China Tax Alert

Issue 11, March 2016

China's new VAT rates & rules – Lifestyle Services impacts

Regulations discussed in this issue:

- Circular Caishui [2016] 36 containing the VAT rates and rules for the lifestyle services sector under China's VAT, which takes effect from 1 May 2016

Announcement

On 24 March 2016 China's Ministry of Finance (MOF) and State Administration of Taxation (SAT) jointly issued Circular Caishui [2016] 36 (Circular 36) which contains the Value Added Tax (VAT) rates and rules applicable to the industries which are transitioning from Business Tax (BT) to VAT with effect from 1 May 2016.

In KPMG China Tax Alert Issue 9 we examine the general impact of the new rules across all industries. However, in this KPMG China Alert, we examine the impact specifically for the lifestyle services sector.

The lifestyle services sector comprises a large and diverse range of taxpayers, including food and beverage providers, hotels and other hospitality providers, the travel industry, education and healthcare providers. From a policy perspective, these sectors present challenges to the government in applying VAT given that some of them are involved in cash based businesses where historically tax compliance may not have been high (e.g. food and beverages), the consumption of these services may be for business or private purposes and distinguishing between them may not be easy (e.g. hospitality services), and finally, because they serve an essential community need which is often funded or supported by government (e.g. education and healthcare), yet may also be served by the private sector.

Applicable VAT rates for lifestyle services

The VAT rates which KPMG foreshadowed in our China Tax Alert of 5 March 2016 have now been confirmed by Circular 36. The VAT rate for lifestyle services, and a comparison with the current BT rates are set out below:

Sector	Current BT rate	New VAT rate
Lifestyle services	Generally 5%, though certain services (including entertainment services) are subject to rates from 3% - 20%	6%

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.

What is meant by 'lifestyle services'?

Lifestyle services is defined in the VAT rules so as to include "cultural and sports services, education and healthcare, travel and entertainment, food and beverage, accommodation and citizens daily services". This definition is broadly the same as under the current BT regulations, albeit that food and beverages and accommodation services have been further defined in the new rules, as set out later below.

"Citizens daily services" is a new category, and it includes activities such as home assistance services, marriage celebrant services, aged care, funeral services, emergency services, beauty, hairdressing, massage and related spa services.

For completeness, a further new category of agency services generally was added to the scope of modern services, and it includes the services of brokers, agents, wealth management services, HR services.

It is also important to understand that "lifestyle services" is actually general catch-all category, meaning that it may apply to any other businesses which are still paying BT, and which will now transition to VAT with effect from 1 May 2016.

Key market impacts

- The F&B sector will be subject to a 6% VAT, but in practice one of the biggest challenges will be in differentiating the provision of F&B services from the sale of food products (which are subject to a 17% VAT rate, with the exception of some food products which attract 13% VAT). The definition of F&B services requires the provision of food and beverages in a "physical venue". When an F&B venue also provides take-out or delivery services, then the VAT rate is likely to be determined by the predominant nature of the taxpayer's business, rather than each sale being assessed for 6% VAT or 17% VAT based on the customer's choice to 'eat in', 'take-away' or 'delivery'. This will open a new frontier for planning and potentially disputes.

- F&B, entertainment and citizens daily services are not creditable for VAT purposes, which relieves those providers from needing to issue special VAT invoices. The denial of input VAT credits is presumably been made because many of these expenses would be purely for private purposes, entertainment purposes or staff welfare.

- The hospitality sector will be pleased that the majority of their services will be subject to a uniform 6% VAT, meaning that in most cases they will not be required to charge different VAT rates for many of their most common services. However, given the fact that the F&B component of their services is not creditable to their customers, they will still need to unbundle and apportion their package prices for the purposes of issuing special VAT invoices for their non-F&B components such as accommodation, conference and events. This is likely to lead to significant pricing challenges in practice. Similarly, there is no exemption from VAT for customer loyalty programs, and given the existing of 'deemed sales' rules under VAT, the provision of benefits such as upgrades and 'free' items may raise compliance and valuation challenges.

- The healthcare sector will be significantly impacted by these new rules, with traditional broad-based exemptions from BT now replaced by exemptions from VAT which are subject to prescribed threshold limits. In practice many private operators in the healthcare sector will now be subject to 6% VAT.

- The lifestyle services sector has not benefited from any form of transitional or grandfathering relief under the new rules. This means that a 6% VAT rate potentially applies to all supplies invoiced from 1 May 2016, even if a booking or reservation was made prior to that time.

- Many businesses in the lifestyle services sector will benefit from a reduction in costs by deferring purchases between now and 1 May 2016. That is, any stocks of food and beverages, equipment and fixed assets purchased on or after 1 May 2016 will ordinarily benefit from a 17% or 13% input VAT credit which would not otherwise be available if purchased prior to that time.

Part 1 - Specific market segments

We set out below the key rules applicable to different market segments of the "lifestyle services" industry. Because all businesses invariably consume services from these sectors, for example, food and beverages for employees or for entertainment purposes, hospitality services for conferences, events and business travel, the VAT rules for this sector are of general interest.

Food and beverage (F&B) sector

Before examining the specific rules for the F&B sector, it's important to note that the 6% VAT rate only applies to "general VAT taxpayers". This means businesses with an annual turnover of RMB 5 million or more. Businesses with an annual turnover below RMB 5 million will typically register as "small scale VAT taxpayers", though they may elect to register as a general VAT taxpayer where approval is granted and they have sound accounting records.

It is expected that the vast majority of F&B operators in China will be "small scale VAT taxpayers", and therefore they will pay output VAT at the rate of 3%, but are unable to claim input VAT credits and similarly unable to issue or receive special VAT invoices.

For those F&B operators which are registered as general VAT taxpayers, one crucial issue which will arise in practice is how to differentiate between the sale of food products (for example, in a market) which typically attracts 17% VAT (though some food products attract a reduced rate of 13% VAT), as compared with the provision of F&B services which attracts a 6% VAT rate.

The definition of a "food and beverage service" under the new VAT rules refers to the provision of food and beverage services to customers "in a physical venue". This suggests that the 6% VAT rate will only apply where the customer is effectively offered seating and has the opportunity to dine-in. Where an F&B provider only offers a take away or delivery service, then it would appear that they fall outside the definition and the sale of their products will attract a 17% VAT rate (or 13% for some food products).

Complications will undoubtedly arise in situations where an F&B providers offers a mix of a dine-in service and either a take-away or delivery service. In this situation, the current BT rules would appear to provide some guidance, though the new VAT rules contain no such guidance. We anticipate that rather than assessing each transaction as being subject to the 6% VAT rate or not, the approach will be to focus on the predominant nature of the business carried on by the F&B provider. That is, if the majority of the F&B provider's income comes from dine-in, then the sale of products as a take-away or delivery service will still attract 6% VAT. The flipside is that if the majority of the F&B provider's income comes from take-away or delivery service, then dine-in sales would still attract the higher 17% VAT rate (or 13%, depending on the food products). Where this occurs, it may be necessary to consider separating the dine-in component of the business (say in a separate legal entity or branch) so as to ensure the 6% VAT rate is preserved for the F&B service component.

Having a different VAT rate for F&B services as compared with the sale of food products is likely to create a new frontier in either tax planning or disputes. Take for example a restaurant which may sell bottles of wine for take-away purposes. Provided the restaurant's predominant business comes from its F&B services, the sale of the wine may attract 6% VAT, whereas liquor outlets will be subject to the normal 17% VAT rate.

In practice, many of the large fast food providers in China have been applying a simplified 3% VAT rate method for some time for delivery orders. This has been done seemingly in reliance on State Administration of Taxation ("SAT") Announcement [2011] No.62 and SAT Announcement [2013] No.17, which allows restaurants or hotels the option to pay simplified VAT at the rate of 3% for food which is not consumed on the spot. Whether these policies and practices may still be applied post-1 May 2016 remains to be seen.

A further issue which arises in practice is the VAT rate applicable to delivery charges that an F&B provider may impose on orders placed for delivery. While the VAT rate for transportation services is 11%, the VAT rules specifically include freight charges as part of the total price for the goods or services being provided, so that it should not be necessary to split out the transportation component. Instead, the transportation component should attract a 6% VAT rate as an F&B service, or a 17% VAT rate as the sale of goods.

From the perspective of businesses consuming F&B services, such as where meals are provided to employees, for business entertaining, or as part of a business trip, the VAT rules specifically provide that input VAT credits are to be disallowed for all F&B services. This means that the VAT in relation to F&B services will always be a real cost. From a VAT compliance perspective, it relieves F&B providers from the need to issue special VAT invoices. In the absence of such a specific rule, the question would have been whether such F&B services constitute 'staff welfare' activities, but the blanket denial of any input VAT credits for F&B services makes this issue redundant.

A major challenge which all F&B providers will have is in obtaining special VAT invoices for their expenses. In other words, when they purchase food or beverage products which they use in providing their F&B service. Unless a special VAT invoice is received, no input VAT credit can be claimed.

The 6% VAT rate for F&B services would appear to apply to catering services too. This should mean that in-house catering service providers should be subject to 6% VAT, though the business which is purchasing those services would not be eligible for an input VAT credit.

One interesting question is how broadly the 6% VAT rate for F&B services will be applied. For example, we envisage that it will apply to room service facilities provided in hotels (as discussed further below), but it would seem unlikely to apply to the meals served on board domestic flights (which attract an 11% VAT rate). In a famous UK case of British Airways v HMRC 1990 STC 643 the UK Court of Appeal considered whether a meal service provided on board an international flight was considered a separate service from the flight itself, and held that it did not. However, in an era when meals may be separately charged to the customer, the position is not as clear.

Hotels, hospitality and other accommodation services providers

The new VAT rules specifically provide that the following "accommodation services" will be subject to 6% VAT with effect from 1 May 2016:

> "the provision of accommodation along with support services, which includes hotels, motels, holiday resorts and serviced apartment accommodation".

What is unclear from the definition is where the dividing line is between hotels or serviced apartment accommodation (6% VAT), and a lease of residential premises (11% VAT, 5% simplified VAT during the period of transitional or grandfathering relief, or 1.5% VAT where the lease is by an individual). In particular, many large hotels have incorporated or attached to them serviced apartments which can be utilized by guests for either longer-term stays or short-term stays. In many countries with VAT/GST systems, a distinction is often drawn on a time basis – that is, if the accommodation is provided to a guest for say 28 days or more, then it is treated as the supply of residential premises, whereas stays less than 28 days may be treated as a supply of hotel accommodation. The new VAT rules in China are silent on this issue.

Another fertile area for disputes internationally is the status of different types of accommodation such as student accommodation, time share resorts and similar. Whether they constitute "residential premises" or an "accommodation service" remains to be seen. In the absence of clear rules, certain criteria may need to be used to enable a differentiation, such as:

- The status of the customer as either a 'guest' or as a 'resident';
- The business licence of the provider of the accommodation;
- The range of services which are provided, with "accommodation services" generally expected to be subject to a broader range of services;
- The nature of the contractual arrangements – for example, with a formal lease being more likely to be regarded as 'residential premises'.

For hotels which are clearly providing "accommodation services", a major issue they will confront is how to deal with the broad array of services they offer. In particular, many hotels offer a combination of any or all of the following:

- Accommodation for guests;
- F&B outlets;
- Conference and event facilities;
- Spa and other health or fitness related services;
- Entertainment services; and
- A travel desk.

For the most part, the new VAT rules should not result in excessive compliance difficulties, though a careful consideration of all revenue streams is still needed. That is because nearly all of the above types of activities should attract a 6% VAT rate. This is not to suggest that there will be blanket 6% VAT applicable to all activities in a hotel

though – for example, the sale of spa products would attract 17% VAT, the sale of products through a shop situated in a hotel may attract 17% VAT, the lease of space to various third party service providers or concessionaires will attract 11% VAT (unless the simplified 5% VAT method is chosen under the transitional or grandfathering rules for real estate).

The difficulties from a compliance perspective will be more from a pricing or invoicing perspective. That is because the VAT rules provide that no input VAT credit may be claimed (and therefore no special VAT invoices issued) in relation to F&B or entertainment. This would seem to extend not only to guests who dine at F&B outlets within a hotel, but also the consumption of room service and mini bar products.

Importantly though, the new VAT rules seem to indicate that guests staying at a hotel for business purposes will be eligible to claim an input VAT credit. However, the input VAT credit will not be available where the guest is an individual staying for reasons of personal consumption. One difficult compliance issue will be whether a business which is registered as a general VAT taxpayer can claim an input VAT credit for accommodation services provided where either one or more of the following occurs:

- The guest reservation is in the name of the individual, rather than in the corporate name; or
- The guest pays for the invoice personally, and is later reimbursed by their employer.

The potential availability of input VAT credits for customers who stay at hotels (and other accommodation providers) is likely to be of real benefit to those providers who service the business travel market – in particular, large city hotels. Instead of the 5% BT being a real cost, the 6% VAT should be creditable to the business employer. This may lead to many hotels in large cities moving to pricing on the basis of the "fee plus VAT and service charges", rather than VAT-inclusive pricing.

In terms of the input VAT credit for the business employer, the position in practice under the BT rules has been that an individual can request a BT fapiao upon checking out of the hotel, and providing to the hotel the name and registration details of their employer, in whose name the fapiao is made out. Whether this same practice would be sufficient under the new VAT rules in order for the employer to claim an input VAT credit remains to be seen. Moreover, there is still the residual question of whether the employer may be denied an input VAT credit where the accommodation is regarded as being for "staff welfare" purposes.

A further common issue is where a hotel provides a business guest with accommodation and 'free breakfast'. The question which arises is whether that guest is entitled to an input VAT credit for the whole price paid, or whether the value of the 'free breakfast' needs to be excluded. Similarly, for conferences and events where F&B is usually provided, it may be necessary to apportion the total package price between the conference or event component, and the F&B component. Undoubtedly hotels will be encouraged to skew their

pricing towards the conference or event component, so as to maximize the business customer's input VAT credit entitlement. There is no clear dividing line, but plainly where F&B is provided at below cost price, then the hotel would be at risk of underpaying VAT.

A further point of note is the VAT treatment related to composite and mixed sales. For composite sales, the rules states that the applicable VAT rate of a transaction involving both sales of goods and services will be determined based on the main business activities of the taxpayer. In the case of mixed sales, where different goods or services are supplied and they have different VAT rates, the highest VAT rate applies to the total price unless there is an apportionment or allocation. Consequently from a compliance perspective hospitality providers have a clear incentive to allocate prices.

The structure of many large hotels in China is that there is a property owner which is separate and distinct from the hotel management company, which is often represented by a well-known hotel brand. The VAT rules would seem to provide that the services provided by the hotel management company to the property owner will be subject to VAT at the rate of 6%. The hotel management company is usually entitled to a share of the gross revenue from operating the hotel, as well as royalties for licensing trademarks, and fees for providing guest reservation services. The property owners will typically be eligible for an input VAT credit for the payments they make to the hotel management company.

Finally, many large hotels offer rewards programs to their guests, to encourage them to continue their custom. Under the VAT rules for other industries such as for the airline industry and for telecommunications services, the provision of benefits under rewards programs were not subject to VAT. However, there is no similar exclusion for benefits provided by hotels reward programs.

From a VAT compliance perspective, this is going to raise a number of challenges. In particular, where frequent guests are entitled to privileges or benefits such as "free breakfast", "free internet", the use of club lounges, 'free upgrades', or even 'free nights', the question is whether the provision of these benefits is subject to VAT as a deemed sale, and if so, how these benefits should be valued. Careful consideration of these rewards programs and other less formal programs will be needed.

Travel services

The travel industry will have a number of difficult VAT issues to manage, mainly because they can operate either as a principal in the transaction, or as an agent, and there may be a range of cross-border issues to consider.

To simplify their compliance, the new VAT rules provide that 'travel services' are to be taxed on a net basis. The rules provide that they can deduct all purchases in relation to accommodation, food and beverages, transportation, visa fees and tickets sales in calculating their VAT liabilities. In effect, the rules would seem to operate such that a travel provider who sells a package as a principal should be in much the same position as a travel provider who acts as an agent.

That is, they both account for VAT at the rate of 6% on the net revenue or commission they derive. Travel agents who collect funds from a customer for the benefit of the principal are not entitled to issue special VAT invoices for that component, but they can do so in respect of the commission component.

When the cross border aspects of the travel industry are overlaid, the position does become more complex. However, the following general guidance may assist:

- Where the travel package is provided to a customer for consumption wholly outside of China, such as for an overseas trip, VAT should not apply to the sale of the travel package. However, the commission or revenue derived from selling the package to the customer in China will likely attract 6% VAT because the travel agent's service is not wholly consumed outside of China.

- Where a hotel or other provider pays commission or a fee to an travel agent who makes a reservation on a customer's behalf, that commission or fee should attract 6% VAT. Importantly though, if the commission or fee is deducted from the accommodation charge, then the two transactions need to be separately dealt with from a VAT perspective. That is, the hotel would not seem to be able to account for VAT on a net basis – they must account for VAT on the gross fee, and obtain a special VAT invoice to claim a credit for the travel agent's services;

- Where the travel agent is located outside of China and is charging a fee or commission to a customer, hotel or other service provider in China, then VAT withholding at 6% applies under the general VAT rules. The hotel or service provider which has incurred that cost will usually be eligible for an input VAT credit.

Healthcare services

KPMG recently released a details publication which examines the VAT issues arising for the healthcare sector in China. While that publication was released in advance of the detailed implementation rules, many of the predictions being made about how the new rules may operate have proven true. A copy of the publication can be viewed here.

Specifically, the new VAT rules provide for the following:

- Healthcare services which are provided by approved healthcare providers, including clinics, hospitals, clinical laboratories, are eligible for exemption from VAT, but the exemption is limited to the fees being charged being below a prescribed threshold for standard healthcare fees approved by certain government authorities. The clear intention of these rules is to limit exemptions to more essential healthcare services which will typically be provided by public hospitals and other similar providers. Private healthcare providers, which are a growing market in China, are unlikely to qualify for exemption in many cases where their fees exceed the prescribed thresholds. What

is not clear from the new rules is whether the exemption applies only where the fees being charged are less than the prescribed thresholds, or whether the exemption applies up to the threshold amounts only.

- Aged care service providers which provide accommodation and healthcare services to elderly people, and which are approved by certain government authorities, will qualify for exemption from VAT.

Under the current BT system, there is a blanket exemption from BT for "medical services". The scope of that exemption has been relatively broad, as discussed in KPMG's healthcare publication, and benefits both public and private operators. However, it would appear that the approach of providing a blanket exemption has been discontinued in favour of a new approach which focuses on two criteria, being (a) whether the healthcare provider is an approved healthcare provider; and (b) whether the fees being charged are within certain prescribed limits. While the details are scant, the effect of these new criteria appears to be that many private healthcare providers will likely now be subject to VAT, and moreover, exemption must be assessed on a fee-by-fee basis.

Many hospitals and other clinics have also been able to benefit from exemptions from VAT in respect of pharmaceuticals and other medicines which they provide in the course of their diagnosis or treatment of patients. The new rules are silent on whether that exemption continues to apply, but there is no indication that Circular Caishui [2000] 42 (which conferred such an exemption) has been withdrawn.

One very significant challenge for all healthcare providers is whether they will qualify for input VAT credits for the substantial fixed assets and high technology equipment they use in their business. The purchase of medical devices and other equipment is already subject to 17% VAT. However, in determining whether an input VAT credit is available for the healthcare providers which purchase such equipment they will need to look at the extent to which they make taxable or exempt supplies. Given that the structure of any exemption from VAT for healthcare services is determined on a fee-by-fee basis and is limited to certain prescribed thresholds, potentially many providers will make a mix of taxable and exempt supplies and therefore be required to apportion their inputs. In addition to this, there is a general rule which allows full input VAT credits to be claimed for the purchase of fixed assets, even if used in a business which is only partially taxable. This concession may prove valuable for many healthcare providers.

In summary, this is an industry which will likely be significantly impacted by these new VAT rules.

Education services

The general position for education services is that they will be subject to VAT at a rate of 6%, unless an exemption applies. However, there are certain exclusions from this, including:

- Services related to childcare, kindergarten and education for children until age 6 is exempt from VAT, but such exemption is limited to the prescribed threshold for basic education/ childcare fees (approved by certain government authorities). In other words, income derived from higher cost (often private) operators, add on services, such as interest groups, sponsorship fees (related to admissions to connected schools for higher education) etc. are all taxable.

- Academic education including primary, secondary, tertiary education provided by approved institutions, Again the exemption is only limited to the prescribed threshold for standard education fees, accommodation, books, exam application fees, food and beverage services provided by school canteens (approved by certain government authorities). In other words, any fees exceeding the standard threshold or out of the above categories are taxable.

Similar to the healthcare sector, the use of "prescribed thresholds" above which VAT applies is likely to result in many private school fees being subject to VAT.

Cultural and entertainment services

The provision of cultural and entertainment services will generally be subject to VAT at a rate of 6%. In many cases this compares favourably with the current BT rates, which can range from 5% to 20% for certain entertainment services.

The new VAT rules provide that no input VAT credits may be claimed for the purchase of entertainment services, which effectively means that providers of entertainment services will not be required to issue special VAT invoices. However, it appears that providers of entertainment services should be eligible to claim input VAT credits for their expenses, where they are registered as general VAT taxpayers. Of course, many entertainment providers are likely to be registered as small scale VAT taxpayers (if their annual turnover is less than RMB 5 million) and therefore subject to a simplified VAT rate of 3%.

The new VAT rules do provide for certain (limited) exemptions from VAT for cultural services comprising:

- Entrance tickets for museums, libraries, exhibition halls; and
- Ticket sales for all religious related venues.

These exemptions are relatively limited in the sense that they apply to the entrance tickets only, and not add on services such as the use of audio devices, guides etc.

Top 10 industry issues – lifestyle services sector

In KPMG's China Tax Alert 7 of 2016, we highlighted the top 10 industry issues affecting the lifestyle services sector. Now that the new rules have been released, we now turn to consider how those issues have been resolved (or not).

Issues	Outcomes
1. Will an input VAT credit be available for the consumption of F&B by a general VAT taxpayer (e.g. a business lunch)?	No
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?	Potentially yes. Unclear whether the employer must book and pay, or whether it is sufficient if the VAT invoice is made out in the name of the employer
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?	Potentially yes, though the practical aspects of when and how to value these benefits will likely need to be sorted out on a case-by-case basis with the tax authority
4. How will VAT at 17% be differentiated for sales of food products, as compared with VAT at 6% for restaurant meals?	F&B services require a physical venue. However, if the predominant business is F&B services, then sales for take-away or delivery should also attract 6% VAT
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?	Apportionment will be required between F&B and non-F&B services for invoicing purposes. Hotels should try to allocate on a reasonable basis
6. Will most hotels advertise their prices "plus VAT and service charges" or "inclusive of VAT"?	Likely yes, especially those hotels catering for the business traveller market where employers can potentially claim input VAT credits
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%)?	Unclear – preliminary view is that 6% would likely apply
8. Will F&B providers be eligible to claim a deemed input VAT credit for the purchase of agricultural products?	Yes, the existing rules for claiming deemed input VAT credits for certain agricultural products should continue to apply
9. Will 'marketing' and 'procurement' services provided by a local Chinese entity to its offshore HQ be eligible for VAT exemption?	Unclear – the scope of exemptions for exported services has not, at this stage, been expanded

10. Will providers of entertainment services be eligible to issue special VAT invoices?	No – the consumption of entertainment services are not eligible for input VAT credits

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