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Individual Income Tax Treatment of Contribution of Nonmonetary Assets Clarified

China's Ministry of Finance and the State Administration of Taxation (SAT) jointly issued guidance on 30 March 2015 that clarifies the individual income tax (IIT) treatment of nonmonetary asset investments by individuals (Caishui [2015] No. 41, (Circular 41)). The SAT subsequently issued guidance (Bulletin [2015] No. 20, (Bulletin 20)) on 8 April, implementing the rules under Circular 41.

Circular 41 provides that an investment with nonmonetary assets by individuals should be treated as two simultaneous transactions: a transfer of the nonmonetary assets and the investment. It further provides that gains derived by an individual from the transfer of nonmonetary assets must be calculated as "gains from the transfer of property." The circular also provides that the trial installment payment method applicable in the China (Shanghai) Pilot Free Trade Zone (FTZ) will be expanded nationwide. Bulletin 20, which became effective on 1 April 2015, clarifies issues relating to the application of Circular 41, such as the calculation of taxable income, registration of installment tax payment plan, as well as the reporting obligation of an investee enterprise.

1. Historical development

The rules and practice governing the tax treatment of investments with nonmonetary assets by individuals have been evolving, and we set out below the major developments over the years.

One of the first official documents in this regard is an SAT response in 2005 to an inquiry from the Fujian Provincial Local Tax Bureau, stating that gains derived from the transfer of nonmonetary assets are temporarily exempt from the IIT at the time an individual contributes such assets to an enterprise. Instead, IIT will be levied at the time of a share redemption or transfer or on liquidation of the investment. (Guoshuihan [2005] No. 319 (Circular 319)). Some local tax authorities (e.g. the Zhejiang Provincial Local Tax Bureau) issued their own circulars to follow the position in Circular 319.

In 2008, certain local tax authorities uploaded onto their websites an SAT notice, "Issues Concerning Individual Income Tax Calculation and Collection in Relation to Appreciation in Asset Values" (Guoshuifa [2008] No. 115, (Circular 115)). According to Circular 115, when an individual invests appreciated nonmonetary assets in an enterprise, the individual will be subject to IIT on the amount of the appreciation, which will be considered gains from the transfer of property; in such a case, the investee enterprise must act as the withholding agent when the individual obtains the equity. However, Circular 115 subsequently was withdrawn by the local tax authorities. Since there is a clear conflict between Circular 319 and Circular 115, such discrepancy created uncertainties as to what the right treatment should be: Circular 319 allows a temporary deferral of tax on gains from the transfer, while Circular 115 requires tax to be withheld upon the individual obtaining the equity, effectively taking away the deferral.

In January 2011, the SAT issued Bulletin 2 abolishing Circular 319; in February, it responded to an inquiry from the Jiangsu Provincial Local Tax Bureau (Guoshuihan [2011] No. 89, (Circular 89)), stating that the individuals' receipt of additional shares of the investee company in a non-public targeted share issuance in exchange for the contribution of appreciated shares of another company by these individuals constitutes an equity transfer and that the income derived therefrom is subject to IIT as gains from the transfer of property. However, Circular 89 does not provide any special rules on when IIT should be paid.

Finally, in 2013, the State Council published a notice on the Framework Plan for the China (Shanghai) Pilot Free Trade Zone (Shanghai FTZ) (Guofa [2013] No. 38, (Circular 38)) that on a trial basis permits individual shareholders who registered in the Shanghai FTZ and contributed nonmonetary assets for investments to pay IIT on the asset appreciation by installment over a five-year period.

2. Highlights of Circular 41 and Bulletin 20

2.1 Scope of application

Circular 41 does not allow deferral of gains from an investment with appreciated nonmonetary assets but extends the installment payment option nationwide to encourage investments by individuals.

"An investment with nonmonetary assets" is defined as using nonmonetary assets to establish a new enterprise or to participate in investment activities, such as capital increases, non-public, targeted issuance of additional shares, restructurings, etc.

2.2 Calculation of taxable income

Circular 41 provides that income derived from the transfer of nonmonetary assets should be recognized at the assessed fair market value of these assets. Taxable income is such income less the "original cost" of the assets and less "reasonable taxes and surcharges".

The original cost is defined in Bulletin 20 as the actual expenditure incurred on the assets. If an individual fails to provide accurate documentation evidencing the cost of the assets, the tax authorities can deem the deductible costs. Reasonable taxes and surcharges are defined in Bulletin 20 as those arising during the course of making an investment with nonmonetary assets, provided that they are relevant and reasonable.

Bulletin 20 also provides that, where an individual uses equity to make an investment, the rules on the determination of the original cost of equity (as stipulated in the circular on the Tax Treatment of Share Transfers by Individuals (SAT Bulletin [2014] No. 67[1], (Bulletin 67)) apply. Unfortunately, Bulletin 20 does not provide any guidance on the calculation of the original cost of intangible assets used to make an investment.

2.3 Tax filing

According to Circular 41 and Bulletin 20, IIT arising from an investment with nonmonetary assets for equity in an enterprise should be paid by the individual making the investment, and such tax should be paid within 15 days after the end of the month in which the investment takes place. Taxpayers unable to pay the tax due in a lump-sum amount, however, can elect to pay the tax by installment (see below).

The tax bureau where the IIT should be paid varies depending on the type of nonmonetary assets contributed:

- Where the individual contributes real property, the in-charge tax authority is the local tax bureau where the property is located.
- Where the individual contributes the equity of another company, the in-charge tax authority is the local tax bureau where the enterprise whose equity is invested is located.
- Where the individual contributes other nonmonetary assets, the in-charge tax authority is the local tax bureau where the investee enterprise is located.

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[1] See Tax Analysis on 30 December 2014 - SAT issues guidance on tax treatment of share transfers by individuals: http://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2014/deloitte-cn-tax-tap2052014-en-301214.pdf

2.4 Installment tax payment and documentation

As mentioned above, Circular 41 permits a taxpayer to pay tax by installment in the five years following the day on which the taxable activity took place if the taxpayer has difficulties in paying the tax in full. The installment payment option generally applies to investments made from 1 April 2015, but also applies retroactively to investments made in the five years before that date for which the tax treatment has not yet been determined. Therefore, certain taxpayers who made investments before 1 April 2015 can still pay tax by installment.

Despite the installment payment option, if a taxpayer receives cash consideration for the investment, the cash must first be used to pay the tax due; any remaining tax liability may be paid by installment. Further, during the installment payment period, if the taxpayer transfers the equity of the investee enterprise and receives cash consideration, the cash consideration must also be used to pay the tax liability.

Circular 41 requires taxpayers to submit an installment payment plan to the in-charge tax authority in advance. Bulletin 20 provides details on how to implement this requirement. For investments taking place after 1 April 2015, the taxpayer must prepare the installment payment plan and submit the required documents within 15 days after the end of the month in which the investment takes place. Documents that must be submitted include the official form for making installment payments, identification, a copy of the investment agreement, an appraisal report on the nonmonetary assets and other relevant documents that can evidence the original cost of the nonmonetary assets and the relevant taxes and surcharges. For investments taking place before April 1, the deadline for choosing the installment method is within 30 days after the date Bulletin 20 was issued (i.e. 8 April 2015).

If the installment payment plan changes during the installment payment period, the taxpayer must submit an amended application to the in-charge tax authority.

2.5 Reporting obligation of investee enterprises

While Bulletin 20 does not require an investee enterprise to be the withholding agent of the relevant IIT, it imposes a reporting obligation on the investee enterprise. When an individual obtains equity for a nonmonetary asset contribution to an enterprise, or when there is a change in shareholders during the installment payment period, the investee enterprise must notify the in-charge tax authority accordingly within 15 days after the relevant event and assist the tax authorities where necessary.

3. Comments

Circular 41 makes it clear that an investment with nonmonetary assets by individuals is a taxable event but allows payment of tax by installment over five years, alleviating difficulties of individuals who may not have the cash to pay the tax. The approach taken in Circular 41 is consistent with the approach of Circular 116 (Caishui [2014] No. 116, (Circular 116)), which also treats an investment with nonmonetary assets by enterprises as a taxable event and allows income from the transfer to be included as taxable income of the transferor over a five-year period. However, unlike Circular 116, which requires taxable income to be included evenly in each of the five years, neither Circular 41 nor Bulletin 20 stipulates how tax payments should be spread out over a five-year period, giving individual taxpayers the latitude in designing their payment schedules. Individuals who plan to make investments using nonmonetary assets and individuals who have finished their investments but have not paid the relevant taxes should all evaluate the potential impact of Circular 41 and Bulletin 20 to determine how to take advantage of the installment payment option and how to mitigate any potential tax risks.

Note: Contents discussed in this Tax Analysis pertain to Deloitte Global Employer Services.

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