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Tax Analysis

Non Performing Loans – Is this the right timing for foreign investors?

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As of the end of 2019, China's commercial banking sector's non-performing loan (NPL) balance reached RMB 2.41[1] trillion (or a ratio of 1.86%, defined as total NPLs over total loans). The balance has been increasing, as the balance in 2015 was RMB 1.27[2] trillion (or a ratio of 1.67%).

As this balance increases, and as China opens its financial services sector to foreign countries (e.g., pursuant to the Phase One trade agreement between China and the US), many foreign investors are exploring ways to invest in China's NPL market.

One of these ways is for the foreign investor to invest in the NPLs directly, although foreign investors may also invest through a state or foreign-owned asset management company, a financial assets exchange, or a qualified foreign limited partnership.

In this article, we will discuss the tax implications of NPL direct investment, whereas the tax implications of other ways of NPL investment will be addressed separately in a series of articles.

NPL direct investment EIT implications

When foreign investors invest into NPLs directly, they are generally subject to a 10% withholding enterprise income tax (EIT) on interest and gains from disposal of NPLs, if the foreign investor has no establishment (or permanent establishment (PE) under an applicable treaty) in China and if the income is sourced in China.

[1] http://www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=890683&itemId=915&generaltype=0
[2] http://www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=92290&itemId=915&generaltype=0

If the foreign investor has an establishment (or a PE under an applicable treaty) in China, any income attributable to the establishment (or PE) will be subject to a 25% EIT on net income (i.e., gross income less deductions), significantly reducing the overall returns of the investor.

If the foreign investor is tax resident in a jurisdiction that has concluded a double tax agreement with China, the investor would be regarded as having a PE in China if the investor:

- Carries on business in China through a fixed place of business (i.e., fixed place PE);
- Carries on business activities through a dependent agent in China (with authority to make decisions on the investor's behalf) (i.e., agency PE) but not if the agent acts independently in the ordinary course of business; or
- Provides services through its employees or other personnel in China for more than 183 days in any 12-month period (i.e., service PE).

In general, a foreign investor is required to engage a debt servicing provider in China to manage its day-to-day NPL operations. To mitigate the PE risk, the debt servicing provider should act independently in the ordinary course of business and be legally and economically independent from the foreign investor. In addition, documents should be drafted carefully and advisors should be provided with operating guidelines to reduce the PE risk.

Other EIT issues include determining how gains should be ascertained, for example, determining how costs should be allocated among assets and how gains and losses arising from the disposal of assets in the same portfolio should be offset against each other in calculating taxable income.

NPL direct investment VAT implications

Foreign investors investing directly in NPLs is generally subject to a 6% value-added tax (VAT) on interest income.

The gains derived from the disposal of an NPL (i.e. the difference between the transfer consideration and acquisition cost) may also be subject to a 6% VAT if the disposal is considered a transfer of financial products. Under VAT regulations, financial products are defined as foreign exchange, securities, non-commodity futures, and other financial products (e.g., funds, trusts, investment products, asset management products, other financial derivatives). Currently, there is no clear guidance on whether an NPL is categorized as a financial product for VAT purposes. One may take the position that an NPL is not a financial product and hence its transfer should not be subject to VAT. However, the practice varies among local tax authorities.

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From a tax administration standpoint, it is also uncertain whether the foreign investor may centralize VAT filings and payments in one location if an NPL portfolio consists of debtors in different locations.

NPL direct investment stamp duty implications

Stamp duty is levied on dutiable documents set forth in stamp duty provisional rules. The transfer of NPLs does not fall clearly within any category of dutiable documents (e.g., transfer of property titles including movable and immovable properties registered with government authorities and equity ownership rights, copyright, exclusive right of use of trademarks, patents, and proprietary technology usage rights). In practice, NPL transfer documents have not been subject to stamp duty. In addition, if the NPL assets to be invested by a foreign investor are qualified as credit asset backed securities, the stamp duty should be exempted.

Comments and recommendations

Due to the current uncertainties surrounding the tax treatment of NPL income, tax costs could impact significantly the investment returns on direct NPL investments. It would be important for a foreign investor to consider these implications prior to investment.

Foreign investors should analyze their potential tax implication for investing in China NPLs, review the relevant legal documentation from tax perspective, provide operating guideline for investment professionals to follow in order to mitigate PE risk in China and discuss with relevant local authorities for clarification of tax treatments and obtaining financial incentives (if applicable).

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