Tax impacts of public-private partnership (PPP) projects in China

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Background to this publication

In China, the concept of public-private partnerships ("PPPs") is not new as they were introduced into China in the mid-1990s. The 13th Five-Year Plan for Economic and Social Development of the People's Republic of China ("the 13th Five-Year Plan") encourages the private sector to:

- invest, construct and operate infrastructure and public utilities;
- enter into environmental infrastructure construction;
- invest in public services which can be provided jointly by the government and private sector; and
- expand market access to the private sector.

On 22 May 2015, the State Council issued an announcement which provided guidance on promoting PPPs for public services (Guobanfa [2015] No. 42). The announcement, which serves as guidance to the development of PPPs, clearly states that, the promotion of PPPs in delivering public services is an important reform measure to transform government functions, to stimulate market vitality and to create new economic growth points.

It is also an important approach to protect and improve people's livelihoods. This announcement expands the scope of industries eligible for PPPs, calls for the establishment of a system which can guarantee the sustainability and healthy development of PPPs, regulates the implementation of PPP projects, and provides a policy framework.

Recently, PPPs have become amongst the most active part of the new economy, like other hotspots such as "Internet +" and "mass entrepreneurship and innovation". As at 31 December 2016, there were 11,260 PPP projects in the Ministry of Finance's ("MOF's") project database with a total investment of RMB13.5 trillion[1]. With the booming development of PPPs, their associated tax issues will become increasingly prominent.

Legislative work in relation to PPPs is currently underway. Prior to its release, KPMG would like to launch this publication which focuses on the impact of tax policies on PPPs projects. We hope this publication will be useful to companies participating in PPPs and provide insight into the tax issues that those entering into financing, operating, or exiting PPPs need to be aware of.

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1 The fifth seasonal report from the National PPP information platform project database, PPP Centre of MOF.

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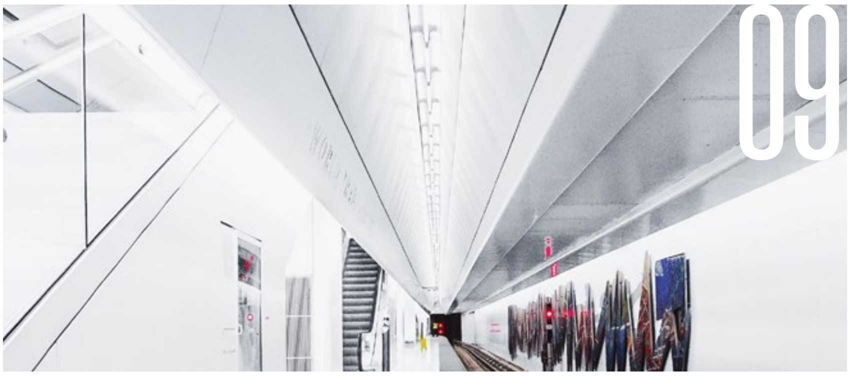


Introduction to PPPs

Concept of PPPs and its development in China

Increasingly the Chinese government is embracing private sector involvement in the development, operation and/or maintenance of major infrastructure projects. These projects are commonly given the acronym PPPs.

In its simplest form, under PPPs, the government selects the most competitive private sector bidder in terms of investment, operation and management capability. The two parties enter into a contract based on the principle of equal consultation, which clarifies the rights and obligations of both parties. In practice, the private sector provides the public with services, the government pays the private sector based on the public service performance evaluation results, which insure the private sector obtains a reasonable income.

PPPs have been used by the government as the means of obtaining new infrastructure which is contributed, developed, operated and/or financed, by the private sector. There are a myriad of reasons why a PPP may be preferred over traditional forms of government infrastructure investment, including cost effectiveness, supplement of expertise or experience, risk sharing; or moving a project off government balance sheet.

Over the past few years, PPPs have been commonly used in China as a means of developing or operating a diverse range of infrastructure assets such as highways, utilities, waste processing facilities, housing, healthcare and education facilities.

With a significant focus on government balance sheets and the need for fiscal discipline, it is quite clear that the growth and development of PPPs in China is not merely a passing fad, but is a key part of an economic development strategy of the Chinese government, explicitly supported by China's State Council. However, as with many aspects of doing business in China, these developments from a commercial perspective often precede the establishment of clear legal frameworks and a taxation system to support them. PPPs are no different.

From a taxation perspective, in China the government itself (whether at a central or local level) are not part of the tax system as it may be considered nonsensical for the government to tax itself. However, as the government is outside the tax system it adds to the complexities which arise in relation to PPPs. This is examined further below.

Types of PPPs

As a starting point, the concept of a PPP is itself imprecise. Put simply, there is no formal definition. Rather, PPPs will tend to have certain attributes to them, such as risk sharing, the formation of a long-term relationship between the government and private sector, the development or operation of public sector assets, and a focus on outputs or service delivery.[2]

Given the imprecision in the concept of a PPP, it is not necessarily possible to be prescriptive in terms of the tax consequences. As such, what we have sought to do in this publication is to highlight some of the more common PPP models used in China, and then go through the lifecycle of a PPP to highlight the key tax issues which can arise. Obviously not all projects will have all of these issues arising, and therefore this publication should be viewed more as providing a framework from which to consider the issues.

2 See for example, International Monetary Fund, "Public-Private Partnerships", 12 March 2004.

Some of the major PPP models include:

Category	Model	Brief description	What the private company earns
New projects	BOT (Build-operate-transfer)	• The private company is responsible for building / constructing the project with its funds. • The private company is responsible for the operation, maintenance and client servicing work in its own capacity . • The private company will transfer the ownership back to government upon the time as agreed in the contract.	• Operating income • Transfer consideration
	BOO (Build-own-operate)	• The private company is responsible for building / constructing the project with its funds. • The private company is responsible for the operation, maintenance and client servicing work in its own capacity. • There is no need for the private company to transfer the project to the government, but likely the government may impose some restrictions on the operation (e.g. to preserve certain public interest considerations).	• Operating income
	BLT (Build-lease-transfer)	• The private company is responsible for building / constructing the project with its funds. • Upon completion of the construction, the private company will lease the premises to the government for its operation, in return for leasing income. • The private company will transfer the ownership back to government upon the time as agreed in the contract.	• Leasing income • Transfer consideration
	BOOST (Build-own-operation-subsidies-transfer)	• This model is similar to the BOT model. The main difference is that under BOOST model, the private company may also receive subsidies from the government for reasons such as the high risk nature of the project.	• Operating income • Government subsidies • Transfer consideration
Operation of existing projects	MC (Management contract)	• Government subcontracts the operation, maintenance and client servicing work to the private company and pays a sub-contracting fee.	• Sub-contracting fee
	O&M (Operations & maintenance)	• Government subcontracts the operation and maintenance work to a private company and pays a sub-contracting fee.	• Sub-contracting fee
	TOT (Transfer-operate-transfer)	• Government transfers its existing project ownership to a private company. • The private company is responsible for the operation, maintenance and client servicing work in its own capacity. • The private company will transfer the ownership back to the government at an agreed time per the contract.	• Operating income • Transfer consideration

Expansion or renovation of existing projects	ROT (Renovate-operate-transfer)	• Government transfers existing project ownership to the private company, and the private company is responsible for the renovation before its operation. • The private company is responsible for the operation, maintenance and client servicing work in its own capacity. • The private company will transfer the ownership back to government at an agreed time per the contract.	• Operating income • Transfer consideration
	LOT (Lease-operate-transfer)	• Government is responsible for the investment of public assets and retains ownership of them. • Government leases existing projects and new projects to the private sector and the private sector is responsible for operation, maintenance and client servicing work.	• Operating income

Payment mechanisms for PPPs

Normally, there are three types of payment mechanisms for PPPs (meaning the ways in which the private company obtains a return on its investment). They are:

User charge

When end consumers purchase public goods and services, they pay the project company directly[3] to enable the project company to recover its construction and operating costs. In general, a user charge mechanism is applicable for public transport projects (e.g. highways, bridges, subways and others) and public utilities projects (e.g. water supply, heating and others).

Government payment

The government pays fees directly to the project company to purchase public products and services, including by way of availability payments, usage payments and performance payments. The government's payments are predominantly based on the following elements: facility availability, usage and quality of products and services[4]. This method is a common payment mechanism in public utilities and public services projects, and is also used in some public transport projects.

Viability gap funding

Under this mechanism, if the fees collected by the project company from end consumers are insufficient to cover the private company's reasonable capital return or the project company cannot recover its costs, the government will grant certain economic subsidies to the private company or the project company, such as financial subsidies, equity investments, concessional loans and other preferential policies[5]. Viability gap funding is a compromise between government payment mechanisms and user charge mechanisms. In China there are many forms of viability gap funding, including land allocation, investment in shares, investment subsidies, preferential loans, loan discounts, abandonment of dividends, and the grant of project development usufruct.

3 Circular Caijin [2014] No. 113
4 Circular Caijin [2014] No. 113
5 Circular Caijin [2014] No. 113

Difficult tax issues for PPPs

Value added tax ("VAT") issues for PPPs

As noted earlier, there are very few VAT rules in China which currently specifically or directly impact on PPPs. Instead, the challenge is in applying very general principles to the intricacies of PPP structures. There are, however, two rules which are worthy of specific note. They are:

- Subsidies provided by the central government are exempt from VAT[6]. Whilst this provision is relatively simple on its face, it does raise the question as to whether subsidies from local government are therefore taxed for VAT purposes, and similarly, what is meant by the term "subsidy"; and
- Government, both central and local, is not within the VAT system in China.

In the following section of this publication, we examine the tax issues which commonly arise in China in relation to PPPs. However before doing so, we would like to make some brief observations which highlight two key VAT problems which recur in one way or another across each of the VAT issues we have identified.

First problem – government breaks the chain

The first problem is that government in China is not part of the VAT system. That is, government, whether at a central level or at a local level, is not registered for VAT purposes in China. This means that they do not account for VAT on the goods and services they supply, and they do not claim input VAT credits for the expenses they incur. In VAT parlance used in China, we describe government as 'breaking the chain' – this means that they can neither issue VAT invoices to service recipients, nor receive VAT invoices from suppliers they engage.

The idea of government being excluded from the VAT system is not unique by international standards, and in a revenue raising sense the idea of taxing government is largely pointless (because it simply creates 'churn' – that is, revenue which is raised from government is later directed towards government providing services). However, international experience often highlights the need for special rules to deal with situations in which businesses and citizens transact with government.

There are essentially three different approaches adopted internationally, which may be categorised as follows:

- Full taxation - This is the approach adopted in countries like New Zealand and Australia, both of which have broad based systems in which government is treated like any other VAT taxpayer (with a few special exceptions).
- Exemption – Under the European Union's 6th Directive, the activities of States, regional and local government authorities as well as other bodies governed by public law are effectively exempted from VAT in respect of the activities or transactions in which they engage in as public authorities, except where exemption would "significantly distort competition". This has led to a reasonably large body of case law and disputes as to the scope of activities performed as public authorities and whether exemption applies or not, and similarly, whether competition is significantly distorted.
- Zero rating – some countries apply zero rating to certain charitable activities, as well as limited activities or transactions of government, such as the provision of education and healthcare.

It is generally accepted from a policy perspective that even where government is brought within a VAT system, not all transactions by government should be subject to VAT. For example, governments levying fines, penalties and imposing taxes should not be subject to VAT, or where governments are carrying out non-commercial activities for those in need. By contrast, it is less clear

[6] State Administration of Taxation Announcement [2013] No. 3

from a policy perspective whether governments should be excluded from accounting for VAT when they are carrying on commercial activities, especially where those activities may compete with those performed by the private sector.

The problem, even in countries which either exclude government from the VAT system, or alternatively provide them with an exemption for some or all of their activities, is that the existence of an exemption can have significantly adverse flow-on impacts for the private sector when dealing with government. By way of example:

1. If government is exempt from VAT, and it stands in the middle of a supply chain, then effectively the costs incurred in early stages of the supply chain become blocked or trapped. This is referred to as the cascading effect.

2. If the private sector buys goods or services from government, then it will be unable to claim an input VAT credit for the purchase. The result is that the private sector entity is taxed on an amount greater than their 'value added'.

3. If the private sector sells goods or services to government, then government will be ineligible to claim an input VAT credit, and therefore may resist VAT being added to the price. It also results in the cascading effect described in point 1 above.

What the international examples highlight is that while there is no 'perfect' solution for dealing with government in a VAT system, it is generally accepted that fewer problems arise if the activities of government are primarily included within a VAT system, and then certain exceptions can be created to deal with meritorious circumstances. As such, while China's VAT system continues to apply a blanket exclusion of government from the VAT system, these inefficiencies or technical issues will either continue, or require band-aid solutions. Typically though, such solutions then give rise to further band-aid solutions to be administered from time to time, often resulting in messy and sometimes inappropriate policy outcomes.

Second problem – tripartite transactions

The second core problem is commonly known as the 'tripartite' tax problem. More specifically, VAT as a form of taxation works effectively when there is a transaction between two parties – a supplier and a recipient. However, when there is a third party introduced into the transaction, complexities arise. The case law from other countries with VAT/GST systems is littered with the wreckage of taxpayers, or tax authorities, seeking to resolve difficult VAT or GST disputes which involve three parties. In short, governments are far more prone to engaging in tripartite transactions.

In the context of PPPs, tripartite arrangements (or even 4 or more parties) are common. They are common because the essence of a PPP is a 'partnership' between two parties, government and the private sector, to deliver infrastructure and provide services to a third party, usually the general public. As noted, frequently there are additional parties involved as well, such as financiers, investors, and multiple government agencies. Often these parties do not interact with each other on normal arm's length commercial terms, because of subsidy arrangements or similar concessions which the government is trying to bestow on the general public.

To put the tripartite problem into a theoretical context, often it manifests itself in two different ways. Either:

- Party A provides goods or services to party B, with party C paying for those goods or services (referred as a 'third party payer'). The question which often arises here is who is entitled to the input VAT credit, and therefore who should receive the special VAT invoice.
- Party A provides goods or services to party B, but party C (often government) provides a subsidy or other financial benefit to party B to help defray the true cost of the goods or services. The question which arises is whether Party A should be liable for VAT on the value of the goods or services it supplies to party B inclusive or exclusive of the subsidy, and furthermore, whether party B should also account for VAT in relation to the receipt of the subsidy from the government.

An analysis of hundreds of cases which have arisen internationally will often leave the reader to declare that the only principle of application is that each example turns on its own facts. While this may seem unhelpful, most of the battle is already won if the tripartite problem is identified before it arises, and then legal or commercial protections are put in place to manage the risks and liabilities between the parties. The early experience with China's VAT reforms since May 2016 has highlighted an extraordinarily high correlation between tax risks and disputes, and tripartite arrangements.

Two real cases in which KPMG member firms have acted may be used to illustrate the problems which can arise with PPPs. Both of these cases are publicly reported, having reached the highest levels of the judicial system in Australia, and therefore the names of the parties involved and the facts are already a matter of public record. However, the facts of the cases have been simplified considerably, for ease of reading.

Case 1

The first case, which is reported as *FCT v Gloxinia Investments* [2010] FCAFC 46, involved a PPP between government and the private sector for a residential property development. In essence, the government granted a lease to a developer (for a nominal rental) solely to allow it to enter the land and carry on the development. Upon completion of the development, the government would transfer the land to the developer, and the developer would pay the purchase price reflecting the land value only (because the developer had met the construction / development costs out of its own funds). The developer would then sell the completed residential apartments to the general public. This structure was commonly adopted because it allowed the government control over ensuring the development was carried out to its satisfaction before it would agree to the transfer of the land to the developer.

The issue in this case essentially turned on whether it was appropriate to look at the overall commercial substance of the arrangements, or the legal form. Here they differed. If the focus is on the commercial substance, then essentially the relevant transactions are:

1. the supply of undeveloped land by the government to a developer;
2. the construction of the apartments on the land by the developer; and
3. the sale of the completed apartments to the general public.

By contrast, if the focus is on the legal form of the transactions, then the transactions are:

4. a transfer of the land and buildings by the government to the developer upon completion of the construction;
5. followed by a transfer of the completed apartments to the general public.

Ultimately the court held that the legal form of the transactions needed to be followed, not the commercial substance, so the developer was successful in its case.

In an Australian GST context, the difference between the commercial substance and the legal form was important, because the Australian GST law taxes the sale of new residential apartments but exempts resale of residential apartments. So following the commercial substance meant that (3) would be subject to GST, whereas if the legal form is followed, (5) is exempt from GST. The government later moved to change the law after the taxpayer was successful.

The relevance of this case in a Chinese context is that if a private sector developer carries on development on land owned by the government (as is common in PPP structures), and then sells the completed development to the public, then there is a question as to whether the developer should be regarded as supplying construction / development services to the government, and similarly whether the nature of what is supplied to the public is of both the land and buildings, and if so, which party supplies the land and which party supplies the buildings.

Case 2

The second case involved a transportation infrastructure PPP. In essence, a company called TT-Line was engaged to provide a ferry service between the mainland of Australia and Tasmania (a State located south of the mainland) to members of the public. The Australian government provided a subsidy towards the price of each ticket sold by TT-Line. That is, every time TT-Line sold a ticket to a customer for say $300, the Australian government would pay TT-Line a subsidy of $100, with the aim of the subsidy being to reduce the price to the customer (to $200). The intention of the Australian government in providing the subsidy was to remove the additional cost which people in Tasmania incur in travelling to other parts of Australia that people who live on the mainland of Australia do not incur. In effect, it was designed to equalise travel costs between different parts of Australia. It is akin to viability gap funding that we discussed earlier.

Ultimately, the Court held that when TT-Line sells a ticket to a customer, it would be subject to GST on the full value of the tickets it sold, inclusive of the subsidy it received. That is, GST was levied on $300, not $200. Furthermore, the Court effectively held that the subsidy was not to be regarded as a transaction between TT-Line and the Commonwealth government (for which an exemption from GST was potentially available), but as a payment by a third party (the Commonwealth government) to the customer for a service supplied by TT-Line to the customer.[7] So in essence, the uncertainty in the case was to understand whether the $100 subsidy was consideration for a transaction by TT-Line with the Commonwealth (and if so, whether it is exempt from GST), or consideration for a transaction by TT-Line with the general public.

Similarly, in a Chinese context the relevance of this case is whether the exemption from VAT applicable to subsidies provided by the central government also extends to situations where the subsidy impacts on the price paid by the public for goods and services they consume. It is also relevant in situations where the subsidy is paid specifically to affect or reduce the price of goods or services supplied to consumers.

Already in a Chinese VAT context, these types of issues are starting to emerge. For example, the problem of government 'breaking the chain' has arisen in the context of property development activities. Specifically, when the local government grants land use rights to a developer, no VAT is levied on that transaction. However, Circular Caishui [2016] 36 specifically allowed developers to deduct the land purchase price from the sale price in calculating their VAT liabilities – otherwise, developers would be taxed on an amount which is greater than the 'value added'. The introduction of this concession then highlighted a further problem, being that developers would still be unable to deduct the value of land compensation payments they make – for example, payments made to the general public to compensate them for their relocation. Again, from a policy perspective the problem is that developers incur these costs as part of their normal operations; they are unable to claim an input VAT credit for these costs; yet unless these costs are taken into account in calculating the 'margin' upon which they pay VAT, they end up being taxed on an amount greater than the 'value added'. While this was ultimately addressed by Circular Caishui [2016] 140, it highlights the core problem that if government is excluded from the VAT system, often many rounds of patchwork solutions will be needed.

The ultimate question for the policymakers in China is whether they wish to continue dealing with the symptoms, or deal with the problem itself.

7 The case is reported as *TT-Line Company Pty Ltd v FCT* [2009] FCAFC 178.

Corporate income tax ("CIT") issues for PPPs

There are no specific CIT rules for PPPs. Currently, a series of preferential policies, which have already been granted to public infrastructure and public services, can be equally enjoyed by the PPP project company. Therefore, we do not expect the policy makers to issue preferential policies specifically for project companies in the future. However, the additional tax burden due to the introduction of the PPP model can be exempted based on the tax principles of fairness and neutrality.

There are two difficult issues which arise when implementing PPPs from a CIT perspective, which are:

- Whether payments and the subsidies provided by the government during the operation stage can be regarded as non-taxable income?
- Whether the special tax treatment is applicable for assets transferred during the lifecycle of a PPP? Related to this, whether there will be any preferential policy specially issued for assets transferred during the lifecycle of a PPP project?

First problem – CIT treatment of payments and subsidies provided by the government

The first problem is, under the government payment model and viability gap funding model, whether or not payments and subsidies provided by the government during the operation stage can be regarded as non-taxable income for the project company.

In the case of PPPs under the user charge model, the project company could obtain operating income from the market and it is reasonable to impose CIT on the fees income collected from end consumers. However, for PPPs under the government payment model and viability gap funding model, imposing CIT on payments or subsidies provided by the government would mean, to a certain extent, that the local government is granting subsidies to the central government.

Specifically, the local government pays the PPP project company directly or provides subsidies to the PPP project. If CIT is imposed on these payments or subsidies provided by local government, the majority of the local government payments and subsidies would be turned over to the central government following the CIT revenue sharing between central and local governments (60:40). In other words, the local government will be providing subsidies to the central government. This is not consistent with the original intention of the use of PPPs to reduce the debt burden of local governments.

Currently, Circular Caishui [2008] No. 151 and Caishui [2011] No. 70 clearly set out the CIT treatment of government subsidies. For certain subsidies obtained from the government (provided special criteria are met), the company can treat them as non CIT taxable income and deduct them from the company's total income when calculating its CIT. However, it is still very uncertain whether the project company could apply the abovementioned Circulars to treat the government payment and subsidies it receives as non CIT taxable income.

Also, the MOF has recently issued Circular Caikuai [2017] No. 15 which modifies the No. 16 Accounting Standards for Enterprises of Government Subsidies. This Circular clarifies the definition of "government subsidy" and emphasizes its gratuitous character. Accordingly, "government subsidies" are defined as monetary or non-monetary assets obtained by enterprises from the government without any consideration. In order words, companies do not have to sell any goods or provide any services as consideration for the economic resources received from the government.

In addition, the Circular also stipulates that the economic resources obtained from the government by the company shall be subject to the No. 14 Accounting Standards of Revenue. Meaning that they shall not be recognized as government subsidies if they are closely related to the activities conducted by the company, such as the sale of goods or the provision of services, and are part of the consideration for the sale of goods or the provision of services. However, it shall be noted that the Circular is an update of the accounting standards and does not provide any clarifications from a CIT perspective. It is not clear if the policy makers will issue CIT regulations to clarify the tax treatment, however we hope that they will consider this in order to clarify the relevant policies.

Second problem – CIT treatment of asset transfers under PPP projects

Multiple asset transfers will be involved through the lifecycle of a PPP project, such as:

- At the establishment stage, the private company may invest non-monetary assets into the project company;
- Under the transfer-operate-transfer (TOT) or renovate-operate-transfer (ROT) models, the local government may transfer certain existing facilities to the project company; and
- At the exit stage, the project company needs to transfer the facilities back to the government.

Currently, there are no CIT specific rules on asset transfers made during the lifecycle of a PPP project. According to the prevailing CIT regulations, the private company and the project company are required to pay CIT on the asset transfers occurring during the lifecycle of PPP projects. If certain criteria are met, special tax treatment can apply to such transfers. However, in practice, these criteria may not be met when the government transfers the assets or equity into the PPP project, or, when the project company transfers back the assets or equity to the government at the exit stage.

In the above situation, the market value of assets or equity should be applied and the gains derived from the asset or equity transfer should be recognized. Given that the nature of the "transfer" is for financing purposes rather than trading the assets or equity, it would be more appropriate to issue special CIT rules to exempt the potential gain in order to be aligned with the nature of the "transfer".

As outlined above, due to the particularities of PPP projects, we recommend that the policy makers consider issuing special preferential policies regarding asset transfers under PPP projects to facilitate their development.

Circular Caishui [2009] No. 59, Circular Caishui [2014] No. 109 and Circular Caishui [2014] No. 116 currently provide special CIT rules for private companies investing non-monetary assets into the project company at the establishment stage.

According to Circular Caishui [2009] No. 59 and Circular Caishui [2014] No. 109, if all of the following criteria are met, the special tax treatment shall apply, meaning that the transferee should use the original tax base of the transferred assets obtained and the transferor does not need to recognize the gains derived from the asset transfer:

1. There are reasonable commercial purposes and the main purpose shall not be reduction, exemption or postponement of tax payments;
2. At least 50% of the target's assets are acquired;
3. The original substantial business operation shall not be changed within 12 consecutive months following the restructuring;
4. 85% of the overall consideration consists of equity consideration; and
5. The original key shareholders who obtain the equity payment during restructuring shall not transfer the equity obtained within 12 consecutive months following the restructuring.

However, in practice, when the private company invests non-monetary assets into the project company, it is difficult to meet criteria (2) above "At least 50% of target's assets are acquired" and as a consequence the special tax treatment provided by Circular Caishui [2009] No. 59 will not be applied. In the situation where the local government transfers certain existing facilities to the

project company, it is debatable whether the application of the special tax treatment will be favourable for the project company or not.

Circular Caishui [2014] No. 109 provides special tax treatment for equity or share assignment between two resident enterprises which have a 100% direct investment relationship, and between resident enterprises which are 100% directly owned by the same resident enterprise or the same several enterprises, if the following criteria are met:

1. The assignment has a reasonable commercial purpose and is not mainly for the purpose of tax reduction or exemption or deferred tax payment;
2. The original substantial business operation of the assigned equity or assets shall not be changed within 12 consecutive months following the transfer; and
3. Both the transferor and the transferee do not recognize any gain or loss from an accounting perspective.

In practice, if a private company establishes the project company (which means the project company is a wholly owned subsidiary of the private company), when assigning assets to the project company, the private company could also consider applying the special tax treatment provided by Circular Caishui [2014] No. 109.

Circular Caishui [2014] No. 116 provides the following tax deferral treatment for non-monetary asset investment:

1. If a company invests with its non-monetary assets, the company could, within a period up to 5 years, split the gains derived from investment with non-monetary assets evenly into the CIT taxable income in the corresponding year.
2. If a company invests with its non-monetary assets, the company should use the fair market value as the transfer price and recognize the gains derived from the transfer of the non-monetary assets.
3. If a company invests with its non-monetary assets and acquires equity of the invested company, the tax base of the equity obtained should be the original tax base of the non-monetary assets, and should be adjusted annually by adding the transfer gains recognized each year. The tax base of the non-monetary assets obtained by the invested company should be the fair value of the non-monetary assets.
4. If the company transfers the abovementioned equity or withdraws the investment within 5 years, it should stop applying the tax deferral treatment and pay CIT at one-time in the transfer or withdraw year for the transfer gains of the non-monetary assets which have not yet been recognized.
5. If the company cancels its registration within 5 years after the investment, it should stop applying the tax deferral treatment and pay CIT at one-time in the revocation year for the transfer gains of the non-monetary assets which have not yet been recognized.

Finally, at the exit stage, the project company will transfer the assets back to the government. In this case, the government will be the transferee. However, since the government is not a CIT taxpayer, it is very uncertain whether the project company could apply the special tax treatment provided by Circular Caishui [2009] No. 59.

In the following chapters, we will discuss in detail the applicability of the special tax treatment to the asset transfer at each stage.

Tax analysis through the lifecycle of PPP projects

In the following section, we outline the common tax issues surrounding the lifecycle of a common PPP. As noted earlier, each project will have its own attributes, so the purpose of this section is to provide a summary of the tax issues in relation to PPPs generally. Whenever entering into a PPP arrangement, it is necessary that a detailed assessment should be carried out to analyse the potential tax implications of the specific facts of that arrangement.

In general, the lifecycle of a PPP comprises of the following stages:

1 **Establishment**

The stage where the government and the private company establish a vehicle or method of investment by which the project will be carried out. Broadly, this may be done in the form of an equity investment (e.g. under the BOT or TOT models), or entering into subcontracting agreements (e.g. under the O&M or MC models).

2 **Financing**

The stage where financing, most commonly provided externally, may be required. This can take the form of say traditional bank loans, or even sale-and-lease-back arrangements for certain assets.

3 **Design**

Where the pre-implementation studies and designs for the project are carried out. For example, design of the operating structure and procedures, financial forecasts, etc.

4 **Construction / transfer of existing facilities**

Where the facilities for the operation of the project are either acquired or built. Subject to the PPP model adopted, this may be carried out in the form of construction or transfer of existing facilities from the government or state-owned enterprises.

5 **Operation**

Where the private company operates the project or asset to derive income within an agreed period. Subject to the PPP model adopted, the private company may operate the project in its own capacity, or merely act as a sub-contractor in managing the project.

6 **Exit**

The final stage where the PPP arrangement expires and the private company exits the project.

1 Establishment

VAT implications

The VAT implications of the establishment stage can vary depending on how the private investors participate in the project. Broadly, where a new project company is established for the PPP project or there is an equity investment in an existing project company, there are two common ways in which investments may be made:

- **Monetary investment** – this refers to the case where investors acquire equity interests via a capital contribution. Generally, this would not give rise to any VAT liabilities, since the issuance or transfer of equity investments in private companies is not subject to VAT.
- **Asset injection** – this refers to the case where investors acquire equity interests through injecting existing assets into the project company. The VAT treatment of the asset injection depends on the nature of the asset being transferred.

Asset injections typically raise the most complexities from a VAT perspective for a number of reasons. First, there is a threshold question about whether it is subject to VAT as a normal sale transaction (that is, where the consideration for the transfer of the assets is the equity interest which is issued to the investor), or as a deemed sale transaction (essentially a transfer for less than market value). If it is the latter, then problems can arise in that no input VAT credit would ordinarily be available to the counterparty, so the VAT arising in respect of the deemed sale is a real cost. This is especially the case for the injection of fixed assets or inventories, because it is explicitly stated under the VAT provisional rules that the injection of such assets is simply considered as a deemed sale (without the need to assess whether the assets are transferred for less than market value or not). Care therefore needs to be taken to manage any asset injection so as to mitigate the risks of a deemed sale arising.

Second, the VAT treatment of asset injections very much depends on the nature of the underlying assets which are injected into the project company. The VAT implications of different types of assets being injected include the following:

Type of injected assets	VAT implications[8]
Real estate properties	• VAT at 11% or 5% would generally apply to the injection of real estate properties. The tax rate varies depending on whether the underlying properties are subject to the general VAT method or are eligible for the simplified VAT method (for example, if they have been held since 1 May 2016). • It is expected that the investor will issue a special VAT invoice for the transfer, and the project company, can claim an input VAT credit. The input VAT credit may need to be apportioned 60:40 over 2 years. • We note that the VAT treatment is different from the old Business Tax (BT) regime. Specifically, under the old BT rules, equity acquisitions via injection of real estate properties were not subject to BT[9]. However, no similar rule applies under the VAT regime. • The parties may have a significant cash flow issue arising. If, for example, the project company has no other trading activities at the time, the input VAT credit may not be able to be utilised. As such, it must be carried forward and can only be offset against output VAT generated in future tax periods.
Intangible assets	• VAT at 6% would generally apply to the injection of intangible assets. • It is expected that the investor can issue a special VAT invoice for the injection, and the project company can claim an input VAT credit. • Similar to real estate properties, we note that equity acquisitions via injection of intangible assets were not subject to BT. However, no similar rule has been released under the VAT regime.
Fixed assets or inventories	• VAT at 17% or 11% would generally apply to the injection of fixed assets or inventories. The specific tax rate varies depending on the nature of the relevant inventories. • It is expected that the investor can issue a special VAT invoice for the injection, and the project company can claim an input VAT credit. Having said that, as discussed above, there is a relatively higher risk that the transfer of fixed assets or inventories will be considered as a deemed sale transaction. In such case, it might be uncertain whether a special VAT invoice can be issued.

Third, where we state in the table above that an input VAT credit should be available, this is based on the assumption that special VAT invoices can be obtained by the project company. However, we note that this is not necessarily the case, mainly because the government is generally not part of the VAT chain as discussed in an earlier section of this article, and therefore will not always be able to provide special VAT invoices to the project company.

CIT implications

At the establishment stage of a PPP project, the CIT implications of the following two aspects shall be considered:

1. Cash injection and non-monetary assets injection

An injection of cash by the private company to the project company would not give rise to any CIT liabilities.

If the private company invests non-monetary assets (e.g. real estate properties, intangible assets, fixed assets or inventories) in the project company, the private company should recognize the transfer gains from non-monetary assets.

As mentioned above, the private company could directly apply the tax deferral treatment as stipulated in Circular Caishui [2014] No. 116. The transfer gains from non-monetary assets recognised for non-monetary asset investment may, within a period up to 5 years, be split evenly into the CIT taxable income in the corresponding year.

If the non-monetary asset investment assigned by the private company to the project company meets the special tax treatment criteria stipulated in Circular 59 and Circular 109, the private company could choose to apply the special tax treatment. If the special tax treatment

8 All examples in the table assume the transferor entity is registered as a general VAT taxpayer, and so too is the transferee entity.
9 Circular Caishui [2002] No. 191

applies, the private company should use the original tax base to record the tax base of the equity obtained, and the project company should use the original tax base to record the tax base of the transferred assets obtained, i.e. the private company does not need to recognize the gains derived from the asset transfer.

2. Two ways to set up the project company

Generally the project company is established in the legal form of a limited liability company. However, a project company can also be set up in the form of a partnership. Under these two different organizational forms, the CIT implications on the profit distribution differ.

1) Set up the project company under the form of a limited liability company

According to the PRC CIT regulations, dividends or profit repatriation received by a resident company from another resident company should be exempt from CIT. That means, if the private company is a resident company, the dividends received from the project company shall be exempt from CIT. However, if the private company is a non-resident company, in principle, 10% withholding tax shall be applied. Where a double tax treaty has been entered into between China and the country or the region where the non-resident company is established, a preferential withholding tax rate shall be applied.

However, a question arises when the actual dividends received by the private company are higher than its shareholding ratio, whether CIT should apply on the excess dividend (i.e. the private company receives part of the dividend which should be paid to the government)? Should the excess dividends still be regarded as a dividend and therefore exempt from CIT? Or should it be considered as income obtained from the government by the private company? And if so, whether the income should be subject to CIT or not? It is hoped that new regulations clarifying the CIT treatment of excess of dividends will be introduced in the future.

The project company can also be structured as either a subsidiary or a branch office of the private company. The CIT implications are different under these two scenarios:

- Subsidiaries can operate independently from their head office, retain separate accounts and file tax returns on their own. Qualified subsidiaries are able to apply for preferential tax treatment by themselves, and carry out tax planning in a more flexible way.
- Branch offices operate under the name of their head office, the taxable income of the branch offices should be consolidated with the head office's taxable income and therefore any losses incurred either by the branch offices or the head office can offset against each other. Branch offices are neither able to apply for preferential tax policies, nor able to carry out tax planning through effective related party transactions.

2) Set up the project company under the form of a partnership

Limited partnership companies are not subject to CIT. According to Caishui [2008] No. 159, each partner of the partnership should be liable for income tax on the distribution of the partnership's operating income. Where a partner is an individual, he/she shall be liable for individual income tax; where a partner is a legal person or any other organisation, it is liable for CIT. Partnerships are transparent from a CIT perspective which means that the principle of "tax after distribution" shall apply to the operational income and other income generated by the partnership. Normally, there is no risk of double taxation. However, countries around the world may have different tax treatments for partnerships. For example, some countries may require the partnership to pay income tax as a taxpayer, while other countries may require the partners to pay income tax. The risk of double taxation may arise if the project company constitutes a permanent establishment of the foreign partner.

Other tax implications

If the private company uses real estate properties or land use rights as a capital injection, the project company should be liable for deed tax, and both the private company and the project company may be liable for 0.05% stamp duty. If the private company uses fixed assets or inventories as a capital injection, both the private company and the project company may be liable for 0.03% stamp duty. If the private company uses certain intangible assets as a capital injection, such as copyright, trademark exclusive right, patent right, proprietary technology use rights, both the private company and the project company may be liable for 0.05% stamp duty. In addition, the newly established project company should be liable for 0.05% stamp duty for the total amount of booked paid-up capital and capital reserve.

2 Financing

VAT implications

The financing of the PPP takes on extra significance in China because VAT applies to financial services generally in China at the rate of 6%. This includes not only interest on loans, gains on trading in financial products, and fees and charges for financial services. Moreover, because the borrower is generally ineligible to claim an input VAT credit for the interest expense (or for fees and charges directly connected with loan services), the VAT in relation to the financing is a real cost.

We note that the government is promoting the use of Asset-Backed Securitization ("ABS") as an alternative means of financing[10], with the aim of attracting more involvement and funds from private investors. The VAT implications of ABS does require further regulatory clarification. Part of the uncertainty stems from the question as to which party is required to account for VAT on the project income when the income and the underlying project assets have been "collateralized" under the ABS arrangement. That is because the income does not legally belong to the project company, but belongs to the ABS investors instead. We expect there will be further policies issued in this regard.

It is worth noting that aside from borrowing in the form of bank loans, there are other alternative forms of "indirect financing" commonly used in China. This may include leasing of movable or immovable assets, and sale-and-lease-back transactions. The VAT implications of these financing methods are briefly summarized below.

Financing methods	VAT implications
Leasing of movable assets	• VAT at 17% would generally apply.
Leasing of immovable assets	• VAT at 11% or 5% would generally apply. The tax rate varies depending on whether the underlying properties are subject to the general VAT method or the simplified VAT method (which may be applicable if the real estate was held as at 1 May 2016).
Sale-and-lease-back transactions	• Sale-and-lease-back transactions fall within the scope of loan services, and therefore VAT at 6% would generally apply on the interest portion. • Similar to direct lending of funds, the input VAT on the interest expense is not creditable.

CIT implications

If the project company borrows from financial institutions, such as banks, it can deduct the relevant interest expense from its taxable income. While, if the project company borrows from non-financial enterprises at a loan interest rate that is higher than the loan interest rate of the financial institutions for the same period, the project company is not entitled to deduct the excess part of the loan interest expense from its taxable income. In addition, it should be noted that, if the project company (a non- financial institution) borrows from its affiliated parties, and the debt to equity ratio is higher that 2:1, the excess part should not be deducted from the taxable income.

Other tax implications

If the project company borrows from a financial institution or a non-financial institution, both parties are liable for 0.005% stamp duty on the signed loan agreement. If the project company enters into a financial leasing contract (including a sale-and-lease-back contract) with a financial leasing company, both parties are liable for 0.005% stamp duty.

[10] Circular Fagaitouzi [2016] No. 2698

3 Design

VAT implications

It is expected that the project company will generally be entitled to claim input VAT credits for any services or goods purchased in the design stage. For example, input VAT credits at 6% are expected to be available when the project company engages external consultancy firms to carry out feasibility studies for the project.

CIT implications

The project company is entitled to deduct the consultancy fee from its taxable income.

Other tax implications

If the project company enters into engineering related survey and design contracts, both parties are liable for 0.05% stamp duty.

4 Construction / transfer of existing facilities

Construction

VAT implications

In general, the following activities may happen in the construction stage of a project. We briefly summarize the relevant VAT implications associated with each of these activities.

Activities carried out by the company	VAT implications
Acquisition of land use rights	• In most cases, no input VAT credit is available for the acquisition of land use rights from the government. • An exception to this is where the project is related to the development of real estate properties for sale (e.g. public housing). In such a case, the land purchase price paid to the government may be deducted against the sale proceeds when calculating the VAT on later sale.
Engaging external construction company	• Generally speaking, VAT at 11% applies to construction services. The project company can generally claim an input VAT credit to the extent special VAT invoice(s) are obtained. • In some cases, VAT at 3% may instead apply. This applies where: – "Old" construction projects[11] were in place on or before 30 April 2016; or – Construction services are obtained and the principal (i.e. the project company) is responsible for the provision of equipment and materials. • Any input VAT credits arising from the construction of real estate properties is subject to the "60/40-rule", i.e. 60% of the input VAT credit can be claimed immediately while the remaining 40% can be claimed only one year later. We note that currently there appears to be some uncertainty as to whether this treatment applies to the properties under a BOT model[12].
Services associated with construction services	• There are some kinds of services that are usually required before or during the construction stage, but which are outside the scope of construction services from a VAT perspective. • For example, Circular Caishui [2016] 36 provides that environmental impact evaluation services and construction project management services are considered to be "consultancy services" which are subject to VAT at 6%.
Procurement of equipment	• Procurement of equipment is generally subject to VAT at 17%.

CIT implications

The project company is entitled to deduct the construction service fees from its taxable income.

Other tax implications

The project company will be liable for deed tax and 0.05% stamp duty on the acquisition of the land use rights. The project company and the construction company will both be liable for 0.03% stamp duty for the construction and installation contracts. The project company and the goods supplier are both liable for 0.03% stamp duty on the procurement contracts.

11 It refers to the projects which either have a construction permit in place on or before 30 April 2016; or a construction contract with a start date on or before 30 April 2016.

12 According to Circular Caikuai [2008] No. 11, any infrastructure constructed for the purposes of a BOT project should be recognized as financial asset or intangible asset, instead of a fixed asset for accounting purposes.

Transfer of existing facilities

VAT implications

In some cases, the project may require the transfer of existing properties and facilities from the government, rather than the construction of facilities from the very beginning. Examples include projects which are undertaken in the form of a TOT or ROT.

We outline below the relevant VAT implications in respect of the acquisition of existing facilities.

Activities carried out by the project company	VAT implications
Acquisition of real estate properties	• VAT at 11% or 5% would generally apply to the acquisition of real estate properties. The specific tax rate depends on whether the underlying properties are subject to the general VAT method, or the simplified VAT method (for example, where the property was held by the vendor as at 1 May 2016). • The project company can generally claim the input VAT credit to the extent a special VAT invoice(s) is obtained. • Any input VAT credit arising from the acquisition of real estate properties will be subject to the "60/40-rule", i.e. 60% of the input VAT credit can be claimed immediately while the remaining 40% can be claimed only one year later.
Acquisition of equipment	• Acquisition of equipment is generally subject to VAT at 17%.
Renovation of facilities	• Renovation services fall within the scope of construction services from a VAT perspective, and therefore VAT at 11% would generally apply. The project company can claim the input VAT credit to the extent a special VAT invoice(s) is obtained. • If the renovation expenditure exceeds 50% of the cost of the underlying real estate property, the relevant input VAT credit similarly will be subject to the "60/40-rule".

As discussed in earlier sections, the availability of an input VAT credit is based on the assumption that special VAT invoices can be obtained by the project company, which may not necessarily be the case when the government is the vendor / service provider.

CIT implications

We noticed that, in most cases, the local government transfers existing facilities to the project company via its financing platform company. In such cases, the local government's financing platform company is the transferor and needs to recognize the gains derived from the asset transfer.

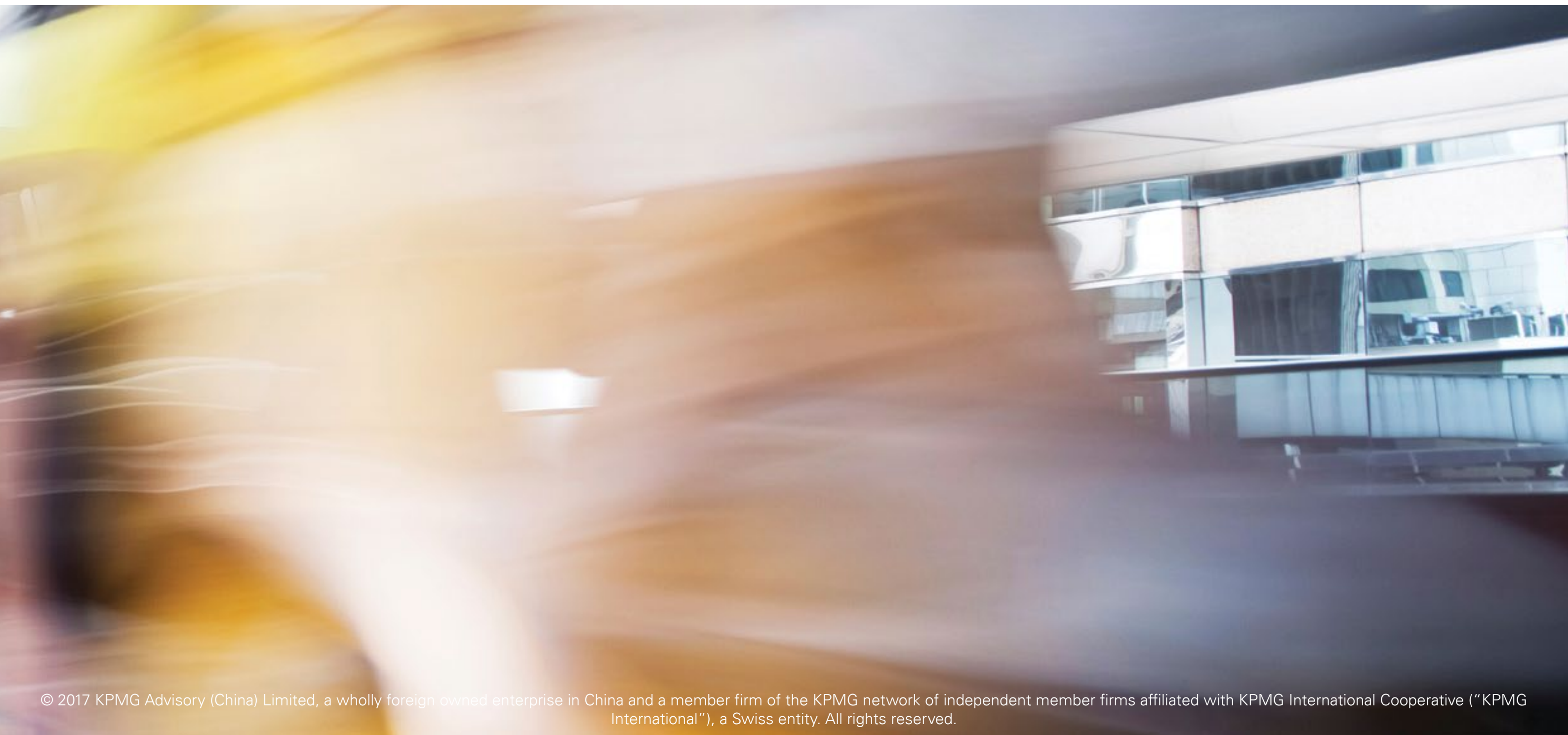
Based on the prevailing CIT regulations, we have considered whether the special tax treatment provided by Circular 59 is applicable for assets transferred at this stage. It is hoped that the policy makers will issue policies to clarify this. If the special tax treatment provided by Circular 59 is applicable, it is favorable to the local government financing platform company as it will not need to recognize the gains derived from the asset transfer. On the other hand, the application of special tax treatment may not be necessarily favorable to the project company for the following reasons:

- If the special tax treatment is applicable, the project company should use the original tax base to record the tax base of the transferred assets obtained, i.e., the book value of the transferred assets in the local government financing platform company. Generally, in this case, the tax base of the transferred assets obtained by the project company will be lower than its fair value. If, at the exit stage, the special tax treatment is not applicable to the asset transfer from the project company to the government, the project company will need to recognize very high gains derived from the asset transfer and will bear more CIT burden.
- If the special tax treatment is not applicable, the project company should use the fair value to record the tax base of the transferred assets obtained. If, at the exit stage, the special tax treatment is not applicable to the asset transfer from the project company to the government, the project company will need to recognize relatively lower gains derived from the asset transfer and will bear less CIT burden.

Therefore, when the local government transfers the existing project to the project company via the financing platform company, the applicability of special tax treatment may not be beneficial to both parties. If the criteria for applying special tax treatment are met, it is worth weighing up the interests of all parties to decide whether to apply the special tax treatment or not. In addition, as mentioned above, in this situation, the purpose of such a "transfer" is not trading the existing assets. We suggest that the policy makers consider issuing a special preferential policy such as granting CIT exemption on gains derived from assets transferred during the whole lifecycle of a PPP project.

Other tax implications

The project company will be liable for deed tax and 0.05% stamp duty on the acquisition of real estate properties or land use rights. If any facilities or goods are involved in the asset transfer, the project company and the goods supplier are both liable for 0.03% stamp duty on the procurement contracts. If certain intangible assets are involved in the asset transfer, such as copyright, trademark exclusive right, patent right, proprietary technology use rights, the project company might be liable for 0.05% stamp duty.



5 Operation

VAT implications

Depending on which PPP models have been adopted by the project, the nature of the income derived by the companies, and hence the corresponding VAT treatment, will be different. Generally speaking, VAT may apply in the following ways:

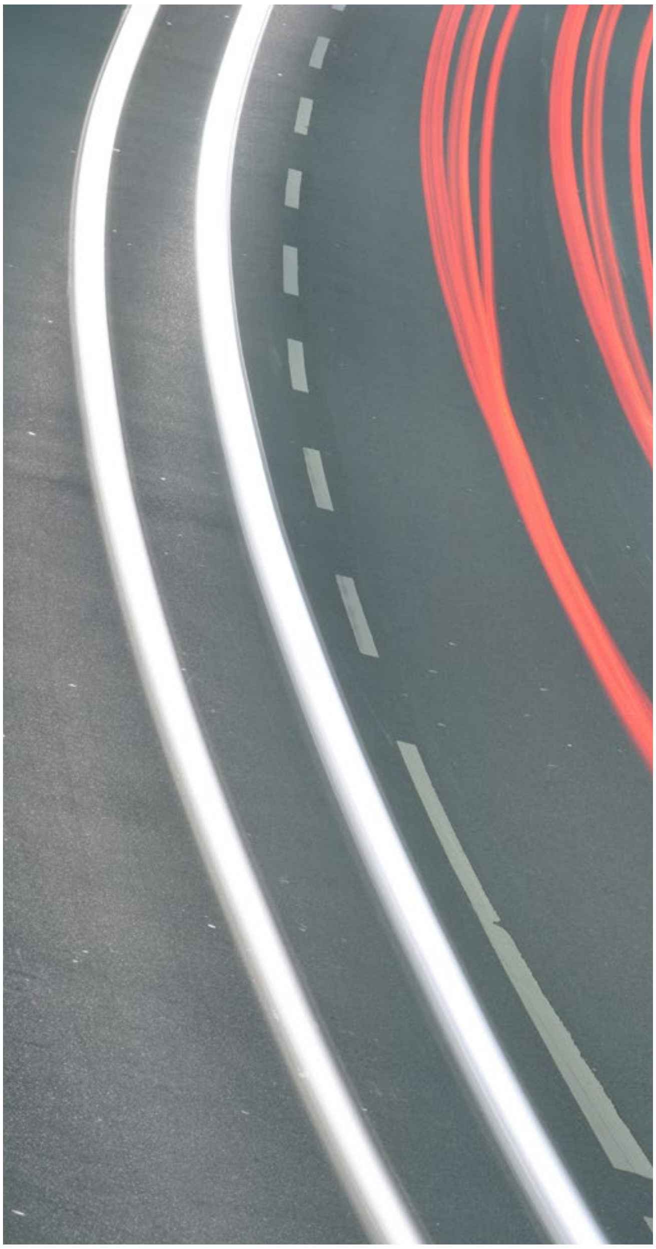
- **Sub-contracting fee** – under the O&M or MC models where the private company does not take ownership of the assets, the private company is instead remunerated for its services by way of a sub-contracting fee for operating the facilities. In most cases, the sub-contracting fee may fall within the scope of "enterprise management services" and VAT at 6% applies.

- **Operating income** – in those PPP models where the private company takes ownership of the assets or business and operates it in its own capacity, the VAT treatment of the revenue it derives from those assets or operations will depend on the nature of the activities. Below is a general summary of the applicable VAT rates.

Nature of transaction	VAT rate
Modern services, financial services, lifestyle services and value-added telecommunication services	6%
Sale and lease of real estate, construction services, transportation services and basic telecommunication services	11%
Lease of movable properties	17%
Sale of goods	11% or 17%

In addition to the above general VAT positions, there may also be VAT preferential or special policies applicable to certain types of business activities, such as VAT exemption for certain healthcare services, partial or full refund of VAT paid (for example, for comprehensive resources utilization), or the adoption of a simplified VAT method for certain types of highways. While this article is not intended to analyse every preferential and special policy that may be applicable for a PPP project, the key message here is that assessment of the output VAT treatment of the revenue derived from the projects must be carried out in advance of the project, as this will directly affect the forecasted return from the project.

- **Government subsidy** – as noted in an earlier section of this article, subsidies provided by the central government are exempt from VAT. Whilst this provision is relatively simple on its face, it does raise the question as to whether subsidies from local government are therefore taxed for VAT purposes, and similarly, what is meant by the term "subsidy".



CIT implications

Currently, there are no specific preferential policies for CIT on PPP projects. In the public service area, PPP projects are mainly used in rail transportation, water supply, heating, waste disposal, comprehensive environment management, sports and medical, etc. The current tax system has given rise to a series of preferential policies for public infrastructure and public services, accordingly, these preferential policies can be equally enjoyed by the PPP project company.

CIT preferential policies are available for investment in, and the operation of, public infrastructure projects eligible for key support from the State, environmental protection or energy and water conservation projects. In particular, income derived from the above projects shall be eligible for tax exemption for the first year to the third year, and a 50% reduction in CIT for the fourth year to the sixth year, starting from the year in which the project first generates operating income.

Public infrastructure projects eligible for key support from the State refers to projects involving ports and wharfs, airports, railways, highways, urban public transportation, electric power, water supplies etc. as prescribed in the "Catalogue of Public Infrastructure Projects Eligible for Preferential Corporate Income Tax Treatment". Environmental protection, energy and water conservation projects shall include public sewage treatment, public garbage treatment, comprehensive development and utilisation of biogas, technology transformation for energy saving and reduced emissions, desalination etc.

Where a company has purchased special equipment for use in environmental protection, energy and water conservation and work safety purposes, 10% of the amount invested in the special equipment may be offset against the company's taxable income of the current year, any excess may be carried forward for 5 succeeding tax years. According to Circular Caishui [2008] No. 48, when a company uses its own funds and bank loans to purchase special equipment, the invested amount can be deducted from taxable income. If a company uses a government subsidy to purchase special equipment, the deduction of the invested amount from taxable income shall not be allowed. If the company subsequently transfers or leases the special equipment they purchased and used for 5 tax years from the purchase date, if they have already started to enjoy the tax incentives, then they should stop enjoying this preferential policy in the month when they stop using the special equipment, and pay back the CIT that has been deducted. The transferee may offset 10% of the amount invested in the special equipment against its taxable income, any excess may be carried forward for 5 succeeding tax years.

Qualified non-profit pension institutions are subject to CIT exemption policy[13]. Both domestic and foreign capital invested pension institutions shall equally enjoy the same tax preferential policies. CIT exemption policy is also applied to income derived by qualified private welfare and non-profit pension institutions.

Medical services income derived by non-profit medical institutions at prices set by the State shall be exempt from all kinds of taxes. This policy shall not be applied to medical services income where the price is higher than the price set by the State. Upon the approval of the tax department, the non-medical services income derived by non-profit medical institutions which is used directly to improve medical and health services conditions can be deducted from taxable income, then CIT will be applied to the balance. Healthcare services income obtained by healthcare institutions and maternal and child healthcare institutions and other health institutions at the price set by the State shall be exempt from all kinds of taxes[14].

PPP projects can also equally enjoy the preferential policies granted by the State to some companies established in certain areas. For example, the policies for Development of Western Regions and preferential tax policies for companies in ethnic autonomous regions.

[13] Circular Guofa [2013] No. 35

[14] Circular Caishuizi [2000] No. 42

6 Exit

VAT implications

VAT liabilities may be triggered upon exit of the project by the project company. Below we highlight the potential VAT treatments which may apply to different exit models.

Exit model	VAT implications
Transfer of facilities	• This refers to the case where the project company needs to transfer the facilities back to the government after the operation for an agreed period of time, under say BOT, TOT or ROT models. • VAT generally applies to the transfer of assets and the applicable rate is subject to the nature of the assets transferred. For example, VAT at 17% should apply to the transfer of equipment and materials, while VAT at 11% or 5% should apply to the transfer of real estate properties. • However, if the overall transaction is considered as a transfer of an on-going business, potentially the transaction can be treated as not subject to VAT. However, our experience indicates that this may be difficult to achieve in practice.
Transfer of operation right	• This refers to the case where the project company is subcontracted to undertake the operating duties in relation to the business or assets, but without taking ownership, such as under the O&M and MC models. • When the sub-contracting arrangement naturally expires, it is expected that no VAT liabilities should arise.

CIT implications

At the exit stage, the project company transfers the facilities back to the government. The government receiving the assets is not a CIT taxpayer, and it is highly uncertain whether or not the special tax treatment can be applied in the same way that it would be if the assets were being transferred from the project company to another company.

It is hoped that the policy makers will consider clarifying the CIT treatment regarding the assets transferred at the exit stage.

Other tax implications

When the project company transfers real estate properties or land use rights back to the government, the project company shall be liable for Land Appreciation Tax (LAT). The project company is also liable for 0.05% stamp duty. If any facilities or goods are involved in the asset transfer, the project company is liable for 0.03% stamp duty. If certain intangible assets are involved in the asset transfer, such as copyright, trademark exclusive right, patent right, proprietary technology use rights, the project company might be liable for 0.05% stamp duty.

Other participants in a PPP project

In addition to the government and major private investors, there are usually many other participants involved in a PPP project. Depending on their roles, they may participate in different stages of the project (e.g. lenders in the financing stage, construction companies in the construction stage) or the overall lifecycle of the project (e.g. various kinds of consultation throughout the project lifecycle), some of which have been briefly discussed in the sections above from the perspective of the project company and private company. For ease of reference, below we briefly summarize again the common participants involved in a PPP project and the general tax treatment of their activities.

Participants	VAT implications	CIT implications	Stamp duty implications
Banks or other lenders	• 6% VAT applies on gross interest income, and they can claim relevant input VAT credits for their expenses	• 25% CIT applies on gross interest income, and they can deduct some of their expenses from the taxable income	• 0.005% stamp duty applies on loan contracts or financial leasing contracts (including sale-and-lease-back contracts)
Construction companies	• Under the general VAT method, 11% VAT applies on gross construction income, and they can claim relevant input VAT credits for their expenses • Alternatively, where the simplified VAT method applies, the net construction income (deducting the amounts paid to sub-contractors) is subject to 3% VAT, but no input VAT credits can be claimed • The simplified VAT method applies where: – "Old" construction projects[15] were in place on or before 30 April 2016; or – Construction services are provided (i.e. the project company) is responsible for the provision of equipment and materials	• 25% CIT applies on gross construction service income, and they can deduct some of their expenses from the taxable income	• 0.03% stamp duty applies on construction and installation contracts • 0.03% stamp duty applies on sales contracts when construction companies sell equipment to the project company
Consultants (e.g. legal, tax, management, engineering and design for construction projects)	• 6% VAT applies on gross service fees, and they can claim relevant input VAT credits for their expenses	• 25% CIT applies on gross service fees income, and they can deduct some of their expenses from the taxable income	• 0.05% stamp duty applies on engineering related survey and design contracts
Auditors	• 6% VAT applies on gross service fees, and they can claim relevant input VAT credits for their expenses	• 25% CIT applies on gross service fees income, and they can deduct some of their expenses from the taxable income	• N/A
Insurance companies	• 6% VAT applies on gross premiums for general insurance, and they can claim relevant input VAT credits	• 25% CIT applies on gross premiums for general insurance income, and they can deduct some of their expenses from the taxable income	• 0.1% stamp duty applies on property insurance contracts
Suppliers of various materials or goods	• 17% / 11% VAT applies on the sale proceeds, and they can claim relevant input VAT credits	• 25% CIT applies on gross sales income, and they can deduct some of their expenses from the taxable income	• 0.03% stamp duty applies on sale contracts

15 Refers to those projects which either had a construction permit in place on or before 30 April 2016; or a construction contract with a start date on or before 30 April 2016

Conclusions

PPPs are a relatively new, but a growing phenomenon in China. The promotion of PPPs in the public service area is an important reform measure to transform government functions, to stimulate market vitality and to create new economic growth points. However, their treatment from a tax perspective in China is, as yet, largely not dealt with by specific rules.

While the government in China sits outside the VAT and CIT systems, their involvement as a party to PPPs raises a number of difficult VAT and CIT issues which can impact on private companies participating in PPPs, and on third parties either funding PPPs or contracting with other PPP participants. These tax issues need to be carefully managed, budgeted for from a cash flow and financial statement perspective, and managed in the legal and other contractual documentation being entered into. According to Guobanfa [2015] No. 42, the State Council clearly states that, the government will provide policies supporting the promotion of PPPs. One of these policy guarantees is to improve and establish fiscal and tax support policies. It is expected that the MOF will issue tax policies for PPPs in the future.

This publication hopefully serves as a guide to the issues which need to be considered. However, specific advice from your regular KPMG advisor should always be sought before acting on any of the observations made in this publication.

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