CMTC
Capital Markets Tax Committee of Asia

asifma
Growing Asia's Markets

To:

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Goods and Services Tax Department, State Taxation Administration

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9 March 2021

Dear Sir or Madam,

Submissions regarding the draft PRC VAT Law consultation paper

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.

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[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.

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We understand that the MoF and STA have jointly issued the draft PRC Value Added Tax ("VAT") Law consultation paper ("the draft VAT Law") on 27 November 2019 to collect comments from industry participants.

The release of the draft VAT Law is warmly welcomed by CMTC and ASIFMA members. We are pleased that the draft VAT Law has elevated the status of the VAT rules in China to a legislative form, reduced uncertainties in the current rules, and implemented more of the OECD's International VAT/GST Guidelines. CMTC and ASIFMA members appreciate this opportunity to provide comments on the draft VAT Law to address key VAT issues arising in the financial services sector in China and to contribute to China's VAT legislation. Specifically, CMTC and ASIFMA members wish to focus on ensuring there is a level playing field with their international competitors. CMTC members believe that by addressing the issues in these submissions, it will result in the Chinese VAT legislation being more internationally competitive, and both fair and reasonable for domestic and international financial institutions.

At the outset, we wish to acknowledge that we fully recognise the release of the draft VAT law is merely the first stage in the legislative process. That is, we understand and recognise that a considerable amount of the detail will come later with the release of the VAT implementation rules. Consequently, while our comments do address the draft VAT law itself, we similarly accept that some of the issues we have raised could either be addressed through changes to the draft VAT law, or considered later in the context of the VAT implementation rules.

We have summarized the key issues below for your consideration in finalizing the VAT law and implementation rules: -

Part 1: Key issues addressed in the draft VAT Law

— VAT exemption for gains derived by foreign investors from trading in financial products

— Place of consumption rule

— Consolidated VAT filing

Part 2: Key issues not yet addressed in the draft VAT Law

— Continuance of VAT incentives applicable to the financial services industry

— Definition of 'financial institution' for which the interbank lending exemption applies

— Carry back / forward of trading loss

— VAT exemption for exports of financial services

Part 3: Other issues

Please refer to the discussion in part 3 for our analysis of other issues.

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

Part 1: Issues addressed in the draft VAT law

Issue 1 – VAT exemption for gains derived by foreign investors from trading in financial products

The draft VAT Law defines taxable activities, which are potentially subject to VAT, as the sale and importation of goods, the sale of services, the sale of immoveable properties, the sale of intangible assets, and the sale of financial products. The sale, or trading, of financial products is a separate

category of taxable activity under the draft VAT Law. Furthermore, the sale of financial product is subject to VAT only if the seller is a domestic entity or the financial products are "listed" in China.

However, the scope of "financial products", how to identify the seller of financial products, and the definition of "listing" are not defined in the draft VAT Law.

Under the existing VAT rules in Caishui [2016] 36 ("Circular 36"), the transfer of financial products refers to the transfer of ownership of foreign currencies, securities, non-commodity futures and other financial products. Other financial products include financial derivatives and asset management products, such as funds, trusts, and other financial products. The current definition of "financial products" in Circular 36 does have a number of ambiguities as set out further below.

First, not all trading of financial products involve the transfer of ownership of financial products. For example, the transfer of the income right of a trust from a regulatory aspect is not clear whether it is treated as the trading of financial products. Second, whether a forward contract conducted in the business or trading of gold would be considered as a financial product is similarly unclear. Last, for certain transactions such as the vesting of options, it is unclear whether this constitutes the trading of financial products from a regulatory perspective. Options are financial instruments that are derivatives based on the value of the underlying securities. Though the transfer of an option is considered to be trading of financial products, the VAT treatment applicable to the exercise of an option is unclear. Similarly, whether the option fee can be used to reduce the capital gain arising from the exercise of the option is also unclear.

For certain transactions involving the trading of financial products, it can be difficult or even impossible to determine who is the seller and buyer. For example, in currency swaps, financial institution A and financial institution B sell to each other undesired currency and purchase desired currency. Another example is a total return swap in which one party make payments based on a set rate, and the other party makes payments based on the return of an underlying assets. Both parties make payments in this single transaction. If the above transaction is regarded as two separate transactions, the taxable basis of trading of financial products would be expanded to two times the original transaction. The financial transactions may become inefficient because of the uncertain tax liabilities, and therefore the function of financial markets may be distorted.

For the definition of listing, it is not clear in the draft VAT Law, or even under the existing tax rules. First, not all financial products are "listed" on the market and financial products can, in certain circumstances, be traded without the process of listing. Second, whether the requirement of listing refers to the issued party or the listing capital market or other factor is also not clear to the market.

We summarize whether listing (in China's financial market) could be applied for each type of financial product in the below table: -

Types of Financial Products	Whether listing is applied (Y/N)
foreign currencies	N
securities (stocks and bond)	Y
financial derivatives (swap, future, forward, options)	N for swaps and forward contract; Y for limited futures and limited options that are listed in the exchange market
Funds	Y for limited funds that are listed in the exchange market
Trusts	N
other asset management products	Y for some asset management products such as asset backed securities and financial products

In the examples above, when foreign trading parties engage in transactions with domestic trading parties involving financial derivatives which are not listed in the market, provided that the financial products are not listed in the market, such trading gains derived by foreign trading parties from trading in financial derivatives is excluded from VAT.

For listed financial products, under existing VAT rules, VAT exemption is currently applied to the transfer of financial products by overseas investors in many programs, such as QFII and RQFII, trading bonds in CIBM and bond connect, trading shares through stock-connect, etc. Confirmation of the continuation of those exemptions would be important to investors to ensure the stability and growth of those markets.

It is also important to remember that virtually all jurisdictions do not levy VAT on gains from the transfer of financial products derived by offshore investors, and therefore imposing VAT on those transactions may discourage offshore investors from entering the China financial market. Last, there may be significant administrative costs in levying on gains derived by offshore taxpayer, as there is no effective VAT withholding mechanism in China.

Our recommendation

With respect to the issues identified, we suggest that the MoF and STA provide a general exemption for offshore investors in relation to gains from trading of financial products in the draft VAT Law, based on the following reasons:

- By granting a broad scope of exemption to foreign investors, China’s financial products market can be more competitive in the global market;
- 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. In practice, there is no effective withholding VAT mechanism in place for domestic trading party to withhold VAT on the behalf of foreign entities.

In case that VAT exemption is not considered feasible, we further suggest that MoF and STA consider clarifying the scope of financial products and definition of “listing” in the VAT Law or VAT implementation rules in respect of the gains from trading of financial products. Options, foreign currency transaction, derivation transaction including total return which do not involve the transfer of the ownership shall be out of the VAT scope.

For the scope of financial products and transferor of financial products, we would recommend that the tax authority clarify the VAT Law, or the implementation rule, and further work with the financial services industry to resolve these uncertainties.

For the definition of listing, we would suggest that the tax authority adopt the definition which is widely accepted by the financial services industry. To be specific, listing refers to being on the list (or board) of stocks, bonds, and other financial products officially traded on a public market. Furthermore, if the VAT implementation rule sets out determinative scenarios about financial products that qualify as being listed in the China market, it would remove the uncertainty for foreign investors investing in China’s financial markets. Finally, the draft VAT law should clarify whether listing refers to the financial product being listed by a Chinese entity, or the financial product being listed in China’s capital markets.

Issue 2 – Place of consumption rule

Article 9 of the draft VAT Law provides that the scope of services which are potentially subject to VAT in China, arises if either the supplier is a domestic entity or individual, or the service is consumed in China. This proposition is different from Circular 36 where the provision of services is subject to VAT if either the service provider or service recipient is in China, but with an exclusion where the service wholly occurs outside of China.

We are delighted to see the draft VAT Law adopting the place of consumption rule following the OECD International VAT/GST Guidelines. However, there is currently no clarity around how to determine the place of consumption in the context of financial services in the draft VAT Law.

First, it is unclear the circumstances under which a financial service can be described as being “consumed” outside of China. We have prepared a non-exhaustive list of examples of the services that we consider are “consumed” outside China in Appendix 1.

Second, if VAT applies, the VAT must be accounted for by the Chinese customer on a withholding basis. If the Chinese customer does not do so, 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 service provider may provide financial services to customers in numerous countries and may not be familiar with the indirect tax implications in each country. Those financial service providers may be exposed to a Chinese VAT liability if it solely relies on the Chinese customer to withhold the VAT.

Our recommendation

In our view, we suggest the draft VAT Law or detailed implementation rules should clarify the principles arising under the place of consumption rule. We would suggest that exclusion from VAT should apply if the service relates to an underlying transaction, asset, property or event arising outside of China to avoid confusion in the definition of “consumed” outside China.

Issue 3 – Consolidated VAT filing

The draft VAT Law has reintroduced the consolidated VAT filing principle, which was stated in Circular 36 and abolished by Caishui [2017] No.58. Under the draft VAT Law, two or more taxpayers can apply for VAT consolidation and be regarded as one taxpayer if they have the approval of the MoF and the STA. We understand that the scope and requirements to apply consolidation may be awaited with interest in the implementation rules.

We noted that currently combined VAT filing may be available for financial institutions at provincial level only. However, most of the banks have branches located in different provinces nationally.

If consolidated filing at national level is not in place for financial institutions, the head office and branches need to file tax returns and pay tax separately to each in-charge tax authority at the location where their respective business operations are situated. The head office and branches also need to issue VAT invoices for internal transactions, which can pose significant practical challenges, especially in relation to head office procurement arrangements.

Furthermore, the inability to apply consolidated VAT filing may lead the head office and the branches to record significant volumes of exempt interbank transactions, which distorts their ability to claim input VAT credits.

Our recommendation

We would like the draft VAT Law to specify that consolidated VAT filing refers to a pooling of input VAT and output VAT across branches.

To reduce compliance costs of tax filings and to ensure fair treatment to different VAT taxpayers, we recommend the implementation rules specify that there is no restriction on the industry / type of company (e.g. state owned, wholly or partially foreign-owned) able to apply VAT consolidated filing at national level.

Similarly, VAT consolidated filing should not merely be restricted to head office and branches, but in fact to entities within the same corporate group. This is in line with principles applicable in the European Union, Australia, Singapore and elsewhere.

Part 2: Issues to clarify in the detailed implementation rules

Issue 4 – Continuance of VAT incentives applicable to the financial industry

Article 29 of the draft VAT Law provides an exhaustive list of VAT incentive policies. We understand from Article 30, that special VAT incentives can be formulated by the State Council, and the taxpayers would expect tax policies in effect before the VAT Law shall remain effective.

We have summarized below a non-exhaustive list of VAT incentives in relation to the financial services sector in China not covered by Article 29 of the draft VAT Law.

VAT incentives	Relevant rules
Interbank lending exemption	Caishui [2016] No.36, Caishui [2016] No.46, Caishui [2016] No.70
Exemption for interest income derived from reverse Repo	Caishui [2016] No.46, Caishui [2016] No.70
Exemption for interest income derived from discounted bills	Caishui [2017] No.58
Exemption for capital gain derived by trading of local securities by QFII and RQFII	Caishui [2016] No.36, Caishui [2016] No.70
Exemption for capital gain derived by trading of financial products in CIBM local currency market, including currency market, bond market and derivative market	Caishui [2016] No.36, Caishui [2016] No.70
Bond interest exemption for foreign financial institution	Caishui [2018] No.108
Exemption for capital gain derived by trading of A-shares through Stock Connect program	Caishui [2016] No.36 and Caishui [2016] No.127
Exemption for capital gain derived by trading of interest in funds under Mainland-Hong Kong Mutual Recognition of Funds program	Caishui [2016] No.36

Our recommendation

The above list of VAT incentives has been extracted from the current VAT rules. To promote the development of China's financial markets, especially to encourage foreign capital inflows, we suggest the current VAT incentive policies shall still be valid after the VAT Law becomes effective to ensure the continuance of those incentive policies, and there should be no specific restriction on the applicable years. The VAT incentive policies could either be specified in the draft VAT Law or the implementation rules, or be addressed in some other format, e.g. approval from the State Council.

Issue 5 – Definition of 'financial institution' for which the interbank lending exemption applies

Similar to other VAT incentives applied to the financial services sector, the draft VAT Law does not mention the interbank lending exemption, which is prescribed in Caishui [2016] 70 ("Circular 70") and

Caishui [2016] 46 ("Circular 46"). We have suggested that the rules about interbank lending exemption shall remain valid after the VAT legislation commences as mentioned in issue 4.

Under the prevailing VAT rules, the exemption only applies to transactions between 'financial institutions', where the scope of the business licence includes "lending to financial institutions". The problem is that while a foreign bank may qualify as being a 'financial institution' under the definition in Article (23)(d) of Appendix 3 in Circular 36, they will often not have a 'business licence' or other similar scope, and they will be regulated by a foreign regulatory authority, not the PBOC.

Many financial institutions do not actually have "lending to financial institutions" in the scope of their business licence. And from the perspective of the lender, it is difficult to know whether the borrower has "lending to financial institutions" in the scope of its business licence.

We also noted the exemption from VAT for interbank lending is very limited where one party is a foreign bank. Specifically, such exemption is limited to lending within the same corporate group. By contrast, there is a much broader category of exemption applicable domestically for lending activities between any financial institutions, including unrelated parties. This is inconsistent with OECD Guidelines, which aim to treat foreign businesses equivalently to domestic businesses.

Our recommendation

Besides the recommendation in Issue 4 about the interbank lending exemption, we would recommend expanding the definition of 'financial institution' to include foreign financial institutions in the detailed implementation rules as follows:

— Foreign financial institutions should be able to claim exemption from VAT in respect of loans made to unrelated financial institutions in China (and vice versa);

— The implementation rule should include a definition of 'foreign financial institutions', which is based on the idea they are financial institutions regulated in their own jurisdictions by regulatory bodies performing reasonably equivalent oversight functions to the PBOC.

This would ensure that foreign financial institutions are treated equivalently to domestic financial institutions, consistent with OECD Guidelines.

Issue 6 – Carry back / forward of trading loss indefinitely

According to Article 15 of the draft VAT Law, the net-off basis method shall still be applicable for the calculation of VAT and it should also be applied to sales or trading of financial products. However, the draft VAT Law does not go into detail on the treatment of losses in this regard.

In Circular 36, taxpayers are allowed to carry forward trading losses within the same year only. It means that losses can only be carried forward to the following filing periods within the same year, not to the next calendar year. Furthermore, losses cannot be carried back to an earlier tax filing period, either.

However, the VAT rules in China generally allow VAT credit balances to be carried forward (potentially indefinitely) for use against output VAT in future tax filing periods. Applying more restrictive VAT rules to offsetting trading gains against trading losses may be inconsistent with these more general policies. As a result of the inability to carry back losses to earlier tax periods, financial institutions which eventually realize a trading loss at the end of the year will not get a refund or crediting of the VAT paid.

This is less favorable than the position under the Business Tax regime. Under the Business Tax regime, financial institutions were allowed to carry back trading losses to offset trading gains realized earlier within the same year. Where the netting between gains and losses resulted in a trading loss for the year, then financial institutions could apply for a refund of the excess of Business Tax paid.

Our recommendation

To solve the issues identified, we recommend the detailed implementation rules under the VAT law should allow trading losses to be carried-back within the same year, and to allow the carry forward of any unused losses indefinitely.

Issue 7 – VAT exemption for exports of financial services

Article 13 of the draft VAT Law states that cross-border services provided by onshore VAT taxpayers can apply VAT at a zero-rate. The draft VAT Law does not provide a detailed list of eligible cross-border services.

We note that there is currently a very limited category of exemption from VAT for exports of financial consultancy services. The category of exemption is very limited under Circular 36. Most foreign banks with operations in China have not been able to utilize this concession, or other exemptions for exports of services, for the revenue they earn from foreign service recipients. We have provided a non-exhaustive list of exported financial services in Appendix 2 for consideration.

The OECD's International VAT/GST Guidelines provide that exports of services should be free of VAT in a B2B-context, 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.

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 or another jurisdiction, either no local VAT applies (exempted domestically or VAT zero rate for exported services) or Input VAT can be claimed. This places Chinese financial services providers at a 6% price disadvantage (the applicable VAT rate to financial services) compared to their international competitors.

We note a key theme of the draft VAT law is to bring China's VAT system towards having greater consistency with OECD principles, including through new rules which seek to emphasise the importance of taxing in the place of consumption only. The inability to claim incentives for exported financial services is inconsistent with these principles.

Our recommendation

To improve international competitiveness and to ensure consistency with OECD Guidelines, we recommend that the scope of the exemption from VAT for exports of services should be expanded to capture general exports by financial institutions in China in the detailed implementation rules under the VAT law.

Part 3: Other issues

We have also noted some other minor issues that we would like seek further clarification or amendment in the draft VAT Law or the following implementation rules. We set out below our comments for your consideration:

Issue overview	Article in the draft VAT Law	Our observation and recommendation
Withholding agent	7	The draft VAT Law specifies that the purchaser should be the withholding agent for VAT. However, in the context of certain financial services, if the foreign purchaser does not necessarily make payment to the domestic seller, this article could not properly be applied. For example, when domestic financial institutions transfer the forfeiting business to an overseas financial institution, there is no withholding tax agent at the time when the foreign institution receives the interest arising from the forfeiting business. Therefore, we suggest allowing foreign taxpayers to appoint designated withholding agents or 3rd party tax agents to make VAT filing and payment.
Scope of taxable transaction and VAT exemption for financial industry	8, 30	Financial institutions may trade standard gold* or gold futures in the Shanghai Gold Exchange and Shanghai Futures Exchange. The standard gold and gold futures traded in the exchange are traded in international currencies. Unlike the processed gold sold to end consumers, where the VAT for trading of goods should apply, the trading of standard gold and gold futures by financial institutions should not be considered as the trading of goods. Similar to the function of interbank lending activities, VAT exemption should therefore apply to the trading of standard gold and gold futures by financial institutions. If the VAT is levied on standard gold for financial institutions, it would distort the currency function of gold, and the gold market's role as a monetary policy tool. * Standard gold refers to purity of AU9999, AU9995, AU999, and AU995; and the weight of 50g, 100g, 1kg, 3kg, and 12.5kg
Scope of taxable transactions and non-taxable transactions	12	We suggest the VAT Law should specify general the principle that could distinguish taxable activities and non-taxable activities.
		The draft VAT Law specifies that employees providing services to their employer in consideration for their salary should not be subject to VAT. Similarly, other forms of monetary consideration (such as housing allowances) received by employees for the provision of services to their employer, should be also excluded from the scope of VAT. We suggest the draft VAT Law clarify and specify the above.
		Per Announcement [2013] No. 66, the transfer of assets and associated liabilities for asset restructuring purpose should not be

Issue overview	Article in the draft VAT Law	Our observation and recommendation
		subject to VAT. We suggest MoF and STA include such VAT incentive in the implementation rules.
		For financial institutions, there is frequent internal settlements between headquarters and branches. Such settlements may not be for the provision of services, and there is no value adding activities or profits generated from inter-branch settlements. Therefore, we suggest MoF and STA consider excluding inter-branch settlements from VAT taxable scope.
Adjustment to the consideration	18	Article 18 of the draft VAT Law specifies that if the sales are relatively low with no reasonable business purpose, the tax authority should have right to deem the sales amount based on "appropriate methods". We suggest the draft VAT Law or the implementation rules should clarify which method should be adopted.
Net-off basis for trading gain derived by financial products	20	For financial products, we suggest keeping the net-off basis method to calculate taxable gains instead of claiming input VAT based on the invoices. This is because the trading of financial products may be of a high frequency nature, and it would be difficult to issue VAT invoices for each transaction in practice.
Abuse of VAT invoice	40	Article 40 of the draft VAT Law mentions the violation of relevant VAT invoice rules should be subject to penalty, and in severe cases constituting a crime, it would be subject to the criminal law. We suggest clarifying that "severe cases" should not include manual or system errors, or misunderstanding of the VAT rule. In such cases, even if the amount of error is significant, it should not constitute a crime as those activities are not conducted intentionally.
Tax control device	41	We consider as technology is improving radically, it is not necessary to specify that VAT invoices should be issued by authorized tax control devices in the draft VAT Law.

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 efforts of the MoF and STA in the process of VAT legislation and improvement of the tax environment for China's 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 implications raised by this letter, please contact Lachlan Wolfers (KPMG China Head of Indirect Taxes, lachlan.wolfers@kpmg.com).

Yours faithfully

Patrick Pang
Head of Compliance and Tax
ASIFMA

Neil Bowen
Chairperson
CMTC

Appendix 1: Financial services "consumed" entirely outside of China

We have set below a non-exhaustive list of financial services that should be considered as "consumed" 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 relates to a subject matter or object which is located outside China and the service is consumed outside China.

We have separated the list into three categories, comprising loan services, fee-based services and financial consulting and investment related 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.

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.

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 bond connect and 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 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. 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.

3.3. Offshore market over the counter ("OTC") charge

This relates to the fee charged by offshore banks to a PRC company in relation to the trading of over-the-counter derivatives on the offshore market.

Appendix 2: 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 STA 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.

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