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China Tax Weekly Update

Reference: Cai Shui [2017] No. 33 / No. 34 / No. 37 / No. 38 / No. 39
Issuance date: 26 April 2017, 28 April 2017, 2 May 2017
Effective date: 1 January 2017 to 31 December 2019, 1 July 2017, 1 January 2017

Relevant industries: All
Relevant companies: All
Relevant taxes: IIT / CIT / UTLUT

Potential impacts on businesses:

- Compliance risks due to regulatory uncertainties reduced
- Operating costs reduced.

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VAT and CIT reduction measures further clarified

As highlighted in KPMG *China Tax Weekly Update (Issue 16, April 2017)*, Premier Li Keqiang, at an 19 April 2017 executive meeting of the State Council, outlined several tax reduction measures. These included, inter alia:

(i). Reduction of VAT brackets for general VAT taxpayers from four to three;

(ii). Increase to research and development (R&D) expense super deduction for science and technology-related small and medium enterprises (SMEs).

Following this, several authorities, including the Ministry of Finance (MOF) and the State Administration of Taxation (SAT), issued additional guidance.

- *Notice on Simplifying VAT Rates (Cai Shui [2017] No. 37, "Circular 37")*

  The VAT brackets will be reduced from four to three from 1 July 2017 onwards, and the 13% rate will be abolished. The 11% (originally 13%) VAT rate will be imposed on the sale or import of the following goods: agricultural products (including grain), tap water, heating, liquefied petroleum gas, natural gas, edible vegetable oil, air conditioning, hot water, coal gas, coal products for residential use, edible salt, agricultural machinery, feed, pesticide, agricultural film, chemical fertilizer, biogas, dimethyl ether, books, newspapers, magazines, audio and video products, electronic publications.

  For purchases of agricultural products a series of detailed rules apply for determining what input VAT credit may be claimed by taxpayers:

  - The first rule applies where the taxpayer obtains special VAT invoices issued by general VAT taxpayers or import VAT payment certificates issued by the customs authorities (customs payment notices). In such cases the input VAT amount will be the VAT amount stated on the special VAT invoice/customs payment notices. This rule is relevant to, inter alia, purchases from domestic wholesalers and from overseas suppliers;

  - The second rule applies where taxpayers obtain special VAT invoices issued by small-scale VAT taxpayers, who are subject to the simplified VAT rate of 3%. In such cases the input VAT amount shall be calculated by multiplying the invoice purchase price by 11%. This rule is relevant to, inter alia, purchases from small domestic wholesalers;

  - The third rule applies where taxpayers obtain sales invoices for agricultural products, or issue purchase invoices for agricultural products, in cases where the vendor of the products is not a VAT taxpayer. The input VAT amount shall be calculated by multiplying the price stated on the sales invoices or the purchase invoices by 11%. This rule is relevant to, inter alia, purchases from individual farmers or farmer's cooperatives.

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Certain complexities enter the rules due to the existence, in the Provisional Regulations on VAT, of a special deeming rule for processing enterprises, and the carrying forward of this special treatment under Circular 37:

- The existing rule (Article 8 of the Provisional Regulations on VAT) provides that processing enterprises that purchase agricultural products, process them, and then sell them on as products subject to VAT at 17%, may claim an input VAT credit calculated as the purchase value of the agricultural products multiplied by 13%. This is regardless of which of the three invoicing situations (outlined above) is in point (i.e. whether the purchase is from a general VAT taxpayer, small VAT taxpayer, or non-VAT taxpaying farmer). Where the principal involved in arranging the processing and selling of the goods gets an enterprise acting on commission to process the goods, and the latter purchases the agricultural products, then the latter can claim the deemed input VAT credit. This rule is to apply during the VAT reform pilot period, which is still ongoing;
- Circular 37, at Article 2 (5), preserves this treatment so long as the processing and sale of goods at 17% can be tracked separately from other activities of the enterprise. Where it is not possible to separate the income streams then this special treatment is lost, and the three main rules outlined above are in point (i.e. input VAT credit of the VAT on the invoice, or deemed credit at 11%).

A further issue relates to the continuation of a special rule from 2012 concerning a deemed VAT credit for general VAT taxpayers engaged in production of liquid milk, dairy products, liquor, alcohol and vegetable oils. The latter are allowed to calculate a deemed VAT input credit at 13% based on the value of their sales or the cost of their purchases (rather than on the sales invoices received or purchase invoices issued). Circular 37, Article 2 (3), allows for the continuation of the deemed credit, but at the new 11% rate. If the conditions of the special treatment for processing enterprises can be met, the13% rate may still apply during the VAT reform pilot period.

Despite the provision of deemed input VAT credits in a number of situations, as outlined above, there is a restriction from 2012 carried over into the new rules. Enterprises purchasing vegetables, fresh meat and egg products from wholesalers or retailers, where the latter benefitted from a VAT exemption and issued VAT general invoices rather than special invoices, cannot qualify for a deemed input VAT credit.

Circular 37 also adjusted export tax refund rates, subject to a transitional period.

❑ *Notice on increasing the R&D expenses super deduction for science and technology-related SMEs (Cai Shui [2017] No. 34, "Circular 34")*

- From 1 January 2017 to 31 December 2019, "science and technology-related SMEs" can obtain enhanced deductions for their R&D expenses. Where the expenses are not capitalized as intangible assets, and are booked to the current period income statement, 75% of the R&D expenses may be taken as a super deduction for Corporate Income Tax (CIT) purposes, in addition to the normal deduction. Where, instead, the expenses give rise to capitalized intangible assets, amortisation for tax purposes shall be made based on 175% of the cost of the intangible assets. Enterprises not qualifying for this new SME super deduction may still potentially obtain the 50%/150% super deduction already in existence.
- The general qualifying criteria for the R&D expense super deduction are set out in Cai Shui [2015] No. 119. The recognition criteria and administrative measures for "science and technology-related SMEs" have been separately promulgated by Ministry of Science and Technology (MOST), MOF and SAT. See KPMG *China Tax Weekly Update (Issue 19, May 2017)* and *China Tax Alert (Issue 14, May 2017)*.

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- [Notice on pilot tax policies related to venture capital enterprises and individual 'business angel' investors (Cai Shui [2017] No. 38, "Circular 38")]

A new incentive treatment for venture capital (VC) enterprises and individual 'business angel' investors 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. This commences from 1 January 2017 for CIT purposes and from 1 July 2017 for IIT purposes. These incentives treatment include:

- VC enterprises taking corporate form: Investments made in science and technology enterprises at seed capital or start-up stage (referred as to "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 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.

The new rules build upon the existing incentive treatment in Guo Shui Fa [2009] No. 87 and SAT Announcement [2015] No. 81. These rules provide that where VC enterprises, taking either corporate or partnership form, invest in non-listed small and medium high and new technology enterprises (HNTE) by way of equity investment then the 70% tax deduction incentive may be obtained (solely for CIT, not for IIT, purposes). A challenge is that for the investees to obtain the HNTE status they must go through a process overseen by MOST and other relevant authorities, limiting the pool of potential investees. The new rules expand the potential investee pool and also allow for the individual VC partnership to apply for IIT purposes.

Going beyond this, the incentive now also applies where individual investors (business angels) make the investment in their own capacity. In such cases, 70% of the investment amount can be offset against taxable gains arising from the 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 enterprise. 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 utilised, then this may 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 given pilot area or whether this covers 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):
  - must be a tax resident enterprise registered in Mainland China which is subject to CIT on an accounts assessment basis;
  - must have fewer than 200 employees, at least 30% of whom must have a university degree. In addition, the investee's assets and annual revenue may not exceed RMB 30 million at the time of investment;

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- must have been in business for no more than 5 years (i.e. 60 months) at the time of investment;
- are not listed in the year in which the investment is made or in the following 2 years; and
- must have incurred at least 20% of total costs and expenses on R&D in the year in which the investment is made and the following tax year.

- For VC enterprises (both corporate and limited partnership form):
  - 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.
  - must register and operate in compliance with the regulations on venture investment stipulated in 10 Departments Order No. 39 or CSRC Order No. 105;
  - the VC enterprises and their related parties may only hold equity interests in technology start-ups which are less than 50% of the share capital of the technology start-ups; and
  - must be registered in the designated areas (i.e., eight pilot innovation areas as stated in the above).
- For individual 'business angel' investors:
  - these cannot be the founders or employees of the invested technology start-ups and cannot supply staff of the technology start-ups. The same restriction applies to family members of individual investors;
  - the individual investors and their family members cannot hold more than 50% of the share capital in such technology start-ups within 2 years after the investment was made;
  - the invested technology start-ups must be registered in the designated areas (i.e., eight pilot innovation areas as stated in the above).
- The tax incentive treatment only applies to equity investments made to technology start-ups by way direct cash subscription for new equity, rather than investment in existing equity transferred from other existing share holders of the technology start-ups.

For detailed implications of this new rule, please refer to KPMG *China Tax Alert (Issue 15, May 2017)*.

❑ *Notice on expanding pilot policy of individual income tax on commercial health insurance for nationwide implementation (Cai Shui [2017] No. 39)*

Preferential tax treatment for premiums paid to eligible commercial health insurance providers shall be applied on a nationwide basis from 1 July 2017.

- Premiums paid to eligible commercial health insurance providers are allowed to be deducted up to RMB2,400 per person per year (RMB200/per month) for individual income tax (IIT) purposes.
- Where an enterprise purchases eligible commercial health insurance products for its employees, such expenditure shall be included in the employees' taxable wages and salaries. The purchase is deemed as being made by these employees and the premiums paid are allowed to deducted, by the employees for IIT purposes, up to the limit as stated above.

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- Taxpayers who may apply this preferential tax treatment include:
  - individuals obtaining wages and salaries or compensation for the provision of continuous services;
  - sole traders deriving income from business operations
  - Sole traders, owners of sole proprietorship enterprises, and partners in partnership enterprises, deriving income from leases or provision of contract services to enterprises or public institutions.

- *Notice on continuation of existing preferential urban and township land use tax treatment on land used by logistics enterprises for bulk commodity warehousing facilities (Cai Shui [2017] No. 33)*

  Notice on continuation of existing VAT policy for cable TV subscription Fee (Cai Shui [2017] No. 35)

  Notice on continuation of existing VAT policy for Xinjiang International Grand Bazaar Project (Cai Shui [2017] No. 36)

  The following existing tax incentives will continue to be implemented from 1 January 2017 to 31 December 2019:

  - 50% reduction of urban and township land use tax (UTLUT) levied on land used for construction of bulk commodity warehousing facilities owned by logistics enterprises. Land used for offices, living quarters, and other land not directly used for bulk commodity warehousing by logistics enterprise shall be subject to UTLUT.
  - basic maintenance fees for cable digital television in non-rural areas, and basic charges for cable television in rural areas collected by broadcasting and television operation services enterprises, shall be exempted from VAT.
  - Income derived from taxable activities in relation to Xinjiang International Grand Bazaar Project carried out by Xinjiang International Bazaar Property Service Co., Ltd. and Xinjiang International Bazar Culture Tourism Industry Co., Ltd. shall be exempted from VAT.

Tax policies on lease of collectively-owned land clarified

Reference: Cai Shui [2017] No. 29
Issuance date: 31 March 2017
Effective date: N/A

Relevant industries: All
Relevant companies: All
Relevant taxes: UTLUT

Potential impacts on businesses:
- Compliance risks due to regulatory uncertainties reduced

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On 31 March 2017, the MOF and the SAT jointly issued Cai Shui [2017] No. 29 ("Circular 29"). This clarifies that lease of construction land collectively owned by rural dwellers shall be subject to the UTLUT and the UTLUT shall be paid by entities or individuals which directly lease land from collective economic organizations.

The existing rule, Cai Shui [2006] No. 56 only provided that, actual user (including enterprise and individual) of taxable collectively-owned construction land shall be subject to the UTLUT if the transfer formalities in respect of the right to use land has not been gone through. Circular 29 provides a clarification on who should be taxpayer of UTLUT for lease of collectively-owned construction land.

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Reference: Shui Zong Fa [2017] No. 42
Issuance date: 24 April 2017
Effective date: N/A

Relevant industries: All
Relevant companies: All
Relevant taxes: N/A

Potential impacts on businesses:
- Operational costs reduced
- Risks of being challenged due to cross-border tax anti-avoidance arrangements reduced

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Tax efforts to serve the "Belt and Road" initiative

On 24 April 2017, the SAT issued Shui Zong Fa [2017] No. 42 setting out tax administration initiatives to better serve the "Belt and Road" initiative:

- **Ensure tax treaties implementation and improve domestic tax policies.** Tax authorities at all levels are required to:
  - i. Ensure that Chinese residents enjoy the benefits of China's tax treaties with other countries through monitoring and support;
  - ii. Monitor the occurrence of tax disputes between "going out" enterprises and foreign tax authorities. Report to the SAT and provide assistance with the conduct of mutual agreement procedures (MAP);
  - iii. Implement domestic tax policies relevant to outbound activities, such as VAT refund (exemption) for cross-border taxable services and CIT tax credit for overseas income.
- **Improve tax services for "going out" enterprises.** These include (i). categorisation of enterprises for export VAT refund (exemption); (ii) simplification of procedures for export VAT refund (exemption); (iii). Issuance of China tax resident certificates.
- **Tax guidance publications for investee countries.** The SAT has released 59 investment tax guides for investee countries. These cover almost all countries along the "Belt and Road" (all will be covered by end 2017) and several other major overseas investment destinations. These cover foreign business regulations, tax rules, and relevant bilateral tax treaties.
- **International taxation cooperation.** Tax authorities at all levels are required to implement bilateral cooperative memoranda signed with the tax administrations of countries along the "Belt and Road". They are to actively participate in regional communication and cooperation platforms, such as the China-Eurasia Expo. Mechanisms shall also be established to provide for cross-border transaction information sharing between the SAT and other authorities, such as SAFE, MOFCOM, NDRC, GAC, and the Exit-Entry Administration**.**

By the end of April 2017, China had signed 106 bilateral tax treaties. Together with other arrangements, such as tax information and exchange agreements, there were agreements with 116 countries and regions in place. 54 of these are with countries along the "Belt and Road".

Two relevant 'going out' cases were reported on SAT's official WeChat, with a view to explaining to 'going out' enterprises how the Chinese tax authorities could assist them. One case concerned a Shandong company undertaking construction of a thermal energy power plant in Kazakhstan. In this case, the timely issuance of a China tax residence certificate by the Chinese tax authorities allowed for a reduction from 15% to 5% in the CIT rate paid (RMB2 million reduction). A second case involved a Fujian company which made an investment in Malaysia and was subject to significant interest withholding tax exposures. In response to this the Chinese and Malaysian authorities negotiated a protocol to the China-Malaysia tax treaty, reducing the interest withholding tax exposure. The enterprise in question was relieve of RMB34 million in tax.

The SAT further noted in their WeChat article that the SAT, since 2013, has negotiated 181 MAP cases and eliminated double tax exposures of RMB13.1 billion (US$1.9 billion) for outbound investors in the process. Increasing overseas investment will inevitably lead to more disputes in future, requiring greater use of tax treaties and MAP by "going out" enterprises, looking forward.

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Reference: N/A
Issuance date: N/A
Effective date: N/A

Relevant industries: All
Relevant companies: MNEs
Relevant taxes: N/A

Potential impacts on businesses:
- Risks of being challenged due to cross-border tax anti-avoidance arrangements increased

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OECD update on CbC global exchange relationships

The Organisation for Economic Cooperation and Development (OECD) on 4 May 2017 announced that international exchanges of Country-by-Country (CbC) reports (BEPS Action 13) are currently facilitated by more than 700 automatic exchange bilateral relationships. Most of these relationships are facilitated under the Multilateral Competent Authority Agreement on the Exchange of CbC Reports ("the CbC MCAA") and others under bilateral agreements. China, while a signatory to the CbC MCAA, has yet to nominate any bilateral exchange relationships, though time remains as China's exchanges will commence in 2018.

The full list of automatic exchange relationships that are now in place is available on the OECD website, together with an update on the implementation of the domestic legal framework for CbC Reporting in jurisdictions; on jurisdictions that will permit surrogate filing and voluntary parent surrogate filing; and on steps that are being taken to address concerns about local filing being applied before the end of 2017. Regular updates will be published on the OECD website on exchange relationships to provide clarity for MNE Groups and tax administrations.

* State Administration of Taxation (SAT) Announcement [2016] No. 42 provides China's CbC administrative guidance, together with a supplementary SAT announcement on 27 March 2017. You may refer to below our KPMG publications for more details:

- ❑ *China Tax Weekly Update (Issue 13, April 2017)*
- ❑ *China Tax Weekly Update (Issue 27, July 2016)*
- ❑ *China Tax Alert: State Administration of Taxation (SAT) Issued Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation (Issue 23, July 2016)*

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