KPMG

China Tax Alert

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China's Value Added Tax expanded to fully replace Business Tax in major new announcement

Regulations discussed in this issue:

- *Premier Li Keqiang's announcement at the opening of the National People's Congress on 5 March 2016 that the real estate and construction, financial services and insurance, and lifestyle services industries will all be subject to VAT with effect from 1 May 2016*

The Announcement

On 5 March 2016 China's Premier Li Keqiang announced at the opening ceremony of the National People's Congress (NPC) the expansion of the scope of the Value Added Tax (VAT) to several key sectors such as real estate and construction, financial services and insurance, and lifestyle services (including hospitality, food and beverage, healthcare and entertainment) with effect from 1 May 2016.

Upon implementation, this will complete the task originally set in the Chinese government's 12th 5 year plan to fully replace Business Tax (BT) with VAT. This means that VAT will ultimately apply to the sale and importation of all goods in or to China, and the provision of all services in or to China. BT will effectively cease to apply.

When fully implemented, China's VAT system will be amongst the broadest based systems amongst over 160 countries in the world which have now implemented a VAT (or equivalent tax). China's VAT system will be unique by international standards in applying VAT to virtually all financial services (including interest income), and in applying VAT to real estate transactions involving not only B2B and B2C transactions, but C2C as well – an outcome not known to exist in any other country. It would not be surprising to see other governments follow China's lead and expand their VAT systems, especially if China is able to implement these changes successfully.

It is important to recognize that this announcement foreshadows not merely a set of tax reform initiatives, but a set of policies with significant macroeconomic impacts. In 2015, the real estate industry contributed 31.6% (RMB 610.4 billion) of all of China's BT revenue, the construction industry contributed 26.6% (RMB 513.6 billion) while the financial services industry contributed 23.6% (RMB 456.1 billion) - these changes are clearly the most economically significant of all the VAT reforms implemented so far. (Source: Ministry of Finance release, 29 January 2016)

According to a report by China International Capital Corp Ltd, which is China's first joint venture investment bank, the overall tax savings for business from the VAT reforms are expected to reach RMB 900 billion (approximately 0.4% of GDP) by the time all industries have transitioned to VAT. Notwithstanding this general tax saving, some industries will be more affected than others. For example, the adoption of an 11% VAT rate for real estate and construction (in substitution for the lower BT rates of 5% and 3% respectively) is likely to have a material

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influence on the property market in terms of pricing, profitability of projects, and market sentiment generally, though Premier Li's announcement specifically referred to the ability to claim input VAT credits for "newly added immoveable assets" – a benefit not previously available under the BT system.

Implementation date

The precise implementation date for the expansion of the VAT to the remaining sectors is **1 May 2016.** By international standards, this is an extremely challenging timeframe for both businesses and the tax authorities to successfully implement VAT, especially given the complexity of the VAT issues arising in these remaining sectors. Nonetheless, many businesses have been preparing and anticipating this change for some time. Furthermore, this timeframe is generally consistent with the lead time given to other industries which have already transitioned to VAT.

Applicable VAT rates for each sector

While Premier Li's announcement does not specifically refer to the VAT rates for each sector, the expected VAT rates have been widely discussed for some time now. In the table below we show both the expected new VAT rates and the current BT rate for these sectors. Given that VAT is effectively assessed on a net basis (outputs less inputs) while BT is ordinarily assessed on a gross basis (outputs only), a straight comparison between the new and the old rates is not valid:

Sector	Expected New VAT rate	Current BT rate
Construction services	11%	3%
Real estate	11%	5%
Financial services and insurance	6%	5%
F&B, hospitality and other services	6%	Generally 5%, though certain entertainment services are subject to rates from 3% - 20%

Detailed implementation rules to follow

The announcement by Premier Li precedes the release of detailed implementation rules, which are expected imminently. Upon their release, KPMG will be issuing a further China Alert.

National framework

In an earlier phase of the VAT pilot program, the rules were introduced initially in Shanghai, then expanded to Beijing, and progressively to other cities and provinces around China. That approach appears likely to have been discontinued in favour of a one-time national implementation date or 'big bang' approach for all affected sectors. In the short-term this is likely to result in more work for larger businesses with operations across China in getting ready for the transition to VAT, but in the longer-term it overcomes the difficulties previously experienced in paying VAT in certain locations and BT in others.

Transitional or grandfathering relief

Premier Li's announcement makes broad reference to the need to manage the tax burden impact on business arising from these changes. Of particular interest will be whether the detailed implementation rules contain any form of transitional rules, or grandfathering relief, especially for the real estate and construction sectors where long-term projects and contracts are commonplace.

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KPMG observations

KPMG has, for some time now, been able to anticipate these changes through our consultation discussions with various government officials. As such, much of what has been announced was expected. Many clients have already commenced preparations for VAT implementation in anticipation of this announcement, and now await the release of the detailed implementation rules to resolve various technical issues. As such, what we set out below is some of the anticipated key financial impacts of these changes, together with the major industry issues which we had identified through our discussions with industry. In preparing for the VAT reforms, affected businesses should familiarise themselves with these issues.

Importantly, we will be including a status update on these key industries issues following the release of the detailed implementation rules.

Real estate and construction sector

The sector which is likely to be impacted most significantly by these changes is the real estate and construction sector, especially so given the real estate markets in major cities across China are not experiencing the same growth levels now to what was experienced 5-10 years ago. Premier Li's announcement specifically refers to the ability to claim input VAT credits for "newly added immovable assets", which will clearly be of assistance to businesses utilising real estate in the conduct of their business, as well as developers and investors. However, what is not explicit in the announcement is whether developers and investors will be entitled to a deemed input VAT credit for the purchase of land use rights, though hopes remain high given the general tone of Premier Li's comments.

Top 10 industry issues – real estate and construction

Issue
1. Will a deemed input VAT credit be available for the purchase of land use rights from local government authorities?
2. Will VAT apply to the sale of shares or other equity interests in a real estate holding company, either offshore or onshore?
3. How will VAT apply to agents and property managers managing trust funds on a client's behalf, and collecting utilities and other fees?
4. Will there be any transitional or grandfathering relief available to existing projects, or lease contracts entered into before VAT reform?
5. Will the taxing point for pre-sales be deferred so as to ensure that output VAT is not payable before input VAT for development is incurred?
6. Will VAT apply as a 'deemed sale' to rent-free periods, 'free' parking and other benefits commonly provided by landlords? Similarly, will there be a 'deemed sale' when a developer provides raw materials and equipment to contractors?
7. Will real estate developers be eligible to claim an input VAT credit for their funding costs?

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8. Will real estate developers be able to register as general VAT taxpayers from the very commencement of their developments (i.e. well before they earn revenue)?

9. Will there be a limitation on the amount or percentage of input VAT credits which can be claimed each year for the purchase of real estate?

10. For sales of second-hand housing by the private sector (e.g. C2C), will VAT be levied on the gross selling price or the gain?

Key financial impacts – real estate and construction

Many real estate developers, landlords, real estate funds and their investors have posed the question as to whether an expected 11% VAT rate will result in an additional tax burden on them, or higher prices for their projects, or a rush to sell projects prior to the commencement of the VAT. There is no simple one-sized fits all answer to those questions, and generally a financial impact analysis or review of a financial model is required. However, there are several key influencing factors, including:

- **The terms of any existing contract** – if a contract has already been entered into where VAT cannot be passed on, then the supplier may be required to absorb an 11% VAT liability in circumstances where the contract price had been struck on the assumption of a lesser BT (3% or 5%) liability.

- **The VAT status of the counterparty** – if a sale is made to a purchaser who is a general VAT taxpayer, or a lease is entered into with a tenant who is a general VAT taxpayer, then the VAT should be able to be passed on to the purchaser or tenant more readily than under the current BT system. In general terms, this should mean that real estate assets commonly traded B2B such as retail, office, industrial, hotels and other forms of commercial property are less likely to be adversely affected by these changes than residential property transactions involving B2C or C2C sales.

- **The value of the land relative to the overall project** – when a developer purchases land use rights, the local government authority is not expected to account for output VAT, however, it is hoped that a deemed input VAT credit will be allowed for the purchase price of those land use rights. This means that when the developer sells the completed project, output VAT would be payable on the differential between output VAT and (deemed) input VAT. Furthermore, the more building work and materials which are used in a development relative to the total value, the higher the input VAT given that many materials will generate 17% input VAT credits and construction costs will generate 11% input VAT credits.

- **The method of sale** – Potentially there may be different VAT treatments in selling a completed property as compared with selling the equity interests in an entity which holds the real estate asset.

- **The impact of any transitional or grandfathering relief** – it is hoped that transitional or grandfathering relief will be introduced in the detailed implementation rules to cater for the situation where a developer may be part-way through a development when VAT commences and therefore has incurred irrecoverable input VAT on the materials used, but would be subject to VAT at the rate of 11% on the whole sale price if they sold the asset following the commencement of VAT. There has been some discussions about giving developers an entitlement to choose a 5%

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simplified VAT method which will hopefully be clarified when the detailed implementation rules are released.

- **The corporate structure(s) used** – many developers operate through special purpose vehicles (SPVs) for each development being undertaken. Under a VAT system which does not allow for consolidation or grouping, this means that each time a new development is undertaken they will need to seek to register each SPV as a general VAT taxpayer at the earliest possible opportunity so as to ensure they can start to accrue input VAT credits. However, until such time as they generate output VAT, the benefit of those input VAT credits is not utilised. That is because China does not permit refunds of excess VAT credits (unlike many other countries), except for certain exporters. Consequently, the cashflow impacts of the VAT can have a significant long-term effect. Moreover, the output VAT generated from one project cannot be offset against the input VAT of another where SPVs are used.

Financial services and insurance sector

The implementation of an expected 6% VAT for the financial services sector is likely to be closely followed internationally given that the only countries known to have applied VAT to interest income are Argentina and Israel. The ability to bring about this result in China is largely a function of the fact that there has been an indirect tax on interest income for some time in the form of a 5% BT rate. It is also important to note that the major banks in China derive a much higher percentage of their overall revenues each year from simple lending transactions as compared with the more complex financial products often seen in other major financial centres around the world. Put another way, the existing tax and regulatory environment in China makes the imposition of a 6% VAT more readily implementable.

Top 10 industry issues – financial services and insurance

Issue
1. Will interbank lending transactions be exempt from VAT? If so, will this be limited to domestic Chinese banks, or will it apply to cross-border loans between banks too?
2. Will interest on loans paid by general VAT taxpayers be ineligible for input VAT credits, and if so, for how long? Will other fees and charges paid in relation to such loans still be eligible for input VAT credits? Is there any relief on invoicing requirements?
3. Will interest on outbound loans (i.e loans by PRC banks to overseas) be eligible for VAT exemption? Similarly, will inbound loans (i.e. loans from overseas banks to PRC customers) be subject to VAT withholding?
4. Will there be any bad debt relief for VAT purposes arising from defaults in customers paying interest?
5. Will gains from trading in financial products be exempt from VAT, or subject to VAT on the gain?
6. Will general insurers be eligible to claim input VAT credits for the goods and services they purchase to settle claims, but not be required to

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pay output VAT when they provide them to an insured?

7. Will VAT exemption apply to: (a) insurance relating to risks taking place outside of China (such as overseas travel insurance, or international goods transportation insurance), (b) policies relating to life insurance; and (c) policies relating to health insurance?

8. Does the VAT treatment proposed for reinsurance transactions follow the same VAT treatment as the underlying insurance to which it relates, especially recognising that in many cases the premium may be ceded to an offshore reinsurer?

9. How will financial services institutions be expected to apportion their input VAT credit entitlements?

10. What will be the VAT treatment of Trust/Fund products? Will each Trust/Fund be required to separately register for VAT purposes, even though they have the same Trustee or Manager?

Key financial impacts – financial services and insurance

For financial institutions the imposition of an expected 6% VAT liability in place of a 5% BT liability is not likely to result in a significant shift in the overall tax burden impact. That is because those financial institutions should now be able to benefit from claiming input VAT credits for many of their inputs for the first time. As a consequence, it is not expected that financial institutions will need to factor in significant price changes to the rates and other charges they impose on their customers.

It will be interesting to see how the detailed implementation rules treat interbank lending transactions and gains from trading in financial products – both are expected to be exempt from VAT. Similarly, over time as China's financial services market deregulates and becomes more sophisticated, it will be interesting to see how the rules respond to those developments.

For commercial borrowers, it had been hoped that they would be able to claim an input VAT credit for the interest expenses they incur. However, based on discussions with government officials preceding the announcement, we expect there to be a "temporary period" where no input VAT credit can be claimed for interest expense and therefore the 6% VAT is effectively a real cost.

For insurers the imposition of an expected 6% VAT rate in substitution for a 5% BT rate is not expected to lead to a substantial tax burden impact, again for the reason that they should now be able to claim input VAT credits for their costs and expenses for the first time. Unlike the position in countries such as Australia, Malaysia, New Zealand, Singapore and South Africa, the VAT system proposed for insurance is not a "pure" system. That is, insurers are not expected to be eligible to claim input VAT credits for the cash settlement of claims. Life insurance is also expected to be exempt from VAT.

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Hospitality, food and beverage, healthcare and other services sectors

A key aspect of these reforms is that the current mix of businesses in the food and beverage (F&B) sector pay either VAT or BT, depending on whether their predominant business is the sale of take-away products (VAT) or a catering / restaurant service (BT) will disappear. However, a new challenge will arise in that the sale of food products will attract a 17% VAT rate whereas a restaurant meal is expected to attract a 6% VAT rate. Distinguishing the point at which a good or a service (which incorporates the sale of a good) is supplied will likely be a new frontier for disputes.

The adoption of an expected 6% VAT rate for the hospitality sector generally should ensure that within the operations of most major hotels, 6% VAT should apply to the major components of what they provide – accommodation, conferences and events, and F&B. However, a key issue yet to be clarified is whether input VAT credits will be available for accommodation for business trips, or F&B more generally. One challenge which this raises for hotels is in separately allocating pricing (and managing invoicing requirements) for conference or event packages, which have either an F&B or accommodation component.

For the healthcare sector, it is expected that the implementation rules will confirm that public hospitals and other healthcare providers will be eligible for VAT exemption for the provision of medical services. It will be interesting to see if the same exemption status will be given to private operators, and moreover, the scope of "medical services" to cover by any such exemption. For example, whether it will apply to B2B healthcare services as well as B2C. KPMG China has just released a report entitled "Proposed Application of VAT to the healthcare sector in China" which examines many of the issues confronting the healthcare sector with the VAT reforms. A copy of the report is available here:-
http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Pages/vat-healthcare-sector-in-china.aspx

Top 10 industry issues – hospitality, F&B and other services sector

Issue
1. Will an input VAT credit be available for the consumption of F&B by a general VAT taxpayer (e.g. a business lunch)?
2. Will an input VAT credit be available for accommodation provided in a hotel to a guest who is travelling for business purposes? If so, will the guest be required to book the hotel and pay for it in the company name?
3. Will VAT apply as a deemed sale to the provision of 'free' benefits to guests, such as room upgrades, 'free' breakfast or Wifi, or for benefits provided under a rewards program such as 'free' nights?
4. How will VAT at 17% be differentiated for sales of food products, as compared with VAT at 6% for restaurant meals?
5. How will hotels be required to apportion conference charges between F&B and events-related charges? Similarly, how will hotels be required to apportion lump sum rates between accommodation and F&B, such as where breakfast is included?
6. Will most hotels advertise their prices "plus VAT and service charges" or "inclusive of VAT"?

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7. How will long-term accommodation provided in hotels be treated for VAT purposes – 6% or 11%? How will serviced apartment accommodation be classified – similar to hotels (6%), or to residential housing (11%)?

8. Will F&B providers be eligible to claim a deemed input VAT credit for the purchase of agricultural products?

9. Will 'marketing' and 'procurement' services provided by a local Chinese entity to its offshore HQ be eligible for VAT exemption?

10. Will providers of entertainment services be eligible to issue special VAT invoices?

Key financial impacts – hospitality, F&B, and other services sector

Interestingly, the adoption of an expected 6% VAT rate for the hospitality and F&B sector is perhaps at the lower end of the rate scale. While the output tax rate is expected to increase from 5% BT to 6% VAT, the ability to claim input VAT credits for the cost of goods sold and other goods or services consumed may lead to a decrease in the overall tax burden impact. A major challenge though in achieving this outcome will be in obtaining special VAT invoices from suppliers – especially given that the F&B industry in particular is characterised by cash transactions, and in many cases, small scale taxpayers.

Impact in other sectors (which are already VAT taxpayers)

A significant aspect of these measures is that the previously bifurcated system of indirect taxes in China will now be unified into a single VAT system. This effectively means:

- Businesses which are already VAT taxpayers will now generally be able to claim input VAT credits for the services they consume from those sectors now becoming VAT taxpayers; and
- Businesses which are now becoming general VAT taxpayers are generally eligible to claim input VAT credits for the goods and services they purchase or consume.

An example which highlights the breadth of these reforms is in traditional industries conducting manufacturing, wholesaling or retailing of goods. Previously, certain marketing or procurement services, such as promotion or incentive arrangements could be subject to 5% BT liabilities, whereas now they will be brought within the VAT system. If structured correctly, they can reduce the price upon which the goods or services are ultimately supplied, but if not, they can trigger VAT liabilities assessed on the gross sale price (before incentives apply), or in some cases even resulting in VAT liabilities for both parties to a transaction.

Likely impact on government tax collections

A largely unrecognised element of these changes is that by unifying the VAT system, the invoicing 'chain' is no longer broken. That is, every business being supplied with goods or services which is a general VAT taxpayer is incentivised to ensure they obtain a special VAT invoice from their supplier to enable an input VAT credit to be claimed. In those sectors of the economy particularly susceptible to cash transactions, or off-record dealings, tax compliance is likely to improve considerably given the commercial pressures to issue special VAT invoices. As such, even though initially these changes are expected to reduce tax revenues in

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the short term, over time overall tax collections are likely to increase, and fraud is likely to be reduced.

Scope of services covered by the new rules

The use of a VAT system with multiple rates (being 6%, 11% and 17%) means that care needs to be taken to ensure the correct VAT rate is being applied. In that regard, there are three guiding principles:

1. The nature of the services being performed determines the applicable VAT rate. As such, simply because a business may describe itself as a "bank", a "hotel" or a "developer", but this broad characterization does not determine the VAT rate.

2. The description of the fee or charge does not determine the applicable VAT rate, it is the nature of the services. As such, merely by calling something a "consulting fee", an "asset management fee" or a "developer's incentive fee" is not sufficient, of itself, to determine the appropriate VAT rate.

3. Anytime a VAT system contains multiple VAT rates, there will, invariably, be areas of uncertainty. For example, a business selling goods may impose interest charges on its customers for late payment. Whether those interest charges should attract VAT at the rate of 6% (as a financial service) or 17% (as additional consideration for the sale of the goods) remains to be seen. In the real estate sector a landlord may seek to recover property management charges from a tenant under the terms of its lease and the issue will be whether those charges are subject to VAT at the rate of 6% (being the rate applicable to property management services) or 11% (as additional consideration for the lease of the premises). These are all issues which will invariably be resolved based on the relevant contracts, invoices and the approaches taken by local tax officials.

Next steps

The timeframe for implementation of the VAT reforms is exceptionally short by international standards. However, for many businesses key decisions will still need to await the release of the detailed implementation rules. Nonetheless, in the period leading up to the release of the detailed implementation rules, businesses should do the following:

- Review and fine tune their implementation plans with a view to a 'go live' date of 1 May 2016;

- Review and update their financial impact models, and start to consider preliminary pricing decisions post-VAT implementation based on the expected VAT rates we have outlined;

- Use the likely public awareness surrounding the announcement to ensure there is adequate resources and budget available internally to implement these changes, especially from an IT systems perspective.

As noted, KPMG will be issuing an alert and providing other related support and assistance following the release of the detailed implementation rules.

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