

China Tax Alert

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New Circular expands upon China's VAT exemptions for financial services industry

Regulations discussed in this issue:

- Circular Caishui [2016] 70 which sets out an expanded scope of VAT exemptions for the financial services industry, and takes effect from 1 May 2016.

Background

On 30 June 2016 the Ministry of Finance (MOF) and State Administration of Taxation (SAT) jointly issued Circular Caishui [2016] 70 (Circular 70) which expands upon the categories of Value Added Tax (VAT) exemption affecting the financial services sector.

To put this change into context, when China's VAT system commenced on 1 May 2016 for the financial services sector, the model chosen by the government was one of having VAT apply to most financial services transactions. This included taxing not only fee based services, which a number of other countries also tax under their VAT/GST systems, but relatively uniquely, also taxing many margin based services / products. By way of example, this meant that lending activities for which interest income was derived was subject to VAT, and so too were gains derived from trading in financial products. Only limited exemptions were provided.

Given the absence of international precedent to call upon, it was inevitable that some of the rules initially set out in Circular Caishui [2016] 36 (Circular 36) would need to change once issues identified in practice emerged. KPMG was very proud to have represented a large number of participants in the financial services sector in making representations to the policy makers to address these concerns. The policymakers have responded quickly with the release of Circular 70, which is timely given its issuance before the first VAT filing deadline for banks, which has recently been revised to 20 July 2016 (per Circular Shuizongfa [2016] No.95). Importantly, Circular 70 takes effect from 1 May 2016, meaning that its impact will affect all transactions by the financial services sector from the inception of the VAT system.

The release of Circular 70 will no doubt be warmly welcomed by the financial services sector, though in this China Alert we highlight certain areas where further clarification or uncertainty may still exist.

KPMG COMMENTARY

Scope of interbank exemptions in Circular 70

At its most fundamental level, a primary concern with the original VAT rules for the financial services sector was the combination of the following policies:

- Interest income was subject to VAT;
- Interest expense was not creditable for VAT purposes; and
- The scope of exemption for 'interbank' funding arrangements was very limited.

In effect, while the government clearly intended that 'retail' lending activities would be subject to VAT (and not creditable where the borrower was a general VAT taxpayer), 'wholesale' lending activities were also subject to the same VAT treatment in circumstances where the interbank lending exemption did not apply. In practical terms, this led to a cascading of VAT. For example, a bank would pay output VAT at 6% on its interest income arising from lending activities with both personal and business customers, but unless the bank could fall within the scope of the limited VAT exemption for interbank funding arrangements, a further 6% VAT liability would be incurred on the bank's borrowing costs, and this VAT liability was not creditable.

A further concern with the VAT rules was the perceived narrowing of the scope of exemption as compared with the previous BT rules. This led to a number of financial institutions asserting that their tax burden had increased by reason of the change from BT to VAT. In reality though, the BT rules were relatively general in nature and various practices had been built up over the years which resulted in them being applied more broadly.

To address these concerns, Circular 70 either clarifies or expands upon the scope of the VAT exemption for interbank funding arrangements. When combined with the existing scope of exemptions for interbank funding in Circular 36 and Circular 46, the scope of the VAT exemption is now as follows:

Item	Category of exemption	Applies to:	Additional requirements
1	Lending activities between a bank and the People's Bank of China (PBOC)	The purchase of central bank bills by a commercial bank; the carrying out of currency swaps and currency deposits between the PBOC and a commercial bank; loans from the PBOC to commercial banks, and rediscounting from the PBOC to a commercial banks	This only applies to 'financial institutions' as defined in Circular 36
2	Interbank placements	The placement and refund of deposits among financial institutions	<p>This only applies to 'financial institutions' as defined in Circular 36</p> <p>The financial institution receiving the deposit must have the qualifications to take deposits</p>
3	Interbank deposits	Fixed deposit certificates issued by deposit-taking financial institutions in the banking sector via the interbank market	This only applies to 'financial institutions' as defined in Circular 36
4	Interbank lending – short-term	Unsecured short-term (i.e. one year or below) interbank transactions executed on the PBOC interbank lending platform	This only applies to 'financial institutions' as defined in Circular 36
5	Interbank lending (domestic)	Lending and borrowing of funds amongst financial institutions	<p>This only applies to 'financial institutions' as defined in Circular 36</p> <p>The scope of the business licence must include "lending to financial institutions" or be a rural credit cooperative institution</p>

Item	Category of exemption	Applies to:	Additional requirements
6	Interbank lending (cross-border)	Lending by a domestic bank and its offshore headquarters / parent company (and vice versa); lending by a domestic bank and its offshore branch or wholly-owned subsidiary (and vice versa)	N/A
7	Interbank payments by direction	Financing transactions where a commercial bank makes payment to a corporate client at the request of another financial institution	This only applies to 'financial institutions' as defined in Circular 36 The financial institution which is the borrower must have the obligation to repay the principal and interest
8	Discounted bills of exchange	Discounted bills of exchange between financial institutions	This only applies to 'financial institutions' as defined in Circular 36
9	Holding of bonds issued by financial institutions (including bonds issued by Export - Import Bank of China, Agricultural Development Bank of China and China Development Bank)	This refers to the situation where bonds have been issued by financial institutions in China via the interbank bond market or the exchange bond market	This only applies to 'financial institutions' as defined in Circular 36
10	Pledged-type reverse Repo	This refers to a short term financing transaction in which the parties use financial products such as bonds as the pledge of rights	This only applies to 'financial institutions' as defined in Circular 36
11	Outright-type reverse Repo	This refers to the situation where there is a sale and buyback of financial products such as bonds, where the holder of the financial products sells them to the buyer, and upon the agreed date, the original holder buys back the same	This only applies to 'financial institutions' as defined in Circular 36

Item	Category of exemption	Applies to:	Additional requirements
		amount of the financial products from the buyer at an agreed price	

In addition to this, it should be noted that deposit taking by financial institutions is not subject to VAT, as per Circular 36.

The two major practical limitations on the previous interbank lending exemption have both been addressed by Circular 70, as follows:

First, the VAT exemption for interbank lending only applied to loans made within the “same bank system”. This raised the concern as to whether the exemption would apply either cross-border, such as where a foreign bank lends money to its branch in China, or in respect of loans made between banks within the same wholly-owned group, such as where a foreign bank lends money to its subsidiary in China.

Item 6 in the table above seeks to address these concerns by providing for a specific exemption in each of these situations. However, already some uncertainty has arisen as to whether the new exemption applies to lending between branches of the same bank, albeit the concern would seem to be limited to cross-border situations because such loans made within PRC should qualify for exemption under item 5 in the table. A further concern is whether item 6 applies to loans between subsidiaries of the same ultimate parent company. It is possible to read Circular 70 in a more expansive way such that it applies generally to loans made within a wholly-owned corporate group, and only time will tell if that interpretation is shared by the tax officials.

Second, there was a concern that the VAT exemption for interbank funding arrangements only applied to loans on the PBOC’s interbank lending platform (known as the CFETS). This did not cover, amongst other things, lending in foreign currencies, nor did it cover lending executed on other platforms such as Reuters and Bloomberg, or so-called ‘offline’ lending. Such lending activities should now be exempted either under item 5 or item 6 in the table above.

In addition to these issues, Circular 70 seems to require the counterparty in respect of outright-type reverse repo transactions to be a financial institution as well, in order to qualify for exemption. If this is the case, those outright-type reverse repo transactions carried out between financial institutions and non-financial institutions, are subject to VAT. This requirement for exemption is consistent with that of pledged-type reverse repo transactions under Circular Caishui [2016] 46.

Another issue not specifically addressed by Circular 70 is whether the requirement to be a “financial institution” (which applies to some of the categories of exemption set out in the table above), will apply to foreign banks which are not regulated by the PBOC.

A similar issue arising under item 3 in the table above is whether exemption may apply to securities companies which are required for regulatory purposes to place deposits or to 'guarantee' funds with exchanges or securities markets. The difficulty in falling within exemption is that they may not qualify as being a "deposit-taking financial institution".

Finally, Circular 70 is silent on the procedures which financial institutions must follow in order to claim exemption. It may be expected that local guidance or implementation rules will be forthcoming, though it is hoped that the absence of such guidance or rules will not preclude financial institutions from claiming the exemption with effect from 1 May 2016.

Scope of financial product exemptions in Circular 70

Circular 36 also provides that gains from trading in financial products are generally subject to VAT, with the VAT liability being calculated in much the same way as the previous Business Tax (BT) system. That is, the scope of "financial products" was modelled on the previous BT system, and in the same way as BT the VAT is not creditable to the counterparty. Any losses can only be carried forward for up to 12 months.

There were limited VAT exemptions provided, and they mainly existed in circumstances where the imposition of VAT would otherwise create problems in the orderly operation of debt or capital markets, especially by foreign investors.

Circular 70 now expands upon the scope of exemptions from trading in financial products, as follows:

1. RQFII – Circular 70 clarifies that the exemption from VAT for QFII investors also applies to RQFII investors too;
2. Interbank money market investments - an investment in the interbank money market by an offshore entity approved by the PBOC.

While Circular 70 resolves a number of areas of uncertainty in relation to the imposition of VAT on gains from trading in financial products, there are still some fundamental areas yet to be clarified. In particular, given the differential VAT treatment of debt related products (where interest and related fees and charges are subject to VAT at 6%), as compared with equity related products (which are subject to VAT on the gain, and where losses cannot be carried forward to the next calendar year), the question of how to distinguish debt from equity may arise. The VAT systems in most countries tend to give precedence to the legal form of the transaction, whereas in China it may be expected that the accounting treatment will be given greater weight. For products such as redeemable preference shares, this differentiation may need to be applied.

A further issue with trading in financial products is what happens where the seller is a non-resident, but the buyer is a PRC resident. The general place of supply rules in Circular 36 would bring this

transaction within the scope of Chinese VAT (because the place of supply is in China where the supplier or the recipient is in China), and the VAT would then ordinarily need to be collected on a withholding basis. The problem with this approach is that it is ill-suited to apply to transactions where the gain is taxed only, because the buyer is unlikely to be apprised of this information. It is also ill-suited to apply given that the VAT is in reality a form of capital gains taxation on the seller.

Consequences for apportionment of input VAT credits

While Circular 70 will be welcomed by the financial services sector given it expands upon the scope of VAT exemptions, a consequence of this is that the amount of input VAT which needs to be 'transferred out' (or to use international VAT terminology, denied) is likely to significantly increase.

Financial institutions carrying on business in many countries around the world spend an inordinate amount of time and effort in seeking to correctly determine their apportionment methodologies, or partial exemption methods. The purpose in doing so is to ensure that the amount of input VAT which is 'transferred out' properly reflects the extent to which the business consumes or utilizes those inputs in making exempt supplies. Following Circular 70, we expect the situation in China to be no different.

In particular, the problem which many financial institutions will face is that the value in revenue terms of their exempt transactions arising from say interbank lending arrangements is disproportionately greater than the amount of inputs they may use or consume in this part of their business. Take the simplistic example of a retail bank which may expend significant amounts of money on infrastructure costs (whether it be IT systems, bank branch premises etc), as well as on marketing, advertising and promotion costs, to attract new retail clients, or to retain existing retail clients. However, they spend comparatively little in managing their interbank funding arrangements. Yet when applying a revenue basis methodology for apportioning their inputs, a significant amount of credits may need to be transferred out.

A further concern with the approach the apportionment is that while deposits generally are not subject to VAT (and therefore will not affect the input VAT transfer out amount), Circular 70 classifies deposits between financial institutions as being exempt from VAT (and therefore do impact on the input VAT transfer out amount). This apparent anomaly should be addressed.

Putting these issues to one side for now, financial institutions seeking to implement an apportionment approach should seek to ensure they apply a 3 step sequential process:

1. Claim full input VAT credits for fixed assets, intangibles and immovable property, provided they have been used other than exclusively in exempt transactions;
2. Apply direct attribution – that is, for costs or expenses which are solely attributable to taxable transactions, then a full input VAT

credit can be claimed. For costs or expenses which are solely attributable to exempt transactions, then no input VAT credit can be claimed;

3. Revenue basis method of apportionment – the balance of the input VAT which must be transferred out should then be apportioned by taking the exempt revenue as a proportion of total revenue.

Conclusions

As noted previously, Circular 70 will clearly be warmly welcomed by the financial services sector because it resolves a number of areas of uncertainty and potential for VAT liabilities which would have otherwise caused a cascading of VAT.

Financial services institutions affected by these changes need to urgently take account of Circular 70 and seek to implement it in time for the first VAT filing deadline of 20 July 2016. This means not only taking account of the circumstances under which VAT exemption is now available (where previously it was not), and the procedures for implementation of Circular 70. Circular 70 will also have a correspondingly significant impact on apportionment of input VAT credits and this need to be taken into account.

Finally, while Circular 70 focuses primarily on banks, it is expected that further Circulars will be issued over the coming months to clarify VAT issues affecting other financial services institutions, such as trusts and funds.

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