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## **Tax Issues Concerning Foreign Investment in NPL Assets in China**

The Chinese market for acquiring and disposing of non-performing loan (NPL) assets is a newly booming market for foreign investors. This article highlights the current status of NPL assets in China and provides some guidance on tax consequences relevant to foreign investment in NPL assets.

In a major step towards the resolution of China's serious banking problems, the PRC government established four state-owned non-banking asset management companies (AMCs) in 1999 to deal with the huge burden of NPL assets that threaten the country's banking system. Over the past few years, AMCs have acquired approximately RMB1.4 trillion (US\$170 billion) of NPL assets from the five state-owned banks. To revive as many state-owned assets as possible, AMCs then transacted with third parties to strategically dispose acquired assets by selling interests in certain portions of their NPL assets portfolio to domestic and large international financial consortiums. In regards to the latter set of transactions, carrying on the business of NPL assets disposition represent a huge potential market for foreign investors in China.

According to the law of commercial banks, if the loans are overdue by more than six months, they are classified as NPL assets. In China, many banks do have NPLs but it does not necessarily mean that these NPLs are unprofitable. In many cases, NPLs arise because the debtors are just in financial difficulty in meeting the repayment deadline. However, these debtors are promising to settle the debt ultimately. Thus NPL assets are not worthless waiting for disposal and gold may be hidden among them. In a bid to reduce and prevent financial risks facing the banking industry in China, the government has in recent years attempted to create viable and attractive regulatory and tax systems to encourage more 'gold-rushers' who possess strong capital resources and professional expertise in managing NPL assets. China presently adopts two strategies to employ foreign capital to manage domestic NPL assets. The first is to set up a cooperative joint venture (CJV) with state-owned AMCs. So far, the government has approved two CJVs - one with Morgan Stanley and the other with Goldman Sachs, to co-manage NPL assets. According to the cooperative agreement, both parties contribute their NPL stakes as in-kind contributions to a newly formed CJV AMC. With the benefit of foreign cooperation, the CJV AMC then begins to engage in a variety of transactions to restructure NPL assets acquired, and subsequent disposal of these assets via transfer, recovery, exchange or sale, etc., thereby realizing profit accordingly. The other strategy to absorb foreign capital is to take NPL assets to the international market and sell them directly to overseas investors. For example, Oriental Assets Management Company signed an agreement with Chenery Capital Incorporated for the sale of RMB1.8 billion of NPL assets on 6 December 2002. Both methods of inviting the participation of foreign investors in settling NPL assets have been proven quite satisfactory. The recent statistics show that China's four state-owned AMCs had managed RMB232 billion (US\$29 billion) of NPL assets by 2002, over 10% of which were involved with foreign investment.

As the business for disposing of NPL assets is an utterly newborn business in China, the Chinese government is struggling to come up with guidance governing the plethora of tax consequences relevant to foreign investment in this area. Among the current tax guidance available to AMC's in connection with their acquisitions and disposition of NPL assets, the Tax Circular on *Tax Issues Relevant to the Engagement in the Business of Financial Asset Disposal by Foreign Investment Enterprises and Foreign Enterprises* (Guo Shui Fa [2003] No. 3. The State Administration of Taxation. 7 January 2003) is more recent and relevant. It clarifies a number of tax issues regarding the chargeability of various taxes applicable to disposition of NPL assets by foreign-invested AMC's (FIEs) and foreign enterprises (FEs).

According to the Tax Circular, disposition of NPL assets refers to enterprises (including FIEs and FEs) that acquire equity, debt, physical assets and "bundled-assets" of another domestic enterprise (hereafter refers to as "Replacement Assets") from an AMC in China, followed by the disposal of such replacement assets, and the obtaining of investment returns therefrom. An enterprise can dispose replacement assets by any of the following ways: (1) recovering or transferring creditors' claims, (2) swapping its claims for equity, (3) disposing physical assets that the enterprise has the right to dispose, (4) selling or transferring equity holdings in other companies, (5) selling-back replacement assets, and (6) disposing replacement assets by means other than those listed above. An enterprise carrying on the above transactions with an aim to derive profits therefrom is considered as engaging in the "financial assets disposition business".

The Tax Circular specifies the potential tax liabilities in relation to disposition of replacement assets by FIEs and FEs. Major taxes are summarized as follows:

1. Business Tax and Value-added Tax (VAT)

Business tax and VAT exposures on enterprises engaging in the financial asset disposition business depend on the type of replacement assets being disposed of. According to the Tax Circular, no business tax is imposed on income derived by an enterprise from the disposal of replacement assets in the form of debt claims against or equities (including debt-to-equity swaps) in other domestic enterprises.

However, income derived from disposition of physical replacement assets is subject to either business tax or VAT. More specifically, enterprises transferring or disposing physical assets are subject to a 5% business tax on gross disposal income if such assets are immovable, or to a 17% VAT if such assets are brand new goods. If such goods are used goods, a 2% VAT on the sales price without allowing offset of their input VAT against their output VAT. The respective VAT payable shall be calculated in accordance with the applicable VAT regulations.

## 2. Enterprise Income Tax

Enterprises disposing NPL assets are subject to income tax on their gains from disposition of replacement assets after deducting from such gross disposal proceeds the historical cost of, and expenses and losses relating to, the disposed replacement assets. The historical cost of a replacement asset should be the actual price paid to acquire the asset or the price at which a debt was converted into equity. Where an enterprise reclassifies or restructures part or all of its replacement assets acquired, the enterprise may re-determine the historical cost of a single (or bundled) replacement assets, but the overall value of these reclassified or re-structured replacement assets should not exceed the total historical cost of these assets at the time the enterprise acquired them.

Where an enterprise disposes replacement assets in stages or different batches, if the aggregated revenue from disposition of the assets (either single or bundled) exceeds the historical cost of replacement assets, the enterprise is required to report the excess amount as taxable income for the relevant tax period and then calculate the amount of income tax payable. Likewise, as a general rule, if an enterprise incurred losses in disposing of its replacement assets, the enterprise is allowed to deduct such losses from its taxable income for the tax period during which such losses incurred. However, if an enterprise disposes bundled replacement assets, it will not be permitted to deduct such losses until the entire bundle has been completely disposed of.

In general, foreign enterprises that have not established an organization or site in China but engaged in the disposal of NPL assets is obliged to file an enterprise income tax return on their own or through an appointed agent located in China and pay income tax to the relevant tax authorities, unless they come from countries that have signed the bilateral tax treaties with China. However, since the tax treaties that China signed with its contracting states normally do not cover turnover taxes, all enterprises (domestic and foreign) are required to pay business tax or VAT on revenues from provision of services or sales of goods.

In conclusion, NPL assets represent a huge market for foreign investors. For the moment, foreign investors find it good to reap short-term profits on one hand and on the other to get prepared for a long-term investment. The Chinese government has offered preferential tax treatment to attract more foreign investment in this area. The exemption of business tax on the disposal of acquired assets in the form of equities and debt claims in other domestic enterprises shall improve the return on investment of foreign investors and hence, encourage the participation of foreign investors in China's NPL assets market. However, although the Chinese government has attempted to clear out some regulatory barriers to facilitate foreign investment in this sector, it has not addressed all of the legal and regulatory concerns of potential foreign investors. First, the current regulation is silent on whether a foreign investor may contribute its acquired NPL assets as the registered capital of the FIE

formed. Second, a FIE is generally subject to the 50% net asset value restriction when it invests in other Chinese enterprise. This ceiling limits foreign investors' ability to acquire NPL assets to 50% of the respective net assets of FIEs. Third, FIEs or FEs are subject to foreign exchange restrictions when they attempt to convert RMB revenue from disposition of NPL assets into hard currency for overseas remittance. Finally, according to the Tax Circular, enterprises (including foreign enterprises) disposing of physical assets are subject to business tax or VAT. From the practical standpoint, it would be somehow difficult for foreign enterprises to re-sell these physical assets due to the fact that they would not be able to issue VAT invoices for these sales, as they have no business establishment in China and thus can not register with the PRC tax authorities as a taxpayer authorized to issue VAT invoices. Though the Tax Circular has cleared out certain barriers in term of tax policy, yet it is still short of related regulations to specify as to how to carry it out. In order to eliminate further uncertainties, foreign investors are advised to seek an advance ruling from the local tax authorities in this regard.

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