

21 November 2019

Dear Sir or Madam,

Submission on the scope of “bonds” eligible for exemption under Circular 108

The Capital Markets Tax Committee of Asia (“CMTC”)¹ and the Asia Securities Industry & Financial Markets Association (“ASIFMA”)², both represent many of the largest financial institutions in the world. The CMTC and ASIFMA have been consulting with the Ministry of Finance (“MoF”), the State Taxation Administration (“STA”), the People’s Bank of China (“PBoC”) and other key regulatory bodies in China in relation to tax and other issues affecting the financial services sector.

The purpose of this letter, which has been drafted with the assistance and input of Lachlan Wolfers, Head of Indirect Tax, KPMG China, is to set out our request in relation to Caishui [2018] No. 108 (“Circular 108”) to clarify the scope of bonds eligible for exemption from corporate income tax (“CIT”) and value added tax (“VAT”).

The CMTC and ASIFMA wish to thank the SAT and MoF for the strong support of the China bond market and financial services sector in relation to the issuance of Circular 108. Circular 108 is warmly welcomed by CMTC and ASIFMA and their members. This should be a significant step in opening up the bond market in China and attracting more foreign capital by providing tax exemption for bond investment in China.

However, there is still some market uncertainty with regard to scope of debt instruments eligible for such exemption. We therefore suggest the STA to confirm that the exemption from CIT and VAT for interest income derived by foreign investors applies to “debt instruments” regulated by the PBoC or other relevant authorities, and issued and traded in the China bond market legally”.

For our more detailed analysis, please refer to the discussion below.

¹ CMTC is a financial services industry body consisting of a number of banks, investment banks, securities firms and other diversified financial services institutions operating in Asia who are represented through their regional tax directors. The main objects of the CMTC, according to its Constitution, are “to provide a forum for discussion by corporate tax managers responsible for the tax affairs of investment banks, securities firms, banks and other diversified financial services institutions of topical taxation issues in Asia affecting their capital and securities markets and similar activities; to keep members informed of up to date information on taxation matters affecting capital and securities markets, and to exchange views on the technical analysis thereof; and to represent the interests of its members through acting as the respected voice of investment banks, securities firms, banks and other diversified financial services institutions, and to participate in liaison or advocacy activities on tax matters either directly or indirectly through representation with other groups or societies concerned with or by fiscal matters.”

² ASIFMA is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative and competitive Asian capital markets that are necessary to support the region’s economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the [GFMA](#) alliance with [SIFMA](#) in the United States and [AFME](#) in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

Current exemption scope of bonds in Circular 108

In August 2018, the 3-year exemption from withholding tax and VAT for bond interest derived by foreign investors was introduced during the State Council's meeting led by the Premier of the PRC. The tax relief for overseas investors participating in the bond market aims to attract more foreign capital and boost economic development.

In November 2018, Circular 108 was released to give effect to the 3-year exemption. For the period from 7 November 2018 to 6 November 2021, there is a tax exemption (covering PRC withholding tax, VAT and local surcharges) on bond interest income derived by overseas institutional investors.

Under the provisions of Circular 108, the 3-year exemption is granted to "bond" interest. In absence of clear scope of debt instruments eligible for such exemption, it is unclear to the market whether definition of bond instrument would differ from definitions set by PBoC or other relevant authorities which are the primary concern to potential investors.

Current types of debt instrument in China bond market

Currently, there are two bond trading markets in China, China Interbank Bond Market ("CIBM") and exchanges, and multiple regulators for different types of debt instruments. The PBoC and the National Association of Financial Market Institutional Investors ("NAFMII") are the major regulators for the interbank market while China Securities Regulatory Commission ("CSRC") regulates the exchange market. In addition, MoF and National Development and Reform Commission ("NDRC") and other government authorities are also involved in regulating the issuance and trading of specific bonds³.

Based on the China Central Depository & Clearing ("CCDC") website, there are currently various types of bonds issued and traded in the market. For traditional products, e.g. Treasury bonds, corporate bonds, financing bonds and etc., it is relatively certain that the 3-year exemption should apply.

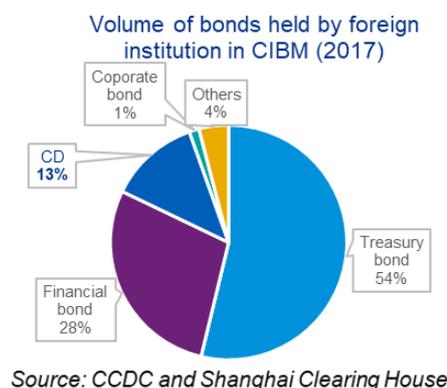
However, with the development of China's bond market, other types of debt instruments, e.g. Asset-backed notes ("ABN"), Asset-backed securities ("ABS") and Interbank Certificates of Deposit ("CD")⁴, have been introduced into the bond market. While these debt instruments are approved by the relevant regulators as "bond", they may lead to confusion and different interpretations on whether they are "bonds" which fall within the scope of exemption in Circular 108.

³ Bond Connect: Linking China's onshore and offshore bond markets, Investco, Nov 2017

⁴ CD refers to the book-entry fixed deposit certificate issued by a financial institution and can be traded in the interbank market. It is also commonly known as Negotiable CD ("NCD").

Those other types of debt instruments are integral components of China’s bond market. For example, commercial banks use interbank CDs to manage financial risks proactively. The interest rate for CDs can even be used as a benchmark for market interest rates. Compared to traditional bonds, financial products such as ABS and ABN can be used to raise funds based on future cash flows generated by underlying assets.

These other types of debt instruments are welcomed by investors, including foreign institutional investors. For example, CDs are currently the third most popular type of bond held by foreign institutions in the China Interbank Bond Market in 2017, surpassing traditional types of bonds, such as corporate bonds. Please refer to the pie chart for the volume of bonds held by foreign institutions in CIBM in 2017.



The debt instrument traded in China bond market share the same features of “Bond”

STA has not published any formal tax rules of explanation to define broad “bond” concept. However, STA and MoF have issued an exemption rule on railway bond (“Circular [2019] No.57”), and clarified that the concept of bond should include railway construction bond, short term financial bonds, medium term note, and other related debt instrument. From the specific rule, even though medium term note and other related debt instrument are not called as “bonds”, STA and MoF considered they are bonds in nature. This indicates that at least for railway bond, China tax and industry regulators would consider the “bond” applies to a broad concept debt instrument.

Other than the above regulation, there is no clear definition of “bonds” in the local China tax regulations, including in Circular 108, therefore we refer to industry regulations and summarize the features of “bonds” as follows:-

- 1) A bond is a kind of security with debt features.
- 2) A bond is issued in accordance with legal procedures and is regulated by a regulator.
- 3) Investors can purchase bonds and trade them in a market that is regulated by a regulator.
- 4) Interest and/or principal is obliged to be paid.

Taking ABN, ABS (senior class) and CD as examples, we note that these other types of debt instrument traded in the China bond market fulfill all four features of a “bond”. They are regulated in much the same way as “bonds” and they are also widely accepted by the industry as being in the nature of a “bond”, though they are not called “bonds”. Therefore, because they exhibit all of the features of a bond and accepted as being in the nature of a bond, ABN, ABS (senior class) and CD should also be included in the scope of exemption.

Features of Bond	ABN	ABS	CD
Bond is a kind of securities	√	√	√
Bond is issued in accordance with legal procedures	√ Regulated by NAFMII & PBoC	√ Regulated by PBoC and CSRC	√ Regulated by PBoC
Investors can purchase bonds and trade them in the market	√ Traded in CIBM	Senior ABS is traded in CIBM and stock exchange	√ Traded in CIBM and stock exchange
Interest and/or principal is obliged to be paid	√	The criterion is met by senior ABS	√

Moreover, the bond market in China is developing rapidly. For example, ABN was first introduced into the China bond market in 2012, and in 2013 for CD. We can expect that there may be other bond products developed in the future. Therefore, the applicability of the exemption should also consider the future development of China's bond market.

In addition, PBoC has issued a consultation paper on "Rules for the Recognition of Standardized Debt Assets" on 12 Oct 2019, and the paper has proposed a detailed definition of "standardized debt assets" to supplement earlier Guiding Opinions on Regulating Financial Institutions' Asset Management Businesses issued on 27 April 2018. The rule has included many debt instruments that are not typically called "bonds", including ABN, ABS and CD. This consultation paper reaffirmed that non-traditional debt instrument legally issued in China bond market should be considered as bond from regulatory perspective.

To conclude, the primary issue is about the scope of exemption. If the tax exemption is only limited to traditional bonds instead of generic debt instruments traded in the market, it may discourage foreign institutional investors to invest in many types of debt instruments in the China bond market.

Less competitive compared to exemption practice in other countries

A country's tax policies, especially tax exemption and incentives, play a key feature when bond investors make decisions about the country they want to invest in. Therefore, to attract foreign investors, many jurisdictions grant foreign investors withholding CIT and VAT exemptions with respect to interest on debt instruments.

For withholding VAT, to the best of our knowledge China is the only jurisdiction that applies a VAT to (non-government) bond interest income and other financial products. All other jurisdictions exempt them from VAT.

Besides VAT exemption, the CIT exemption rules in some major bond markets extend the exemption to not only traditional bonds, but also new types of debt instruments traded in the market, e.g. CDs and ABSs. For example, we note that the United States, per 26 USC § 881(c), exempts interest derived from investment portfolios, including mortgage-backed securities and certificates

of deposit. In Japan, the Japanese Bond Income Tax Exemption Scheme grants CIT exemption on TMK bond (equivalent to ABN / ABS) and J-REIT bond (ABS backed by real estate) traded in the Book-Entry System.

We understand that recent tax policies including the 3-year exemption are aiming to build an internationally competitive bond market in China. However, without a clear scope for exemption, foreign investors may be subject to potential CIT and VAT exposure arising from bond interest. In this case, any potential tax imposition on bond investments in China may reduce the overall return to foreign institutional investors, leading to a material disadvantage in attracting foreign investors. In that case, the achievement of the objective above may be difficult in the near future.

Our Recommendation

With respect to the issues identified, we suggest to clarify the scope of “bonds” eligible for exemption by a nationwide announcement or guideline in respect of interest income in the context of Circular 108.

As discussed, besides traditional bonds such as government bonds, financial bonds, corporate bonds, there are many new types of debt instruments with the same characteristics as bonds, including ABS, ABN and CD. So it is important to make it clear whether the scope of exemption should be applied to these other types of debt instruments. If so, the practice would be consistent with the trend towards encouraging foreign investment in the China bond market and would be in line with the tax practice generally adopted by other major jurisdictions on the interest income derived by foreign investors from bonds.

Therefore, we suggest the tax authority to adopt an inclusive and generic approach to define the scope of bonds subject to the 3-year exemption. To be more specific, we think that debt instruments issued in local bond market shall have obtained the approval from relevant regulators to be traded as “bond”

From a practical front, we would suggest that as long as the debt instruments are traded in local bond market (i.e. CIBM and exchanged bond market) and regulated by certain authorities (e.g. PBoC, CSRC, National Development and Reform Commission, NAFMII, etc), it should be considered as eligible for Circular 108 exemption because

1. These instrument should have been reviewed by relevant authorities before approved for trading and point 3 above should have already been taken into account in the approval process
2. It will remove the current ambiguity to investors on the tax exemption basis otherwise investor may rely on two set of definition to decide PRC bond investments
3. The above proposal would be in line with the spirit of circular 108 (i.e. to remove the tax compliance uncertainties from the market)
4. It will support development and innovation of new type of bond products in China. Otherwise there will always be of ambiguity whether the newly designed bond features is eligible for the circular 108 exemption

The definition above would help to clarify that exemption under Circular 108 should apply to all the bond products foreign investors can participate in the China bond market. It would boost the confidence of foreign investors to participate in the China bond market through all kinds of available debt instrument, and improve the global competitiveness of China's bond market.

We would be pleased to elaborate on any of the points made in this submission, and we take this opportunity to thank you for your consideration of these important matters. Again, to reiterate, the CMTC and ASIFMA members warmly welcome the effort of STA to improve China bond investment environment.

If you need to know more about the industry practice, please contact Patrick Pang (ASIFMA Head of Compliance and Tax, ppang@asifma.org); if you would like to know more about the tax implication, please contact Lachlan Wolfers (KPMG China Head of Indirect Taxes, lachlan.wolfers@kpmg.com).

Yours faithfully

Patrick Pang

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Neil Bowen

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Appendix: definition of bond and common instrument in bond market

Definition of “bonds” in industry regulations

There is no clear definition of “bonds” in the China local tax regulations, including in Circular 108. So we refer the ordinary meaning of the term “bonds” as it is used in the industry regulations.

Under PBoC Announcement [2015] No. 9, bonds refer to government bond, central bank bond, financial bond, corporate bond, ABS and etc.

PBoC has recently issued a consultation paper on “Rules for the Recognition of Standardized Debt Assets” on 12 Oct 2019. Regarding the definition of standardized bond financial asset, the paper defined new types of debt instrument as bonds, including government bond, central bank receipt, local government bond, governmental institution bond, financial bond, non-financial corporate debt instrument, corporate bond, international institution bond, Interbank Certificates of Deposit, asset backed security, asset back note, and securities investment fund with fixed income.

Under the rules of the Administrative Measures on Issuance and Trading of Corporate Bonds, a corporate bond refers to a security issued by a company in accordance with legal procedures. The essence of a corporate bond is that the company agrees to repay the principal and interest within a certain period of time.

The China Securities Regulatory Commission’s website describes a bond as a type of security. It is a creditor's debt certificate issued by an economic entity to raise funds, to pay interest on a regular basis and to repay the principal.

Definition of “ABN”

According to the “Guidelines on Asset-backed Notes for Non-financial Enterprises on the Interbank Bond Market” issued by NAFMII in August 2012 and PBoC Circular [2009] No.1, ABN refers to non-financial institutions who use structured methods for financing purposes. Furthermore, ABN is a kind of securitization financing instrument where the interest and /or principal is paid by the cash flow / profit generated by the underlying assets.

NAFMII has also issued Announcement [2017] No. 27 based on PBoC’s regulation on the debt instrument in bond market (PBoC Circular [2008] No.1), to regulate the issuance of ABN traded in the CIBM.

Definition of “ABS”

In accordance with the interim administrative guidance on Credit Asset Securitisation issued by the PBoC and China Banking Regulatory Commission, a banking financial institution, as the sponsoring organization, entrusts the credit assets to the trustee, and the trustee then issues a form of asset-backed security to the investment institution. After that, the investment institution receives interest and / or principal based on the cash flow generated from and/or collateralized by the underlying assets.

Other than ABSs issued in the China Inter-Bank Market, there are ABSs traded on the stock exchange. The website of the China Securities Regulatory Commission says that Asset Securitisation is a business activity where organizations issue ABS based on the cash flow generated by underlying assets through structured methods to enhance credit rating. ABS refers to a kind of security issued by the creditability or the cash flow generated from underlying assets. A security company or asset management company as the ABS manager, initiates the ABS plan to operate the business.

Specifically, we understand that senior ABS is traded in the bond market through credit rating mechanisms while junior ABS without credit rating is not traded in the market. Announcement of the PBoC [2005] No.14 requires that ABS should fulfil certain credit rating and information disclosure requirements to ensure only senior ABS is issued and traded in the bond market.

Definition of “CD”

In accordance with Interim Measures for the Administration of Interbank Certificates of Deposit (Announcement of the PBoC [2013] No.20), CDs refer to the book-entry fixed deposit certificate issued by a financial institution which is eligible to accept the deposit. By the nature of the deposit, the holder of the CD has right to receive the interest and/or principal from the issuer. The CD is traded in the interbank market, and it is a common debt instrument in the monetary market.

On China Central Depository & Clearing Co., Ltd’s website, the CCDCC maintains a list of debt instruments traded on bond market. In addition to the debt instruments mentioned above, we can find all the tradable debt instruments on the bond market. This list could be used as a good reference of bond products approved by the relevant regulator.

<https://www.chinabond.com.cn/>