., fewer than 200) and asset and annual revenue (i.e., both may not exceed RMB 30 million). These thresholds mean that eligible enterprises must be even smaller than those qualifying for the small and medium HNTE incentives (i.e., fewer than 500 employees, assets and annual sales (business) revenue may not exceed RMB 200 million). This reflects the policy makers' intention that the technology start-ups assisted by the incentive should be at a quite early stage of development. This is reinforced by the fact that the new incentive requires that technology start-ups must have been in business for no more than 5 years at the time of investment.

   - The new incentive also provides that the technology start-ups must incur at least 20% of their total expenses on R&D activity. This is a different threshold than that applied for the small and medium HNTE incentives, which requires the relevant enterprises to meet a target of R&D expenses as a percentage of their total revenue.

This might also be considered reflective of the policy maker's focus on early stage enterprises, whose earned revenue may be very low or nil, meaning that this more meaningful threshold was selected. It might be noted that, with respect to the administrative control and tracking of R&D expenditure conducted by the technology start-ups, Circular 38 requires that a set of auxiliary R&D tracking accounts, equivalent to those mandated by Cai Shui [2015] No.119 for HNTEs, will need to be maintained on an ongoing basis.

It might also be noted that while the earlier VC incentives simply applied the tax incentive treatment to equity investment in HNTEs, not saying in what form this investment should be made (e.g. in cash, in kind, etc.) the new incentive demands a cash investment for newly subscribed equity.

2. **Greater number of potential incentive beneficiaries:**

The new incentive is more expansive than the prior VC incentives, as it also applies to individual investors for IIT purposes, whether investing through VC partnerships or in an individual capacity as 'business angel' investors.

This being said, and as noted above, the utility of the business angel incentive is more limited that the other variants of the incentive. With the exception of cases where one of the investees undergoes de-registration/ liquidation, the tax deductible 70% of the investment in a given start-up may be solely offset against the taxable gains arising from the disposal of equity in the same start-up. It can also not be offset against dividend income derived from the technology start-up. This is different from the treatment of individuals and enterprises investing through VC partnerships, who may offset the 70% deduction against all taxable income amount allocated to them through the partnership. It also differs from the treatment of a VC corporate enterprise which is similarly unrestricted. It also differs from the earlier incentive covering VC investment in HNTEs.

3. **Geographic restrictiveness:**

The new incentive treatment is initially only being piloted in eight designated areas. As seen from the above, either the investee or the VC enterprise itself must be in one of the areas for the incentive to apply. However, it can be foreseen that this incentive treatment is likely to be expanded nationwide in due course.

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