China Tax Alert

Issue 12, March 2016

China's new VAT rates & rules - Real Estate & Construction industry impacts

Regulations discussed in this issue:

- Circular Caishui [2016] 36 containing the VAT rates and rules for the real estate and construction industry 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 all of 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 affected industries. However, in this KPMG China Alert, we examine the impact specifically for the real estate and construction sector.

Applicable VAT rates for real estate and construction industry

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

Sector	Current BT rate	New VAT rate
Construction	3%	11%
Real estate	5%	11%

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. Furthermore, these new rates are impacted by several transitional or grandfathering policies, which are described further below.

High level impacts

The real estate and construction industry has historically been the sector which has contributed the most amount of BT revenue to the government. It is also the most economically sensitive sector affected by these reforms, especially because the VAT rates for the real estate and construction industry are substantially higher than the current BT rates. The government has been very careful to ensure that the tax burden impact associated with the transition from BT to VAT is managed appropriately and has introduced several specific rules to achieve that objective.

In summary form, there are really 4 major policies relating to the real estate and construction which we believe will have a substantial macroeconomic impact. They are:

- **Generous transitional or grandfathering relief** – The rules contain relatively generous transitional or grandfathering relief which effectively ensures that the current rates of BT are replicated under a VAT for properties where construction commenced before 1 May 2016, or for properties which are held as at 1 May 2016 and are later sold or leased. This is intended to smooth the transition to VAT, such that the tax burden impact on the industry does not immediately increase to 11%. It will only be new developments commenced post 1 May 2016, or on the 2nd sale which takes place post 1 May 2016 (excluding residential properties held by individuals) where the new VAT rate of 11% will really be felt;

- **A deemed input VAT credit for purchases of land use rights** – When developers sell real estate, they will be eligible to deduct from the sale proceeds the purchase of land use rights from the local government authority in calculating their VAT liability. This concession effectively ensures that VAT is only paid on the "value added" by the developer, but it can only be used where the developer pays an 11% VAT rate, and not where the sale is subject to a reduced rate of VAT, such as where grandfathering or transitional relief has been applied;

- **An exemption from VAT for sales of owner occupied or residential investment properties (i.e. Mum and Dad properties) held for >2 years** – to encourage longer-term holdings of real estate assets, and to discourage speculation, sales of residential properties held by individuals will be subject to a 5% simplified VAT rate if they are sold within 2 years of purchase, and exempt from VAT if sold 2 years or more after purchase (except for 'high end' properties located in Beijing, Shanghai, Guangzhou and Shenzhen, where 5% simplified VAT method applies to the net gain after 2 years). This policy is consistent with the position under the current Business Tax regime. This new policy appears to apply to both owner-occupied housing and to investment properties held by individuals;

- **A staged input VAT credit for purchases of property subject to 11% VAT** – where real estate is purchased on or after 1 May 2016 which has been subject to an 11% VAT rate, and the purchaser is registered as a general VAT taxpayer, then it may ordinarily claim an input VAT credit in its VAT return. However, there is a special rule which effectively 'spreads' the input VAT credit over a 2 year period following the purchase, with 60% of the input VAT credit claimable in year 1, and the remaining 40% claimable in year 2. Given that under the current BT system purchases of real estate assets are never creditable in China, this represents an improvement from the current system, albeit that a phasing in of input VAT credits in this way is uncommon by international VAT standards.

While the new rules manage the immediate impact on the real estate and construction sector in a relatively smooth way, we anticipate that many construction projects and real estate sales will be pushed through before 1 May 2016, so that the grandfathering or transitional relief will benefit new developers or purchasers.

What is included in 'real estate and construction'?

The rules define 'real estate' and 'construction services' on the same basis as under the BT regulations. In effect, real estate includes both sales and leasing, and it affects all major real estate categories, such as residential, retail, office, industrial, commercial property.

Importantly, the activities of service providers such as real estate agents, property managers, architects, surveyors would not be regarded as falling within "real estate and construction" services, but would instead be subject to VAT at a 6% rate on the basis that they fall within the category of "other services".

Transitional or grandfathering relief

Perhaps the most significant aspect of the rules most eagerly awaited by property owners, landlords, funds and investors is the transitional or grandfathering rules. Put simply, one of the most difficult issues for any government introducing a VAT is how to apply such a new tax to existing real estate assets, and existing construction projects, without causing unnecessary market disruption.

In summary, the transitional or grandfathering rules apply as follows:

Applies to:	**Requirements:**	**VAT rate**
Developers of "old projects"	Must have in place, A construction permit with a project start date on or before 30 April 2016	5% simplified VAT method on gross revenue
Second hand sale of properties (by non-real estate developers)	Seller must have obtained the property before 30 April 2016	5% simplified VAT method, and able to deduct the original purchase price of the property (as per current BT policy)
Leasing	Landlord must have obtained the property on or before 30 April 2016. It is unclear whether this concession can be applied to self-developed properties.	5% simplified VAT method on gross revenue
Construction	• Construction services where the construction company only provides labour services; • Construction services where the principal provides equipment and materials; • Construction services on existing projects which satisfies either: (1) Must have construction permit in place on or before 30 April 2016; or (2) if no construction permit, then a construction contract with a start date on or before 30 April 2016	3% simplified VAT method, and able to deduct amounts paid to subcontract or (as per current BT policies)

The use of a "simplified VAT method" means:

- output VAT is paid at a reduced rate of either 3% (construction) or 5% (real estate sales or leasing);
- the supplier is unable to claim input VAT credits in relation to that transaction.

As a further generous relief measure, the VAT paid under the simplified VAT method for construction and real estate may be creditable where the recipient is a general VAT taxpayer. It remains to be seen whether suppliers may issue special VAT invoices (if they are already a general VAT taxpayer), or whether they must procure the tax authority to issue a special VAT invoice on their behalf. In addition, it remains to be seen whether this will apply not only to sales of real estate, but also to leases.

It appears from the rules that the use of a simplified VAT method is a "choice" by the supplier, but it is not a requirement. It also appears to be a choice which can be made on a project-by-project basis. As such, a property developer holding say residential property may wish to apply a 5% simplified VAT method where the price is fixed as a VAT-inclusive price, but may prefer to apply an 11% VAT method where the supplier wishes to claim input VAT credits and it can pass on the VAT to a purchaser. Importantly though, once a choice is made, it cannot be retracted by the taxpayer for a 36 month period.

There are several interesting aspects to how these "choices" may operate in practice. First, for property leasing it appears that the choice to apply a 5% simplified VAT method could be made in relation to leases which are entered into many years in the future. That is because transitional relief only requires the property owner to have "obtained" the property on or before 30 April 2016. In other words, a building which has been in the same ownership for many years will be able to offer leases subject to a 5% simplified VAT method, whereas newer buildings, or those where ownership has changed cannot.

Second, the choice made by a landlord may have significant implications for a tenant. In particular, a landlord able to pass on VAT (at whatever rate) may prefer to have the lease being subject to an 11% VAT rate so they can claim an input VAT credit for their costs, whereas the landlord may prefer the lease being subject to a 5% simplified VAT rate method where they are unable to pass on the additional VAT cost under the terms of the lease. Clear negotiation and communication between landlords and tenants will be needed as part of any lease negotiations.

Small scale VAT taxpayers

The new 11% VAT rate only applies to taxpayers which are registered as "general VAT taxpayers". This is compulsory for any taxpayer with an annual turnover exceeding RMB 5 million, but is optional for taxpayers with a turnover below this amount, provided they have sound accounting records and are approved by the tax authority.

For taxpayers who are not registered as general VAT taxpayers, then they may register as "small scale VAT taxpayers". This means:

- they pay output VAT at a reduced rate, in this case, 5% for real estate transactions and 3% for construction services;
- they are not eligible to claim input VAT credits;
- they are not eligible to issue special VAT invoices, though businesses which are registered as general VAT taxpayers who purchase services from small scale VAT taxpayers may claim input VAT credits based on invoices issued through the tax authority.

There is an exception to the 5% simplified VAT rate for individuals who lease residential property – this is instead subject to a 1.5% VAT levy rate. This is the same as the rate which applied under BT.

IMPACTS IN KEY MARKET SEGMENTS

Individual owner occupiers and residential investors - 'Mums and Dads'

As mentioned earlier, one of the key beneficiaries of the new rules will be "Mums and Dads" holding real estate in China. In effect, where individuals sell residential property which is held for less than 2 years, they will pay VAT at a 5% simplified VAT rate. That 5% simplified VAT rate will be based on the gross selling price of the property.

Where individuals sell residential property which is held for 2 years or more, the sale will be exempt from VAT. The evident purpose of this is to encourage longer-term holdings in real estate assets, and to discourage market speculation. What is interesting about this rule is that it is applicable to all "residential property" which is held by individuals. Consequently, individuals who are property investors (e.g. landlords) should be able to obtain an exemption from VAT in respect of a sale, as well as owner occupiers. Those same individuals will similarly benefit from a 1.5% VAT rate applicable to residential property leasing.

The VAT exemption for sales of residential properties held for more than 2 years is comparable to the current BT system. According to Caishui [2016] 23, all residential properties held for more than 2 years benefit from exemption, while all residential properties held for less than 2 years are subject to a 5% BT rate on the gross selling price. An exception to this is in Beijing, Shanghai, Guangzhou and Shenzhen where only 'ordinary' residential properties held for more than 2 years benefit from exemption, whereas 'higher-end' residential properties held for more than 2 years were subject to BT on a net basis. The new VAT rules replicate these same concessions.

There will no doubt be issues in terms of the measurement of the 2 year period where certain life events intrude. For example, what happens when the 2 year period is broken as a result of death of either or both co-owners, or divorce necessitates a transfer from one co-owner to the other. Thankfully there is an exemption specifically applicable to transfers upon death or divorce, but whether such an event restarts the 2 year holding period is less clear.

Construction and design services

Construction companies will be subject to an 11% VAT rate, except for existing projects where a 3% simplified VAT method applies if a construction permit has already been granted for the project on or before 30 April 2016 (or where there is no construction permit, a construction contract which provides for construction to commence on or before 30 April 2016). Where the 3% simplified VAT method applies, the amounts paid to subcontractors can be deducted from gross revenue, in much the same way as the BT system currently works.

In a post-VAT environment, construction companies will face two major issues:

- the ability to claim input VAT credits will be subject to getting special VAT invoices. Many head contractors will be dealing with a mix of subcontractors with varying levels of tax compliance. Furthermore, subcontractors who are small scale VAT taxpayers are unable to issue special VAT invoices, so credits will only be available where they are obtained from the tax authority;
- where construction companies purchase materials which they provide as part of their service, there is an issue as to whether this is subject to an 11% VAT rate applicable to construction, or the 17% VAT rate which applies to most materials. Logically, the answer should be that because the value of any materials is incorporated into the fee which the construction company is paid by the developer, an 11% VAT rate applies to the total fee. However, this uncertainty has been suggested by some officials in discussions about the proposed rules.

One concession which will benefit certain segments of the construction sector is a concession for those who provide construction services but do not supply materials in the provision of those services. They are entitled to use a 3% simplified VAT method. This is intended to cater for businesses in the design services industry as well as to cater for situations where the developer may buy the materials, and simply rely on the construction company to provide services. This concession is of ongoing usage (i.e. its not a transitional measure), and is consistent with a clear policy intention to keep construction companies out of the VAT invoicing system as much as possible.

The rationale behind this concession is to enable a reduced rate of output VAT to cater for the fact that these construction businesses will not obtain the benefit of significant input VAT credits, given their major costs will be labour.

Property developers

Leaving aside the generous transitional or grandfathering relief which will benefit property developers in respect of their existing projects, there are a number of other aspects of the rules which will assist. Most importantly, developers which register as a general VAT taxpayer will be eligible to deduct from their sales revenue the purchase price of the land use rights. This effectively ensures that they only pay VAT on the true 'value added' to the property. This concession can, however, only be applied where the developer is paying an 11% output VAT rate, and not where the 5% simplified VAT method is chosen. Consequently, there will be a need to perform calculations so as to make an informed assessment of the preferred approach when selling.

One concern previously addressed by industry was whether they would be required to pay VAT up-front in relation to pre-sales. However, the new rules do not require this. The time of supply of immoveable property is when the transfer occurs. However, a 3% VAT prepayment needs to be made at the time of pre-sale.

Property funds, investors, and those holding for use in a business – longer-term holdings

Property funds and investors holding real estate in China for the purposes of leasing will also benefit from the relatively generous transitional or grandfathering relief contained in the rules. In particular, the ability to apply a 5% simplified VAT method to either:

- any leases that the owner of the property as at 30 April 2016 enters into any time in the future (or until the rules are changed); or
- any subsequent sale of those properties held as at 30 April 2016.

Furthermore, there is an additional rule which allows for a "net basis" method to be used where the 5% simplified VAT method is applied to property which is not self-developed. This effectively means that property funds, investors and those who hold property for use in their business (e.g. a factory) as at 30 April 2016 can pay VAT on a subsequent sale at 5% of the difference between the gross selling price and the purchase price. This similarly replicates the current position contained in the BT rules.

On the purchase of real estate assets on or after 1 May 2016 which has not been subject to the 5% simplified VAT method, the purchaser will be able to claim an input VAT credit for the 11% VAT applicable. However, there is a special rule which seeks to apportion the input VAT credit over a 2 year period – with 60% being available in year 1, and 40% in year 2. This rule will also apply to the sale of real estate developments under construction. However, it will not apply to self-produced properties (e.g. it will not apply to developers), to properties held under finance lease, or to temporary properties (e.g. a site office on a construction site).

What is curious about this rule is that while it appears at first glance to be a revenue raising measure for the government, its utility is questionable given that in China there is no ability to claim a refund of excess VAT credits (except for exporters). This means that a purchaser with a 'lumpy' credit does not get a cash refund in any event. Its also unclear whether the 60% input VAT credit for year 1 may be claimed in the month in which the purchase takes place, or is to be apportioned over that 12 month period, and similarly with the 40% in year 2. Its also unclear what happens to the credit if there is a disposal somewhere in that 2 year period. In addition, if the purchase of an immovable asset is not recognized as a fixed asset for accounting purposes, but is instead recognized as an investment property for example, what should be the treatment of claiming the input VAT? The rules remain silent on this aspect.

A common method of effectively disposing of real estate in China is through the sale of shares or other equity interests in a real estate holding company. Such a sale does not attract BT and would not be subject to VAT either. The rules do not appear, at least at this stage, to contain any 'look through' rules similar to Announcement 7 in a CIT context, which seek to tax the sale of such shares as being akin to the disposal of the underlying real estate asset.

Property managers, agents and other similar service providers

As noted previously, the services of property managers, agents and other similar service providers will be subject to VAT at the rate of 6%. The services of property managers have been included in the category of "commercial assistance services", along with real estate agents.

Recharge of utilities and other costs - leasing

It is very common in the real estate sector for property management companies or landlords to recharge certain utilities costs to tenants under the terms of the lease. The question is whether the VAT treatment of those recharges retains their original character, which may attract different VAT rates depending upon which costs are being recharged, and would also overcome double taxation for VAT purposes where the lease is subject to the simplified VAT method. Alternatively, the recharge may be treated as being additional consideration for the lease of the premises and therefore attract an 11% VAT rate. The new rules do not provide any guidance on this issue.

Financing costs

As noted in our China Tax Alert dealing with financial services, there is no entitlement to an input VAT credit for interest expenses, or for fees and charges which are directly connected with loan services. This will add to financing costs for real estate projects.

Significant issues we anticipate arising in practice

The VAT reforms represent a major tax reform initiative, and whenever these types of new rules are released, there is typically a period of approximately 12-18 months of 'settling in'. However, at first glance there are a number of systemic issues we have seen arise in VAT/GST systems throughout the world which we believe have been replicated in the rules in China. They will no doubt cause issues or uncertainties for some time to come. They are:

- **The identity of property problem** – many of the rules operate on the assumption that the nature of the property which is being sold is the same as the property which was acquired. Consider for example the ability for property developers to deduct the price of the land use rights which they acquire. What happens if the developer sells only part of the land use rights they acquired, or if they sell airspace rights? Similar issues will undoubtedly arise in relation to the transitional provisions where say one of the co-owners held their 50% share of the property as at 30 April 2016, but the other co-owner purchased their 50% share post-30 April 2016. Upon a subsequent sale, will the 5% simplified VAT method be available to both co-owners, only one, or neither?

- **Commercial v residential property** – the rules for 'Mum and Dad' owners provide for special concessions for residential property sales and leases. The difficulty is in determining what constitutes "residential property" as compared with "commercial property". For example, how to classify student accommodation, or serviced apartments.

- **Developers registering as a general VAT taxpayer** – developers will have an incentive to register as a general VAT taxpayer right at the outset of the project, so that they may commence claiming input VAT credits. The practical difficulty is that at this time they may have no sales revenue and therefore may find it difficult to register as a general VAT taxpayer. This type of business model where there is often a long lead time between expenses being incurred, and revenue being generated, has not been a common feature of the VAT system in China. It is hoped that the tax authority recognize this quickly and allow developers to register for VAT at the outset of their projects.

Top 10 industry issues for the real estate & construction sector

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

Issues	Outcomes
1. Will a deemed input VAT credit be available for the purchase of land use rights from local government authorities?	Yes
2. Will VAT apply to the sale of shares or other equity interests in a real estate holding company, either offshore or onshore?	Preliminary view is that VAT does not apply
3. How will VAT apply to agents and property managers managing trust funds on a client's behalf, and collecting utilities and other fees?	Yes, expected that a 6% VAT rate will apply to the services of agents/managers
4. Will there be any transitional or grandfathering relief available to existing projects, or lease contracts entered into before VAT reform?	Yes
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?	Yes – the time of supply is when the transfer of the immoveable asset occurs. However, a 3% VAT prepayment needs to be made when pre-sales occur.
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?	Deemed sale will likely apply to rent-free periods, 'free' parking and other benefits. However, at this stage, nothing specifically stated for the '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?	No
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)?	At this stage, nothing specifically stated
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?	Yes, for purchases of real estate, 60% in year 1, 40% in year 2
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?	5% gross basis for residential properties sold by individuals held < 2 years, and exempt if held 2 years or more

Managing the 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 11% VAT rate will result in an additional tax burden on them, once the transitional or grandfathering relief expires. 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 prefer to apply a reduced 3% (construction) or 5% (real estate) simplified VAT method to lessen the VAT impact.

- **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, 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 sale of equity interests would appear not to attract VAT.

- **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.

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