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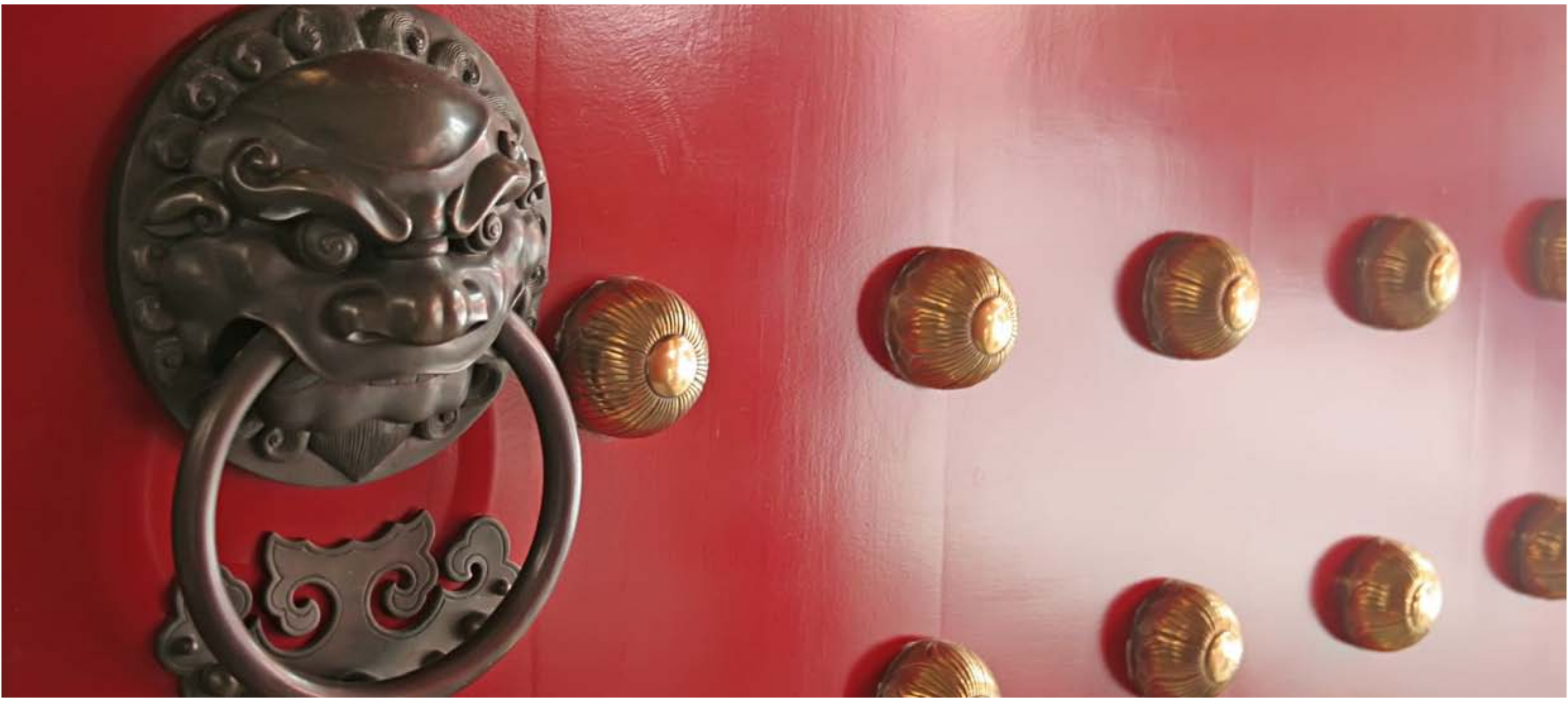

New business tax treatment on the transfer of financial commodities

Regulation discussed in this issue:

- *Notification of Business Tax Treatment on the Transfer of Financial Commodities* (SAT Announcement [2013] No. 63 ,"Announcement 63"),issued by the State Administration of Taxation on 6 November 2013, effective from 1 December 2013)

Background

Recently, the State Administration of Taxation (SAT) issued Announcement 63 "Notification of Business Tax Treatment on the Transfer of Financial Commodities", which modified the policy of business tax (BT) treatment on the transfer of financial commodities. Pursuant to Announcement 63, the transfer of financial commodities will no longer be classified into the previous four categories of stocks, bonds, foreign exchange and others. Instead, they will be consolidated into one category, i.e. financial commodities. Trading gains and losses of different categories of financial commodities can now be offset across different categories within the same BT reporting period. BT will be imposed on the balance after offsetting. Any negative balance (i.e. net loss) can be carried forward to the next BT reporting period. Any remaining losses not yet utilised cannot be carried forward to the next fiscal year.

This modification of BT policy may be considered favourable for taxpayers. However, as the effective date of Announcement 63 is 1 December 2013, it will give rise to some practical uncertainties.

Implications under the old policy

Before the issuance of Announcement 63, BT on the transfer of financial commodities in the PRC was levied according to Circular Guoshuifa [2002] No.9, which provided that financial commodities should be classified into four categories, i.e. stocks, bonds, foreign exchange and others. Trading gains and losses can be offset within the same category. BT will be imposed on the balance after offsetting. Trading gains and losses cannot be offset across categories. Trading losses within the same category after the offset can be carried forward as a credit to the next BT reporting period. Any negative balance (i.e. net loss) not utilised cannot be carried forward to the next fiscal year.

Meanwhile, pursuant to Circular Caishui [2003] No. 16, enterprises following the above reporting method to arrive at positive or negative balances for each BT reporting period can file a year-end true-up reporting. To the extent that the net taxable gains within a category for a fiscal year is less than the amount previously reported, a refund mechanism is available.

When the old policy was issued, it did resolve the issue of offsetting trading gains and losses and had a positive impact on the trading of financial commodities at that time. However, due to the development of financial markets and the improvement of financial innovation in the PRC, artificially classifying various financial commodities into four categories no longer satisfies financial business needs and does not reflect the reality of financial innovation. The promulgation of Announcement 63 finally resolves this long standing issue for the financial services sector and meets the needs of taxpayers.

KPMG observations

Generally speaking, this modification of BT policy is favorable for the taxpayers.

Most taxpayers who undertake trading of financial derivatives do so for the purpose of mitigating risks. That is to say, the main purpose of trading financial derivatives is to mitigate the foreign exchange risks and interest rate risks of the underlying financial assets (e.g. stocks, bonds, foreign exchange). Under the former policy, financial derivative products and the underlying financial products in the same investment portfolio were artificially divided into different categories and it was not possible to offset their trading gains or losses for tax purposes, which led to an increased tax burden for taxpayers. This does not align with the original intention of hedging the risks of underlying investments and also has a negative impact on the development of financial innovation.

From a tax collection perspective, due to the complexity of categorisation and the uncertainty in practice, tax authorities of different regions often hold different opinions on categorisation. This resulted in different BT treatments for different branches within one company. Thus, the former BT policy increased the tax compliance and administration costs of taxpayers as well as the tax authorities.

Therefore, the SAT modified the BT policy according to market developments which will solve the above mentioned issues and improve the tax administration efficiency to some extent.

However, it is important to note that the effective date of Announcement 63 is 1 December 2013, which means it will give rise to some practical uncertainties. Under the current BT regime, financial and insurance taxpayers should perform BT filings on a quarterly basis. Technically speaking, the fourth quarter of the year 2013 should be divided into two tax periods, i.e. October and November, during which the former BT policy applies, and December, during which the modified BT policy applies. Similarly, the year 2013 should also be divided into two tax periods for tax true-up and refund purposes. In addition, taxpayers should further confirm the following potential issues with the in-charge tax authorities:

- Whether the tax payers should prepare two sets of tax returns when performing the BT filing for the fourth quarter of the year 2013
- Whether the tax authorities will update the BT return and how it will apply to the taxpayers
- The requirement of year-end settlement or refund of BT payments for the year 2013. Specifically, whether the tax authorities would allow the tax payers to offset the net gains or losses of the two tax periods within one fiscal year, i.e. January to November, during which the former BT policy applies, and December, during which the modified BT policy applies.

- If the tax authorities allow the offset of the net gains or losses of the two tax periods within one fiscal year, how are the gains or losses to be reconciled under different category methods?

In addition to communication with the tax authorities, we suggest that tax payers commence summarising the tax filing status for the transfer of financial commodities for the period January to November 2013 in order to prepare for the modification of the BT policy in advance.

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