



New asset loss rules simplify tax deduction procedures but increase tax audit risks

Regulation discussed in this issue:

- Announcement on Measures for CIT Deduction on Asset Losses of Enterprises (New Measures), SAT Announcement [2011] No. 25, issued by the SAT on 31 March 2011, effective from 1 January 2011
- Circular on Policies Concerning CIT Deduction on Asset Losses of Enterprise, Cai Shui [2009] No.57, (Circular 57), issued by the MOF and SAT on 16 April 2009, effective from 1 January 2008

Background

On 31 March 2011, the State Administration of Taxation (SAT) issued the Measures for Corporate Income Tax (CIT) Deduction on Asset Losses of Enterprises (New Measures) by way of Announcement No. 25. New Measures replace the Measures for Tax Deduction on Asset Losses of Enterprises issued in 2009 (Old Measures). New Measures have broadened the scope of asset losses, removed the requirement of prior approval for asset losses and, in some cases, simplified documentary evidence requirements. Under New Measures, SAT will give more power to enterprises to manage their compliance with the asset loss deduction rules while reserving its right to conduct audits on their compliance. With the resultant redeployment of resources, tax authorities will be able to focus on conducting tax audits on high risk targets or areas.

New Measures are effective from 1 January 2011. At the same time, Old Measures and the circulars, Guo Shui Han [2009] No. 772 and Guo Shui Han [2010] No. 196 were abolished. New Measures should apply to the tax year ended 31 December 2011 and subsequent tax years.

The salient points of New Measures and our comments on them are set out below:

1. Scope of assets

New Measures have expanded the scope of assets. Under the sub-category of accounts receivable and prepayments, New Measures have added different types of payments made on behalf of other parties and inter-company receipts and payments. New Measures have also added a main category

Changes in New Measures at a glance

1. Scope of assets expanded to include intangible assets
2. Distinction made between actual asset losses and statutory asset losses, both deductible
3. Accounting recognition of losses required
4. Prior approval no longer required and replaced by mere itemised reporting
5. Re-opening of prior year tax position and making of belated loss claims possible up to five years
6. Reporting to tax authorities in charge of head offices required for cross-regional operations
7. Third party technical opinions and professional reports given greater reliance as evidence
8. Detailed documentary evidence simplified for certain asset losses
9. Losses from related party transactions deductible upon presentation of special reports

of intangible assets. The losses on all these newly added assets have long been recognised in the CIT Law. New Measures simply provide guidance on the procedure and documentary evidence for making claims on losses on such assets.

In addition, according to Article 50 of New Measures, for asset loss matters that are not covered by New Measures, the enterprises may also submit deduction claims to the tax authorities as long as they comply with the provisions in the laws or regulations such as the CIT Law and the related implementation rules.

2. Definition of asset losses

Based on the circumstances under which they are identified, New Measures distinguish two types of deductible asset losses:

- Actual asset losses

These are reasonable losses incurred in the process of actually disposing of or transferring the assets covered by Circular 57 and New Measures

- Statutory asset losses

These are losses on assets that have not actually been disposed of or transferred but are calculated and identified by operation of the relevant regulations i.e., Circular 57 and New Measures, for example, accounts receivable that have been outstanding for more than three years.

Old Measures did allude to the distinction between losses "actually incurred" and losses "actually identified", which loosely correspond with actual asset losses and statutory asset losses. However, New Measures have given formal definition to these two types of losses.

3. Timing of loss claims

According to New Measures, actual asset losses are deductible in the year in which they occur. Statutory asset losses are deductible in the year in which the enterprises provide to the tax authorities in charge evidence and information to prove that the assets concerned have complied with the criteria for identifying statutory asset losses. In both cases, the asset losses should have been treated as such for accounting purposes before they can be deducted in calculating the taxable income of the enterprises for CIT purposes.

Unlike Old Measures, New Measures make the accounting recognition of the asset losses a key prerequisite for the deduction of asset losses.

Old Measures required enterprises to deduct asset losses in the year in which they were actually identified or incurred and "not to deduct them earlier or later". New Measures have removed that provision. However, to all intents and purposes, that provision should still apply because the CIT Law requires that taxable income be computed based on the accrual principle.

New Measures have clarified the time limit for taxpayers to apply to re-open prior year tax position and seek tax refund where asset losses are not deducted in the year in which they arise. Generally enterprises can go back five years in making belated claims. However, under special circumstances, the period for making belated claims can be extended upon approval of SAT.

Such special circumstances include the following:

- Legacy asset losses incurred by enterprises in the process of reform of the planned economy regime.

- Asset losses on which deduction is not claimed by enterprises in time due to rights dispute during the process of restructuring for public listings.
- Asset losses incurred by enterprises in taking on duties as a matter of national policy.
- Asset losses caused by lack of clarity in policy characterisation.

However, for statutory asset losses, the deduction should still be made in the year in which the losses are reported.

According to Article 51 of Tax Administration Law, where a taxpayer discovers overpayment of tax within three years of the date of tax settlement, the taxpayer can require the tax authority to refund the excess tax payment as well as interest. It would, therefore, appear that while New Measures allow enterprises to re-open a tax year five years or more later, the enterprises may obtain interest only if the claim is made within three years from the date of tax settlement. In practice, it is advisable to enquire with the tax authorities in charge in this regard.

4. Procedure for making deduction claims

New Measures have removed the requirement for obtaining prior approval from the tax authorities for deduction on asset losses. Under Old Measures, certain asset losses were subject to self-administered deduction and the other asset losses were subject to deduction upon prior approval. Under New Measures, all asset losses do not require prior approval for deduction and are deductible as long as the required asset loss evidence and information has been submitted to the tax authorities. However, certain asset losses require the submission of more detailed information than the others.

The reporting requirements under New Measures are divided into non-itemised reporting and itemised reporting. Under non-itemised reporting, asset losses are sorted into different broad categories and consolidated into a list in accordance with accounting classification, and the related accounting and tax information should be kept by the enterprises in anticipation of examination by the tax authorities. Under itemised reporting, asset losses are reported on an item by item or deal by deal basis together with the related accounting and tax information.

Basically, in terms of nature of asset losses, deduction claims under non-itemised reporting and itemised reporting under New Measures correspond with self-administered claims and prior approval claims under Old Measures respectively. In general, non-itemised reporting applies to asset losses incurred in ordinary course of business while itemised reporting applies to other asset losses. Where they are in doubt, enterprises may make itemised reporting.

However, New Measures require more judgment to be exercised in non-itemised reporting than Old Measures would require for self-administered claims. New Measures allow non-itemised reporting on losses from sale, transfer or disposal of non-monetary assets if such transaction is made at "fair value". New Measures only allow non-itemised reporting on losses from trading in bonds, securities, futures, funds and financial derivative products if such transactions are made in accordance with "fair market trading principles". For enterprises with cross-region operations, New Measures have given less discretion than Old Measures to the provincial tax authorities in charge of the enterprises to decide on which local authorities to deal with deduction claims. According to New Measures, besides reporting to their tax authorities in charge at the local level, branches of enterprises should also report to the tax authorities in charge of the head offices via the head offices. Under Old

Measures, depending on the amount of losses involved, the provincial tax authorities in charge of the enterprises could decide how approval power should be divided among tax authorities in different regions. However, for losses arising from transfer of assets bundled on a cross-region basis, both Old and New Measures require submission to be made to the tax authorities in charge of the head offices.

Under New Measures, non-itemised and itemised reporting may be made at the same time as the annual CIT filing. If, for special reasons, an enterprise cannot submit related information for itemised reporting, it may apply to the tax authority in charge for an extension of time limit.

Under both non-itemised and itemised reporting, the tax authorities reserve the right to audit the claims after they have been submitted and seek adjustments to the taxable income if the claims prove to be untrue or illegal.

5. Documentary evidence required for loss claims

For loss of assets in general, both Old and New Measures rely on external and internal evidence as required by Circular 57. The external and internal evidence required are very similar between Old and New Measures in terms of scope.

For specific asset losses, both Old and New Measures require different types of evidence for monetary asset losses, non-monetary asset losses and investment asset losses. New Measures add an additional category of “other asset losses”.

5.1 Monetary asset losses

Under both Old and New Measures, monetary asset losses are further divided into losses on cash, bank deposits, accounts receivable and prepayments respectively.

Old Measures provide detailed definitions of losses on cash and deposits, but New Measures do not define cash losses and simply state that deposit losses are losses of deposits due to liquidation of financial institutions. The lack of definition can give both the tax authorities and the tax payers more flexibility in identifying cash and deposit losses but can also create more uncertainty.

Under New Measures, acknowledgments of receipt of counterfeit money issued by financial institutions can also be taken as evidence of cash losses.

Under New Measures, where a financial institution has been in the process of liquidation for more than three years, an enterprise can recognise deposit losses if the enterprise can produce a certificate issued by a law court or the liquidator to state that the liquidation has not been completed.

As far as losses on accounts receivable and prepayments are concerned, the changes under New Measures are not significant. New Measures have a new requirement for the submission of related contracts, agreements or statements as evidence of losses. In the event of losses resulting from debt restructuring, under New Measures, the enterprise making a loss claim should also produce a statement on taxation of the gains derived by the debtor from the debt restructuring. In practice, this can create a heavy administrative burden on the creditor because the creditor may not have control over how the debtor handles its tax affairs.

New Measures also add that in the event of losses on accounts receivable or prepayments caused by force majeure such as natural disasters and wars, enterprises that suffer such losses should produce statements on how affected the debtors have been by the events and declarations that the enterprises have given up the debt claims.

For losses on accounts receivable that have been outstanding for more than three years, it is important to note that New Measures no longer require the creditors to:

- Produce records on reminders sent and negotiations conducted to recover the debts in accordance with the law.
- Prove that the debtors are insolvent, suffer losses for three consecutive years or remain dormant for three years or more.
- Prove that the creditors do not have any business with the debtors within three years.

Instead, New Measures require that the losses on the accounts receivable have been so dealt with for accounting purposes. But the enterprises suffering the losses should produce special reports issued by legally qualified intermediaries in respect of such losses.

For small losses on accounts receivable, New Measures provide clearer guidelines. Under New Measure, an account receivable is small if, on its own, it is of an amount not more than RMB 50,000 or 0.01 percent of the annual revenue of the enterprise suffering the losses. In addition, such accounts receivable has to be outstanding for more than one year and has to have been treated as written off for accounting purposes by the enterprise claiming the loss deduction. In that case, the enterprise must produce a special report issued by a legally qualified intermediary to support the deduction claim.

5.2 Non-monetary asset losses

Both Old and New Measures divide non-monetary asset losses into losses on inventories, fixed assets, projects under construction and productive biological assets respectively. New Measures also include intangible assets in the scope of non-monetary assets.

Overall, as far as non-monetary assets are concerned, the key differences between the Old and New Measures are as follows:

- The evidence required under New Measures for the deduction claims on losses refers to the “tax base” rather than the “book value” of the assets concerned as required by Old Measures. This is consistent with the provisions on inventories and assets in the CIT Law. These changes will bring the rules on deduction of asset losses into line with those provisions.
- New Measures place more emphasis than Old Measures on the professional technical authentication opinions issued by legally qualified professional organisations.
- In many cases, New Measures also impose the new requirements of special reports issued by legally qualified intermediaries on the losses.
- New Measures also place more emphasis on statements on attribution of liability for the losses concerned, especially in cases where compensation from persons responsible or insurers are relevant.
- New Measures have, however, dispensed with detailed documentary evidence in many cases e.g. inspection or examination reports on vehicles, elevators.

Regarding the new category of “intangible assets”, New Measures state that losses relating to intangible assets arise where the assets have been replaced by other new technologies or have passed the legal protection time limit. To claim deduction on losses on intangible assets, enterprises should

prove that the assets have lost their use value or transfer value and have not yet been fully amortised.

In the case of losses on intangible assets, New Measures require enterprises claiming the deduction to produce the following documents:

- Accounting information.
- Internal verification and approval documents and related statements on the circumstances surrounding the losses.
- Technical authentication opinions and written declarations signed and sealed by the legal representatives, key officials and financial officials of the enterprises stating that the intangible assets have no use value or transfer value.
- Documents on the legal protection time limit of the intangible assets.

5.3 Investment losses

Both Old and New Measures divide investment losses into losses on investments in debts and investments in equities respectively.

Under Old Measures, it was provided that where enterprises that were permitted by the State to carry out activities other than lending business suffered losses from direct lending, such losses would not be deductible. This provision has been removed under New Measures. On the face of it, it follows that such losses have now become deductible under New Measures. This change might be due to the fact that, although the lending activities are outside the approved business scope of the enterprises, the enterprises will still have to include any loan interest or gains from the transfer of such debt investments in calculating its taxable income for CIT purposes.

Correspondingly, related expenses and losses should be deductible. Another interpretation of this change of provisions is that there is no need to separately single out such losses as non-deductible because Article 46(5) of New Measures is wide enough to cover and disallow those losses. Article 46(5) states that losses on debt claims that are not related to business activities are non-deductible. In practice, it is advisable to inquire with the tax authority in charge on this issue in advance.

5.3.1 Losses on debt investments

New Measures have simplified the requirements for documentary evidence for losses on debt investments considerably. New Measures set out the general requirement that the enterprises claiming losses on debt investments should produce original vouchers, contracts or agreements and accounting information for the debts investments.

Like Old Measures, New Measures set out special documentary requirements for the following circumstances:

- The debtors are legally declared bankrupt, closed down, dissolved or de-registered, have their business licenses revoked, have disappeared or died.
- The debtors suffer catastrophe or accidents.
- The debtors incur legal liability.
- The enterprises take legal proceedings or instigates arbitration procedures against the debtors. The debtors are unable to meet debt claims despite

enforcement by a court of law or a court refuses to deal with or support the action of the enterprises.

- The debt claims are allowed to be cancelled by the State Council under special circumstances.

New Measures have dispensed with the special documentary requirements for losses on credit card debts and student loans suffered by financial institutions. However, the general documentary evidence requirements for losses on debt investments shall apply in those cases.

Under some circumstances, New Measures allow deduction on losses on debt investments even if the enterprises cannot produce proof of settlement by the debtors out of their assets or estate in the case of bankruptcy, closure, dissolution or de-registration, revocation of business license, disappearance or death. According to Article 40(1) of New Measures, in those cases, enterprises can claim deduction on the losses by simply producing proof of bankruptcy, closure, dissolution or de-registration, or the revocation document or inquiry documents issued by the State Administration for Industry and Commerce as well as records of action taken to pursue the debts. However, for the enterprises to do so, the bankruptcy or similar events as mentioned above must have happened more than three years ago, or the balance on the debt investments must be RMB 3 million or less.

5.3.2 *Losses on equity investments*

New Measures have added documentary requirements for losses on equity investments similar to those for losses on debt investments. According to Article 42, where investees are legally declared bankrupt, closed down, dissolved or de-registered, have their business license revoked, have ceased production or operational activities, disappeared, the enterprises making the claims on loss deduction should produce proof of settlement out of the assets or estates of the debtors.

Where the above events have taken place more than three years ago and the liquidation of the investee has not yet been completed, the enterprises making the claims should produce proof of bankruptcy, closure, dissolution or de-registration or license revocation as well as statements on the reasons for not completing the liquidation.

New Measures have also removed the limit to the losses on equity investments imposed by Old Measures. According to Article 38 of Old Measures, losses on equity investments would be calculated as the investments after deduction of compensation from persons responsible and insurers, disposal proceeds or recoverable amounts. "Recoverable amounts" were deemed to be five percent of the book value of the investments. New Measures no longer assume such recoverable amounts.

New Measures also specifically provide that asset losses arising from related party transactions are deductible, but the enterprises making the claims must produce special reports issued by legally qualified intermediaries.

5.4 **Other asset losses**

"Other asset losses" are actually some of the asset losses that were originally contained under the category of "investment asset losses" in Old Measures and have been reclassified as "other asset losses" under New Measures. In particular, these losses are:

- Losses arising from sales of bundled assets through market methods e.g. auction, bidding, competitive negotiation and tender.

- Losses caused by unsound internal controls or foraying into innovative businesses.
- Losses caused by criminal cases.

The evidence required for such losses are similar under Old and New Measures.

KPMG observation

Old Measures were released in May 2009, less than two years to the time of issuance of New Measures. One of the key drivers of the change can be the heavy demand for resources Old Measures have made on the tax authorities at the local level for asset losses that required prior approval.

Under New Measures, the burden of compliance with the deduction rules will be placed squarely on the shoulders of the enterprises. That way, the tax authorities at the local level will be able to focus their attention on high risk targets or areas and deploy their resources to audit those targets accordingly. Under New Measures, enterprises will first see the benefits of being able to obtain deduction on asset losses easier and quicker and manage their cash flow better. However, the risk of certain enterprises being audited will increase for the reason mentioned above. Therefore, despite the streamlined deduction claim procedures and simplified documentary requirements, enterprises should still put their asset loss claims through vigorous internal verification process and prepare detailed relevant accounting and tax information in anticipation of tax audits.

In this regard, it is worth noting that the tax authorities can go back three years to recover unpaid or underpaid tax due to excessive loss claims. Where the amount of tax involved is more than RMB 100,000, the recovery period can be extended to five years. For losses arising from related party transactions, the tax authorities can go as far back as ten years.

New Measures have also established a closer link between tax treatment and accounting treatment of asset losses. Accounting recognition of losses is a prerequisite for identification of asset losses for both actual asset losses and statutory asset losses. Therefore, it is more important than ever for tax department and accounting department within an enterprise to work closely on asset loss claims.

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