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Global Tax Alert

China releases the corporate income tax treatment on perpetual bonds

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Executive summary

China's Ministry of Finance (MOF) and State Taxation Administration (STA) jointly released MOF/STA PN [2019] No. 64 (PN 64)[1] to clarify the corporate income tax (CIT) treatment on perpetual bonds. PN 64 becomes retroactively effective on 1 January 2019.

Detailed discussion

PN 64 defines perpetual bonds as renewable corporate bonds, renewable company bonds, perpetual debt financing instruments (including perpetual notes), and non-fixed-term capital bonds approved by the government authorities and issued according to the legal procedures.

The issuer can choose to apply the CIT treatment of stock or bonds on the perpetual bonds as discussed below. The CIT treatment is irrevocable once adopted and it should be disclosed in the issuance documents of the stock exchange, inter-bank bond market or other issuing markets.

If the CIT treatment of stock is adopted and both bond issuer (issuer) and the bond investor (investor) are Chinese resident enterprises, the investor will be exempt from CIT on dividends from perpetual bonds; whereas the issuer's bond interest expense is not deductible for CIT purposes.

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If the CIT treatment of bonds is opted, the investor's interest income from the perpetual bonds will be subject to CIT and the issuer's bond interest expense is deductible for CIT purposes.

To apply for the CIT treatment of bond interest, at least five of the following conditions must be met:

- The issuer has the obligation to repay the capital for the investment.
- Rates and payment frequencies are clearly specified in the instrument.
- The investment period is specified.
- The investor does not have the ownership of the net assets of the issuer enterprise.
- The investor does not participate in the daily operating activities of the issuer enterprise.
- The issuer enterprise may redeem the bonds anytime or when certain conditions are met.
- The issuer enterprise books the investment as its liabilities.
- The investor does not bear the same business risk as the shareholders of the issuer enterprise for this investment.
- The investment has priority liquidation order over the shares held by the shareholders of the issuer enterprise.

PN 64 provides the issuer an option to choose the tax treatment of bonds or stocks on the perpetual bonds. It is consistent with the recommendation in OECD's[2] final report on BEPS[3] action plan for Hybrid Mismatch Arrangements. This reflects China's positive attitude in responding to international anti-tax avoidance actions in its tax reform. Foreign investors may be allowed to invest in perpetual bonds through certain investment channels. It is recommended for the foreign investors to understand the specific China CIT treatment on the perpetual bond before making the investment in the market.

Endnotes

1. PN 64 was issued on 16 April 2019.
2. Organisation for Economic and Co-operation and Development.
3. Base Erosion and Profit Shifting.

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