

China Tax Alert

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New Circular clarifies China's VAT treatment of reinsurance arrangements

Regulations discussed in this issue:

- Circular Caishui [2016] 68 which sets out the VAT treatment of reinsurance arrangements, and takes effect from 1 May 2016

Background

On 21 June 2016 the Ministry of Finance (MOF) and State Administration of Taxation (SAT) jointly issued Circular Caishui [2016] 68 (Circular 68) which sets out the VAT treatment of reinsurance arrangements.

Circular 68 has been issued to provide much needed clarification on the Value Added Tax (VAT) treatment of reinsurance arrangements, and is the first in a series of guidance likely to issue over the coming months to clarify uncertainties in the recently released VAT rules. Circular 68 is effective from 1 May 2016, and should therefore be taken into account by reinsurers and insurers in preparing their first VAT returns (due on 27 June 2016).

By way of background, when the VAT reform policies were recently introduced by Circular Caishui [2016] 36 (Circular 36), the rules were silent on the VAT treatment of reinsurance arrangements. At the time KPMG noted that there were two potentially valid treatments available, being that:

1. Reinsurance services should take on the same VAT treatment as the underlying insurance policy which is being reinsured. This approach is generally consistent with the international VAT treatment given to reinsurance arrangements; or
2. Where the underlying insurance policy is subject to VAT, then the reinsurance of that policy should be exempt from VAT. This approach was consistent with the previous Business Tax (BT) treatment. It was designed to ensure there was no cascading of BT.

As predicted, Circular 68 adopts the first approach. That is, the VAT treatment of the reinsurance policy takes on the same VAT treatment as the underlying insurance policy which is being reinsured. This approach is consistent with recommendations provided by KPMG to the MOF, the SAT and the China Insurance Regulatory Commission (CIRC) back in 2013.

Reinsurance follows the same VAT treatment as the underlying insurance policy

As noted, Circular 68 provides that reinsurance services take on the same VAT treatment as the underlying insurance policy which is being reinsured. This means, for example, that reinsurance of taxable general insurance policies will be subject to VAT at a rate of 6%, and the reinsurance of exempt life insurance policies for a term greater than 1 year will similarly be exempt from VAT.

The categories of VAT exemption which currently apply to insurance policies, and therefore the reinsurance of which is now potentially also exempt from VAT include:

- Life insurance for a term > 1 year;
- Health insurance for a term > 1 year;
- Pension annuity insurance for a term > 1 year;
- Insurance relating to the export of goods;
- Export credit insurance;
- Agricultural and animal husbandry insurance

Export of reinsurance services

Circular 68 provides that where a Chinese reinsurer provides reinsurance services to an offshore insurer which is wholly consumed outside of China, then VAT exemption may apply. It is not clear from Circular 68 whether the reinsurer must go through the record filing process to claim exemption, though this would seem to be the logical requirement because it is consistent with the processes applicable to other categories of exported services.

Import of reinsurance services

It is perhaps more common for reinsurers to be located outside of China, with the Chinese insurer ceding the risk to them. While Circular 68 does not specifically state this (albeit that this is consistent with the principles of Circular 36), where the reinsurer is offshore and is providing reinsurance services relating to taxable general insurance policies to a domestic Chinese insurer, then the VAT will be collected on a withholding basis. Ordinarily the Chinese insurer should be eligible for an input VAT credit upon completion of the withholding procedures, so this outcome should be revenue neutral between the parties (assuming there is a VAT withholding gross up provision).

Technical and practical issues which will arise

While Circular 68 is relatively light on detail, the following issues emerge:

- Where the reinsurance policy covers both taxable and exempt underlying insurance policies, no VAT exemption will apply to the reinsurance of the exempt component. On a literal reading of Circular 68 there needs to be a separate reinsurance arrangement entered into for taxable as compared with exempt insurance policies, otherwise the exempt insurance policies do not qualify. It further appears that its insufficient to simply allocate the premium between the different types of policies – conservatively, they need to actually have separate policies. This means that care needs to be taken when drafting and entering into reinsurance arrangements. Existing reinsurance policies will need to be reviewed for this purpose.
- It appears that exemption from VAT will not apply where, for example, there is a round robin arrangement which is quite common in Hong Kong where Chinese consumers buy insurance from a HK provider (whilst in Hong Kong), which is then reinsured back into mainland China. In this situation, where the risk being insured covers (in whole or in part) the insured's activities in mainland China, then it is difficult to see how the underlying insurance may be seen as being wholly consumed outside of mainland China.
- Similarly, where the underlying insurance policy is outside the scope of Chinese VAT (for example, because both the supplier and the recipient are outside of China), then there is a technical issue of uncertainty about whether the reinsurance of that policy by a Chinese reinsurer will qualify for exemption from VAT - the concern being that on a technical viewpoint the underlying insurance is merely outside of scope of VAT, not exempt from VAT.
- Circular 68 is silent on the question of how the commission payable to the reinsurer is to be treated for VAT purposes. One view is that this is to be treated as a separate transaction for VAT purposes which attracts a 6% VAT rate, while the alternative view is that its a reimbursement of costs which should not be subject to VAT as separate VAT taxable transaction, consistently with the previous BT position expressed in Circular Guoshuifa [2002] 9. Given the uncertainty, insurers and reinsurers should seek clarification of these issues with their in-charge tax officials.

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