



cutting through complexity

TAX

VAT reforms for the construction and real estate sectors

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Part 1: construction and related services

With the Value Added Tax (VAT) pilot program for the modern services and transportation sectors now implemented in many of the major commercial centres across China, attention is now turning to those industries that are yet to transition from Business Tax (BT) to VAT. Of particular interest is the construction and real estate sector.

There are few industries which evoke as widespread analysis and scrutiny of taxation policies as the construction and real estate sector. This Special Publication takes an in-depth look into many of the issues that the industry, tax authorities and advisors will need to consider in relation to the conversion of the construction and real estate sectors from BT to VAT. However, given the lack of detail announced so far by the Ministry of Finance (MoF) and the State Administration of Taxation (SAT), any predictions are purely speculative only.

The significance of the construction and real estate sector may be illustrated by reference to the statistics published in The China Tax Yearbook 2011, which indicate that the BT revenue collected from construction and real estate combined now represents approximately 51 percent of total BT revenue in China.

Background

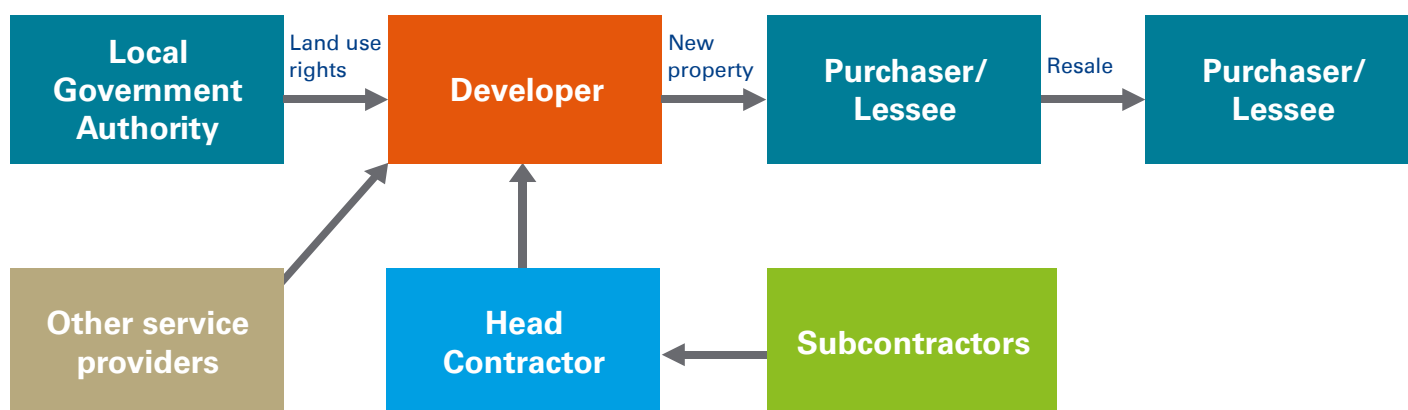
To put the issues into context, in many other countries with a VAT, the treatment of construction and real estate transactions presents many difficult challenges. The values of transactions in this sector are often very high; there is usually a multiplicity of different taxes already applicable to transactions in this sector, so the introduction of VAT needs to 'fit' into the existing tax regime. The effect of taxation policies on property values evokes enormous interest amongst the general population, and whether to tax passive increases in land values as part of the 'value added' upon which VAT is based, is often contentious.

The treatment of real estate transactions under VAT (or Goods and Services Tax (GST)) regimes used internationally is also far from uniform, which makes predictions about what will take place in China even more difficult. As a general proposition, there is the position in European Union countries where most sales of residential property are exempt from VAT, meaning that inputs into housing production are generally taxed. By contrast, the more modern VAT systems in Canada, Australia and New Zealand apply VAT to the first sale of new residential property, but then exempt subsequent sales and leasing of residential property on the basis that by taxing the first sale, the net present value of future payments has effectively already been taxed.

In the past few months, China's new leaders have publicly stated their desire to expand the VAT reforms to new industries in 2013, and construction and real estate is widely expected to be part of those reforms.

What has been officially announced in Circular Caishui [2011] 110 is that construction services will be subject to VAT at the rate of 11 percent. No mention is made of the intended treatment of real estate transactions, nor has there been any further details announced on the scope of 'construction services' which will be subject to VAT.

This publication is intended to provide an overview of the many issues that the industry will need to address in preparation for entry into the VAT system. Our approach to this is to go through the typical lifecycle of a property development project, and to highlight some of the different approaches adopted internationally. While there are clearly many unanswered questions, this is intended to provide a framework through which businesses in the construction and real estate sector can start to consider the issues, and take early steps to prepare for the reforms.



The analysis set out below follows the pathway of a ‘typical’ property development project. Plainly, not all projects will follow this same pathway – specific features or arrangements will always need to be considered on a case by case basis. However, this pathway is intended to deal with the major transactional aspects of the lifecycle.

Initial grant of land use rights to developer

The practical commencement of a property development project is ordinarily signalled by the initial grant of land use rights by a local government authority to a property developer. Under the BT regime, this transaction has not been subject to BT on the basis that the taxpayer would have been the local government – in effect, imposing tax would be akin to a government taxing itself. For similar policy reasons, we would anticipate that the initial grant of land use rights will not be subject to VAT.

Funding of the development project

Once land use rights are secured by a property developer, they will ordinarily seek to obtain a loan or another form of funding from a bank or other financial institution to fund the property development project.

In China, funding is typically only advanced once the foreign developer has contributed 35 percent or more of its development costs as its registered capital (per Circular Jianzhufang [2006] No.171).

At present, interest paid to a bank or another financial institution is subject to BT at the rate of five percent. It is expected that in due course, financial services, including lending activities, will be included in the VAT regime.

Internationally, most countries exempt interest revenue from VAT. However, the position currently set out in Circular Caishui [2011] 110 is that financial and insurance services will be subject to a ‘simplified VAT method’. The VAT rate under this simplified method is not actually specified in Caishui [2011] 110, but the inference is that a rate of three percent may be applied. If this approach is implemented in practice, then the VAT payable on interest will still be levied on banks and other financial institutions, but such VAT payments would not be creditable to the developer. In other words, the VAT payable on interest is expected to be a real cost to be absorbed in the property development project.

More recently, there has been a significant increase in the use of property trusts in China as financing vehicles. Whether or not the contribution of the developer’s equity to the trust, and the later redemption of that equity by the developer will fall within the scope of VAT remains to be seen.

Construction works

Head contractor

A property developer will usually need to engage a head contractor to take responsibility for the overall construction project. The head contractor may be a related entity of the developer, or an independent third party.

Under the current BT regime, construction services are subject to BT at the rate of three percent. Moreover, a head contractor is eligible to deduct payments made to subcontractors in calculating its BT liability, subject to receipt of appropriate construction invoices.

What is currently proposed in Circular Caishui [2011] 110 is that construction services will be subject to VAT at the rate of 11 percent. At first glance, this has caused some anxiety amongst construction companies. However, there are two critical factors which must be considered:

1. If the head contractor is providing its services to a property developer who is registered as a general VAT taxpayer, then the property developer would ordinarily be eligible to claim an input VAT credit. In other words, if the VAT is ultimately creditable, there should be no real adverse consequences for either party (cashflow issues aside). However, if the construction service is provided to a private homeowner (for example, some basic renovation work, or a decoration service), then the higher VAT rate would have real consequences.
2. The expected trade-off of a higher VAT rate should be the ability for construction companies to claim input VAT credits for any materials and other equipment they use in providing their construction services. In other words, while the output tax rate may increase from three percent (under BT) to 11 percent (under VAT), the flipside is that materials and other equipment used in the course of a construction project should qualify for 17 percent input VAT credits. This credit has not previously been available under the BT regime.

What follows from this is that the key to considering the effect of an 11 percent VAT rate on the tax burden of a construction company is their ability to claim input VAT credits, and for their downstream customer (i.e., the developer) to do likewise.



The existing VAT pilot program rules have a number of provisions which may potentially create confusion for the construction services industry. For example, where a construction service is provided along with materials, there are three potentially conflicting outcomes that could arise under the current rules:

- The provision of the construction service (including the materials) may all be taxed at 11 percent VAT
- The materials may be treated as a separate transaction (which is taxed at 17 percent) from the construction service (which is taxed at 11 percent)
- The whole transaction could be treated as a mixed supply if the relevant revenue cannot be accurately accounted for separately and the higher tax rate of 17 percent shall apply.

It is clear that specific rules will need to be introduced to ensure that the application of these general rules to the construction sector are clarified.

Overall, the effect of transitioning from BT to VAT for the construction sector must be measured or assessed on a case-by-case basis depending on the level of services being provided (relative to materials), and depending on the VAT status of the intended recipient of the construction service. As a general rule, if the intended recipient of the construction service is a general VAT taxpayer, the VAT impact should be neutral between the parties, and in fact, may reduce the tax burden as compared with the previous three percent BT liability. If the intended recipient of the construction service is not a general VAT taxpayer, then the higher the component of the service in the overall provision of a construction project, the greater the increase in the overall tax burden.

Preparation Tip #1

Businesses in the construction industry would be well-advised to consider undertaking a financial impact assessment to determine the likely implications of the VAT reforms for their business.

One critical issue for the construction services industry will be the precise transition time from BT to VAT, and whether any grandfathering relief is available. For example, if a construction project commences prior to the transition from BT to VAT, construction companies will need to consider issues such as:

- Whether the construction contract allows them to pass on the VAT impact to the property developer
- Whether materials purchased prior to the commencement of the transition to VAT, but incorporated into the project later, qualify for input VAT credits
- Whether progress claims for construction services invoiced after the transition to VAT will be subject to VAT, even though the materials used in providing those construction services may have been purchased while the BT regime was still in operation, thereby denying input VAT credit entitlements
- The likelihood that many construction companies will initially have net VAT credit balances in the period between purchasing materials and receiving payment for their services.
- Whether the old construction contract can continue to be subject to BT until the project is completed.

Preparation Tip #2

The potential risks for the construction industry are heightened by the fact that they typically enter into construction contracts which may span the duration of one or more years. Construction companies should ensure they put in place appropriate contractual provisions now to safeguard them against any adverse VAT impact.

As noted previously, the ability for a construction company to pass on the full impact of VAT to property developers will very much depend on whether those developers will be eligible to claim a full input VAT credit. This, in turn, will be determined by reference to the VAT treatment of the real estate transactions that the developer enters into. Given the interrelated nature of construction services with real estate transactions, in that the former is a key input to the latter, it is hoped that both sectors transition to VAT at the same time. Furthermore, given the relatively transitory nature of many workers in the construction sector, it is also hoped that the entire construction and real estate sectors throughout mainland China transition to VAT at once. The staged province-by-province approach to the VAT reforms that has so far been adopted is ill-suited to the construction and real estate sector.



Preparation Tip #3

The way that the business operations of a construction company is structured, and their engagement of subcontractors, may need to be reviewed in light of the VAT reforms. Potentially, significant efficiencies from a VAT perspective may arise from a close review.

Subcontractors

Just as the services of a head contractor will be subject to VAT once the construction services industry becomes part of the VAT reforms, so too will the services of subcontractors. The key difference in practice will be that many subcontractors are likely to fall below the RMB 5 million threshold for general VAT taxpayer status (assuming that the threshold will apply to the construction sector). Businesses with a turnover below that threshold are still eligible to register as general VAT taxpayers, provided they maintain sound accounting records and controls.

For those subcontractors who will become small scale VAT taxpayers, some important planning issues will arise, including:

- Based on the existing pilot program rules, it is likely that the VAT rate for their services will be three percent, which does not represent a change from the current BT rate for their services. However, the VAT payable in respect of their services is potentially creditable to the head contractor if the head contractor is a general VAT taxpayer. The subcontractor will need to get the tax authorities to issue a special VAT invoice in order for the head contractor to be eligible for an input VAT credit. In the past, the failure of some subcontractors to provide appropriate invoices to head contractors has negated the ability for those head contractors to reduce their BT liability. These challenges are likely to remain under the VAT regime.
- Some other countries have sought to introduce special regimes for subcontractors, such as reverse charge rules, or withholding rules, to facilitate higher levels of compliance. It will be interesting to see if that occurs in China.
- Head contractors who register as general VAT taxpayers are expected to be eligible to claim input VAT credits for any materials they purchase in carrying on their business. However, subcontractors who are small-scale VAT taxpayers would not be eligible. This may lead to some cost shifting to ensure that materials are generally purchased by the head contractor. Under the current BT regime, this has not been an issue, so it will be interesting to see how the tax authorities deal with it.

For subcontractors who become general VAT taxpayers, many of the principles already described above in the context of head contractors will apply. The need for subcontractors to provide special VAT invoices to head contractors on a timely basis will be enhanced given the higher VAT rate applicable to their services.

Other service providers

A property developer will, during the course of the project, need to engage a wide array of specialist service providers, such as architects, engineers, quantity surveyors, lawyers, real estate agents and property management companies.

Currently, of those service providers referred to above, only legal services and some architectural services (being 'construction drawing verification services', per Circular Caishui [2012] 86) fall within the scope of the VAT pilot program, where VAT is payable at the rate of six percent. By contrast, the services of quantity surveyors, real estate agents and property management companies currently remain within the BT regime.

It is hoped that at the time of transition of the construction and real estate sectors to VAT, these other service providers are also brought within the VAT regime. Given the VAT rates which have been applied already to many professional services (six percent), logically, we would anticipate a similar rate to be used for these other providers. We would also anticipate that property developers would be eligible to claim input VAT credits for the costs of these services.

Given this, a simultaneous transition to VAT of not only the construction and real estate sectors, but those who provide services to them, would assist in mitigating any irrecoverable BT liabilities.

Conclusion for construction sector

In summary, pure economic theory would suggest that if the construction sector is subject to an 11 percent VAT, this should not detrimentally impact on that sector, provided the recipient of their services, being property developers, are eligible to claim input VAT credits. However, as has often been seen, practical issues surrounding the rules for transitioning to VAT, the ability to obtain appropriate invoices from downstream subcontractors, the effect of having entered into long-term contracts, and the status or nature of the recipient of their services, may ultimately produce winners and losers.

While the details of the way that the VAT reforms will apply to the construction sector are yet to be announced, KPMG understands that the MoF is currently taking a close look at the issues. We anticipate that further details will be released during 2013.

Businesses in this sector should consider the potential implications of the reforms on their business and if appropriate, ensure relevant issues are communicated to the MoF. KPMG is currently liaising with the MoF in relation to the transition to VAT for the construction sector and would be happy to pass on any issues to them.

Part 2: real estate transactions

In Part 1 of this publication, we considered the potential VAT treatment for the construction sector. In Part 2, we consider the VAT treatment of certain real estate transactions, starting with the initial sale or letting of the completed property by the developer (including the provision of any lease incentive arrangements), and then the potential VAT treatment of any subsequent sales or letting by purchasers to other third parties.

We have separately considered the consequences for residential property transactions from commercial property transactions because the policy issues tend to be separate. We note that no formal details in relation to the transition to VAT for the real estate sector have been released by the MoF and the SAT. As such, any predictions are purely speculative only.

Policy background

Before delving into the detail, it is worthwhile noting that the methods chosen for taxing real estate transactions in those countries with a VAT are diverse. Some countries exempt a broad range of residential real estate transactions from a VAT, while others choose to exempt only some transactions from a VAT (for example, residential rental only).

Some of the policy reasons for exempting certain types of residential real estate transactions from a VAT are:

- Housing is regarded as a 'necessity of life' which should not be subject to VAT in order to protect the poor or vulnerable
- If the sale of new housing is subject to VAT, then pure economic theory suggests that it is unnecessary to tax the subsequent rental of those houses on the basis that the sale price of the new house should represent the net present value of the future rental income stream
- Most countries limit their VAT systems to entrepreneurs who carry on economic activities (for example, a business). With real estate transactions, it can be difficult discerning whether the supplier falls within that description
- Land is not 'consumed' in the normal sense of that term, and excluding the value of land from buildings can be difficult to achieve.

Ultimately though, there are some common problems experienced in different countries which it would be worthwhile for the MoF and the SAT to take note of in formulating the policy in China:

- For a range of policy reasons, it is often necessary to distinguish the VAT treatment of residential property from commercial property. This can lead to 'definitional' issues, particularly in terms of classifying those types of properties, which may lie on the boundary between a residence and a business, such as student accommodation, serviced apartments, resort-style living facilities, and aged care accommodation.
- Perhaps the largest source of disputes between taxpayers and tax authorities in most countries with a VAT relates to the real estate sector. This reflects not only the complexity of issues, but also the financial implications for taxpayers.
- Managing the transition to VAT can be very challenging, given the potential for creating inflationary effects on pricing. There is also the challenge of determining the point at which VAT should commence, particularly in relation to subsequent sales of existing housing stocks, or even partly completed housing.

While the MoF and the SAT have taken into account international VAT principles in designing the VAT pilot program in China, whether they do so for real estate transactions is less certain. Some of the reasons for this are:

- Historically, China has collected substantial amounts of BT on real estate sales and rental activities – accounting for approximately 27 percent of total BT collections in 2010. Granting broad ranging exemptions would have significant fiscal consequences.
- There has been some debate in China over recent years about the need to embark on a broader reform of property-related taxes, given the breadth of different taxes, which currently apply to the real estate sector. Whether that happens as part of the VAT reform project, remains to be seen.
- Unlike many other countries, the predominant system of land ownership in China is based on land use rights, rather than freehold ownership. Simply adopting the rules used in other countries will not be possible.
- Also unlike many other countries, the existing BT system for real estate transactions in China is not limited to taxpayers who are entrepreneurs carrying on economic activities – the range of taxpayers currently paying BT in China is broader. The government may be reluctant to give up this revenue.

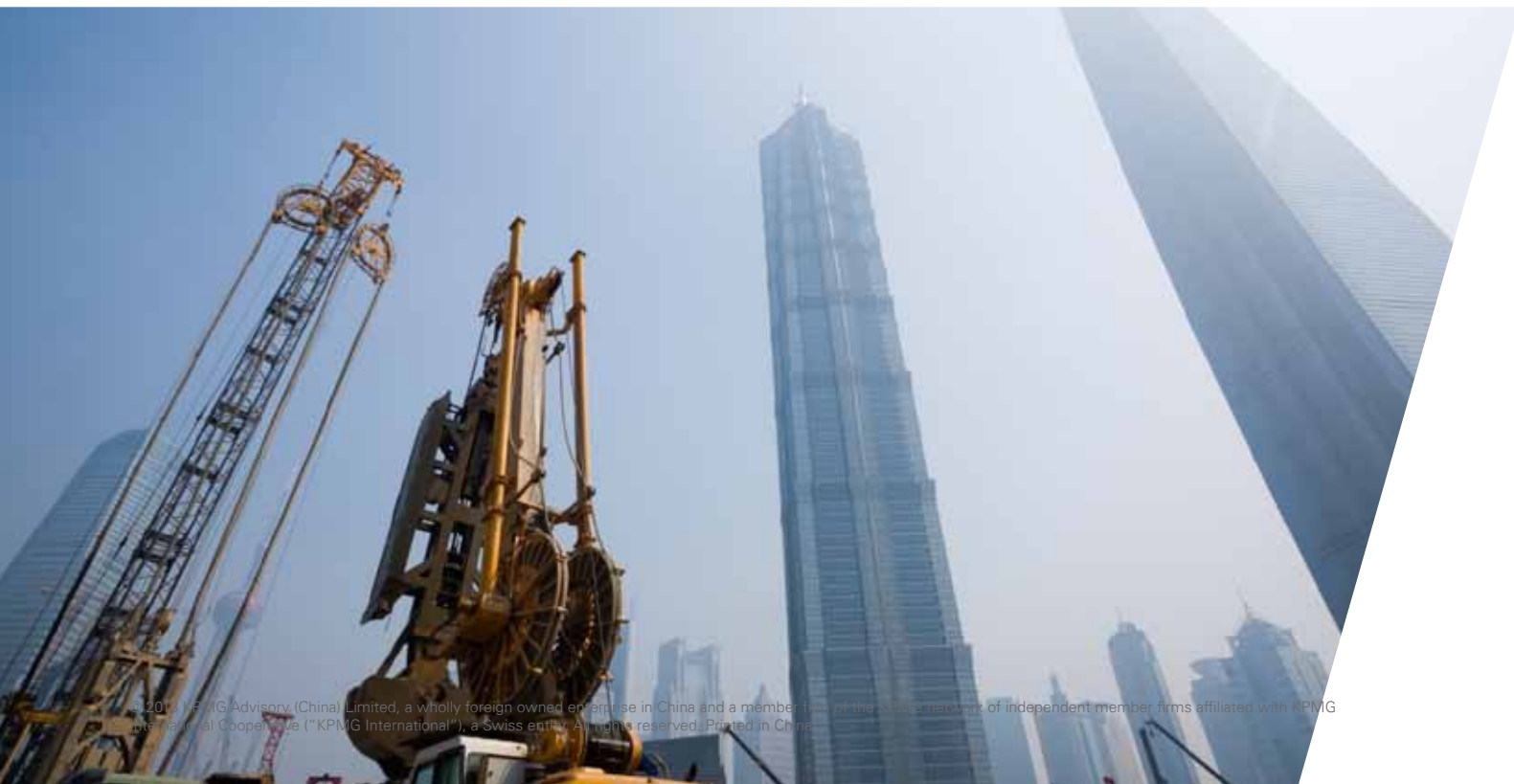
All of this may be taken to suggest that the VAT treatment of real estate transactions in China is likely to have some uniquely Chinese characteristics.

Residential property

Initial sale by developer of residential property

When a property developer completes a residential property, the developer will ordinarily enter into (or have already entered into) contracts with prospective purchasers.

Under the current BT regime, property developers pay BT at the rate of five percent of the gross selling price of the property. There is no deduction for the purchase price paid for the grant of the land use rights.



Under a traditional VAT model, it may be expected that property developers would have the following VAT transactions:

- The purchase price paid for the grant of the land use rights would not be expected to be creditable for VAT purposes, on the basis that no output VAT is paid by the local government when they are granted
- The progress claims and other payments made to the head contractor would ordinarily be creditable for VAT purposes, provided the head contractor is a general VAT taxpayer and issues special VAT invoices
- The payments made to other advisers in connection with the project would ordinarily also be creditable for VAT purposes, again provided they are general VAT taxpayers and issue special VAT invoices
- Output VAT would be payable on the transfer of the completed property to purchasers.

One critical issue for the MoF and the SAT to consider is the transitional rules for developers entering the VAT system. For example, if a property developer is part-way through a project when VAT commences, in the absence of any special rules, they could potentially be required to remit output VAT on the transfer of the completed property, but have been denied input VAT credits for the construction works and other services received prior to the transition to VAT. The end result would place those developers who are part-way through a project when the VAT system commences in a worse position than those who start a project after the VAT system has already commenced.

There are at least two alternative solutions to this problem. Either:

- Projects which are already commenced when the real estate sector transitions to VAT could remain subject to BT until sold; or
- The 'value added' after the commencement of VAT could be subject to VAT, while the 'value added' prior to that time could remain subject to BT. This is, in effect, similar to the margin scheme introduced in Australia when transitioning to GST. This is discussed further below.

The former approach would have the benefit of certainty. That is, when a developer enters into a project, it budgets its costs on the assumption that BT applies. This approach does not undermine that budgetary process. Having said that, if the developer has to bear irrecoverable VAT on its inputs and at a higher rate than under the BT regime, then its cost structure would be adversely affected. For example, if the construction costs are subject to 11 percent VAT, instead of three percent BT, then plainly their costs would be affected.

The latter approach would require a valuation mechanism to be introduced to apportion the value between the BT period and the VAT period. Neither solution would be easy to implement.

Preparation Tip #1

Entering into new development projects will require careful planning and budgeting to take into account the potential transition to VAT. Certain assumptions may need to be built into project budgets to ensure the impact is properly taken into account.

Residential property resales

Perhaps the area of the VAT reforms with potentially the widest impact on the community is the VAT treatment of resales of residential property by the general public.

If VAT applies, China would be, to the best of our knowledge, one of the only countries to apply a VAT to resales of residential property. As noted earlier, most countries only impose VAT on the activities of entrepreneurs – that is, business activities. They do not tend to impose VAT on passive investment activities, or on self-used real estate.

Conceptually, China could be the first country to do so, simply because its BT system currently does so. To exempt residential property resales from a VAT would not only create a hole in government revenue collections, but it would also potentially ignite the residential property market at a time when various restraining measures are being sought.

While the introduction of VAT for residential property resales is feasible, there are a number of issues which would need to be considered by policy-makers. For example, one significant issue is whether the current threshold for registration of a general VAT taxpayer of RMB 5 million will be applied to the construction and real estate sectors. That threshold would ordinarily be exceeded by property developers and head contractors, but in many cases, it would not be exceeded by private home owners selling their used properties.

The current structure of the VAT pilot program rules is such that small-scale VAT taxpayers pay VAT at the rate of three percent. However, they are not entitled to claim input VAT credits. If this applies, then the implications would include:

- Output VAT payable at the rate of three percent would represent a reduction against the current BT rate of five percent. However, the tax base under each is different. In a BT context, the five percent liability is assessed on a net basis – that is, on the difference between the sale price and the initial purchase price. By contrast, three percent of the gross selling price may be higher or lower, depending on the extent of capital appreciation.
- The VAT pilot program currently allows taxpayers who previously paid BT on a net basis, to continue to deduct those same items under a VAT (or claim input VAT credits, but not both). If this rule is to apply to real estate sales, then a VAT rate of three percent would represent a real reduction in the tax burden, as compared with the previous five percent BT liability. It is difficult to foresee the Chinese government introducing such concessional policies, particularly if the property market in China remains robust in terms of growth.

One of the difficulties in transitioning to a VAT in China is that it is an input/output based system. If the tax authorities were to allow an input VAT credit for the purchase of a property, then this would lead to many taxpayers accruing significant input VAT credit balances. The potential solution that the tax authorities may wish to consider is Australia's margin scheme. That scheme effectively taxes the 'margin' at the time of the sale of the property by allowing as an offset against the sale price of the property, either the purchase price of the property, or the value of the property upon commencement of the VAT regime. Such an approach would replicate many of the features of the 'net' basis of BT currently applicable in China.

A further issue for the tax authorities to consider is the need for transitional rules. Take the example of a residential property purchased in 2004, upon which BT was paid. Assume the real estate sector transitions to VAT in 2013, and the property is subsequently sold in 2015. When the property is sold in 2015, the question will be whether the amount of output VAT payable at the time of sale may be reduced by the BT paid on the purchase. Alternatively, whether the taxpayer would pay VAT on the increase in value referable to the period from 2013 to 2015, and BT on the increase in value referable to the period from 2004 to 2013. If the VAT rate differs from the BT rate, this distinction may be very important.

Preparation Tip #2

The aspect of the VAT reforms with potentially the widest community impact is in respect of resales of residential property. When further details of the VAT reforms are known, potential vendors that are considering selling their property may wish to carefully consider the timing of any sale in terms of whether it is preferable to sell prior to the reforms, or following the reforms.

Initial leasing of residential property by developer to public

Where a developer leases residential property to third party lessees, it is unclear whether this will be subject to VAT. Pure economic theory suggests that if the sale of a residential property is subject to VAT, then the leasing of residential property should be exempt from VAT. This is based on the principle that the sale price represents the net present value of the future rental income stream, upon which VAT has been paid.

The difficulty with making this assumption in China is that BT currently applies to residential property leases. Interestingly though, the amount of revenue derived from leasing of real estate in China is around one percent of total BT revenue (based on The China Tax Yearbook (2011)), and this amount includes both commercial and residential property leases.

From a developer's perspective, if residential property leases were exempt from VAT, but sales of residential properties were subject to VAT, which is the position in a number of countries such as Australia, Canada and New Zealand, then:

- Input VAT credits would be available for the costs incurred in constructing and developing residential properties for resale; but
- Input VAT credits would not be available for the costs incurred in constructing and developing residential properties for leasing.

In countries such as Australia and New Zealand, this has led to complex 'change of use' rules, whereby an apportionment (or reapportionment) of input VAT credits may occur if the residential property ceases to be held for the purposes of letting, and is subsequently held for the purposes of sale (or vice versa).

The flipside is that if residential property leases are subject to VAT, then potentially real estate developers would be eligible to claim input VAT credits for the costs of construction and development of the property. However, given that the costs of construction and development are likely to be significantly greater than the amount of monthly rental income being received, it would be expected that those developers will generate significant input VAT credit balances, which may take several years to consume. Some developers may consider selling some residential properties (to generate output VAT), while letting other residential properties. Planning will be critical given that any unused VAT credit balance effectively means the developer is funding the VAT cost.

Subsequent leasing of residential property by the public

At present, the letting of residential real estate by individuals and individual businesses is subject to BT at the rate of three percent, but then reduced by half, in accordance with Circular Caishui [2008] 24. Moreover, there is a threshold below which BT does not apply, and that amount differs from location to location.

Similar to the discussion above, it will be interesting to see if residential real estate leasing transactions will be exempt from VAT (which is similar to the position in most other jurisdictions), or whether VAT will apply. If VAT does apply, then there are a range of policy implications which would need to be carefully considered, including:

- Whether the current threshold of RMB 5 million for registration as a general VAT taxpayer would apply
- Whether input VAT credits would potentially apply to members of the public who purchase residential real estate for the purposes of letting it out
- What specific VAT rules would need to be introduced to ensure that the existing BT concessional treatment of residential real estate leasing may continue.

Commercial property

Commercial property sales

In almost all jurisdictions with a VAT, the sale of commercial property is treated as a 'normal' VAT transaction. That is, VAT is payable in respect of the sale. However, the purchaser of commercial property will ordinarily be eligible to claim an input VAT credit in respect of the purchase.

Unlike the position in China, many countries allow the purchaser to claim a refund of any excess VAT credit balance on the purchase. The issue in China is that VAT credits in respect of the purchase may only be carried forward and offset against current and future output VAT. This means that for many purchasers of commercial property in China, they will need to effectively fund the VAT on the purchase for a period of time until such time as they generate sufficient output VAT.

A further issue in China is that in accordance with Announcement 47 of 2011, where land use rights or real estate are sold together with fixed assets attached to the land, then the fixed assets are subject to VAT and the sale of the real estate is subject to BT. It is expected that this policy will continue even when real estate becomes subject to VAT given the likelihood of different VAT rates applying to each. This necessitates an apportionment of the total sale proceeds on a reasonable basis.

Preparation Tip #3

The sale of commercial property under a VAT may be expected to lead to better tax outcomes than under BT, given the potential for the purchaser to claim input VAT credits. This should be taken into account in terms of the timing of any sale. In addition, the purchaser should carefully consider whether they have sufficient output VAT in the legal entity undertaking the purchase to offset any VAT credits arising from the purchase.

Commercial property leases

It is expected that commercial property leasing would similarly be treated as a 'normal' VAT transaction, based not only on international experiences, but also on the fact that they are currently taxed for BT purposes at the rate of five percent.

Assuming VAT is payable on commercial property leases, if the lessee is a general VAT taxpayer, it would be eligible to claim input VAT credits, provided they obtain special VAT invoices.

One transitional issue the MoF and the SAT will need to consider is whether existing leases will become subject to VAT immediately, or whether only new leases entered into from the commencement of VAT applying to the real estate sector will become subject to VAT. Circular Caishui [2011] 111 currently provides that only new leases of tangible goods become subject to VAT from the commencement of the VAT pilot program, so potentially the same rule could be applied to commercial leases. If so, then potentially some lessors and lessees may seek to terminate existing leases and enter into new leases so as to mitigate their ongoing exposure to irrecoverable BT.

Lease incentives

It is relatively common for property developers, particularly in the retail, office and industrial markets, to offer rent-free periods and other lease incentives to prospective tenants. Under the current BT regime, there is no general deemed sales rule, so that BT is not payable in respect of the rent-free period. However, the VAT rules contain broad deemed sales rules. Whether those rules will apply to deem market value rental during a rent-free period remains to be seen. Pure economic theory suggests that it should not apply to leases between arm's-length parties given that the rent-free period is effectively subsidised by the higher rental received during the remaining term of the lease.

Preparation Tip #4

The types of lease incentives offered in the marketplace may alter as a result of the VAT reforms. For example, if the developer is a general VAT taxpayer, but the lessee is not, then it may be preferable for the developer to undertake any fit-out works as part of any incentive arrangements, rather than the tenant.

Other issues

Hotels and other short-term accommodation

At present, hotels and other forms of short-term accommodation providers pay BT at the rate of five percent as a general service. The transition to VAT may occur at a different time (and at different VAT rates) than the construction and real estate sectors. Nevertheless, the impact of the construction and real estate sectors paying VAT will flow through to hotels and other accommodation providers.

For example, hotels will often have a separate landowning company from the business which is operating the hotel. VAT may be payable in respect of the lease of the hotel land, but BT may remain payable (at present) in respect of the hotel operations. This may lead to the hotel operator incurring irrecoverable VAT.

A further issue with other short-term accommodation providers is the way in which they will be classified for VAT purposes. As noted earlier, residential property leases are often treated as exempt from VAT in most countries, whereas commercial residential property is generally treated as being subject to VAT. The delineation between residential property on the one hand, and commercial residential property on the other, becomes critical. For example, whether serviced apartments, student accommodation, resort-style living, aged care facilities are treated as residential property, or as commercial residential property. The position can be complicated further by the fact that some individuals staying in those facilities may be occupying them on a long-term basis (effectively as their home) whereas others occupy them on a short-term basis.

It will be interesting to see if the tax authorities base their position on the approved usage of the land as the basis for defining the nature of the service being provided.

Sale of real estate as part of the sale of a business

A further issue for the MoF and the SAT to consider is what happens when real estate is sold as part of an overall sale of a business, e.g., when a factory is sold together with the business operations of the factory.

Currently, Announcement 13 of 2011 provides for a limited form of VAT relief on the transfer of tangible goods as part of a corporate restructuring. It is unclear whether that Announcement applies to asset transfers (absent a corporate restructuring). Furthermore, the effect seems to be that the sale is exempt from VAT, meaning that input VAT credits would need to be transferred out.

Many countries provide for zero rating for VAT purposes where there is a sale of a business as a going concern. The evident purpose of this concession is to overcome the need for purchasers of a business to fund the VAT cost on the purchase. It will be interesting to see if the MoF and the SAT broaden the scope of Announcement 13 so that it mirrors the concession applicable in other jurisdictions. At the very least, Announcement 13 will need to be updated once the real estate sector joins the VAT reforms because it currently only applies to transfers of tangible goods.

Sale of shares in real estate development companies

At present, the sale of shares in a real estate development company remains outside the scope of VAT and BT. It will be interesting to see if the sale of shares in a real property development company will continue to be outside the scope of VAT, or perhaps at a lower VAT rate than is applicable to the sale of real estate assets. If that occurs, this may create incentives for the sale of real estate development companies to occur by way of share transfer, rather than asset sale.

Special industry roundtable event

KPMG will be hosting roundtable discussion forums with businesses in the construction and real estate sector during February and March 2013. Please look out for invitations which will be sent out shortly. The feedback from those discussion forums will be communicated directly to policy-makers at the MoF, giving you a direct opportunity to ensure your views and concerns are considered.

Conclusion

There are some unique challenges facing the MoF and the SAT in designing a VAT system for the real estate sector in China given the breadth of the existing BT system, the desire to minimise inflation in the real estate sector, and the scope of the existing taxes already applicable to real estate transactions. Whether the MoF and the SAT will be influenced by international experiences remains to be seen. Either way, it is expected that the VAT treatment of real estate transactions will be an area of significant interest across a broad cross-section of the community.

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