



China Financial Services

Tax Alert

Issue 1
April 2017



VAT Reform Impact on Asset Management Products

Regulations covered in this issue:

- *Notice on the VAT policies concerning financial services, real-estate development and educational support services* issued by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) in December 2016 (Circular Caishui [2016] No.140)
- *Supplementary notice on VAT policies concerning asset management products* issued by MOF and SAT in January 2017 (Circular Caishui [2017] No.2), to be implemented from 1 July 2017.

Background

In December 2016 the MOF and SAT issued Circular Caishui [2016] No.140 (Circular No.140). Article 4 of the circular provides that managers for asset management products shall be treated as VAT taxpayers. Shortly afterwards, in January 2017, the MOF and SAT issued Circular Caishui [2017] No.2 (Circular No.2), postponing the implementation date of the clarified tax treatment to 1 July 2017.

The SAT is still in the process of developing the relevant implementation rules but, insofar as there are only two months before Article 4 is implemented, industry players should start their preparations without further delay. KPMG has been helping banks, asset management companies, trusts, fund management companies and their subsidiaries to prepare for the implementation of the new VAT rules for asset management products and has accumulated extensive experience – we share below some key insights on how to best prepare.

Preparation steps may be divided into three categories – (i) product design and (ii) product operation, which focus on upgrading business procedures, as well as (iii) tax filing. These are elaborated below.

Product Design

Product design issues include questions of (i) who should bear the costs of VAT, (ii) how the product offering memorandum should reflect the changes due to VAT reform, (iii) how to effectively communicate these changes to the existing or potential investors, as well as (iv) other tax matters requiring forward planning. In order to ensure that VAT costs are appropriately matched with the income to be received by the investor in the asset management products, managers will also need to design different tax burden pass-on schemes, which can include the following:

1. Tax burden direct pass-on: For some net-worth products the investment return received by the investors will be clearly and transparently linked to the income of certain specific investment assets underlying the product. In such cases, the asset managers may be able to structure arrangements to directly pass-on, to a given investor, the VAT burden arising on the underlying assets directly attributable to that investor. In this case, the VAT arising is simply deducted from the relevant investment income on payment to the investor.
2. Tax burden indirect pass-on: Certain products give a relatively fixed return to their investors, for example, bank-offered financial products with an agreed yield, but the yield of the product does not directly correlate to the investment income of the underlying assets. In such cases managers might need to build in a mechanism to adjust the product yield arising to investors, during product design stage, in order to provide for the indirect transfer of the VAT burden to the investors.

Meanwhile, for existing products, if the forthcoming implementation rules do not provide for special transitional treatment, managers might need to prepare a range of different potential tax burden transfer schemes. This is particularly pertinent considering that some investors might be reluctant to accept the additional tax burden arising from the changes brought by Circulars No. 140 and No.2. In certain special circumstances, managers might even develop different VAT burden transfer schemes for each product. For instance, when debt-based products of trust companies are concerned, trust managers might need to design multiple tax burden transfer schemes based on factors such as management fee rates for individual products, investor's willingness to bear the VAT burden, the feasibility to allocate VAT burden to various service providers, etc. These VAT burden transfer schemes may include one that transferred all to the investors, one that is borne by the manager, one that is borne jointly by both the investors and the manager, or one that such VAT burden is shared by the managers, trustees and other service agencies, etc.

In order to achieve a fair allocation of VAT burden, the wordings and contract terms in the offering memorandum are also very important. Managers need to consider factors such as whether the product is a net-worth product and whether it has a lockout period, then to sort out different product types and arrange disclosure accordingly. Specifically for net-worth products, it might be necessary to specify the basis for deduction of VAT in the product offering memorandum. Since the tax deducted from net-worth products is not based on the actual tax payment, so managers need to consider whether to include tax calculation formula in the product offering memorandum. For products with lockout periods, e.g. debt-based products, the tax deduction will be based on actual tax payment, which should also be explained clearly in the offering memorandum.

At the same time, if the manager is not planning to settle the taxes in advance for asset management products using the manager's funds, cash will need to be transferred from the product's custody account when tax payment is required. If this is the case, managers need to include in the offering memorandum some provisions regarding the arrangement of funds transfer for tax payment and related legal rights and obligations.

From the perspective of investor communication, managers also need to consider various communication channels which may include the issuing of announcements, sending client communication letters, and/or signing of supplementary agreements, in order to communicate the asset management products are now obligated to bear the VAT costs.

As asset management products will soon be subject to VAT, the related tax planning work will become more important and should be viewed as an on-going exercise. When the manager is designing an asset management product, the manager should analyze and understand whether the underlying investment assets are taxable, non-taxable or tax exempt from a VAT perspective. Specifically, for non-standard assets, manager needs to analyze whether there are principal guaranteed provisions in the contract of each non-standard asset, and hence whether the gains from the asset are taxable. Based upon that, manager can then design an optimized taxation arrangement for each of the products.

Product Operation

In terms of product operation, managers need to adjust IT systems (such as updating existing valuation systems) to accurately account for the net asset value of the product and ensure the transfer of the VAT burden, as appropriate. This includes:

- The system transformation needs to consider taxable ranges for all types of investments.
- The system transformation needs to set tax calculation methods for different sets of report.
- The updated system should be capable of calculating the VAT on different income items, such as gains from trading of financial goods vs interest income, as explained below.

Interest Income

For bond investments, it may be necessary to calculate VAT every day on the basis of daily accrued interest income. This should be booked into the VAT cost account at month end, and arrangements should be made to pay the corresponding VAT in the following month.

For debt-based products, it may be necessary to estimate VAT when accruing interest income, and the estimated VAT will be carried forward to the VAT cost account on the agreed interest payment date.

Gains from Trading of Financial Goods

Gains from trading of financial goods could include both realized capital gains and unrealized gains due to the changes in fair value. The changes in fair value do not result in immediate VAT liability under general rules. However, from a business perspective it is still advisable to accrue VAT on those gains in order to allocate the relevant tax burden to the investors when they redeem their asset management products. Therefore, system transformation needs to capture the appropriate VAT allocation between those realized capital gains vs gains from changes in fair value respectively.

For the carry-over of realized losses and losses from changes in fair value, the updated system needs to be capable of carrying-over realized losses and accruing creditable output VAT on the day when losses occur. In order to avoid a situation where the net value of the product is affected because net realized capital losses could no longer be carry-forward to next taxation year according to the rules, managers may consider not accruing output VAT deductibles on capital losses.

- If the implementation rules, which are set for release in the near future, clearly state that a general VAT calculation approach will be adopted (i.e. creditability of input VAT), the updated system needs to be able to calculate and record deductions of input VAT from output VAT. Some possible options that can be adopted by managers to conducting VAT calculations include:

- (1) Estimate input VAT of the current period when accruing expenses;
or
- (2) Deduct the input VAT when it becomes certain that the related input VAT can be deducted; usually, this is when the related VAT special invoices are certified.

From a prudent point of view, we suggest managers to adopt option (2). This makes it easier to accurately calculate and deduct input VAT against the output VAT and those that require the input VAT transfer-out.

Tax Filing

Tax filing issues include invoice issuance, the obtaining and certification of input VAT invoices, invoice retention and management, regular reporting and other related matters:

- 1、 To complete tax filing on time, managers usually need to ensure that there is sufficient balance in the custody account of the product. Due to frequent daily transactions, net-worth products usually have enough balance to pay off the VAT imposed on its gains. For debt-based products, managers need to design appropriate mechanisms to ensure that when VAT tax liability on the interest income arises, there is sufficient balance in the custody account to pay the VAT.
- 2、 In terms of tax filing, managers need to consider whether the valuation system could be modified to generate the VAT payables in the current month/quarter for the products. If this is possible and the VAT payables of debt-based products can be calculated manually, managers will be able to perform tax filing for their products. On the other hand, if the valuation system cannot generate tax filing data, managers may need to consider adopting specialized VAT management systems to realize VAT calculation and filing.
- 3、 Managers need to consider allocation of staff to be responsible for product-related invoice management and tax-related operations. The decision on whether to have product-level tax-related operations staff depends on factors such as the current workload of tax-related operations staff and internal risk-control requirements.

The above is a summary of the preparation work for VAT to be imposed on asset management products. For more information on each aspect of the preparation, please contact related personnel at KPMG. We will also follow up with more legal and practice-related content on the subject of VAT on asset management products.

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