To: State Administration of Taxation

27 November 2019

Dear Director Zhang Ying,

**Submissions on VAT rules for the financial services sector**

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.

We understand that the MoF and SAT are proposing to introduce new VAT legislation, which process is expected to be completed in the coming years. In that context, the CMTC would like to address some key VAT issues arising in the financial services sector in China, including their practical considerations. Specifically, the CMTC members focus on ensuring there is a level playing field with their international competitors, and consistency of the Chinese VAT rules with OECD principles. CMTC members believe that by addressing the issues in these submissions, it would result in the Chinese VAT system operating more internationally competitively, fairly and reasonably for both domestic and international financial institutions. We would like to submit that the follow types of activities should be exempted or outside the scope of VAT in China:-

— gain from trading in financial products by foreign investors;

— exported financial services; and

[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.

— services occur entirely outside of China.

We welcome the opportunity to provide you with this submission. We would be pleased to meet with the MoF and the SAT, along with several of the CMTC members, to further elaborate on any of the submissions made in this document.

**Issue 1 – gain from trading in financial products by foreign investors**

The primary rule in Circular 36 is that VAT applies to net gains derived from trading in financial products. Circular 36 then provides for a limited category of exemption for gains derived from trading in securities by Qualified Foreign Institutional Investors (QFII), and this exemption has been further expanded by Circular 70 to include Renminbi Qualified Foreign Institutional Investors (RQFII). Similar exemptions have also been granted under Circular 70 to foreign financial institutions approved by the PBOC to participate in the Chinese interbank bond market. However, the VAT exemption is still limited to the local currency market.

The rules in Circular 36 work appropriately where the gain from the financial product is derived by a Chinese entity from trading activities taking place in China. However, for the reasons set out further, this is different where the gain is derived by an offshore entity from the sale of a financial product to a Chinese entity.

The following key issues arise under the current scope of the VAT exemption for net gains derived from trading in financial products:

— The "VAT" in respect of the net gains from trading in financial products is not, in truth and reality, a 'value added tax'. Rather, it is more akin to a capital gains tax or a wealth tax, because it is not creditable

— In many cases, the role of the foreign entity is very much similar to that of an exchange, a central marketplace that companies of all nationalities come to invest or trade. It is surely not the intention of the rules to impose VAT on the activity of such an "exchange" located outside China.

— Foreign investors should not be taxed on these gains. Other jurisdictions do not tax PRC investors for VAT purposes on such gains.

— The VAT withholding rules should not apply to gains from trading in financial products by foreign entities merely because it trades with a Chinese entity, for the following reasons:

    - The application of VAT to net gains from trading in financial products serves a completely different purpose than the normal VAT withholding rules. Specifically, the underlying economic purpose of taxing net gains from trading in financial products is to impose the VAT solely on the Chinese entity making the net gain in China, on the basis that they consume the service in China. By contrast, the offshore counterparty who merely executes a transaction with a China counterparty should not be caught by the VAT rules on the basis that they will consume the service outside of China.
    - The normal VAT withholding rules are intended economically to tax the foreign entity on importing services in China through the collection of tax by the Chinese domestic entity. However, here the 'service' is not imported because the gain is consumed by the foreign entity for themselves, and is not a service which is provided to the Chinese domestic entity.

— The domestic Chinese entity will not practically be able to calculate the 'gain' arising on the trade – they may only know the selling price, but not the purchase price (or vice versa).

— Under the current rules, specific VAT exemptions need to be sought for each new scheme introduced by the government.

— In practice, considerable confusion and uncertainty arises where the gain is derived by an offshore entity from the sale of a financial product to a Chinese entity in circumstances where the gain is not already exempt from VAT (such as with QFII). Specifically, whether there is any VAT withholding obligation imposed on the Chinese entity.

In short, the VAT withholding rules in Circular 36 should not apply to gains from trading in financial products by foreign entities. We recommend introducing a general VAT exemption for gains derived by foreign investors from trading in financial products. Furthermore, the types of financial products and trading activities eligible for exemption from VAT needs to be clarified.

**Issue 2 – exported financial services**

Under the current VAT rules (Circular 36), there is no category of VAT exemption for exports of financial services, except for limited fee based services and financial consulting services[3].

The following key issues arise under the current VAT rules in respect of exports of financial services:

— The OECD's International VAT/GST Guidelines[4] provide that exports of services should be free of VAT in a B2B-context, so as to ensure that the foreign business which is receiving the service does not incur irrecoverable VAT. Alternatively, a refund mechanism should be available for the foreign service recipient. Foreign businesses should not be taxed because VAT, if any, should only be applied in the location where the services are consumed, not in the country from which the services originate, in accordance with the "destination principle". Any misalignment between countries in this respect creates a risk of double taxation, both in the originating country and in the recipient country.

— While we note that there is a limited category of exemption from VAT for exports of financial consultancy services, this category of exemption is very limited. Most foreign banks with operations in China have not been able to utilise this concession, or other exemptions for exports of services, for the revenue they earn from foreign service recipients.

— The application of VAT to exported financial services makes China's financial services sector less competitive internationally. Put simply, if the recipient of financial services buys those services from a Chinese provider they incur VAT, whereas if they buy the same financial services from a provider:

    • in their own country: either no local VAT applies (because financial services are generally VAT exempt in the majority of jurisdictions), or input VAT credits can be claimed where the service recipient has taxable outputs;

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[3] Fee based services which qualify for the VAT exemption include fee based services in relation to financial transactions between two overseas entities which are not related to goods, intangible assets or immovable property located in China. So it means that to enjoy the VAT exemption on the basis of fee based services, there are two conditions which need to be met. The first condition is that the service should be a fee based service as defined in Circular 36, and the second is that the service is rendered between two overseas entities.

As Circular 36 does not provide a clear definition of exported financial consultancy services, we understand that they shall consist of consulting services including the activities of providing information, financial planning, wealth management and bank consultancy services.

[4] OECD, "International VAT/GST Guidelines", November 2015.

- in another jurisdiction: no foreign VAT generally applies as exports of services are VAT exempt, VAT zero rated or outside the scope of local VAT in the majority of jurisdictions.

In any scenario, VAT in the country of the service provider is generally not adding to the cost of the financial services bought. This places Chinese financial services providers at a 6% price disadvantage (the applicable VAT rate to financial services) compared to their international competitors.

— In practice, this is also specifically an issue for intra-group recharges of services by financial institutions in China to overseas group companies. Currently, they cannot access zero rating or exemption from VAT; the overseas group company cannot register, and so the VAT is a real cost – this is inconsistent with OECD's International VAT/GST Guidelines.

To illustrate this principle in the context of financial services and to facilitate your better understanding, we have summarized a list of exported financial services which are consumed outside China (please refer to Appendix 1).

To improve international competitiveness and to ensure consistency with OECD Guidelines, we recommend:

(a) The scope of the exemption from VAT for exports of services should be expanded so as to capture exports by financial institutions in China generally to offshore; and

(b) The inclusion of a category of VAT exemption for cross-border intra-group recharges by financial institutions in China.

**Issue 3 – services occur entirely outside of China**

Article 13 in Circular 36 provides that where the service recipient is in China, but the services occur entirely outside of China, then the transaction is not subject to VAT.

The following key issues arise as a result of the current VAT rules in respect of the place of consumption rule:

— Firstly, it is often unclear whether the service 'occurs entirely outside of China'. In this respect, the view taken by many tax officials in practice is that VAT applies simply if the service recipient is a Chinese entity/person (e.g. taking the position that at least a small part of the service must therefore occur in China). This essentially makes Article 13 in Circular 36 meaningless.

— Secondly, if VAT applies, then the VAT must be accounted for by the Chinese customer on a withholding basis. If the Chinese customer does not do so, then both the overseas financial services provider and the Chinese customer may be held jointly and severally liable for the VAT. The problem is that in practice the overseas financial services provider may provide financial services to customers in numerous countries and may not be familiar with the indirect tax implications in each customer's country. It is exposed to a Chinese VAT liability if it solely relies on the Chinese customer to withhold the VAT. In addition, Chinese customers in different locations often take different positions, leading to confusion.

— Thirdly, when an overseas bank provides fee based services to a Chinese customer, it is common for the overseas bank to deduct its commission or service fee from the total consideration paid to the Chinese customer (i.e. from the Chinese customer's earnings from their financial products). In such a case, there is no actual payment from the Chinese customer to the foreign bank for the service fees. If VAT applies, practically it is difficult for the Chinese customer to withhold the VAT on behalf of

the foreign bank. Therefore, it is difficult in practice for foreign banks to manage their VAT risk in China.

— Fourthly, where a Chinese company or bank issues bonds on the overseas capital market, the Chinese company or bank pays interest to the overseas holder of the bond. If subject to VAT, the Chinese company or bank has to withhold and pay VAT on the interest paid to the overseas holder. However, practice has shown that in most cases, it is not possible for the Chinese bond issuer to identify the holder of the bonds and the place where the holder of the bonds is located. Thus VAT cannot be withheld in practice and the overseas bond holder is not able to manage its VAT risk in China.

— Finally, where an overseas headquarter provides services to its Chinese entity on a 'cost plus' basis, the recharge of salaries and wages to the Chinese entity results in VAT withholding applying. If the Chinese entity is a financial institution, it will typically need to transfer out some input VAT credits, arising from its exempt interbank transactions. Many jurisdictions exclude the recharge of salaries and wages within a corporate group from their reverse charge rules, so as to overcome this anomaly.

In our view, Article 13 needs to be amended in the following key respects:

— Article 13 needs to be reworded so as to make it clear that the exclusion from VAT applies if the service is consumed outside of China, rather than if the service occurs or is provided or performed outside of China. The place where the service is consumed is consistent with the destination principle as set out in the OECD International VST/GST Guidelines. The OECD International VAT/GST Guidelines in relation to the destination principle have already been adopted (to a large extent) in Circular 36 in relation to exported services and therefore underpins the current system.

— The rules should clarify that exclusion from VAT will apply if the service relates to an underlying transaction, asset or event arising outside of China. This would solve the problem, for example, where asset management or custody services relate to assets being managed or maintained outside of China

— To resolve the problem that Article 13 applies an 'all or nothing' approach, Article 13 should allow for apportionment of the service between the component which is consumed in China and the component which is consumed outside of China, applying similar principles to the apportionment in Article 29. Such an approach is consistent with VAT/GST systems in common usage throughout the world. Alternatively, a de minimis approach could be adopted whereby VAT only applies if say 10% or more of the value of the service is consumed in China.

— To cater for the problem of VAT withholding (without a full credit to the service recipient), for intragroup recharges, an exclusion should apply to recharges of salaries and wages, along similar lines to what is adopted in jurisdictions such as Singapore and the UK.

To illustrate this principle in the context of financial services and to facilitate your better understanding, we have summarized a list of financial services which are necessarily rendered and consumed outside China (please refer to Appendix 2). We wish to highlight that this is not intended as an exhaustive list of services which occur entirely outside China. Consequently, the non-application of the VAT for services occurring outside of China should not be limited to the listed services; rather it should be applied following the principle suggested above.

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 tax environment for China financial services sector.

If you need to know more about the industry practice, please contact Patrick Pang (Managing Director, 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

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## Appendix 1
## Exported financial services

The concept of 'exported' financial services refers here to examples where the place of consumption of the relevant service is outside mainland China. As you will see from the below list, some of these examples currently qualify for exemptions from VAT, while most do not.

We have intentionally excluded from the list of examples below situations where a service may be provided for a foreign recipient, but where the underlying service may relate to goods or real property in China. For example, we have excluded situations where a PRC bank lends to a non-resident where the loan is secured against real estate or assets in China. Likewise, we have excluded custodian services provided by PRC custodians where the custody services are provided to non-residents but relate to assets in China.

To be specific, we have further separated this list into three categories, comprising loan services, fee based services and financial consulting services. The intention of these categories is to identify common commercial circumstances under which financial services are exported and therefore should benefit from exemption from VAT. It is important in this context to recognize that compared with VAT and GST systems in many other countries throughout the world:

- China applies VAT to financial services, unlike many other countries where no concern would arise;
- Many other countries (especially the EU) allow foreign entities in receipt of services where VAT has been charged to claim a refund. China does not allow foreign entities to register and therefore no refund entitlements can arise;
- OECD principles support the view that VAT is not intended to be a real cost in B2B transactions, and therefore there should be no VAT leakage (i.e. there should not be a situation where VAT is charged by the PRC service provider for which a non-resident business is unable to claim a credit (or refund).

### Part 1 - Loan services

#### 1.1. Non-mortgage loan services (including overdraft)

When non-resident customers borrow money from Chinese banks, non-resident customers have to make payments over a set time span until they pay back the Chinese bank in full. The cost (i.e. interest and service fee) of borrowings usually are calculated as a percentage of the amount of the outstanding loan principal. This is an example of an exported service for which currently no VAT exemption applies.

#### 1.2. Syndicated loan services

Syndicated loans are provided by a consortium of financial institutions where the loan size is beyond the capacity of a single lender and it is desired to spread the risk. Generally, one or a few institution(s) acts as lead managers/arrangers earning a fee based on a percentage of the total facility to arrange or manage the loan facility. Where a number of lenders, including Chinese banks, then make up the syndicate that lends the money to borrowers located outside China on a joint basis, this should be regarded as an exported service. However, currently no exemption from VAT applies.

#### 1.3. Trade finance – Letter of credit ("LC")

This includes but is not limited to Trade-letter of credit issuance, LC financing, Standby letter of credit, reverse factoring, receivable financing. It refers to the case where a Chinese importer agrees with an exporter located outside China to settle trades via LC. The importer establishes a LC facility with its Chinese bank. The issuing bank draws up the LC and issues it to the exporter's bank.
A Chinese importer requests the LC issuing bank to offer early payment to the non-PRC exporter. As a service provider, the LC issuing bank located in China pays the non-resident exporter the LC value minus a discounting charge and retains the full LC amount received at maturity from Chinese importer. This is an example of an exported service since it is effectively a funding mechanism by which the non-PRC exporter gets paid. Currently no exemption from VAT applies.

### 1.4. Panda bonds invested by Chinese investors

Where Chinese investors purchase RMB denominated bonds ("Panda bonds") issued by foreign companies in the China bond market, the investment in Panda bonds should be considered as a funding service provided by Chinese investors to overseas debtors. This is an example of an exported service for which currently no VAT exemption applies.

## Part 2 – Transaction fee based services

Under the current VAT rules in Circular 36, a Chinese finance institution could be eligible for VAT exemption if its fee based services relate to the facilitation of financing activities between two or more non-resident companies. Furthermore, in order to qualify for exemption, such services must not be related to goods, intangible assets and real estate in China. Currently this qualifies for VAT exemption, though the examples where this applies appear relatively rare.

### 2.1. Underwriting services

One example of an exported underwriting service is where a domestic investment bank provides underwriting assistance to foreign service recipients for RMB denominated bonds ("Panda bonds") issued in the Chinese bond market. This can also extend to domestic investment bank underwriting CDRs in the Chinese equity market in the future.
Another example is where domestic investment banks provide underwriting assistance to foreign service recipients for securities listed in overseas capital markets. In each case, currently the rules do not provide for VAT exemption.

## Part 3 – Financial consulting and investment related services

According to Circular 36 and SAT Announcement [2016] No. 29, exports of consulting services qualify for VAT exemption if the service is provided to an overseas entity and if the service is not in connection with goods or real estate in China.

### 3.1. Financial advisory services

This relates to the fees paid for providing financial advice on a transaction. If the service recipient is located outside of China and if the services does not relate to goods or real estate in China, VAT exemption should apply.

### 3.2. Financial consulting and other services

When Chinese financial institutions provide customer referral services and sales and marketing support and other consulting services to customers who wish to take out loans, obtain LC (or acquire other financial products) offered by offshore headquarters of the Chinese financial institutes, it is quite

common for headquarters to pay related service fees and other amounts to the Chinese financial institutions. These service fees are often charged on a ‘cost plus’ basis as a funding mechanism for transfer pricing purposes. The issue with the scope of this exemption is that it can be difficult to access for financial institutions in PRC.

**Appendix 2**
**List of financial services occurring entirely outside of China**

We have set below a non-exhaustive list of financial services that should be considered as occurring entirely outside of China, and therefore outside the scope of VAT.

The underlying principle is that no VAT should apply when a foreign service provider provides services to a Chinese service recipient if the service is rendered and consumed outside China.

Similarly, we have separated the list into three categories, comprising loan services, fee based services and financial consulting services.

**Part 1 - Loan services**

**1.1. Non-mortgage loan services (including overdraft)**

Where PRC resident customers borrow money from offshore banks, no VAT should apply, provided the loan is not secured against assets in China. The PRC resident customers have to make payments over a set time span until they pay back the offshore bank in full. The interest and service fees should not be subject to Chinese VAT.

**1.2. Security lending interest and security lending agency fee**

This is the case where a PRC company borrows from an offshore bank's securities against certain collateral. As a payment for the borrowed securities, the offshore bank receive interest. In addition, the offshore bank also receives from the lender a fee for the use of the borrowed securities.

**Part 2 – Transaction fee based services**

**2.1. Banking and handling services**

Where PRC resident customers open bank accounts with an offshore bank outside China, and consume banking and other services outside China, then similarly no Chinese VAT should apply. Handling and similar banking services such as inter-bank wires and money transfers, payment requests, issuing bank cashier orders, overdraft, safe deposit box services, etc taking place outside China should not be subject to VAT in China. Other services such as buy/sell of investment products, securities brokerage and execution services, insurance policy subscriptions, non-CNY account clearance services performed by offshore banks to Chinese individuals and companies, and traveler's checks charged by offshore bank to local individuals, should also be outside the scope of Chinese VAT if the service is performed outside of China.

Given the service providers (i.e. offshore banks) are located outside of China and services are provided and consumed by PRC resident customers outside of China, the service fee should not be subject to VAT. In any case, for regulatory and compliance reasons, offshore banks are generally prohibited from providing cross-border services and soliciting customers on product offerings in the PRC. Therefore banking and handling services provided by an offshore bank occur entirely outside of China.

**2.2. Nominee or custodian services**

Where the assets in custody are located outside of China, then the provision of such nominee or custodian services to PRC customers should be outside the scope of Chinese VAT. Custody is a generic term which includes a variety of custodian roles including core custody, safe custody and services in

relation to assets or properties. Where custodial services involve holding securities, the arrangement is usually a bare trust where the shares are legally owned by a nominee for the benefit of the beneficial owner.

Custody services shall be regarded as entirely occurring outside of China given that the service providers are located outside of China, especially when the service is provided outside China for overseas stock connect investors.

### 2.3. Trustee services

This relates to the services of a trustee where the assets in trust are located outside of China, and the trustee providing the service is outside of China.

The trustee will typically provide services including the holding and administering of property or assets for the benefit of third party beneficiaries for which a fiduciary responsibility is owed to the beneficiaries.

### 2.4. Securities registry services

This relates to securities registry services to companies or trusts where the securities being registered are outside of China and the service provider is outside of China.

### 2.5. Brokerage and/or Commission for securities, derivatives and commodities traded outside of China

This is the case where offshore brokers or agents provide brokerage and/or commission services for securities, derivatives (including trading of over-the-counter derivatives) and commodities traded on the offshore market. Payments made to brokers or agents are usually calculated as a percentage of the amount of the transaction.

### 2.6. Clearance and settlement services for securities or derivatives

This relates to the services of clearance and settlement for the transfer or exchange of securities or derivatives transactions (and the related settlement of monetary obligations for those transactions) for securities or derivatives which are located outside of China and the service provider is located outside of China.

### 2.7. Managing / arranging deposits, loans and securities transactions

Syndicated loans are provided by a consortium of financial institutions where the loan size is beyond the capacity of a single lender and it is desired to spread the risk. Generally, one or a few institution(s) acts as lead managers/arrangers earning a fee based on a percentage of the total facility to arrange or manage the loan facility. A number of additional lenders then make up the syndicate that lends the money to the business on a joint basis. VAT should not apply where the arrangers, lenders and the funds are all located outside of China and monies are made available to borrowers located in China.

### 2.8. Securities / loan agency services

This relates to agency services to manage syndicated loans or the issue of securities. An agent may be installed to manage the securities holdings and related cash flows and regulatory issues. Where the agents are located outside of China and the loan or issuance of securities is outside of China, then no VAT should apply.

### 2.9. Interchange services (for Point-of-Sale ("POS") transactions)

This relates to the services provided by overseas card issuing financial institutions for POS credit card transactions. The offshore card issuing financial institutions will issue credit cards to cardholders. After the credit cardholder makes a purchase, the card issuing financial institutions will deduct the interchange fee from the amount they pay to card associations and will receive the settlement amount outside China from the cardholders.

### 2.10. Interchange fees (Automatic Teller Machines ("ATM") transactions)

This relates to services for the use of ATMs outside China. Offshore financial institutions receive interchange fees for ATM transactions when PRC customers use credit cards issued by PRC banks to withdraw money via the ATM (which are provided by the offshore banks) outside China.

### 2.11. Distribution services

Where offshore distributors distribute investment and other products (e.g. funds, insurance) to PRC resident individual customers or distribute mainland funds to Hong Kong market investors when the individual customers/ investors are physically outside China, no VAT should apply. On the basis that the service providers (i.e. offshore distributors) are located outside of China; the distribution services are provided outside of China; and the underlying individual investors/customers subscribe for the fund units/ apply for the products outside of china, the services should not be subject to VAT.

## Part 3 – Financial consulting and investment related services

### 3.1. Asset management and administration service

This relates to an offshore asset managers providing asset management and investment advisory services, etc. to Chinese resident investors which relate to assets outside of China. The services should be regarded as entirely occurring outside China given that the service provider (i.e. the offshore asset manager) is located outside China and the services are provided by the asset manager outside of China. Therefore the service fee should not be subject to VAT.

### 3.2. Consulting services

This relates to an offshore financial institution providing consulting services to Chinese resident, in relation to offshore merger and acquisition, sales of asset, restructuring, and etc.

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