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In this issue of the China Tax Update, we will discuss the following tax developments in China:

1. Interest free loans between corporate group entities are exempt from VAT from 1 February 2019 to 31 December 2020
2. SAT expands pilot scheme enabling small-scale taxpayers to issue special VAT invoices and further simplifies the verification process of special VAT invoices
3. Anhui case: transfer pricing adjustment to intercompany service fees
4. Notice 8 clarifies the IIT accounting methods available for individual partners in VC partnerships
5. More small-scale and low-profit enterprises eligible to receive lower EIT rates

We will issue separate updates regarding recent IIT rules on non-domiciliary individuals and the VAT reform.

1. Interest free loans between corporate group entities are exempt from VAT from 1 February 2019 to 31 December 2020

The Ministry of Finance and the State Administration of Taxation (SAT) jointly issued Notice 20[1] to provide a VAT exemption on interest free loans between entities within a corporate group. The exemption is available from 1 February 2019 to 31 December 2020.

Before Notice 20, if a company provided an interest free loan to another company in its corporate group, the loan was deemed as a sale. The company was deemed as having received interest and such interest was subject to VAT.[2] The lender could not avoid this VAT because input VAT credits are not available for financing. Under Notice 20, if a company provides an interest free loan to another company in its corporate group, the loan is exempt from VAT.

However, the definition of corporate group is not clarified under Notice 20. A company may refer to the related party concept in the enterprise income tax (EIT) law[3] and rely on the common shareholding argument. However, it remains to be seen how local tax authorities will interpret Notice 20.

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[1] *Notice of Ministry of Finance and State Administration of Taxation on Clarifying the Exemption of Elderly Care Agencies from Value-added Tax and Other Policies*, Caishui [2019] No. 20, dated and effective from 2 February 2019 ("**Notice 20**").

[2] Attachment 1 of the *Notice of Ministry of Finance and State Administration of Taxation on Comprehensively Promoting the Pilot Program for the Collection of Value-added Tax in Lieu of Business Tax*, Caishui [2016] No. 36, dated 23 March 2016 and effective from 1 May 2016.

[3] For standards of common shareholding, please refer to Article 2 of the *Announcement of the State Administration of Taxation on Matters relating to Improvement of the Filing of Related-Party Transactions and the Management of Contemporaneous Documentation*, SAT Bulletin [2016] No. 42, dated and effective from 29 June 2016.

Taxpayer key take-away points

In practice, a corporate headquarters commonly loans money to entities within its corporate group without charging interest. The headquarters can avoid potential VAT between 1 February 2019 to 31 December 2020 when providing these interest free loans. However, the corporate group still faces some risks when enjoying this VAT exemption.

First, in practice, banks usually charge consulting fees in addition to interest in lending money to a headquarters. If the headquarters then lends that money interest free to a group member, the headquarters cannot obtain input VAT credit on the consulting fees paid to the bank because the output VAT on the interest free loans is VAT exempt.

Second, though companies can enjoy the VAT exemption on interest-free intragroup loans, they might expose themselves to an EIT adjustment. For example, if the lender is operating at a profit while the borrower is operating at a loss, the tax authority could impose extra tax on the lender if the loan is deemed as a profit transfer that violates the arm's length principle.

2. SAT expands pilot scheme enabling small-scale taxpayers to issue special VAT invoices and further simplifies the verification process of special VAT invoices

From 1 March 2019, the pilot scheme enabling small-scale taxpayers to issue special VAT invoices covers three additional industries: the leasing and business service industry; the scientific research and technical service industry; and the residential service, repair and other service industries. These three industries are being added to the currently covered five industries: the hotel industry; the authentication and consulting industry; the construction industry; the manufacturing industry; and the information transmission, software and information technology service industry. Small-scale taxpayers who operate in these eight covered industries can issue special VAT invoices themselves rather than needing their local tax bureaus to issue them, except they need their local tax bureau to issue special VAT invoices when selling real estates. By issuing the special VAT invoices themselves, small-scale taxpayers can reduce their administrative costs.

With regard to the simplified VAT invoice verification process, the rule requiring general taxpayers to conduct in-person VAT invoice verification at the tax bureau has been fully cancelled. Before, to claim input VAT credit, general taxpayers who are classified as type D taxpayers were required to verify VAT invoice in-person at the tax bureau. Now, all general taxpayers, including type D taxpayers, can claim input VAT credit by identifying VAT invoices online. Type D taxpayers can reduce their administrative costs through online verification.

Observations

Small-scale taxpayers in the eight industries can reduce administrative costs by issuing special VAT invoices themselves rather than applying to local tax bureaus to issue the invoices. In the past, some companies refused small-scale taxpayers as their providers because small-scale taxpayers have difficulty to provide special VAT invoices. Now, companies enjoy an expanded choice of suppliers including small-scale taxpayers if they are in the eight industries.

3. Anhui case: transfer pricing adjustment to intercompany service fees

On 25 December 2018, the China Taxation News reported that the Anhui Province Tax Bureau conducted a transfer pricing audit on the intercompany service fees paid by a Chinese manufacturing company to its offshore parent. The tax bureau collected CNY 8.2 million in EIT and interest after the Chinse manufacturing company agreed to a tax adjustment.4

Facts

Company B is a well-known manufacturing company located in Anhui Province. In 2012, Company A, an offshore company, acquired full ownership of Company B. After the acquisition, Company B had an annual gross margin over 30% and an operating margin of 15%. Company B paid CNY 120 million in service fees to Company A. The tax authority investigated the large service fee payment.

During the investigation, the tax authority found that Company B had an established management system and independent R&D, production, sales and accounting departments. Meanwhile, business processes like raw material procurement, production management and product sales were stable both before and after the acquisition in 2012. The tax authority also found that Company A mainly provided management on corporate group-wide planning and monitoring and did not actually assist Company B's manufacturing and operations.

Company B argued that its operating income increased significantly after the acquisition; thus, the service fee paid was related to its economic benefit and was therefore deductible from EIT. However, after reviewing the service contracts, the tax authority discovered that the service fee paid by Company B was not paid item by item according to service contract. Instead, the payment was based on Company B's proportion of the operating income or costs within the entire corporate group.

Company B stated that all subsidiaries in the corporate group applied the same method to calculate service fees paid to the group headquarters. The tax authority pointed out that Company B was permitted to pay service fees to Company A only for services actually received and conferring a benefit to Company B. For example, Company A impermissibly allocated to Company B expenses from Company A's CEO's office, CFO's office, and HR department. These expenses were incurred by Company A in decision-making, supervision, and management of the corporate group; thus, the expenses should have been borne by Company A itself. The tax bureau disallowed Company B's deduction of the service fees paid to Company A in calculating EIT.

As Company B could not prove the service fees paid were directly related to the services received, it agreed to the tax adjustment on the service fees.

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[4] See http://www.ctaxnews.com.cn/2018-12/25/content_947349.html.

Observations

It is not uncommon for MNCs to allocate centralized services to subsidiaries based on each subsidiary's income, expenses and headcount. This allocation arrangement does not necessarily prevent the Chinese subsidiaries from deducting the intercompany service fees. However, to reduce the risk of the intercompany service fees being challenged by the Chinese tax authorities, the MNC should:

- conduct an internal transfer pricing study and develop appropriate methods to allocate intercompany service fees
- implement an intercompany service agreement containing a clear description of the different service types and of the specific allocation methods
- keep all related contracts and documents to support that the fees paid by its Chinese subsidiary were directly or indirectly related to the economic benefit the subsidiary received instead of being mere general stewardship fees
- retain a tax advisor to defend the transfer pricing position if challenged by the Chinese tax authorities

4. Notice 8 clarifies the IIT accounting methods available for individual partners in VC partnerships

On 10 January 2019, Notice 8 was issued to clarify the individual income tax (IIT) accounting methods allowed for individual partners in venture capital (VC) enterprises that are partnerships. Notice 8 directs VC partnerships to choose between one of two accounting methods for all their individual partners to calculate their IIT: (i) accounting based on a single investment fund or (ii) accounting based on the VC partnership's annual income. Notice 8 is effective from 1 January 2019 to 31 December 2023.

Background

Generally, under a national rule, an individual partner's income from a partnership is characterized as operating income and is subject to a 5% to 35% progressive tax rate with an exception that dividend and interest income is taxed separately and is subject to 20% IIT.[5] For individual limited partners in a private equity (PE) enterprise that is a partnership, local tax authorities generally apply 20% IIT to those limited partners' share transfer, dividend and interest income. For individual general partners in a PE partnership, local tax authorities vary in how they treat the general partners' share transfer, dividend and interest income.

Some tax authorities, such as Beijing and Xinjiang province tax authorities, tax the general partners' share transfer, dividend and interest income the same as the limited partners, i.e., the income is subject to 20% IIT. Other tax

[5] *Circular of the State Administration of Taxation on Implementation Standards for Provisions on Levying Individual Income Tax on Investors of Wholly Individually-owned Enterprises and Partnership Enterprises*, Guo Shui Han [2001] No. 84, dated and effective from 17 January 2001.

authorities, like Shanghai tax authority, treat all income, including share transfer, dividend and interest income, earned by a general partner from the PE partnership as operating income and apply the 5% to 35% progressive tax rate to that income.

On a meeting dated 30 August 2018, a SAT official stated all individual partners' share transfer income should be treated as operating income and be subject to a 5% to 35% progressive IIT rate according to the law; thus, local tax authorities should revise their noncompliance. This news panicked individual partners of PE partnerships who used to enjoy a 20% IIT on their share transfer income. Notice 8 has been released to specifically provide guidance on IIT treatment of individual partners of VC partnerships, which are a form of PE partnerships.

IIT accounting methods

Notice 8 consolidates and clarifies the treatment for both limited and general individual partners in VC partnership by allowing the VC partnership to choose between one of two accounting methods: (i) accounting based on a single investment fund or (ii) accounting based on the VC partnership's annual income. Once the VC partnership chooses the accounting method, it cannot change the accounting method for three years.

If a VC partnership chooses accounting based on a single investment fund, all individual partners in the VC partnership will be subject to IIT at a 20% rate on their share transfer, dividend and interest income. Under the old national rule, an individual partner's share transfer income was subject to a progressive IIT rate ranging from 5% to 35%, meaning that an individual partner was subject to a 35% IIT rate on annual taxable income over CNY 500,000. Thus, by choosing accounting based on a single investment with its flat IIT rate of 20%, the VC partnership can largely reduce the IIT liability for its individual partners who receive high share transfer income from the VC partnership.

If a VC partnership chooses accounting based on the VC partnership's annual income, the individual partners in the VC partnership will be subject to the progressive IIT rate ranging from 5% to 35% on all income from the VC partnership as that income will be treated as operating income. However, the individual partner can deduct costs, fees and losses when calculating their taxable income from the VC partnership. If the individual partner does not have comprehensive income, the partner can also deduct basic deductions, special deductions, additional special deductions and other deductions[6] from their income from the VC partnership. Thus, by choosing accounting based on the VC partnership's annual income with its progressive tax rate as low as 5%, the VC partnership can largely reduce the IIT liability for its individual partners who receive low income from the VC partnership.

Observations

Notice 8 clarifies the IIT treatment for VC partnerships for individual partners. VC partnerships have the freedom to choose one of two accounting methods to calculate all their individual partners' IIT. Because a VC partnership must choose one method to apply to all its partners, the VC partnership should

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[6] Please refer to our July 2018 Client Alert for more information of these deductions. Our February 2019 Client Alert provides a detailed introduction of additional special deductions.

choose carefully to provide the maximum benefits to the maximum number of its individual partners.

As Notice 8 is limited in scope and only clarifies the IIT treatment for individual partners in VC partnerships, the IIT treatment on individual partners in other kinds of PE partnerships remains unclear in practice.

5. More small-scale and low-profit enterprises eligible to receive lower EIT rates

On 9 January 2019, the State Council decided to introduce several tax incentives for small and micro-sized companies. Soon after, the State Administration of Taxation released a series of rules to implement those tax incentives. Among those rules, the most noteworthy one, Bulletin 2,[7] expands the scope of enterprises eligible to qualify as a small-scale and low-profit enterprise, which can receive preferential EIT treatment. Bulletin 2 also includes a lower EIT rate for those qualifying small-scale and low-profit enterprises. The tax incentive in Bulletin 2 is effective from 1 January 2019 to 31 December 2021.

More enterprises to qualify as small-scale and low-profit enterprises

Bulletin 2 has expanded the scope of enterprises that qualify as small-scale and low-profit enterprises. According to Bulletin 2, an enterprise qualifies as a small-scale and low-profit enterprise if it does not conduct business in a prohibited industry and it meets the following conditions:

- has no more than CNY 3 million in annual taxable income;
- has no more than 300 employees; and
- has no more than CNY 50 million in total assets.

Before Bulletin 2, enterprises had to be much smaller to qualify as small-scale and low-profit enterprises. To qualify, enterprises could have only had a maximum of CNY 1 million in annual income, a maximum of 80 employees (100 for industrial enterprises) and a maximum of CNY 10 million in total assets (CNY 30 million for industrial enterprises).

Lower EIT rate for small-scale and low-profit enterprises

The old rules provided a single 10% EIT rate for small-scale and low-profit enterprises. Bulletin 2 provides an EIT rate of 5% on a small-scale and low-profit enterprise's taxable income that is less than CNY 1 million and an EIT rate of 10% on the enterprise's taxable income between CNY 1 million and CNY 3 million. If the enterprise's taxable income rises above CNY 3 million, then the entire amount of taxable income will be subject to a 25% EIT rate as the enterprise will no longer qualify as a small-scale and low-profit enterprise.

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[7] *Announcement on Issues Concerning the Implementation of the Policy on Inclusive Income Tax Relief for Small Low-profit Enterprises*, SAT Bulletin [2019] No. 2, dated 18 January 2019 and effective from 1 January 2019 ("**Bulletin 2**").

Observations

The expanded EIT incentive will largely benefit consulting firms and start-ups that were too large to qualify as small-scale and low-profit enterprises under the old rules.

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