The overall tax burden of venture capital funds will not increase - the newly held State Council Executive Meeting proactive response to taxpayer's request

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In brief

On 30 August 2018, the State Administration of Taxation (the "SAT") clarified at the 2018 third quarter video conference on policy interpretation that natural person partners shall be subject to individual income tax (IIT) according to the income category of "income derived from production and business operations" at the progressive rate of 5% - 35% on equity transfer income allocated from domestic partnerships. This clarification aroused wide concern and vigorous reactions from the private equity (PE) industries. Later on, a piece of welcoming news was released on 6 September. In order to promote entrepreneurship and innovation, the State Council Executive Meeting has decided to maintain the stability of the local tax policies supporting venture capital (VC) funds that have been implemented in various regions. In that respect, relevant governmental departments would revise the IIT Detailed Implementation Rules (IIT DIR) to optimise the tax policy to uphold the development of VC funds. Meanwhile, the principle of the revision is not to retrospectively apply the rules and to ensure the general tax burden of VC funds does not increase.

In detail

The short message unveiled at the State Council Executive Meeting includes the following three key information.

Maintain the stability of locally implemented tax policies supporting VC funds

Previously, various local level governments provided relatively "lenient" IIT interpretation on natural person limited partners (LPs) of PE funds in the form of a partnership, in order to facilitate the development of PE funds. Specifically, income from equity investment derived by natural person LPs who do not engage in the operation of limited partnership shall be subject to IIT at a rate of 20% according to the income category of "income derived from interest, dividends, and bonus" or "income derived from transfer of property". According to the State Council's latest message, these "lenient" local tax treatments may be expected to be allowed to continue. It is also worth noting that it is still uncertain, whether the supportive tax policy for "VC funds" stated in the State Council Executive Meeting also apply to PE funds at large.

Tax policy for VC funds will be taken into account when revising the IIT DIR

Given the opportune time of the revision of the IIT DIR, it appears that the State Council plans to incorporate the "lenient" local tax policy into the tax legislation. In recent years, no matter it was the B2V Pilot Reform or the IIT Law Amendment, certain matters raised by the public could always be timely addressed during the tax legislation process. As such, let us wait and see how the upcoming IIT DIR designs specific provisions to address the tax treatment for income derived by LPs of VC funds in the form a partnership.

The principle of not to retrospectively apply the rules and to ensure the general tax burden of VC funds does not increase

After the SAT video conference, it was the general concern of PE funds on whether natural person LPs who have already settled IIT payment at 20% have to retrospectively make any tax supplementary payments at the 5%-35% progressive IIT rate. This time, the State Council Executive Meeting not only assured taxpayers that the rules would not be applied retrospectively, it also ensured that the general tax burden of VC funds would not increase.

The takeaway

If the upcoming new tax policy intends to continue the "lenient" local tax treatment and tax natural person LPs of equity investment funds at the 20% IIT rate, policy details from both technical and industry characteristic perspective have to be considered comprehensively. Under the current principle of "allocation before taxation" stated in Caishui [2000] No.91, business operation income derived by individual investors is calculated by deducting costs, expenses and losses from the total amount of income of the partnership in a tax year (i.e. the "net income" concept). However, under the prevailing IIT regime, income from transfer of property uses the "gross income" concept which is simply transfer income minus the cost of equity investment. As such, it remains to be seen how the new IIT DIR would address this technical issue. Furthermore, whether the profits and losses from the disposal of different investment projects can be netted against each other and how to technically realise such netting also merits consideration.

Although the specific policy remains unclear, the State Council Executive Meeting sent a positive signal, i.e., China will use an open-minded and equality attitude in the statutory taxation process, listen to the voices from taxpayers among industries to solve the unreasonable and uncertain tax issues faced by taxpayers. Meanwhile, PwC China will closely monitor the development, timely share our observation and insights, and provide a full-range support to private equity industries.

Endnote

1. *For details, please refer to China Tax Business News Flash [2018] No.27*
2. *For the details of the State Council Executive Meeting held on 6 September 2018, please refer to the following link: http://www.gov.cn/guowuyuan/2018-09/06/content_5319849.htm*

Let's talk

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