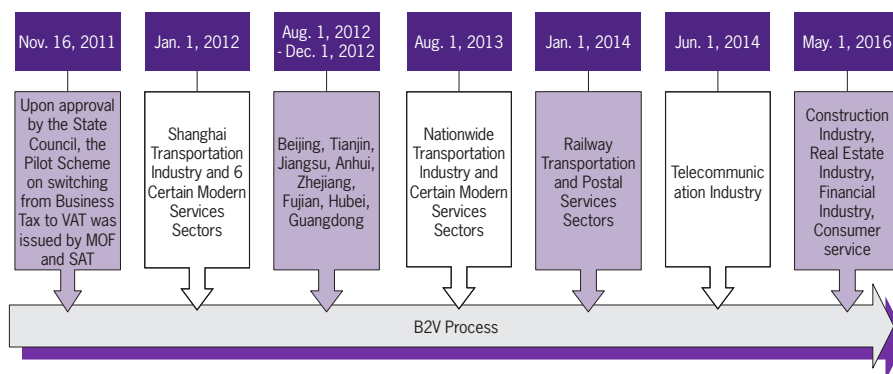


# A New Era of VAT

Issue 2 April 2016

# China tax alert

On 23 March 2016, Ministry of Finance (MOF) and State Administration of Taxation (SAT) of the People's Republic of China (PRC) jointly issued "Notice of Taxation on Full Launch of the Pilot Scheme on Levying Value-added Tax in Place of Business Tax" Caishui [2016] 36 (Circular 36), which indicates that with effect from 1 May 2016, the transformation of pilot programme from Business Tax to VAT (B2V Reform) will cover sectors of construction, real estate, financial services and consumer services and China enters into a new era of VAT.



To assist taxpayers in these four sectors to understand the subsequent implications from Circular 36 and this significant tax reform and areas to which that they need to pay particular attention, Grant Thornton provides key points of analysis by sector on Circular 36 from a taxpayer's operating perspective.

## Construction

The term of "Construction" has been redefined. Construction services refer to business activities related to construction, renovation and decoration of buildings, structures, and auxiliary facilities, installation of lines, pipelines, equipments and facilities etc., as well as other engineering operation. Construction services include engineering services, installation services, renovation services, decoration services and other construction services. The VAT rate applicable to Construction is 11%.

### Transition rules

- Construction projects will be classified into new projects or old projects upon the contract commencement date which is indicated by “Construction Permit for Construction Project” (Construction Permit) or the construction project contract in the case that Construction Permit will not have been obtained. Old projects mean projects with a contract commencement date no later than 30 April 2016.
- A general taxpayer providing construction service for old projects may opt to compute VAT payable under the simplified taxation method.

### Considerations on routine operations after B2V Reform

#### Sales amount:

- In terms of the construction services provided by taxpayers under simplified taxation method, the taxpayers should deduct subcontracting payments from the total price and additional charges to reach the sales amount.
- In terms of the construction services provided by taxpayers under general taxation method, the sales amount should be determined as the total price and additional charges.

#### Administration of tax collection:

- Construction services where the construction company purely provide labor services, or construction services where the principal provides equipment and materials may opt to apply for simplified taxation method.
- A general taxpayer, who provides construction services in a different county (city) than its registration location, must pay VAT on a provisional basis at the location where the construction services take places and then file and settle VAT payable at its registration location. The provisional collection rate is 2% for general taxpayers who apply for general taxation method; and the collection rate is 3% for general taxpayers who apply for simplified taxation method. The provisional tax payment and tax filing procedure for small scale taxpayers who provide

construction services in a different county (city) than its registration location, shall be conducted with reference to the situation of general taxpayers who apply for simplified taxation method.

### Real Estate

The definition of real estate development is not clarified in the new policy, however, the services related to real estate have been classified into sales of real estate, sales of intangible property-land use right, and leasing of real estate. Meanwhile, sales of real estate has been classified into NOT self-built and self-built, which apply for different sales determination and collection rate, respectively.

Real estate acquired after 1 May 2016 and recorded as fixed asset in accounting, or real estate developments under construction acquired after 1 May 2016, the input VAT credit should be apportioned over a 2 year period with 60% being available in year 1, and 40% in year 2.

### Transition rules

- The classification of real estate project is based on the contract work commencement date indicated by “Construction Permit for Construction Project”. A real estate started working on or before 30 April 2016 shall be identified as old project and may opt to apply for simplified taxation method or general taxation method.
- For a real estate developer as a general VAT taxpayer, it may opt to pay VAT payable under simplified taxation method with a 5% collection rate for sales of old real estate projects which are self-built.
- When a general taxpayer sells real estate which was acquired on or before 30 April 2016, it may opt to apply for a simplified taxation method with a 5% collection rate, compute the sales amount for NOT self-built real estate as that the total price and additional charges minus original cost of the real estate or the

net value of the real estate at the time point of acquisition, and total price for self-built real estate; the taxpayer needs to pay VAT on a provisional basis at the location of the real estate, and then file and settle VAT payable with the competent tax authority at the registration place.

- When a general taxpayer leases out real estate which was acquired on or before 30 April 2016, it may opt to apply for a simplified taxation method with a 5% collection rate. If such real estate locates in a different city (county) than its registration location, it should pay VAT on a provisional basis at the location of the real estate, and then file and settle VAT payable with the competent tax authority at the registration place.

### Considerations for routine operations after B2V Reform

#### Sales amount:

- For a real estate developer as a general VAT taxpayer, sells self-built real estate, it will be eligible to deduct from the sale proceeds with the cost of land use rights purchased from the local government authority in calculating its VAT liability. The valid certificate of purchase of land use rights is the financial receipts issued by the finance department of provincial level or above.
- When a general taxpayer sells real estate (including self-built and NOT self-built) which is acquired after 1 May 2016, shall apply for a general taxation method and determine the sales based on the total price and additional charges.
- The collected government charges could be deducted from the sales if the receipts issued by the government support.

#### Output VAT:

A real estate developer sells real estate by way of advance payment shall pay a 3% VAT prepayment at the time of receiving the payment.

#### Administration of tax collection:

- When a general taxpayer sells real estate which was acquired on or before 30 April 2016, it may opt to apply for simplified taxation method;

- When a general taxpayer sells real estate which was acquired on or before 30 April 2016, it needs to pay VAT on a provisional basis with a 5% collection rate at the location of the real estate, and then file and settle VAT payable with the competent tax authority at the registration place. For the real estate is NOT self-built by the taxpayer, it may deduct the original purchase price of the real estate from the total price and additional charges to compute the provisional tax; for the real estate is self-built by the taxpayer, it the provisional tax should be computed based on the total price and additional charges. When a small scale taxpayer sells self-built or NOT self-built real estate, it shall conduct reference to the calculative method of general taxpayer, pay VAT on a provisional basis with a 5% collection rate at the location of the real estate, and then file and settle VAT payable with the competent tax authority at the registration place.
- When a general taxpayer leases out real estate which was acquired after 1 May 2016 and locates in a different city (county) than its registration location, it should pay VAT on a provisional basis with a 3% collection rate at the location of the real estate, and then file and settle VAT payable with the competent tax authority at the registration place.

## Financial Services

Financial Services refer to services related with finance and insurance, including loan services, financial services which are subject to fee based income, insurance services and trading of financial products.

Taxpayers purchase loan services, the investment and financing consulting fees, consultancy fees and handling charges paid to the loan party directly connected with this loan, shall not be able to claim input VAT credits.

## Transition rules

Sale and leaseback financing services for tangible and movable properties could

be a kind of finance services. Meanwhile, taxpayers in the Pilot Scheme can still apply the current 17% VAT treatment for contracts signed before April 30th 2016 and they can also choose whether or not to deduct the principle amount from sales revenue under the 17% treatment.

## Considerations for routine operations after B2V Reform

### Sales amount:

- Loan services, all interest income and income as interest attribute derived from loan services shall be defined as sales amount.
- Financial services which are subject to fee based income, directly income (such as handling charge, commission, remuneration, management fee, service fee, brokerage fee, activation fee, clearing fee, transfer fee, custody transfer fee and etc.) from providing fee-based financial services are defined as sales amount.
- Trading of financial products, the balance of deducting purchasing price from the selling price is defined as sales amount. The purchasing price can be calculated based on weighted average method or moving weighted average method, however, once the computation method is selected, such method shall not be changed within 36 months. (Note: financial commodity transfer shall not issue special VAT invoice)
- Interest on deposit and compensation claimed by insurant shall not be the subject to VAT.
- When financial enterprises make loan to others, interest receivable in the initial 90 days after the expiry date for interest is required to account for output VAT. The interest arises after 90 days should not be account for VAT immediately. However it will account for output VAT when actually received.

## Preferential policy after B2V Reform

For qualified finance leaseback services after new policy execution, the policy on refund upon levy of VAT shall apply to the part in excess of 3% of their actual burden of VAT.

Besides, the VAT exemption preferential policy for interest income derived from national debt, local government debt and transactions among financial institutions etc. have been succeeded from BT rules.

## Consumer Services

Consumer services is the provision of different kinds of service activities that aims to satisfy citizens' daily demands and needs, which includes cultural and sports services, education and healthcare, travel and entertainment, food and beverage, accommodation and citizens' daily services, and other consumer services. The new VAT tax rate to "general VAT taxpayers" will be 6%, while 3% VAT collection rate will be applicable to "small scale VAT taxpayers". The input VAT paid for food and beverage services, citizens' daily services and entertainment services shall not be claimed for deduction.

## Considerations for routine operations after B2V Reform:

### Sales amount:

- Special Point: Taxpayers who provide tourism services, may opt to compute sales amount as that the fees of accommodation, food and beverage, transportation, visa, tickets collected from tourism service buyers and subsequent transfer the payments to other parties and/or individuals, and tourism fees paid to other outsourced parties, shall be deducted from the total price and additional surcharges. Taxpayers who choose the above simplified taxation method, shall not issue official VAT invoice but normal VAT invoice for the payments received from tourism buyers. The fees deducted from the total price and additional surcharges, shall be supported by valid receipts complied with legislation, administrative regulations and rules issued by the State Administration of Taxation. Otherwise, shall not be claimed for deduction.
- In addition to the particular terms mentioned above, sales amount shall be computed as the total price and additional surcharges derived from taxable activities conducted by taxpayers.

## Tax exemption

Service income derived from consumer activities within the following scope shall be exempted from VAT during the transition period of B2V Reform:

Childcare services and kindergarten and education for children; aged-care services for elderly people; nursing services for handicapped; matchmaking services; funeral and interment services; service provisions from handicapped; medical services; education services; services provided by students on a work-study basis; entrance tickets for memorial hall, museums, and related religion venues; housekeeping services; lottery sales income; and etc.

### Focus:

- The education and child-care fees, collected by public nursery and kindergarten, shall be exempted from VAT with a standard approved by government authorities' permission. In the meanwhile, those collected by private nursery and kindergarten shall be exempted from VAT limited to a standard recorded and announced by local authorities.
- Only educational institutions with valid state-recognition qualifications shall be exempted from VAT and the exemption is limited to educational services provide to current enrolled students. Sponsorship, school choosing fee, and other relevant extra service fees shall be taxable.
- Revenue of training and retraining courses is tax-exemption with a precondition that be recorded into uniform account, categorized into budget, and turned in fiscal revenue management with full amount, and bills/invoices managed and issued by the same institutions are exempted from VAT. On the other hand, such revenue, recorded under account established by subordinate department, shall be taxable.
- Entrance tickets for science propaganda which enjoy tax exemption policy shall be counted from policy execution date (May 1<sup>st</sup>, 2016) until Dec. 31<sup>st</sup>, 2017.

- Tax free medical services refer to the medical institutions which provide various services list in the “regulation of national medical service price and project” with determined price not higher than the guide approved by relevant authorities, as well as the health and epidemic prevention, the health and quarantine service.

## Cross-Border exemption for VAT taxable income:

Cultural and sports services, education and healthcare services, and tourism services provided by China domestic enterprises and individuals consumed outside of China's territory, shall be exempted from VAT.

Circular 36 indicates a comprehensive B2V pilot programme, leads to a new era of China comprehensively carrying out VAT implementation whilst BT completely out from the stage of China tax history.

## Stipulated Criterion of General Taxpayer

| Sector   |  | Stipulated standard of general taxpayer (within 12 consecutive months) |
|--|--|--|
| Original VAT taxpayer (Sale of goods or provision of processing and repair labor services or importation of goods) | Taxpayers engaging in goods production or providing taxable labor services and taxpayers mainly in goods production or providing taxable labor services and concurrently doing wholesale or retail sales | 0.5 Million  |
|  | Taxpayers engaging in wholesale or retail sales  | 0.8 Million  |
| B2V Reform taxpayer  |  | 5 Million  |

## Applicable Tax Rate

| Sector  | Tax Rate |
|---|----------|
| Sales or importation of goods (excluding specified goods), processing and repair labor services   | 17%      |
| Leasing services of tangible movables   | 17%      |
| Specified basic necessities (e.g. agricultural products, edible vegetable oils, tap water, heating, water heating, air-conditioning, coal gas, books, newspapers, publications etc. )   | 13%      |
| Transportation, postal service, basic telecom service, construction service, leasing of real estate, sales of real estate, sales of land-use rights   | 11%      |
| Financial service, Value-added telecom service, modern service (R&D and technical service, information technology service, cultural creativity service, logistics ancillary service, assurance and consulting, radio, film and television programs, business support service, other modern service), consumer service (culture and sports service, education and medical care service, tourism and entertainment service, catering and accommodation service, resident daily service, other consumer service)                                 | 6%       |
| Exportation of goods (excluding goods prohibited or without permissions), international transportation service, space transportation service, service provided to overseas entities and fully consumed outside of China (e.g. R&D service, energy management contract service, design service, production and distribution of radio, film, and television programs, software service, circuit design and testing service, information system service, business process management service, offshore outsourcing service, technology transfer) | 0%       |



### Items not subject to VAT

| No. | Items not subject to VAT   |
|-----|--|
| 1   | Railway transportation services and air transport services provided free of charge as ordered by the State governments, qualifying for free services for public interest   |
| 2   | Interest on deposits   |
| 3   | Insurance compensation obtained by the insurant  |
| 4   | Special housing repair fund collected by the in-charge housing authorities or the delegated entities (e.g. the developer, the property management service provider) on behalf of the house owners  |
| 5   | Transfer of real estate and land use rights that is associated with a transfer of the entire or part of an enterprises' tangible assets, along with the relevant receivables, liabilities and personnel, in the course of asset reorganization through merger, division, sale or exchange of assets. |

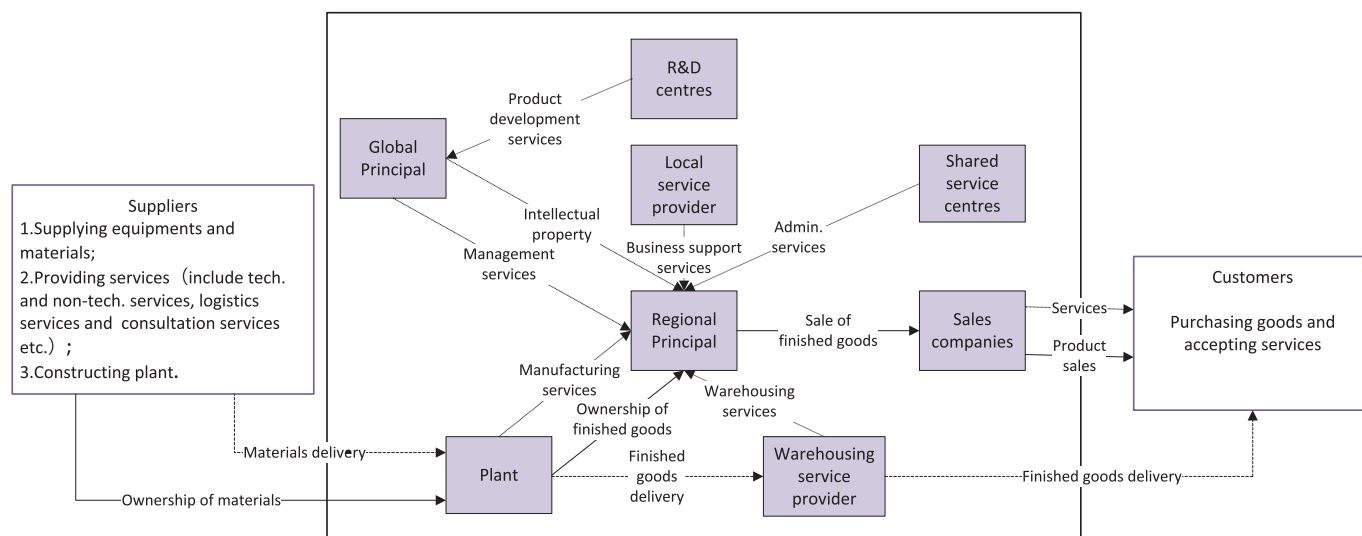
### Simplified Taxation Items

| No. | Simplified taxation items   | Collection rate |
|-----|---|-----------------|
| 1   | Public transportation services  | 3%              |
| 2   | Identified animation enterprises provide the following services for the development of any animation products: animation scriptwriting, image design, background design, animation design, storyboard, animation making, production, tracing, coloring, picture mixing, voice dubbing, music dubbing, sound effect mixing, editing, subtitling, compression and transcoding (compatible with online animation and cell phone animation formats), and transfers animation copyrights in China (including the licensing and re-licensing of animation brands, images or contents) | 3%              |
| 3   | Film projection services, storage services, loading/unloading services, and collection and delivery services  | 3%              |
| 4   | Operating lease services using purchased or self-made tangible movables as the subject matter prior to the date of implementation of the pilot scheme at their locality   | 3%              |
| 5   | Tangible movables lease contracts entered into by taxpayers under the Pilot Scheme prior to the date of implementation of the pilot scheme at their locality which have not been fully performed  | 3%              |
| 6   | Construction services where the construction company only provides labor services; construction services where the principal provides equipment and materials; construction services on existing projects   | 3%              |
| 7   | A general taxpayer sells real estate (self-built or NOT self-built) acquired on or before 30 April 2016   | 5%              |
| 8   | A general taxpayer among developers sells self-built existing real estate project   | 5%              |
| 9   | A general taxpayer leases real estate acquired on or before 30 April 2016   | 5%              |
| 10  | Vehicle tolls on highway, which commencement data before the Pilot Scheme, acquired by a general taxpayer among highway operation enterprises   | 3%              |

### **A new era of VAT – actions required by enterprises**

Shifting to VAT is not just a tax issue, it also deeply impact the business operation in a long run. Enterprises have to study thoroughly the VAT regulations, to undertake a comprehensive review and adoption of pricing policy and supply chain with regard to the new tax system. A clear tax strategy will assist enterprises to respond to challenges of commercial and operational aspects.

Unlike BT, VAT is levied on the added value of transactions (i.e. difference between the purchased and the resale price), VAT paid on purchase can be claimed for deduction. It is anticipated that refinement of sectors, specialization and cooperation would become a new normal mode. Specialization and division of duties with a group or outsourcing outside the group will be options for management of enterprises which will result in a more complex business relationship and supply chain. Pricing for inter-company transactions and for transactions with third parties will become the focus of tax management.



Enterprises could respond to the B2V Reform by the following four steps, rethinking the VAT tax exposure of the supply chain and ensure the commercial interest:

- Assess the compliance and risk of the existing supply train according to VAT regulation, assess applicability of VAT preferential policy and current exposure, adjust and improve accordingly from compliance perspective.
- Consider re-allocating the key assets in the Group, adjust the sales/service chain of sales of product, lease of immovable asset, service providing and the payment of royalty.
- Consider necessity of restructuring, reorganization of business, setting up relevant management center in the Group for specialization, design related party transactions and transfer pricing policy which is complied with VAT rules.
- Consider the pricing policy and re-negotiation with suppliers and customers outside the Group as a whole on the basis of completion of formation of supply chain within the Group.

During the adjustment above, transfer pricing for related parties transactions within a group will be a significant compliance issue that enterprises need to face and it will impact on corporate income tax position. These together trigger the need for a comprehensive tax arrangement. It will be more complex if cross-border transactions are involved where export tax rebates, customs duty, tax system and requirements of different countries are required to be taken into consideration. Under tax reforms/ initiatives like BEPS and multilateral tax collection and administration convention, enterprises need to consider the overall commercial plan to keep the systematic tax risk under control.

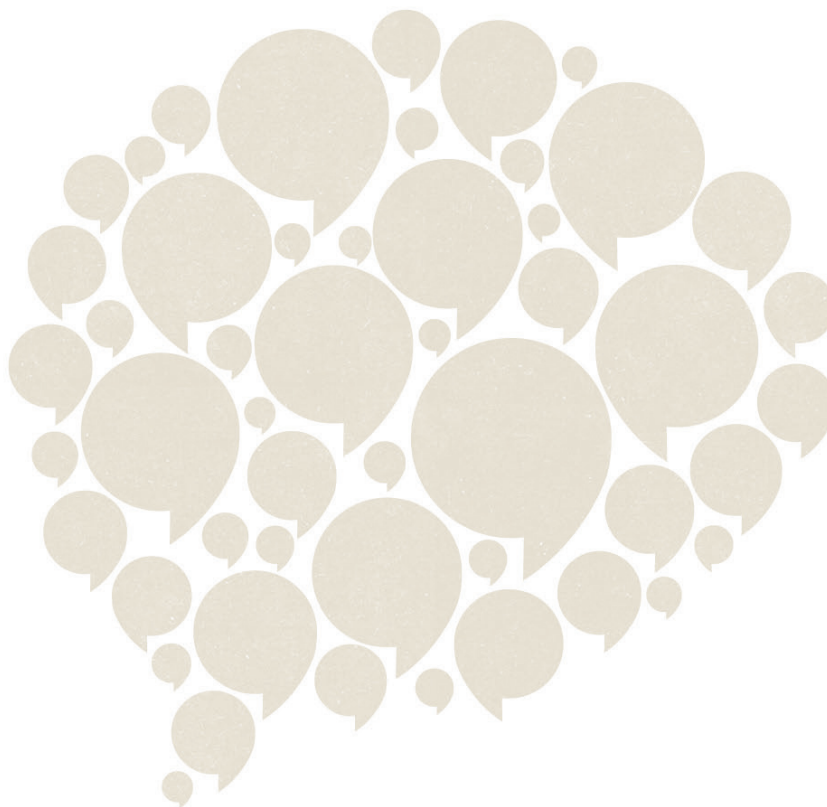
The impacts of B2V Reform on and the corresponding responses from enterprises will certainly a challenge of the operating system of enterprises. This requires not only the attention of accounting and tax department but also the collaboration of all functions of the entire organisation. (see chart below )

|                                   |                     | General awareness | Legal accountability | Compliance | IT Changes | Pricing changes | Operational changes |
|-----------------------------------|---------------------|-------------------|----------------------|------------|------------|-----------------|---------------------|
| <b>Executive Level Management</b> |                     | ✓                 | ✓                    |            |            | ✓               | ✓                   |
| <b>Departments</b>                | Accounting          | ✓                 | ✓                    | ✓          | ✓          |                 | ✓                   |
|                                   | Finance             | ✓                 | ✓                    | ✓          |            |                 | ✓                   |
|                                   | IT                  | ✓                 |                      | ✓          | ✓          | ✓               | ✓                   |
|                                   | HR                  | ✓                 |                      | ✓          |            |                 | ✓                   |
|                                   | Legal               | ✓                 | ✓                    | ✓          |            |                 | ✓                   |
|                                   | Procurement         | ✓                 |                      |            |            | ✓               | ✓                   |
|                                   | Sales and Marketing | ✓                 |                      |            |            | ✓               | ✓                   |
| <b>General Staff</b>              |                     | ✓                 |                      |            |            |                 | ✓                   |

## How Grant Thornton help you

Grant Thornton's VAT service team, transfer pricing team and Merge & Acquisitions team will collaborate to provide a full range of tax services in respect of the above four steps:

- Analyze the operating functions and exposure undertaken by each legal entities in supply chain within the Group, distribution and usage of each material asset, assist the Group to setup related party transaction pricing policy from compliance perspective, keep tax systemic risk under control;
- Analyze the VAT (including the export rebate and customs duty), tax incentives of the income tax in the Group's related party transactions and to optimize the tax burden in the Group's supply chain by adjusting the allocation of the assets and the transactions;
- Propose the tax implementation plan and coordinate with enterprises' IT department to achieve the control of tax risks systematically;
- Assist in the establishment of the tax strategies when negotiating the new prices with the suppliers and customers;
- Optimize the tax structure based on enterprises' business strategy and the sector characteristics.



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