In brief

On 19 April 2017, Premier Li Keqiang presided a State Council executive meeting (the Meeting) where a package of tax incentives was announced in the light of the government work report for 2017. In response to this announcement, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) together with other government departments jointly and separately issued four tax policies soon after the Meeting, including simplifying the Valued Added Tax (VAT) rate categories, increasing the percentage of Research and Development (R&D) expenses super deduction for Corporate Income Tax (CIT) purpose for small and medium-sized technological enterprises, extending the pilot Individual Income Tax (IIT) policy on commercial health insurance nationwide, and offering tax incentives to venture capital enterprises (VCEs) as well as angel investors (AIs).

Among the four tax policies, Caishui [2017] No.38 (Circular 38) attracts most attention. According to Circular 38, for equity investments in start-up technological enterprises made by the VCEs (including both corporate VCEs and limited partnership VCEs) and AIs in pilot areas, a certain percentage of the investment amount can be used to offset their taxable income. Compared with the current tax incentives for VCEs, this new policy is a significant breakthrough which would encourage more investors to be actively involved in the venture capital market and also promote the development of China’s innovation-driven strategy. In this issue of News Flash, we will introduce the highlights of Circular 38 and share our observations.

In detail

Evolution of the tax incentives for venture capital investment

Tax incentives to support VCEs originates from the new CIT Law which took effect in 2008 – it stipulates that where a VCE makes equity investment in a non-listed, small-to-medium-sized New/High Tech Enterprise (SMNHTE), 70% of the investment amount can be deducted from the taxable income of the VCE in the year after the investment has been held for 2 years. Any unutilized amount can be carried forward and deducted in the following years. Subsequently, Guoshuifa [2009] No.87 was issued to clarify that such favourable treatment is only applicable to corporate VCEs.

As more and more VCEs are established in the form of limited partnership, the MOF and SAT have issued a series of pilot policies since 2012, allowing corporate partners of limited partnership VCEs to also enjoy such CIT incentive in certain areas. From 1 October 2015, this incentive was rolled out nationwide.

Along with the growth of individual wealth and the increasing individual demand of venture investment in China, the VC industry is in urgent need of relevant IIT incentive for support. As a result, Circular 38 was issued, with two major breakthroughs based on the prevailing CIT incentives, including: (1) allowing AIs and individual partners of limited partnership VCEs to enjoy similar IIT incentive; (2) allowing the same favourable treatment for investment in start-up technological enterprises with a relatively smaller scale.

Policy beneficiaries: both corporate and individual investors

One of the major highlights of Circular 38 is to allow both corporate and individual investors to enjoy similar tax incentives. Further, whether an individual makes equity investment as a partner of a limited partnership VCE or as an AI, the IIT incentive would be available. The detail policies are as follows:

- **For VCEs**, 70% of the equity investment in start-up technological enterprises can be used to offset the taxable income of the corporate VCEs or the
partners of limited partnership VCEs in the year after the investment has been held for 2 years. Any unutilized amount can be carried forward and deducted in the following years. Specifically, for corporate VCEs, the investment amount is deducted against the taxable income of such corporate VCEs. As for limited partnership VCEs, the investment amount can be deducted from the income allocated to the corporate and individual partners by the partnership. It is important to note that such policy only applies to VCEs registered in the pilot areas.

For AIs, 70% of the equity investment in a start-up technological enterprise is allowed to be deducted from the taxable income derived from the equity transfer of that start-up technological enterprise after a 2-year holding period. If the taxable income is less than 70% of the investment, the unutilized portion can be carried forward to offset the taxable income from the further equity transfer of such enterprise. Where a start-up technological enterprise is being deregistered and liquidated, any unutilized portion of the deductible investment amount can be allowed to offset the taxable income derived from the transfer of other start-up technological enterprises invested by AIs within 36 months from the day of the deregistration. It should be noted that the eligible start-up technological enterprises invested by AIs should be registered in the pilot areas.

Moreover, it is imperative to note that Circular 38 only applies to equity investment in cash and does not apply to investment through equity transfer from other shareholders of the start-up technological enterprises.

**Investment: start-up technological enterprises**

Before the release of Circular 38, eligible investment for the CIT incentive should be SMNHTE. In this regard, enterprises that cannot obtain the NHTE qualification due to certain reasons (e.g. the core technology does not fall within the technology area of the Catalogue of High and New Technology Areas Specifically Supported by the State) are relatively less attractive to the venture capital market from a tax perspective. Circular 38 focuses on “start-up technological enterprises” in order to provide tax support to those enterprises dedicated to R&D activities at the seed stage or early stage. As reflected in the criteria for “start-up”, the enterprise cannot be established for more than five years; and there are smaller number of employees, smaller amount of total assets and sales revenue requirements (e.g. pursuant to Circular 38, at the time of a start-up technological enterprise accepting the investment, the number of employees shall not be more than 200, and both the amount of total assets and annual sales revenue shall not be more than RMB 30 million; as compared with SMNHTE, the number of employees shall not be more than 500, and both the amount of total assets and annual sales revenue shall not be more than RMB 200 million). In terms of the requirement of “technological”, the R&D expenditures of the enterprise accepting the investment shall not be less than 20% of its total expenditure for the year of investment and the following year.

It is no doubt that Circular 38 will play a positive role in promoting the development of start-up technological enterprises without a NHTE qualification but with a good prospect.

**The takeaway**

During recent years, the Chinese government has committed to supporting start-up and innovation. It is expected that the release of Circular 38 will, from a tax perspective, motivate more capital flow into the venture capital market to fill up the capital need resulting from a large number of emerging start-ups, and which will also promotes economic growth and create more job opportunities. Considering the purpose of stimulating investment, the investment amount which is allowed to be deducted from the taxable income is the actual paid-in capital amount and not the subscribed capital amount.

Meanwhile, corporate and individual investors who wish to enjoy the incentives stipulated in Circular 38 should note that eligible start-up technological enterprises refer to tax resident enterprises that file CIT on an actual basis, and have not been listed domestically or abroad within two years from the acceptance of investment. When choosing an investment target, investors should pay attention to its financial compliance status and have a comprehensive consideration of the future exit plan. As for the start-up technological enterprises, they should enhance the management and setting up relevant accounts to accurately identify and calculate the R&D expenditures to meet the 20% prescribed ratio requirement, in order to attract more premium investors.

Furthermore, since Circular 38 is only for pilot areas, it does not apply to overseas investments. According to Several Opinions of the State Council on Promoting the Sustainable and Healthy Development of Venture Capital Investment (Guofa [2016] No.53), VCEs are encouraged to “go abroad” and invest in overseas R&D projects. It is believed that overseas venture capital investment projects may also be eligible for the tax incentives in the future.

The CIT incentives in Circular 38 took effect from 1 January 2017, while the IIT incentives shall take effect from 1 July 2017. For investors who had made investments within two years before the effective date and have held it for two years or more after the effective date, they may also be eligible for the tax incentives in Circular 38. Meanwhile, Circular 38 also requires AIs, corporate VCs, corporate partners of limited partnership VCs and start-up technological enterprises to comply with the record-filing procedures. Currently, although most of the record filling can be performed in Golden Tax III system, it is not clear how to update the system and perform the record filing in line with this new Circular. It is believed that SAT will release a follow-up policy to further clarify the implementation of Circular 38 soon. We will closely monitor the development and timely share our observation.

**Endnote**

1. For details of the Meeting, please refer to the official website: [http://www.gov.cn/premier/2017-04/19/content_5187318.htm](http://www.gov.cn/premier/2017-04/19/content_5187318.htm)

2. For details of the government work report for 2017, please refer to our [News Flash 2017 Issue 6](#).

3. Four tax policies refer to Notice Jointly Issued by the MOF, SAT and Ministry of Science and Technology Increasing the Percentage of R&D


5. Pilot areas including 8 Comprehensive and Innovative Reform Pilot Regions, i.e. “Beijing-Tianjin-Hebei”, Shanghai, Guangdong, Anhui, Sichuan, Wuhan, Xi’an, Shenyang, and Suzhou Industrial Park.
News Flash — China Tax and Business Advisory

Let’s talk

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