client alert

CHINA TO EXTEND VAT REFORM TO ALL INDUSTRIES NATIONWIDE

During the recent National People's Congress session, Premier Li Keqiang announced that starting 1 May 2016, China will be extending VAT reform nationwide to all remaining sectors still subject to business tax ("BT"). Following this announcement, on 24 March 2016, the Ministry of Finance ("MOF") and State Administration of Taxation ("SAT") jointly issued Caishui [2016] No. 36 ("Circular 36"), which provides the detailed implementing rules for the VAT reform expansion and the new VAT framework.

BACKGROUND

China began reforming its turnover tax structure in 2012, with an aim to eventually merge industries subjected to BT into the scope of VAT. Since its first trial run in Shanghai, the government has gradually expanded the scope of the reform to cover most service sectors (e.g. transportation, postal, telecommunications, modern services, and transfer of intangibles) by the end of 2015. However, four industries (construction, real estate, financial services, and lifestyle services) have not yet been included in the reform due to their nature and the economic slowdown.

The upcoming VAT reform roll-out will cover the above remaining sectors and is thus being seen as the last phase of the project. With the elimination of BT, China's current turnover tax regime will be replaced by a modern VAT regime, which will undoubtedly be a landmark milestone in China's economic development.

CIRCULAR 36 HIGHLIGHTS

Extended VAT scope and VAT rate

Starting 1 May 2016, the following four sectors will be subject to VAT instead of BT:

SECTOR	SCOPE	VAT RATE	BT RATE
Construction	Engineering, installation (including equipment installation), renovation, interior decoration, and other construction services	General VAT payers: 11% Small-scale VAT payers: 3%	3%
Real Estate	Sale of buildings, structures, and land use rights, as well as lease of immovable assets	General VAT payers: 11% *(5% during transition period)* Small-scale VAT payers: 5%	5%
Financial services	Loan services, direct charge services, insurance and financial commodity transfers	General VAT payers: 6% Small-scale VAT payers: 3%	5%
Lifestyle services	Culture and sports, education and medical care, tourism and entertainment, catering and accommodations, daily residential services, and other lifestyle services	General VAT payers: 6% Small-scale VAT payers: 3%	5% *(3% for culture and sports services; 5%-20% for entertainment services)*

Reclassification of certain taxable items

Circular 36 clarifies the current scope of taxable services and reclassifies certain taxable items such as:

- Sale-and-leaseback (融资性售后回租), which is currently subject to 17% VAT as a “lease of movable assets”, is reclassified as a “financial service” subject to 6% VAT;

- Carrier business without vehicle (无运输工具承运业务), which is currently classified as “auxiliary logistics” subject to 6% VAT, is reclassified as a “transportation service” subject to 11% VAT;

- Parking fees and tolls (停车费、道路通行费) are considered a “lease of immovable assets” subject to 11% VAT;

- The scope of intangible assets is expanded to include “other economic interest”, such as operating rights for infrastructure, public utility concessions, quotas, franchises, memberships, domain names, naming rights, and club transfer fees. The transfer of such intangible assets in China will be subject to PRC VAT at 6%.

Clarification of VAT-exempt items

- General VAT exemption

  Under Circular 36, the following activities are not subject to PRC VAT:

  - Provision of services and transfer of intangible or immovable assets free of charge for the public welfare (e.g. rail and air transport provided free of charge by State order)
  - Deposit interest
  - Insurance payments to beneficiaries
  - Special housing maintenance funds collected by real estate administrative departments, housing fund management centres, real estate developers and property management companies
  - Transfer of buildings and land use rights as part of a business transfer (the assets and associated rights, liabilities, and workforce must be transferred at the same time)

  In line with the State Council’s objective to reduce the tax burden, Appendix 2 of Circular 36 provides a comprehensive list of VAT-exempt items categorised by sector, including:

  - Preferential BT/VAT treatments for each sector before the VAT reform (e.g. qualifying educational services previously exempt from BT will continue to be exempt from VAT)
  - New exemptions for certain industries (e.g. certain types of interest income received by financial institutions)

- VAT exemption on export service

  Furthermore, exported services will continue to qualify for VAT exemption or be subject to a 0% VAT rate. Appendix 4 of Circular 36 provides a detailed list of such qualifying exported services. However, Circular 36 imposes a new requirement for certain types of exported services and intangible assets to qualify for VAT exemption: The provision of telecommunication, intellectual property, ancillary logistics, assurance and consultation, professional technical services, and advertising services for ads published outside China, as well as the transfer of intangible assets, will be exempt from VAT only if they are provided or transferred to overseas entities and fully consumed outside China. To be "fully consumed outside China",

- The service recipient must be located offshore and the service must not be related to goods or immovable property in China; or
- The intangible asset must be used entirely offshore and not be related to goods or immovable property in China.

This new requirement may limit the scope of eligible exported services and make it more difficult for VAT payers to provide sufficient proof that the services/assets were fully consumed outside China when applying for VAT exemption.

Input VAT deduction

Now that the real estate sector will be included into the scope of VAT industries, input VAT incurred on real property acquired on or after 1 May 2016 may be credited against the output VAT. Unlike the general input VAT deduction rule, which allows general VAT payers to immediately credit all input VAT indicated on special VAT invoices received from a seller, the input VAT incurred on newly acquired real estate must be credited over a two-year period, with 60% of the input VAT credited in the first year and the remaining 40% credited in the second year. This treatment does not apply to the projects of real estate developers or real estate acquired through financial leasing. As the granting of land use rights ("LUR") is exempt from VAT, real estate developers cannot deduct input VAT on the purchase of LUR from governments. To reduce the potential tax increase on real estate developers caused by the VAT reform, real estate developers will be permitted to calculate their output VAT by deducting any LUR grant price paid to the government from their sales revenue.

Lessees may also credit any input VAT charged by their landlord on top of the rent for real property.

Taxpayers may not credit the input VAT incurred on loan services (including input VAT incurred on loan interest, investment/financing advisory fees, commission charges, and consulting fees directly related to the loan borrowed by the taxpayer and paid by the taxpayer to the lender), catering services, daily residential services, and entertainment services against their output VAT.

Special sector rules

To ensure a smooth transition from BT to VAT, Circular 36 provides special rules for financial services, construction, sale and lease of real estate:

- Financial services: special rule for calculating the output VAT tax base;
- Construction: general VAT payers may opt for the simplified VAT taxation method for certain types of construction services;
- Sale and lease of real estate: transition rules for the sale and lease of real estate before 1 May 2016.

COMMENTS

Circular 36 lays down detailed rules for the transformation of the construction, real estate, financial service and lifestyle service sectors from BT to VAT and the general VAT framework for all VAT payers starting 1 May 2016. While more specific rules for the transition period and special industries are expected, this 92-page circular will be the fundamental guide for both tax administrators and taxpayers until a comprehensive VAT law is promulgated. Therefore, it is crucial for both domestic companies and foreign businesses with Chinese operations study this regulation in depth and assess its potential impact on their operations.

Business	Recommendation
Chinese companies in the financial, construction, real estate or lifestyle sectors	➥ Assess the financial impact and adjust business model and pricing methods ➥ Review existing contracts and revise tax and pricing clauses (to reflect the change from BT to VAT) and price composition (include or exclude VAT depending on commercial situation) ➥ Manage and upgrade internal financing system, implement control process for managing VAT compliance work, and conduct VAT training for employees ➥ Complete VAT registration, purchase VAT invoice machine and invoices, and be ready for first monthly VAT filing by 25 June 2016 (except financial institutions, which are subject to quarterly VAT filing)
Other Chinese companies that are already VAT payers	➥ Review supply chain and supplier qualifications, follow up with suppliers on their VAT registration status, and obtain special VAT invoices to obtain more deductible input VAT for crediting purposes ➥ Review customer list, assess and determine whether to adjust the pricing mechanism for customers transformed from BT to VAT payers
Foreign companies with Chinese operations	➥ Understand the PRC VAT rules applicable to foreign companies and the VAT withholding mechanism ➥ Assess the potential tax impact on China-related transactions (e.g. sale or procurement of goods and services to/from China) and negotiate with Chinese counterparties regarding price adjustments ➥ Review and amend cross-border contracts to clarify the party responsible for VAT and VAT filing

Gide will continue to monitor the VAT reform developments. Please feel free to contact us should you have any questions.

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