CHINA EXPANDS VAT REFORM TO NEW SECTORS

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China's Premier Li Keqiang has announced, in the Annual Government Working Report to the National People's Congress, held in March that Value Added Tax ("**VAT**") reforms will be fully implemented and expanded from 1 May 2016 to include the construction, real estate, financial and consumer services industries.

VAT reform was first introduced in 2012 as a trial program to replace Business Tax (**"BT"**) with VAT in Shanghai. Since then, the program has expanded to several municipalities and provinces and has been applied to various sectors including railways, postal services, telecommunications and certain service industries.

Once China's VAT reform is fully implemented nationwide, China will have one of the most advanced VAT regimes in the world.

New Reform Sectors

The four sectors subject to the last round of VAT reform and their applicable rates are as follows:

Industry	Scope	Current BT Rate	Applicable VAT Rate
Construction services	• construction, installation, repairs, decoration and other construction projects	3%	11%
Real estate	• sales of buildings and other structures built on land • assignment of land-use rights and natural resources use rights • real estate leasing	5%	11%

Industry	Scope	Current BT Rate	Applicable VAT Rate
Financial and insurance		5%	6%
Consumer services	hospitality, food and beverage, healthcare and entertainment	5% (entertainment 5- 20%)	6%

Timeline and Actions

In a press conference in March, Wang Jun, Chief of the State Administration of Taxation ("SAT"), stated a detailed scheme of the VAT reform would be submitted to the State Council executive meeting for approval. Thereafter, it is likely that the Ministry of Finance ("MOF") and the SAT will jointly announce a detailed policy reform by April this year with a launch date of May 1, 2016 expected. As a transitional measure, it is also anticipated that taxpayers will be granted an additional 10-day period to complete the VAT filings for May and June.

"The progress in the VAT reform last year was slower than was planned and efforts would be made to meet the May 1 deadline this year," said Lou Jiwei, Minister of Finance on the sidelines of the legislature National People's Congress.

Since this VAT reform will have a significant impact on at least 10 million taxpayers in China, and it is only less than two months from now to the launch date on May 1, 2016, the SAT has issued an internal circular ("Shuizongfa [2016] No. 32", hereinafter referred to as "Circular 32") regarding implementation plans and a timetable to be followed by the local tax bureaux at provincial and municipal levels.

This Circular 32 sets out several milestones and key steps that include the following:

- Fix the working plans for each level of tax bureaux.
- Transfer taxpayers from local tax bureaux to state tax bureaux (BT and VAT payers are under the administration of local tax bureaux and state tax bureaux respectively).

- Complete preparation work for conversion of BT to VAT[1].
- Organize internal training for tax officers.
- Organize external training for taxpayers.
- Conduct trial run of VAT reform.

Circular 32 further requires that all levels of the tax bureaux make their best efforts to complete the above milestones in a bid to make the launch date of May 1 achievable. The Chief of the SAT, Wang Jun, also confirmed that all tax bureaux would provide green channels to new VAT taxpayers under this latest VAT reform to facilitate their tax filings.

What's more?

It is anticipated that the VAT reform will bring about significant benefits to enterprises. With the VAT reform being extended, the tax burden of taxpayers engaged in these four industry sectors will be significantly reduced, in turn affecting other enterprises which are in the supply chain of these affected sectors.

The Chief of SAT, Wang Jun, also confirmed that the government has formulated associated policies, such as continuing the preferential tax treatment originally provided for BT payers to VAT payers after the implementation of the new policy; as well as providing transitional policies to support the smooth transition from BT to VAT. Wang also assured taxpayers that tax authorities at all levels would be committed to continue the transition of preferential tax policies.

Contrast with EU VAT

The proposals are very different from the VAT systems of the EU. For example, in the financial and real estate sectors, most suppliers are exempt though some are taxable whilst others carry the right to opt to tax. Those supplying goods and services into China will need to be aware of the VAT implications as law and practice develops. It is hoped that the SAT will learn from the European experience of VAT in formulating laws and practices, so that problems can be alleviated. Financial services and real estate VAT are two of the most

[1] Preparation work include recognition and certification of general VAT payers status; setup of tripartite automatic tax deduction agreements with the state tax bureaux; testing of hardware and software for online tax filings and tax control systems; estimation of the volume of VAT invoices based on the new VAT payers' revenue and printing of VAT invoices, etc.

complex areas of EU VAT and much can be learned from the European Court of Justice case law.

More to come

Before the launch date of May 1, 2016, we expect the SAT will issue more detailed rules to illustrate how the new VAT system will work.

Specifically, for finance and insurance sectors, apart from the common issues that all business sectors would encounter in switching from a BT to VAT system (such as how to effectively claim input VAT credit and pass on output VAT to customers, the continuity of the existing tax exemption/reduction treatments under BT system, etc.), a key challenge faced by the business operators in sectors, including financial institutions, insurance companies, security companies and asset management companies, would be the upgrading of the current IT system to cope with the change. Because of the time consuming nature of a system upgrade, such as integration and testing, there has already been predictions of a possible delay in the VAT reform timeline for certain enterprises in these sectors.

In addition, we have provided an overview below of some of the major issues we expect the construction and real estate sectors to face in respect of the new VAT reform.

	Issues	Observation/Challenges
Real Estate	**1. Cost deduction/input VAT credit**	• VAT is not charged on the initial grant of land use rights by the government and therefore, property developers will not be able to claim any input VAT deduction on initial land acquisitions. Given that land is the main cost of developers, the proposal of a notional deduction was raised and discussed but MOF did not seem to favour this option. • Previously, real estate enterprises might not be able to obtain official VAT invoices from their vendors (such as head contractors, financial institutions, equipment suppliers, etc.) for input VAT credit because the vendors were not general

	Issues	Observation/Challenges
		VAT payers. However, with BT being replaced by VAT, the above should become less of an issue. • VAT on labour costs is still not creditable.
	2. Sales revenue/output VAT	• VAT is payable in full for presale revenue if a VAT invoice is issued to customers in the full amount . If no VAT invoice is issued for presale, MOF may consider a prepayment of VAT calculated using a reduced levy rate (or other method) to be confirmed by the SAT. • Free area, parking lot, renovation, etc, sold together with the properties are currently not required to be separately accounted for or treated as a deemed sale for VAT purposes. However, while household electrical appliances are provided when the properties are sold, the sales price will need to be split between appliances and property which are subject to different VAT rates.
	3. Transitional rules	• For construction of properties that have commenced but not been sold, there should be transitional rules in place to ensure the overall tax burden of the real estate enterprises will not be significantly affected due to the new VAT reform[2].
	4. Sale of second-hand properties	• In the residential property market, sellers of second-hand properties are mostly individuals. To better manage VAT credit and collection in the supply chain, there is a proposal to implement tax administration rules on individual sellers for the first time.

[2] By reference to the transition rules on finance lease industry, MOF is considering offer a reduced levy rate on sales revenue but with no input credit. For the real estate industry, it is expected that the transitional period will be longer given its unique business model. The projects that are eligible for the transitional rules would also be subject to discussion.

	Issues	Observation/Challenges
	5. Real estate leasing	• Real estate leasing is subject to the same VAT rates as real estate sales (i.e. 11%). There is currently a discussion to distinguish the sales/service nature between real estate leasing and short-term service apartments leasing. For short-term service apartment leasing, a lower VAT rate of 6% will be levied if it is considered a type of customer service. MOF is considering income derived from leasing service apartments for a term of less than four weeks (or a term to be determined) as a type of customer service income which is subject to 6% VAT.
Construction	**1. Cost deduction/Input VAT credit**	• Since raw materials used for construction work are usually sourced from domestic individuals or small business operators who do not issue VAT invoices to their business partners, the head constructor and/or sub-contractors may not be able to obtain valid VAT invoices in respect of the domestic purchases from their individual or local vendors for input VAT credit purposes. • Similar to the real estate sector, in that VAT on labour costs is still not creditable.
	2. Transitional rules	• For on-going construction projects, there should be transitional rules in place to ensure the overall tax burden of the construction enterprises will not be adversely affected due to the new VAT reform. Reduced VAT levy rate or immediate VAT refund are proposals being considered among others.
	3. Offshore construction services	• Provision of offshore construction services may be exempted from VAT with the relevant materials VAT costs incurred in China being refunded upon export.

As outlined above, the real estate and construction sectors are closely linked and will always encounter similar problems in the VAT system (such as the input VAT deduction, transitional issues, mismatch of income and costs due to the long lifecycle of projects, etc.). With the new VAT reform coming into effect soon, we expect we will have a much clearer direction to deal with the above key issues that are in debate.

Further, in order to prepare for the new VAT reforms, enterprises particularly in real estate and construction sectors should review the status of their current projects and contracts with vendors and customers not only from the tax perspective, but also more widely from a cash management perspective including review the possibility on any room for potential pricing adjustment, etc.

Although policy makers have stated that the new reform will reduce VAT burdens on all industries, this will depend on each individual case. Enterprises who experience a reduction in tax burden after the VAT reform, may not experience an increase in profit levels as compared to profits under the BT regime since VAT and BT are structured differently. Therefore, a proper consideration of transfer prices between vendors and customers will be vital to ensure an enterprise maintains its profit level while reducing its VAT burden at the same time.

FOR MORE INFORMATION

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