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VAT Reform - Real Estate Sector

On 24 March 2016, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly published Caishui [2016] No. 36 (Circular 36), which provides the detailed implementation guidance on the further rollout of the Value-Added Tax (VAT) reform to sectors such as construction, real estate, financial services and lifestyle services, as well as modifications to the current VAT rules for transportation services, modern services, postal and telecommunication services. Circular 36 takes effect from 1 May 2016, superseding Caishui [2013] No. 106 (Circular 106). The VAT reform will be rolled out to cover all sectors that used to fall under the Business Tax (BT) regime, and upon implementation, BT will be completely replaced by VAT.

We covered, in our earlier Tax Analysis, an overview on Circular 36 and a generic summary of all the key points. This newsletter is industry-specific, focusing on the detailed rules on real estate sector, the implications and the implementation actions.

Highlights of Circular 36 related to Real Estate Sector

Sale of Real Estate

From 1 May 2016, the VAT reform will cover the real estate sector whereby the sale of real estate, and land use rights, are subject to VAT at 11%. General VAT taxpayer may opt for the general taxation method (11% VAT rate) or simplified taxation method (5% VAT rate) when selling Old Real Estate Project (OREP) or Old Real Estate (ORE).

OREP or ORE is defined:

- where the property developers sell self-developed real estate, OREP refers to projects with commencement date stipulated on the Construction Permit being no later than 30 April 2016;

- for other situations, ORE refers to real estate which is obtained or self-built by taxpayers no later than 30 April 2016.

Circular 36 also specifies the calculation of sales amount under different scenarios. Details are outlined in *Table 1* and *Table 2*.

Appendix 3 of Circular 36 clarifies the VAT rules for the sale of residential properties by an individual as follows:

- Sale of self-built and self-occupied residence is exempt from VAT;
- Depending on holding period and location of property, sale of residential properties purchased by individuals may follow different VAT treatment. Details are outlined in *Table 3*.

Leasing of Real Estate

From 1 May 2016, VAT rate applicable to leasing of real estate is 11%. General VAT taxpayer engaged in operating lease of ORE may opt for general taxation method (11% VAT rate) or simplified taxation method (5% VAT rate). Details are outlined in *Table 4*.

Table 1: VAT treatments related to property developer[1] engaged in the sales of self-developed real estate

	OREP				New Real Estate Project			
	General Method (G)	Simplified Method (S)	VAT Rate/ Provisional Rate	Special treatment on sales amount	General Method (G)	Simplified Method (S)	VAT Rate/ Provisional Rate	Special treatment on sales amount
General Taxpayer	V	V	G: 11% (3% provisional rate)[2] S: 5%	G: Deduction of acquisition cost of land paid to government is allowed; but such deduction is not allowed at the stage of paying provisional VAT S: None	V	X	11%	Deduction of acquisition cost of land paid to government is allowed
Small-Scale Taxpayer	X	V	5%	None	X	V	5%	None

[1] Real estate developer should pay VAT at 3% provisional collection rate when receiving advance payments for the sales of real estate.
[2] Taxpayer opts for general taxation method should pay VAT at 3% provisional collection rate at the location of the real estate, then file and settle VAT with the respective tax authority at its registration place.

Table 2: VAT treatments related to non-property developer[1]

	ORE				New Real Estate			
	General Method (G)	Simplified Method (S)	VAT Rate/ Provisional Rate	Special treatment on sales amount	General Method (G)	Simplified Method (S)	VAT Rate/ Provisional Rate	Special treatment on sales amount
Non-Self-built Real Estate								
General Taxpayer	V	V	G: 11% (5% provisional rate) S: 5%	G: Deduction of acquisition cost is *only* allowed at the stage of paying provisional VAT S: Deduction of acquisition cost is allowed	V	X	11% (5% provisional rate)	Deduction of acquisition cost is *only* allowed at the stage of paying provisional VAT.
Small-Scale Taxpayer[2]	X	V	5%	Deduction of acquisition cost is allowed	X	V	5%	Deduction of acquisition cost is allowed

[1] Non-real estate developers who sell property should pay provisional VAT at the location of the real estate, then file and settle VAT with the respective tax authority at its registration place.
[2] It excludes sales of residential property by individual industrial and commercial households or real estate by other individuals.

Table 2: VAT treatments related to non-property developer (continued)

	ORE				New Real Estate			
	General Method (G)	Simplified Method (S)	VAT Rate/ Provisional Rate	Special treatment on sales amount	General Method (G)	Simplified Method (S)	VAT Rate/ Provisional Rate	Special treatment on sales amount
Self-built Real Estate								
General Taxpayer	V	V	G: 11% (5% provisional rate) S: 5%	None	V	X	G: 11% (5% provisional rate)	None
Small-Scale Taxpayer	X	V	5%	None	X	V	5%	None

Table 3: VAT treatments related to sale of residential properties purchased by individuals

	Holding for less than two years	Holding for two years or more	
		Non-Ordinary Housing	Ordinary Housing
All other areas (except Beijing, Shanghai, Guangzhou and Shenzhen)	5% VAT on gross sales amount	VAT Exempt	
Beijing, Shanghai, Guangzhou and Shenzhen	5% VAT on gross sales amount	5% VAT on sales amount less acquisition costs	VAT Exempt

Table 4: VAT treatments related to operating leasing of real estate

	ORE			New Real Estate		
	General Method (G)	Simplified Method (S)	VAT Rate/ Provisional Rate	General Method (G)	Simplified Method (S)	VAT Rate/ Provisional Rate
General Taxpayer[1]	V	V	G: 11% (3% provisional rate) S: 5%	V	X	11% (3% provisional rate)
Small-Scale Taxpayer[1, 2]	X	V	5%	X	V	5%
Residential properties leased out by individuals	X	V	1.5%	X	V	1.5%

[1] When the taxpayer's place of registration and real estate are not located in the same county (city), the taxpayer should pay provisional VAT to the local tax authority at the location of real estate, and then file and settle VAT with the respective tax authority at the taxpayer's place of registration.
[2] It excludes the situation where residential properties are leased out by individuals.

Comments

Short-term Tax Impact To Real Estate Sector May Not Be Significant

The real estate sector generally has a long operating cycle and been considered as capital-heavy, complex and with significant demands in cash flow. Therefore, Circular 36 provides transitional rules for dealing with OREP and ORE. A general VAT taxpayer is allowed to opt for taxation at 5% under the simplified taxation method for income derived from selling or leasing of OREP and ORE. Looking at the industry as a whole, if taxpayers opt for the simplified taxation method, the VAT burden of real estate sector may remain the same or slightly decrease in the short run for OREP and

ORE, which is also one of the objectives set by the policy-makers striving for a smooth transition for VAT reform. New real estate projects will be eventually subject to 11% VAT rate. Considering labor and finance costs, which are often the major components in the total construction costs, do not offer input VAT credits, the VAT burden of real estate sector may be ultimately increased in the long run.

Input VAT Credit Mechanism May Benefit Real Estate Sales

Starting from 1 May 2016, when a taxpayer pays VAT under the general taxation method acquires real estate and records the real estate as fixed asset for financial accounting purpose, the input VAT incurred may be credited against the output VAT over a two-year period, with 60% of the input VAT credited in the first year and the remaining 40% credited in the second year. This tax treatment should help enterprises who have acquired real estate to significantly increase input VAT credit and, in return, alleviate their VAT burden. It is especially beneficial to the entities with limited input VAT credits. The introduction of this input VAT credit mechanism should foster the sale of commercial real estate, particularly with the current real estate market situation and the fact that real estate investments could preserve wealth in the long-run.

Options For Taxation Method Are Available To Real Estate Developers When Dealing With OREP

Real estate developers may choose either general taxation method or simplified taxation method when dealing with OREP. Details are outlined as below:

Item	General Method	Simplified Method
VAT Rate	11%	5%
Input Credit	Allowed	Not Allowed
Deduct acquisition cost of land paid to government from sales amount	Allowed	Not Allowed
VAT Management	Relatively Complex	Relatively Simple

As the general taxation method and simplified taxation method convey both advantages and disadvantages, real estate developer should estimate and assess the quantum of input VAT that would be available after 1 May 2016, together with the in-house resources for invoice management, before deciding the taxation method when dealing with OREP.

Deduction of Land Cost Is Allowed For VAT Purpose

Circular 36 clarifies that a real estate developer who is a general VAT taxpayer is allowed to deduct land cost, from the sale proceeds, which was previously paid to the government, when it sells the self-developed real estate (not applicable to real estate developer who opts for simplified taxation method for selling real estate related to OREP), in order to compute the VAT payable.

We consider that the introduction of above treatment can benefit the real estate developer, as the land cost paid to government is currently outside the scope of charge of VAT, thus, no input VAT should be claimed by real estate developer. Please note, however, that if the simplified tax method is adopted, real estate developers enjoying 5% VAT rate is not allowed to deduct land cost from the sale proceed. We, therefore, recommend the enterprises to carefully consider the tax impacts between two different taxation methods.

Inherit some of the existing BT Treatments

Under the framework of VAT reform, some BT treatments related to real estate business are inherited in order to ensure a smooth transition of VAT reform for real estate business. The following are some examples:

- VAT treatment for individuals who sell residential properties basically remains the same as the existing BT regime while special rules apply to sales of non-ordinary residential property which has been held for more than two years in Beijing, Shanghai, Guangzhou and Shenzhen.
- Transfer of real estate and land use rights that is associated with a transfer of the entire or part of an enterprise's tangible assets, along with the relevant receivables, liabilities and personnel, in the course of an assets reorganization through merger, de-merger, sale or exchange of assets, etc. is not subject to VAT.
- Special housing repair fund collected by the in-charge housing authorities or the delegated entities such as developer, property management service provider etc. on behalf of the house owners is not subject to VAT.
- Transfer of real estate without consideration is deemed as sales, except for purposes of charity or public welfare.
- Real estate leasing service provider is obligated to pay VAT when receiving advance payment.

Face the challenges

As there are significant differences in the tax administration and collection between VAT and BT regimes, the VAT reform will bring significant financial and tax impacts to entities and create challenges to business operations as well as internal control. As the final rollout will take place in less than a month, and first VAT tax filing will be due on the 25 June 2016, we suggest real estate enterprises should prioritize and focus the following key actions:

Before 1 May 2016

- Complete general taxpayer registration, choose appropriate taxation method, purchase tax invoice devices, complete the tasks related to application for VAT invoice from the relevant tax authorities, according to requirements from the tax authority in-charge;
- Estimate and evaluate tax impact, and elect an appropriate taxation method for OREP;
- Consider to formulate sales and purchasing strategies to cope with changes in VAT reform;
- Review business operation model from the angle of separating VAT from sales revenue;
- Complete VAT accounting modification;
- Complete supplier information collection and categorization;
- Complete contract review and modification; and
- Conduct training for management, accounting, and business personnel.

Before 25 June 2016

- Complete the tasks for VAT operational procedures and compliance matters to ensure issuance of General VAT and Special VAT Invoices according to the request of customers; and to verify Special VAT Invoices received from suppliers ;
- Ensure a smooth transition of accounting practice;
- File first VAT return;
- Develop and amend VAT manual; and
- Conduct specific training

After 25 June 2016

- Modify information system structure, develop VAT management system so as to manage VAT and business operations in a systematic manner;
- Optimize business operation flow to improve tax efficiency of real estate business.

For some of our recommendations mentioned above, we further elaborate as follows :

Re-evaluate tax impacts to the real estate business and elect an appropriate taxation method for dealing OREP

OREP may come across different situations: such as a delay in commencement of project development, slow development progress which may lead to large collection of input VAT credit, half-completed project with large input VAT credit to be available later, almost completed project which may not have much input VAT credit available for offsetting output VAT. Real estate developers is suggested to revisit the development progress of OREP for estimating the available input VAT credit against future sales so as to compare the tax impacts under two different taxation methods. Based on the outcome of the systematic analysis, the management should be able to elect an appropriate taxation method.

Please note that, though a general VAT taxpayer of real estate developer may opt for simplified taxation method under specific situations as defined by MOF and SAT, once a taxation method is chosen, it should remain for unchanged for at least 36 months.

Develop sales and purchasing strategies to cope with changes in VAT reform

Based on the performance of real estate market and the bargaining power between contractual parties, strategically implementing a price adjustment at the negotiation process for selling or leasing real estate may help to achieve a favorable outcome for passing on the VAT burden to counter-party. At the same time, in the procurement process, real estate developer, in general, should endeavor to collect all the special VAT invoices when making purchases so as to increase the input VAT for offsetting output VAT, except in the situation where the taxpayer opts for simplified taxation method.

Fully consider the tax impacts of VAT reform and optimize business operation procedures

Taxpayers should review VAT related operation flow and existing business model-

Output VAT

- Understand the sales approach and relevant procedures, resolve the VAT related steps and identify potential risks, re-categorize business items based on the adapted taxation method and corresponding attributes, or consider asset restructuring if appropriate; and
- Review business flow and accounting policies, appropriately separate VAT from sales revenue; accurately account for the VAT-exclusive revenue and corresponding output VAT.

Input VAT

- Understand the procurement approach and relevant procedures, sort out procurement process and identify potential risks, analyze VAT treatment for cost and expense, review business flow and accounting practice, accurately account for the expenses and corresponding input VAT;
- Carefully categorize VAT taxable business / VAT exempted business / business under simplified taxation method, identify input VAT which needs to be allocated between different businesses, determine the rules to calculate the portion of input VAT which is not allowed to be credited (if any); and
- Identify the situation where the credit of input VAT may potentially be challenged and develop solutions.

Improve the following business flows:

- Sales: invoicing and collection, categorization of transaction items, determination of the applicable tax rate, separation of price and tax, invoice management, client management, and potential pricing adjustment;
- Procurement: invoice management, payment and reimbursement, advances, accruals, and suppliers management.

Revisit accounting policies, tax reporting and invoice management, and develop VAT manual

By mapping the VAT related accounting policies into current accounting framework, enterprises are advised to identify key items in the existing accounting system that need to be modified or added, including setting up / adjusting accounts and journal entries, mobilizing the control system for input VAT related to fixed assets, etc. Accurate recording of price and VAT are essential for valid tax reporting.

Enterprises are also advised to develop comprehensive VAT invoice management system, review VAT manual / rules / policies, identify key items need to be modified or added, further improve the existing VAT manual and invoice management system.

Review the existing database for clients and suppliers

Review and re-categorize clients and suppliers if appropriate:

- Clients: distinguish between individuals and enterprises. For enterprise clients, distinguish them between general taxpayers and small-scale taxpayers;
- Suppliers: identify and distinguish supplier's VAT taxpayer status and collect the VAT related information;
- Analyze the issuance of VAT invoices to clients and collection of VAT invoices from suppliers, determine maximum face value and monthly demand for VAT invoices;
- Estimate potential tax impact under different scenarios of issuance and collection of VAT invoice.

Review and revise business contracts to cope with the tax impact brought by VAT Reform

Review sample contracts, identify business terms that may be affected by VAT reform, including:

- Identify and collect sample contracts from different functions including business, financial, operations, and legal departments;
- Identify business terms that are affected under VAT Reform in sample contracts, for example: invoice, price, payment method, etc., propose amendment to business terms after considering the bargaining power between contracting parties; and
- Propose suggestion for contracts covering transitional period for VAT reform, add supplementary provisions for uncertain tax related items, carefully issue invoice / settle amounts prior to the final rollout of VAT Reform.

Conduct VAT reform training

Enterprises engaged in real estate business is recommended to conduct VAT reform training to management, accounting, and business personnel, mainly focusing on the financial impacts, implementation of VAT rules, new accounting policies, business and management processes (including signing of contracts, collecting information of contractual parties, procurement and invoice management), to rapidly respond to the challenges of VAT reform.

Monitor closely the development of the implementation rules and VAT practice of tax authority

There are still unclarified issues in Circular 36. We suggest enterprises in real estate sector should closely monitor the development of the implementation rules and the practice adopted by tax authorities.

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