



## Take Advantage of a More Equitable Deduction Method for Land Appreciation Tax (LAT) Paid

Announcement 29, issued by the State Administration Taxation (SAT), sets out procedures for property developers to claim Corporate Income Tax (CIT) deductions on LAT costs on final settlement before tax-deregistration and obtain refund of excess CIT paid. This announcement provides regulatory ground for property developers to eliminate extra CIT burden potentially resulting from the timing difference between the recognition of sales revenue and the deduction of the LAT costs for CIT purposes.

### Regulations discussed in this issue:

- Announcement on the CIT treatments of property developers before tax-deregistration, SAT Announcement 2010 No.29, issued by SAT on 24 December 2010, effective from 1 January 2010 (Announcement 29)

### Background

LAT final settlement on a real estate development project often takes place at the end of the project development and sales period. Generally, LAT costs would only be deductible for CIT purposes when they have been settled. However, property developers may not have sufficient taxable profits at the end of a project to absorb such LAT costs. As the CIT regime does not allow carry back of tax losses, such mismatch of timing for recognition of sales revenue and the deduction of the LAT costs may increase the effective CIT burden as well as cash cost of the property developers. In practice, some property developers went through the time consuming and costly negotiation process with the in-charge tax authorities in an attempt to solve the CIT deductibility issue on a case by case basis.

Announcement 29 has addressed this problem by allowing property developers to spread the total LAT costs over the development period and obtain refund of any overpaid CIT.

## **CIT refund**

- **Conditions of CIT refund**

After completing the LAT final settlement, property developers can apply for CIT refund when performing tax-deregistration with the in-charge tax authorities if the following conditions are met:

- LAT final settlement has been completed for the project; and
- CIT reconciliation has shown a tax loss for the tax-deregistration period

- **Calculation of CIT refund**

Property developers should first allocate the total LAT costs of the project (including the LAT in the final settlement) to the project development period (Annual allocated LAT costs) for CIT deduction purposes, based on the ratio of annual project sales to total project sales. The calculation formula is as follows:

$$\text{Annual allocated LAT costs} = \text{total LAT costs} * (\text{annual project sales} / \text{total project sales})$$

Next, property developers should re-calculate the additional LAT costs to be deducted in calculating CIT taxable income for each year of the project (Annual allocated LAT costs less LAT costs previously deducted for each year). Retrospective adjustments on CIT taxable income and CIT payable will be made after deducting the additional LAT costs. Property developers may apply for a refund of the overpaid CIT after such adjustments.

## **KPMG Observations**

- **Positive impact on effective CIT burden**

According to PRC LAT regulations, LAT should be prepaid for pre-sale of properties based on a percentage of pre-sale proceeds. Upon the completion of a project and satisfaction of LAT final settlement conditions, property developers should reconcile actual LAT liability and perform LAT final liability settlement with the in-charge tax authority on the remaining LAT payable.

On the other hand, property developers should go through CIT reconciliation and settlement process on an annual basis over the life of the project. Hence, most of the CIT computation and payment processes take place before the final settlement of LAT liabilities. Since LAT liabilities generally would only be deductible for CIT purposes upon actual payment, even if the property developers accrue the LAT liabilities during the life of the project, such accrued LAT costs would not be deductible for CIT purposes until the period of the final LAT settlement.

Given the recent market environment and the administration on the collection of LAT, the majority of property developers' final LAT settlement payments involve very significant amounts. Accordingly, they may incur a significant tax loss in the LAT settlement/tax de-registration period as most of the properties were already sold and revenue already recognized in prior years. If property developers cannot generate sufficient income in subsequent years to utilize such tax loss, the effective CIT burden will be increased.

Announcement 29 provides clarification on the CIT deduction of property developers' LAT costs for the entire project and allows refund of overpaid CIT. With the issuance of Announcement 29, property developers will have regulatory ground and procedural guidance to request for refund of overpaid CIT, and hopefully will no longer have to bear the costs associated with negotiations with in-charge tax authorities and the uncertainties over the leniency of the tax authorities.

Announcement 29 is effective retroactively from 1 January 2010. Property developers who apply for tax de-registration after 1 January 2010 and have overpaid CIT due to the LAT settlement issue should apply for refund of the overpaid CIT.

Companies who are finalising their 2010 4Q or 2010 annual financial statements and supplementary information may wish to assess the impact of Announcement 29 on their after-tax profit and effective CIT burden computation.

- **Unclear issues under Announcement 29**

In the meantime, we also note that Announcement 29 does not clarify certain implementation issues, which may still be subject to interpretation by the in-charge tax authorities in practice.

- *Property developers who applied for tax de-registration before 1 January 2010*

While Announcement 29 clearly addressed the cases in which property developers applied for tax de-registration after 1 January 2010, it does not provide any guidance to the property developers who applied for tax de-registration before 1 January 2010 and overpaid CIT. Are those cases closed and opportunity for refund forever gone? Maybe case by case consultation by those property developers with the local tax authority is the way to shed further light for now.

- *Property developers whose LAT final settlement is calculated based on deemed LAT collection method*

For property developers, LAT final settlement is generally calculated based on the appreciation value (sales proceeds less allowable deductions). In practice, some property developers may be approved to calculate the LAT liabilities based on the deemed LAT collection method, subject to the assessment by the in-charge tax authority. There has been no guidance on whether those property developers are eligible to apply for CIT refund under Announcement 29. We may see variations in the interpretation and practice of in-charge tax authorities in this regard until further regulatory clarification is provided.

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