



Challenges and opportunities for foreign capital investing in China's NPL market

[Asset management and private equity series]

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Foreword

China Banking and Insurance Regulatory Commission (CBIRC) statistics indicated that at the end of 2019, the non-performing loan (NPL) rate of China's commercial banks has reached up to 1.86%, registering a staggering amount of RMB 2.41 trillion, and therefore, China becomes the world's largest NPL market. Particularly noteworthy, since the NPL outbreak in 2010, the prominent foreign investors are increasingly attracted to the China's NPL investment opportunity and many investors have been invested into this market. However, due to China's strict license control, foreign investors currently can only invest NPLs on secondary market via establishing wholly foreign owned enterprise (WFOE) (as a non-licensed foreign asset management company (AMC)); establishing a qualified foreign limited partnership (QFLP); or making NPL investment through approved pilot cross-border transaction.

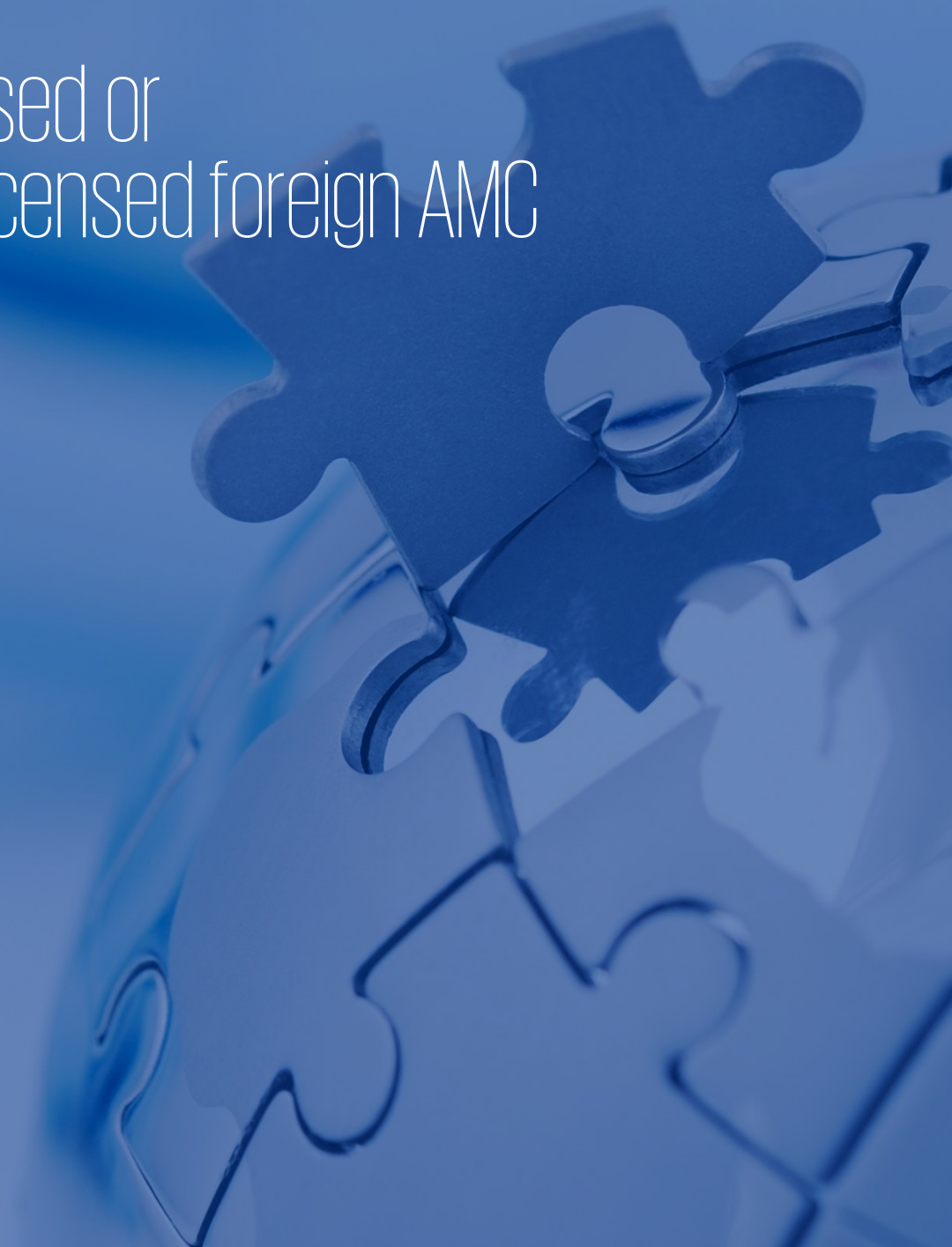
On 3 January 2020, *the Guiding Opinions of the China Banking and Insurance Regulatory Commission on Promoting the High-quality Development of Banking and Insurance Industries* indicated that China will ease market access to foreign financial institutions, including business related to the disposal of NPLs. On 15 January 2020, China and the United States agreed in Phase 1 trade agreement that the US financial service providers could apply for the license to operate provincial AMC and China has promised to treat domestic and US applicants equally in newly granted national license application.

The AMC operated by foreign financial institutions solely or partnering with other investors is bound to bring new dynamics to the market. However, we cannot ignore the fact that there are still range of tax challenges foreign players should pay attention when entering the market, conducting NPL transactions as well as capital and profit repatriations. In this article, we highlight some of the key tax issues and challenges for you to consider.



I.

Licensed or
non-licensed foreign AMC



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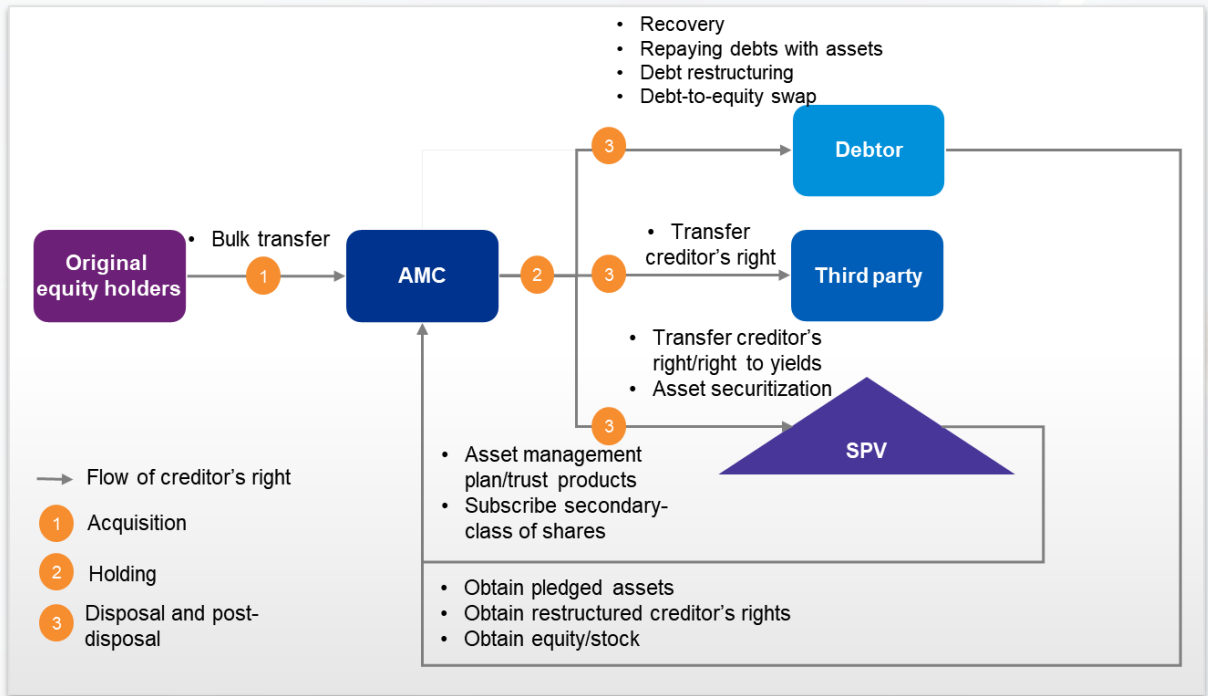
Tax challenges and solutions at set-up stage

		Challenges 1	KPMG solutions 2	Results 3
Set-up phase	Structure	<ul style="list-style-type: none"> There are a number of structuring models for foreign institutions investing into domestic NPL with each involving different tax implications. What are the differences of available structuring options from legal, tax and foreign exchange perspective? How to design an tax-efficient investment structure that matches the business objectives? 	<ul style="list-style-type: none"> Assist you to understand the rules and regulations, operational models and scope of investment. On the basis of above, analyse and compare tax cost, foreign exchange rules and approval procedures to identify the optimal investment structure. 	<ul style="list-style-type: none"> Understand the full picture of the overall tax burden at the initial stage in order to minimize future tax risks. Select the most suitable and tax efficient plan. Make sure the plan is feasible.
	Location	<ul style="list-style-type: none"> Local governments have introduced many local fiscal incentive policies to attract investments. How to collect and understand all local incentives applicable to asset managers in a short time? How to identify the optimal location? 	<ul style="list-style-type: none"> Assist you to gather information from different dimensions, e.g. capital supporting, contribution supporting, talents and capital injection support etc. to compare alternatives for you to make informed decision. Assist you to negotiate with local government and subsequent implementation. 	<ul style="list-style-type: none"> Understand fiscal policies of potential locations in a short time. Identify the location most catering for your business strategy and with strongest fiscal support. Make sure the fiscal supporting polices could be implemented.
Operation phase	Compliance assurance	<ul style="list-style-type: none"> Finance and tax functions are low on resources. It is critical to complete tax filings in a timely manner at initial stage of establishment, otherwise the tax payment credit rating will be negatively impacted. Further, failure of issuing Fapiao on demand will also hamper business development. 	<ul style="list-style-type: none"> Assist you to complete a range of preparatory work, e.g. tax payer registration, applicable tax review and registration, Fapiao issuance review and registration and tax control equipment purchase, etc. Provide daily tax compliance assistance at initial stage, e.g. tax filing, Fapiao issuing and verification. 	<ul style="list-style-type: none"> Ensure smooth running of back-office at initial period to support future business development. Avoid the negative impact of tax noncompliance on your credit ranking.
	Team building	<ul style="list-style-type: none"> It take times for finance and tax staff to become familiar with business operations. Busy with daily routine, struggle with internal and external requests. 	<ul style="list-style-type: none"> Assist you to quickly understand business-related tax issues by virtue of our extensive experience in the industry that you operate. Provide policy support, interpretation and observations timely. 	<ul style="list-style-type: none"> Ensure tax compliance and that is consistent with industry practice. Share knowledge with finance and tax staffs.
	Business model	<ul style="list-style-type: none"> Tax treatment is complicated. Is the business model tax efficient? Whether the tax clauses in the contract comply with relevant laws and regulations? Whether it could avoid tax risks effectively? 	<ul style="list-style-type: none"> Discuss with front office on how to reduce overall tax burden while taking consideration of your business needs. 	<ul style="list-style-type: none"> Ensure tax compliance Keep the tax burden at minimum level.
	System framework	<ul style="list-style-type: none"> Promote business as quickly as possible at one hand, and lay a solid foundation for internal policy framework at another. 	<ul style="list-style-type: none"> Assist with you to build policy framework and advice on short-medium-long term management objective and direction for continuously improvement Share with you the industrial best practice. 	<ul style="list-style-type: none"> Shorten growth cycle and avoid setbacks or detours. Clear path for further improvement.

02

Tax challenges of NPL business and its solutions

Taxation is one of the key success factor in running an NPL business. If not managed properly, the recovery and disposal of NPLs may trigger significant tax cost, and reduce recovery rate drastically, and may even incur greater losses. Currently, NPL business, except for policy NPL targeting the Big-four AMCs and NPL arising from bank institutional reform, are not entitled to tax preferential policies. Given the distinctiveness of NPL business, uncertainties and ambiguities continue to exist during the application of tax rules and regulations. In view of this, it would be advisable for investors to deal with tax issues carefully and formulate appropriate tax planning and risk control measures.



1 Traditional NPL business model

(1) Acquisition

Acquisition	Main tax issues
AMC acquires NPL from financial institutions or non-financial business and exercise the right of claims by itself or a third party (including transferor and its related parties or others with collection capability). Certain business is backed by guarantee.	<p><i>Corporate income tax ("CIT")</i></p> <ul style="list-style-type: none"> Should the tax base of NPL be calculated on single NPL item basis or NPL portfolio basis? For the former, is there any generally accepted cost allocation method for tax purpose? This will largely depend on the manner of loss recognition during future transfer.
	<p><i>Value added tax ("VAT")</i></p> <ul style="list-style-type: none"> Is the NPL transfer VAT-able or not? This remains a controversial issue to some extent. If guarantee is introduced, will the transaction be deemed as financing to transferor, thus AMC is liable to pay VAT on the deemed interest (i.e., the amount exceeds the acquisition cost)?

(2) Recovery

Recovery	Main tax issues
AMC may recover funds from debtors through various means, e.g. collection, litigation (arbitration) and bankruptcy settlement, etc.	<p><i>Corporate income tax ("CIT")</i></p> <ul style="list-style-type: none"> Based on current laws and regulations, where interest income has not been received 90 days after the due date can be deducted from taxable income amount. In addition, a percentage of loan loss reserves is also deductible from taxable income. Strictly speaking, this provision is not applicable to AMC, which can only set off the bad debt impact through loss deduction.
	<p><i>Value added tax ("VAT")</i></p> <ul style="list-style-type: none"> Whether proceeds from debt recovery should be deemed as VAT-able interest income or not? If yes, is the interest being the amount that exceeded the original principal, or that exceeded the acquisition price? How to determine the repayment order of principal and interest? These issues currently lack regulatory guidance and are handled differently in practice.

(3) Transfer

Transfer	Main tax issues
AMC may make single NPL transfer or bulk-transfer of NPLs (NPL portfolio) to get the money back through auction, competitive bidding, bidding transfer and negotiation transfer.	<p><i>Corporate income tax ("CIT")</i></p> <ul style="list-style-type: none"> Should the cost deduction be based on single NPL item or the NPL portfolio? How to allocate cost in single transfer? Whether the profit or loss of single NPL of one portfolio could be offset with each other? Is transfer loss deductible? If yes, should it be deducted from actual disposal loss on single NPL basis or on portfolio basis? Is there specific deduction limitation and tax recordal filing requirements? <p>The above issues currently lack regulatory guidance and are handled differently in practice.</p>
	<p><i>Value added tax ("VAT")</i></p> <ul style="list-style-type: none"> Is the NPL transfer VAT-able or not? This remains a controversial issue to some extent.

In addition to the direct transfer of NPLs, certain derivative business models are also lack of tax regulatory guidance and would result in double taxation if relevant tax analysis are not considered in advance. Further, it is also important for investors to pay attention to the VAT Fapiao issuer and recipient over the overall business chain, which also have some controversies remain to be solved.

- Transfer right to yields of NPL
- Set up NPL disposal fund with other investors by contributing the right to yields of NPL
- Issue ABS as underlying assets for right to yields of NPL

2 NPL restructuring

Many AMC regards NPL restructuring as an important way to dispose NPL, which also involves complicated tax issues. It is advisable for AMC to fully assess the tax cost of possible restructuring options and obtain advice on tax planning.

(1) Debt restructuring

The deduction of the debt restructuring losses (if any) should meet certain conditions and obtain supporting documents. Prevailing laws expressly provide the deduction conditions and supporting documents for cases of judicial recourse termination (suspension), bankruptcy or deregistration of corporate debtors, death or missing of individual debtors. However, for mutually-agreed debt restructuring arrangement for non-bankrupt debtors, the related tax rules and compliance requirements are not clear, and often handled inconsistently in practice, e.g. whether the statement of tax payment on debtor's restructuring proceeds, expressly waiver the loan receivable in the agreement are necessary, etc.

(2) Repaying debts with assets

Here are some main tax challenges of the business of repaying debts with assets, which may incur loss if not handled appropriately:

- Unable to obtain valid Fapiao from debtors and it is costly to obtain judicial documents. For AMC, the depreciation, cost and input VAT in connection with assets without the support of valid Fapiao or judicial documents is not deductible for CIT purpose nor creditable as input VAT.
- In some cases, AMC would have to pay tax on behalf of debtor to obtain Fapiao during transfer of the underlying real estate collateral, and depending on the approach of competent authorities, this could result in additional cost.
- The tax paid by AMC on behalf of debtors cannot receive tax clearance certificate in its name, thus resulting in nondeductible expense for CIT purpose. If such cost is written off as other receivables, loss deduction issue will then be triggered.

(3) *Debt-to-equity swap*

Some aspects of the debt-to-equity swap lack clear regulatory guidance, which if handled improperly, may result in major tax cost, for instance:

- In the debt-to-equity swap, should we determine the tax basis of equity and debt restructuring losses at fair market value (FMV), or deem the debt is fully repaid and the equity swap losses should be deducted in future equity disposal?
- Whether the losses incurred from debt-to-equity swap is deductible for CIT purpose? How to manage the deduction conditions and supporting document requirements?
- Could the debt-to-equity swap apply special tax treatment or not? What should we do when creditor and debtor could not reach an agreement?

Where special commercial arrangement such as creditor's fixed dividend distributions, debtor's guarantee, earn-out provision, buy-back provision is attached to the conversion plan; then whether the proceeds received by creditors could constitute "guaranteed profit" stated by the VAT regime and therefore liable to pay VAT as deemed interest. Given the complexity of contract and unclear regulations, uncertainties in tax treatment continue to be a challenge.

Further, the debt-to-equity swap conducted by large group company often involves complicated asset and equity restructuring. For instance, they may carve-out, integrate and demerge different types of assets and debts and introduce social capital to invigorate existing assets and further diversify its equity structure. Such sophisticated transactions often result in complicated and significant tax issues.

(4) *Debt-to-equity swap via trust*

Some AMC's creatively combine debt-to-equity swap with asset management products, e.g. trust. Under this special model, AMC can obtain the right to claim yields or shares of the trust. However, this arrangement would greatly complicate tax matters.

- Where converted at a discount, should the losses be recognized at AMC level or trust level? For the latter, the losses cannot be deducted by the investor in the swap because a trust is not recognized as a taxpayer in China.
- As trust is not a taxpayer, whether the special tax treatment in corporate restructuring is still applicable? Under such tax treatment, parties engaged in the debt-to-equity swap could delay the recognition of proceeds and losses derived from debt restructuring provided certain conditions satisfied.
- There remain uncertainties to a large degree in taxability of dividends received by trust, proceeds received by investors and capital gain arising from future exit. Without proper planning, double taxation at the trust and investor levels may be triggered.

Court auction is a common way for AMC to dispose the underlying collateral. This process may trigger significant amount of tax expense, e.g. land value-added tax. AMC may confront the following challenges.

- How to determine the tax on auction price? In the absence of financial documents, how to calculate the tax? Is there any room for tax planning?
- Should the tax and duties on ownership transfer registration be borne by the buyer or by the buyer and the debtor respectively? The practice is varied at local court and tax authority. If tax and duties are deducted from the auction price, the amount of repayment to creditor would be greatly reduced.
- Many judicial cases showed tax authorities tend to deduct overdue tax owned by the debtor from the auction price, meanwhile for similar cases a very different result was concluded. This means, inconsistency on how tax authorities treating these tax issues are still common.



When repatriating capital/funds outside of China, foreign owned AMC should consider the whether a tax treaty relief is available between China and the country of the foreign shareholders. Tax treaty conditions including but not limited to the eligibility for preferential tax rate and related requirements, e.g. the status of beneficial owner should be taken into account. We are of the view that foreign owned AMC should fully consider the tax burden on capital repatriation at the set-up period and work out investment structuring plan at the earliest possible time.

The chart below summarizes a series of notable tax elements at various phases of investment. We also suggest AMC to establish and improve tax management system to strengthen the effectiveness of tax management and enhance tax value.



II.

Tax challenges of alternative investment models and related solutions

Besides participating the NPL market through AMC, new channels for foreign investors to access China's NPL market is emerging. Due to the limited availability of onshore license and higher tax cost for onshore model, those alternative models may become their primary choice in the foreseeable future.



01

Acquire NPL portfolio directly by foreign institutions

Under this model, foreign investors should pay closer attention to the following tax issues in addition to regulatory requirements of capital entry and profit repatriation.

1

Business model and personnel arrangement: Whether your potential business model and personnel arrangement will constitute permanent establishment (PE) in China. Once tax authority identifies that foreign investor has formed PE in China, the profit attributable to the PE will be subject to 25% PRC CIT, which will increase the overall tax cost.

2

Asset transfer: The specific practice of local tax authorities in aspects of the taxability of asset transfer, e.g. whether the gain of NPL disposal is VAT-able? If yes, could foreign investors complete their tax filing and payment by themselves or by local tax agent? In terms of tax jurisdiction, where the NPL under a portfolio is located at different places, is it possible to fulfill tax obligations collectively at the tax authority where the investor opens its bank account remains unclear from regulatory and tax perspectives.



Areas of tax concerns under QFLP model include:

1

Structuring design: As there are restrictions on the business scope of QFLP, business scope faces restrictions, one-tier or multi-tiers SPV need to be inserted in the QFLP holding structure. However, the profit attributable to those SPVs is subject to CIT in China, thus pushing the tax cost higher.

2

General partner (GP) set-up: It would be advisable to give due consideration to the tax implications of different legal forms and investors when establishing GP. For example, which legal form is more tax efficient, limited partnership or WOFE? Whether the home country of the investor has entered into tax treaty with China and whether the preferential tax rate is applicable?

3

Location: It would be advisable to fully consider the tax policy, tax incentives and fiscal subsidies of potential locations to set up QFLP.

4

Business model and personnel arrangement: It would be advisable to consider whether those arrangements will form PE in China. Given lack of clear-cut indicator under current regulations, a great deal of uncertainty surrounds the determination of PE in practice.



03

Assets exchange model

Foreign investors are greatly concerned in the complex steps and procedures involved in obtaining the recovery and proceed of NPLs.

According to the current policy, banks or other institutions and individuals holding NPL could conduct cross-border listing transfer on Qianhai Financial Assets Exchange (QEX) and Guangdong Financial Assets Exchange (GEX), which provide centralized and one-stop online business services, inter alia, assets information presentation, deal-making, bidding arrangement, external debts registration and filing, assets transfer registration, deposit and settlement, post-disposal tax withholding, foreign currency exchange for profit repatriation and external debts deregistration.

From tax perspective, the assets exchanges will withhold income tax (currently at 10%) on NPL disposal gain in a collective manner which can not only save time for taxpayers, but also enhance efficiency of tax collection and increase the certainty of tax cost.






KPMG's observations and outlook

Foreign financial institutions, on the strength of its vast reserves of capital, matured management mechanism and extensive technical experience, will inevitably come as a shock and challenge for local AMC and intensify competition of China's NPL market. At the same time, a growing sense of cooperation and competition will also push domestic AMC to enhance overall competitiveness and management skills.

Tax cost is a core parameter for the success of NPL business. However, current tax policies targeting NPL market require further clarification. Foreign AMC is advised to fully aware the status quo and engage external advisors for assistance, if necessary, to ensure tax compliance and enhance tax efficiency.

KPMG tax team has extensive advisory experience in NPL market. We adept at providing quality and credible tax advisory services, including design and implementation of NPL restructuring plan from tax perspective and discussion and negotiation with tax authority on tricky tax issues. If you have any tax queries regarding NPL business, please feel free to contact KPMG tax experts.



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