KPMG

China Tax Alert

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New tax incentives for Beijing Zhongguancun corporate venture capital

Summary:

On February 1, 2021, Beijing Municipal Bureau of Finance released Announcement No.63 (2020), which officially unveils the income tax incentives for corporate venture capital enterprises (CVCEs) in Beijing Zhongguancun National Innovation Demonstration Zone ("Demonstration Zone"). This provides for two incentives which aim to promote the development of the VC industry and encourage long-term investment. Meanwhile, double taxation issues for individual investors will be alleviated and institutional investors will also benefit from the new policies.

Background

On August 28, 2020, China's State Council (cabinet) authorized pilot corporate income tax (CIT) incentive schemes for CVCEs in the Demonstration Zone. Subsequently, the Ministry of Finance (MOF), the State Taxation Administration (STA), the National Development and Reform Commission (NDRC) and the Securities Regulatory Commission (SRC) jointly published Announcement No.63 (2020) which sets out specific detail on the new incentives and applicable conditions.

KPMG observations

I. Announcement No.63 sets out "two conditions" and "two incentives":

- Two Conditions (both must be met)
  1) The resident CVCE is registered and established in the Demonstration Zone and is subject to taxation based on audited financial statements;
  2) The CVCE should comply with the Interim Measures for the Administration of Venture Capital Enterprises (NDRC and other 10 departments Decree No.39) or the Interim Measures for the Supervision and Administration of Private Investment Funds (SRC Decree No.105) and should meet the filing and operational requirements of the regulations.
- Two Incentives (CIT is 50% or 100% exempt)
  1) For a given tax year, if the gains on the transfer of equity, which has been held for not less than 3 years, exceeds 50% of the total gains on the transfer of equity that year, then the CIT exemption is determined by the following formula.

     CIT Exemption= Shareholding ratio of individual shareholders at year end * CIT liability for year ÷ 2

     (i.e. 50% exemption for CIT)
  2) For a given tax year, if the gains on the transfer of equity, which has been held for not less than 5 years, exceeds 50% of the total gains on the transfer of equity that year, then the CIT exemption is determined by the following formula.

     CIT Exemption= Shareholding ratio of individual shareholders at year end * CIT liability for year

     (i.e. 100% exemption for CIT)

The shareholding ratio for the CVCE operates as follows; if individual investors hold 40% of the CVCE, and institutional investors hold 60%, the shareholding ratio in the formula above will be 40%.

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II. Tax benefit arising from “passing-through” rule in Announcement No.63

- At corporate VC level
  1) Dividends from invested enterprises are not covered the Announcement No.63 incentive. However, under the existing policies, dividends obtained from shares of non-listed companies, or from listed stocks held for not less than 12 consecutive months, is tax-exempt at fund level.
  2) For the gains from the transfer of equity of the invested enterprises, if the above two conditions are met, then 50% or 100% CIT exemption applied.
- At investor (shareholder) level
  1) Individual shareholder: Dividends obtained from the fund are subject to the 20% individual income tax (IIT). The double tax issue for individual investors is alleviated to some extent with the implementation of the incentives at fund level, compared with the 40% comprehensive tax burden without the CIT incentives (i.e. 25% CIT on the CVCE’s disposal gains and 20% IIT on the after-tax gains distributed to the shareholders). It should be noted that the incentives are designed to reduce tax burden at corporate level rather than at individual level. In the case where the 100% CIT exemption is applied, there will still be 20% tax imposed on individual investors. The tax rate the same as when an individual investor makes an investment via a partnership VC. Moreover, to qualify for 100% CIT exemption, investors must all be individuals but not (professional) institutional investors. This is not a common situation in the VC fund industry. Correspondingly, if the shareholding ratio of individual investors is relatively low, the tax benefit passed-through to individual investors will be greatly diluted.
  2) Corporate shareholder: Dividends obtained from the fund are exempt from CIT. If the CIT burden decreases at fund level (due to the presence of some individual investors at fund level), the distributable profit of the fund will increase correspondingly, and institutional investors will benefit as a result.

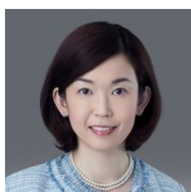
KPMG suggestions

In combination with Announcement No.63 and the existing tax policies, VC enterprises may consider the following:

- Prior to Announcement No.63, there are regulations that encourage the development of VC enterprises in place, such as Caishui [2018] No.55 and Caishui [2019] No.8. From tax perspective, a corporate VC vehicle is different from a partnership VC vehicle in terms of tax determination, tax collection methods and the conditions to enjoy tax incentives. As such, VC enterprises should make a comprehensive plan based on business operations for determination of the optimal legal form to be adopted.
- Overall, Announcement No.63 is straightforward, and to some extent, this should reduce the possibility of disputes and the difficulty in determining incentive applicability. However, several matters still need attention in the course of implementation. For example, how does one calculate the holding period for disposed of shares (i.e. has the 3 year threshold been met?) when separate investments have in the same enterprise at discrete times? Will it be considered as intentional tax avoidance if the enterprise increases the shareholding ratio of individual shareholders at year end? How to respond if individual shareholders demand to exclusively claim the tax incentives? In short, China's tax system for funds is still under development - it is recommended to follow closely the latest polices and best practices for the industry in order to enjoy tax incentives in compliance with the regulations.

In a forthcoming series of articles, KPMG will continue to explore and analyse in depth the tax considerations arising during fund establishment, operation and exit stages. KPMG has always had deep insight and rich experience in the fund industry. Please feel free to contact KPMG's tax experts. We can provide funds and the investors with full cycle tax planning and advisory services.

Contact us：



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