

A Legal Reflection on Reform of Internet Finance Tax

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Abstract

Internet finance is a product of the interaction of many industries in this information era. On basis of internet, it is quite often free from present taxation regulations on the financial industry. Legal absence in this newly-merging financial form requires urgent solution as it develops. Taking online P2P (peer to peer) lending as an example and referring to legislation experience in EU and US, this paper centers on taxation mode for internet finance from three main categories of taxes like enterprise income tax, individual income tax and business tax, and at the same time gives special attention to the top-level institutional design of internet finance tax and its detailed application in the process of value added tax (VAT) pilot reform.

Key words: Internet finance; Taxation legislation; Online P2P lending; VAT pilot reform

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INTRODUCTION

Internet finance, parented by internet and finance, is an innovative financial mode in the modern IT era. Taking

advantage of internet, internet finance makes financial work more efficient, improves business operation and enlarges business scopes of traditional financial industry. Besides, it covers functions of fund raising, payment and transaction medium, mainly reflected by the rise of such modes as third party payment, online P2P lending and crowdfunding, among which online P2P lending is of revolutionary significance in financial operations. No exclusive or systematic laws are available to taxation on internet finance since it is still in a primary stage of development in China. Current laws in the likes of Law of Individual Income Tax, Law of Enterprise Income Tax, the Interim Regulations on Business Tax, and the Interim Regulations on VAT are of certain applicability to internet finance though, there still exist a lot of legal emptiness and ambiguities which need a faster legislation pace to regulate it.

1. IMPROVEMENT OF INTERNET FINANCE SUBSTANTIVE TAX LAW

The main achievement in internet finance of China is the rise of such modes as third party payment, online P2P lending and crowdfunding, among which online P2P lending is of revolutionary significance. Online P2P lending is in essence a kind of private lending, evolves from offline to online and differs from traditional lending which requires lending medium. It poses a severe challenge on current tax laws because it is not limited by restrictions like regions, lending threshold and human relationships.

According to parties participating in the lending, private lending is mainly divided into three types: lending between enterprises, between enterprises and individuals and between individuals. Related taxes are business tax and surcharges, enterprise income tax and individual income tax. In business tax, taxation legislations that are applicable to all kinds of lending are relatively unified. No matter what the lenders are, financial institutions,

non-financial institutions or individuals, the act of lending money to others by means of traditional ways or through the internet could be regarded as lending, which should be levied business tax at a tax rate of 5% and its corresponding urban construction and maintenance tax and education surcharges as regulated in finance and insurance industry. In income tax, profits made from any lending belonging to that between enterprises should be considered as enterprise income and the lender should pay proportional taxes accordingly¹. When enterprises borrow money from individuals for fundraising, the individual should pay business tax and surcharges as well as individual income tax at a rate of 20% based on income from interests, dividends and dividend on shares as he requires an interest receipt issued by taxation institutions. If the individual fails to show receipts issued by taxation institutions, the enterprise should withhold and pay business tax and surcharges along with individual income tax which the individual has to pay. If lending between individuals still needs a receipt, the individual should pay business tax and surcharges as well as individual income tax at a rate of 20% based on income from interests, dividends and dividend on shares as he requires an interest receipt issued by taxation institutions². Generally speaking, related regulations on P2P lending are simple and clear though, problems still exist. Levying turnover tax and individual income tax on private lending in China makes the entire taxation on private lending oppressive, which hinders the stable and sound development of online P2P lending. Moreover, as the primary supplier of funds in P2P transaction and the tax payer, the individual gets unfairly treated due to the coexistence of turnover tax and individual income tax on him. Take income tax for instance, enterprises could avoid paying enterprise income tax by means of offsetting interest income with accounting process and amortization expense within the current law of enterprise income tax. However, the individual tax system in China requires individual tax payers to pay individual income tax independently for every interest income, allowing no offset with other expenses. The treatment individual tax payers get is much poorer than enterprise tax payers.

Therefore, the author of this paper holds the view that in order to boost the development of online P2P lending in a healthy way, current taxation legislation should be reformed, keep business tax while exempt income tax temporarily, and grant tax preference to tax payers according to investee and industrial development. This, on

¹ Relevant and irrelevant enterprises are subject to different restrictions only when it comes to pre-tax deduction standards of enterprise income tax which is calculated on basis of profits from cost of borrowing and interest cost. It will not be analyzed in depth since it is not directly related to the theme of this paper.

² Refer to relevant provisions stipulated in *Law of Individual Income Tax of People's Republic of China*, and *Law of Enterprise Income Tax of People's Republic of China*.

the one hand, generally lessens tax burden on tax payers, alleviates financial pressures on small and medium-sized enterprises; and eliminates treatment differentials between enterprises and individuals in terms of taxation, liberating all private lending industries including online P2P lending from taxation burdens on the other.

2. IMPROVEMENT OF INTERNET FINANCE PROCEDURAL TAX LAW

Internet finance brings traditional financial operations from offline to online, which greatly enlarges the scale of private financial transactions. The latest amendment of the Tax Administration Law was made in 2001 when internet finance was paid little attention to and no corresponding regulations was made, resulting in a failure to supply effective taxation basis for the currently active internet financial activities. Deficiency of current tax administration on internet finance finds its reflections in the following aspects: (1) Taxation elements are hard to be clearly confirmed. Identity of tax payers, for instance, is difficult to be determined. Individuals and enterprises in private lending demand different income tax laws, but in online P2P lending tax payers can easily conceal their real identities. As a result, it is hard to confirm the identity of tax payers and the tax payment places. Transactions done at the virtual cyber space make confirmation of tax payment place deviate related regulations in tax laws of our country, bringing about uncertainty in making sure either national tax bureau or local tax bureau should be in charge of taxation on one certain transaction. (2) Being electronic, internet finance makes tax administration harder. Offline tax administration bases itself on a variety of tickets, account books and financial reports, while various vouchers in an online environment are easy to be altered or deleted without being noticed, putting obstacles to tax administration due to lack of reliable tax basis. What's more, anonymous operations supported by electric banking and electronic check as well as internet applications like data encryption are technical barriers that are hard to be tackled in tax administration.

With the introduction of new transaction mode and intermediary institutions, internet finance brings about difficulties and challenges to tax administration, it also offers a precious chance to make innovations in tax administration manners. We should amend current tax administration law according to features of internet finance and take the following measures: (1) appoint the online P2P lending platform as the obligor who should undertake obligations to withhold and pay. As an obligor for withdrawing and paying business tax, the online P2P lending platform is supposed to embed in the operation a complete set of standardized program which can roughly work out the tax to be paid (expected interest times tax rate) according to transaction information in every

transaction, and transit the information to the third party payment platform that assumes the responsibility to assist. This obligation starts at the lending deadline when capital and interests are transferred to the lender and expected taxes is deducted from interests and have it shifted to the online P2P lending platform. At the same time, the obligor should inform the tax payer of the sum of deducted tax and tell him he could review it within a certain amount of time, one week for example. Any question or eligible tax privileges could be stated or declared but cash pooling forming before the time the tax payer confirms the tax should not be used. The obligor transfers the tax money to designated bank accounts of tax institutions directly and tells the tax payer the way to appeal if no problem is found or reported within the specified time. (2) Electronize receipt management and tax inspection. We should adopt electronic receipts³, fully initiate such tax office software as the recognition system for electronic transactions and anti-counterfeiting system for exclusive receipts to catch up with the paperless characteristic of online P2P lending. Furthermore, we could develop a more convenient and effective electronic receipt system by taking advantage of the quite mature technology of Quick Response Code (QR Code). In addition, tax inspection should focus on withholding and payment on online P2P lending platform, on telling if the data base provided by the platform is right and whether all tax money is paid and transferred to treasury in time so as to get objective and complete taxation information to the largest.

3. USE FOREIGN FINANCIAL LEGISLATION EXPERIENCE FOR REFERENCE

Financial industries in countries which enjoy a developed market economy are special, thus usually levied a tax less than that of other industries. Related taxes include VAT, stamp duty, securities exchange tax, enterprise income tax, individual income tax, etc. usually with income tax accounting for a larger proportion than indirect tax. The rapid development of internet finance will naturally bring disputes on whether or not to levy a tax and how. In the past two decades, market-economy developed countries has shared different opinions on whether or not levy taxes on internet finance though, they gradually come to a consensus, which could provide reference for internet finance tax legislation in China.

As internet finance develops, two groups sharing different opinions on internet finance taxation appear. The United States maintains tax exemption while the EU insists on taxation. The EU is a pioneer in construction of internet finance tax system, holding the view that tax legislation should be legally clear and certain, and that e-commerce should not be levied extra taxes nor

³ Electronic receipts are the electronic image of traditional receipts.

exempt from all taxes, otherwise an unfair competition between e-commerce and traditional commerce will arise. Therefore, the EU proposes to levy VAT on e-commerce transactions within its member countries to protect their interests, and puts forward a specific idea of building a tax administration system focusing on supervising the payment system (Department of International Economic and Social Affairs, 2005). On July 8, 1997, the ministerial conference of the European telecom passed a declaration (Declaration of Bonn Ministerial Meeting) supporting e-commerce. This declaration expounds the basic principle of creating "clear and neutral taxation environment" for the development of e-commerce, and advises the government to cut down on unnecessary limitations, help private enterprises develop e-commerce on their own so as to accelerate competition in the internet industry and enlarge the business uses of internet (International Fiscal Association, 1997). The European Commission advised, in 1998, to levy VAT on European consumers who engage in e-commerce on the internet. The Meeting of European Union Finance decided to levy VAT on suppliers outside Eurozone for digital products sold to European consumers through the internet on Dec. 13, 2001. The tax rate is determined according to the current VAT rate being practiced in EU countries. It is specifically stipulated as follows. Since July 1, 2003, the EU has started levying VAT on companies outside the Eurozone who sell computer software, game software, or provide downloading services for digital music to the 15 member countries of EU through internet. Non-EU companies whose annual turnover exceeds 100,000 euros must pay VAT. Non-EU companies are demanded to register in only one of the EU countries, and pay taxes according to the tax rate in that country where their company is registered. After registration, the taxation institutions of that country should transfer the tax money to the country where the buyer comes from (The buyer must provide actual address when purchasing) (Chen, 2010; Zhang, 2000).

The United States is the country where e-commerce is the most widely used, and at the same time the typical representative for "tax exemption on internet finance" for the reason that taxation on e-commerce would seriously hinder its development, which is not accordant to the trend of globe economic integration. Therefore, the US has been implementing the policy of not levying any tax on domestic and international e-commerce, and bans any new federal or local taxes on it. In December 1995, the US formulated taxation policies related to e-commerce, and set the goal of supporting and creating a legal environment that is simple predictable, consistent and suitable for e-commerce to avoid improper limitations on e-commerce. In 1996, the US Treasury Department released the white paper "The Selective Taxation Policy on Global E-commerce", which mainly centers on the technical features of e-commerce, policies it shall abide by and tax management methods. On July 1, 1997, the former US

president Bill Clinton released the “Global E-commerce Outline”, making three basic policies for e-commerce taxation, calling on government of every country to encourage and help enterprises to develop internet business applications as much as possible and advising to regard the internet as free zones. In October 1998, the US congress passed the “Internet Tax Freedom Act” covering the following contents: (1) Avoid new taxation on internet for the next three years. (2) Avoid multiple taxation on or tax discrimination against e-commerce. (3) Matters on taxation on remote sales. Furthermore, the act prohibits federal tax on e-commerce and designates internet as free zones. The US congress adopted the resolution to lengthen the expiry of Internet Tax Freedom Act by two years in November 2001. In April 2003, Some US senators agreed to further defer the date of levying internet tax through legislation, hence the tax exemption system till today (Arnold & Brian, 1998). What’s worth mentioning is that the tax exemption system in the US is only confined to internet finance transaction, not entirely tax free. That is to say, the US proposes to exempt taxation on VAT and tariffs, but not giving up to levy property tax on internet finance. Virtual currencies are considered as property, not any kind of currency. Therefore, related tax laws and their specific principles for property transaction can be applied to virtual currency transaction. To be specific, levying taxes on virtual properties in online games or not depends on whether the number of online property auctions has reached business standards.

Though the US and EU hold different opinions on taxation on internet finance, the former is actually starting thinking about innovations to tax exemption in internet finance transactions and gradually coming to an agreement with EU at least in terms of the following matters: (1) Lay emphasis on the neutral tax policy, and consider it as the basic principle for e-commerce taxation. Under this principle, instead of levying new taxes or surtax, taxation institutions will amend current tax laws to ensure it applies to e-commerce and e-commerce development will not distort taxation fairness. (2) Emphasize international cooperation. Tax avoidance and tax evasion are becoming easier since e-commerce transactions are usually highly liquid, untraceable and anonymous. More research should be done and tracking institutions should be established when necessary to protect the interests of the government in taxes, prevent market distortion, and ensure and promote the legitimate trade and stable development of the internet finance. (3) Lay stress on taxation exemption or light duty on internet finance. Avoid multiple taxation on or tax discrimination against internet finance. Tariffs on e-commerce (sales of digital products on the internet) should be exempted.

We maintain the view that e-commerce and internet finance are newly-merging services on basis of internet, and both have impacted traditional trade and financial activities. Attitudes on e-commerce taxation of every

country mirror a balance between internet economy and tax laws in that country. In spite of the differences in operation and tax elements between e-commerce and internet finance, the aim of e-commerce legislation in every country is a reflection of their taxation policy for the internet industry including e-commerce and internet finance. We can refer to relevant experiences in the US and EU: adhere to taxation principles of neutrality, fairness and simplicity. get over or avoid unfavorable factors that may keep internet finance from stable and sound development; stick to tax fairness by treating traditional finance and internet finance equally and applying the same tax burden so that people’s decision on operation or investment mode will not get influenced; Tax simplicity requires tax legislation to be simple, transparent and easy to operate, which facilitates tax reduction for tax payers and punctual transfer of full tax money to treasury.

4. TOP-LEVEL INSTITUTIONAL DESIGN OF INTERNET FINANCE TAX LEGISLATION AND ITS CLASSIFICATION INTO THE SCOPE OF VAT PILOT REFORM

For the sake of the development and stability of related tax management system in China, it is of great necessity to, on basis of scientific analysis, fasten the pace of legislation and make top level institutional designs for internet finance tax, and classify internet finance tax into the scope of VAT pilot reform for a normative and sound development of internet finance industries during the process of tax reform.

The fact that current internet finance tax laws are lagging behind and lacking top level system designs needs amendments to laws as such as Law of Individual Income Tax, Law of Enterprise Income Tax, The Interim Regulations on Business Tax, The Interim Regulations on VAT and Administration of Tax Collection so that they could meet the need of internet finance development in a normative way. Besides, the circumstance that no laws to which internet finance tax can stick is available and that current tax laws lack effective regulations needs to be improved as much as possible. It is also necessary to make Law of Internet Finance Tax in due time, improve the top level institutional design of internet finance tax, and establish a scientific, normative and thorough legal system for internet finance tax so as to safeguard substantive tax legislation and procedural tax legislation for internet finance.

At the same time, pace of VAT pilot reform for modern service industry in China must be accelerated. Business tax with a tax rate of 5% is a main tax levied on financial insurance industry in China. However, there exist the following problems in the business tax levied on financial industries in China: (1) Comparatively high tax rate. Compared with that of transportation and

construction industries whose tax rate is 3% before VAT pilot reform, the business tax rate of financial industries is obviously much higher, what is worse, such surtaxes as urban construction and maintenance tax and education surcharges further increase the actual tax burdens on financial industries. (2) Large tax base. Business tax on financial industries is calculated on basis of the gross turnover rather than net turnover. Sometimes collect charges, which are not supposed to be considered as income, transfer fee and activation fee withheld and paid by securities companies for their clients for instance, are counted in as gross turnover. Obviously, it is unreasonable and increases tax burdens on enterprises. (3) Repetitive taxation. Business tax does not work the same way as VAT which is only levied on the value-added proportion, neither can it deduct the paid VAT in input cost. Therefore, taxation is repeated. (4) Insufficient support for innovative business in finance. In order to encourage financial innovation, tax privileges should be granted to new financial business like offshore finance and internet finance. The Ministry of Finance and State Administration of Taxation jointly issued a notice on publication of VAT pilot reform Program on Nov 16, 2011, and decided to start pilot reform in transportation and partial modern service industries in Shanghai from Jan 1, 2012. The scope of VAT pilot reform has extended itself from Shanghai to the whole country and from transportation and partial modern service industries to postal industry and telecommunication industry, applying to more and more industries and providing a direction for tax reform in China. High tax rate, large tax base, repetitive taxation and insufficient support for financial innovations in financial tax would, in the long run, impede development of new financial business and the whole financial industry of our country. Business tax must be replaced by value added tax before achieving a low taxation and a proper taxation structure. Seen from the domestic background, VAT reform pilot is expanding and is bound to reach the financial industry (Xu, 2014). Internationally, a majority of European countries have adopted the policy of VAT pilot reform. VAT on financial industry is calculated according to the value added amount. Financial supporting business such as custody services will also be levied VAT. But exporting business and financial service related to export and labor service is tax free. Though one or two countries are levying business tax on the financial industry, it is levied on basis of interest rate spread rather than the gross turnover (Su, 2008).

Without any doubt, internet finance further enriched financial business modes. Internet finance share, in

essence, characteristics of traditional finance, though it takes advantages of internet and big data technology. For example, Yu Ebao is actually a fund business, P2P is essentially a petty loan business. So levying VAT on internet finance business as an experiment is of referential significance to the traditional or even the entire financial industry in terms of VAT pilot reform. The problem of having difficulty working out the value added amount in internet finance business is, in fact, a problem of having trouble calculating offset cost and proceeds deductions. We can adopt the simple tax-calculating methods applied to VAT in VAT reform Pilot Program, refer to tax-calculating methods adopted by previous business tax, i.e. not offset input tax. It is worth noting that a proper tax rate is crucial to simple tax-calculating methods (Zhang & Liang, 2012). VAT reform will bring about changes in tax categories and tax rates on the one hand and national-local tax prorate adjustments on the other. In short, VAT reform should encourage innovation in and development of internet finance according to the principle of not increasing tax burdens.

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