

# Tax Analysis

PRC Tax

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## VAT Reform – SAT Promulgated Interim Measures Related to Real Estate and Construction Sectors

On 31 March 2016, the State Administration of Taxation (SAT) further released five administrative interim measures in relation to VAT reform for real estate and construction sectors. They are listed as follows:

1. The Interim Measures for Administration and Collection of VAT on Sales of Real Estate (Bulletin of the SAT [2016] No. 14 or Bulletin 14);
2. The Interim Measures for Credit of Input VAT on Real Estate (Bulletin of the SAT [2016] No. 15 or Bulletin 15);
3. The Interim Measures for the Administration and Collection of VAT on Operating Lease of Real Estate (Bulletin of the SAT [2016] No. 16 or Bulletin 16);
4. The Interim Measures for the Administration and Collection of VAT on Cross-county (city, district) Construction Services (Bulletin of the SAT [2016] No. 17 or Bulletin 17); and
5. The Interim Measures for the Administration and Collection of VAT on Sales of Self-developed Projects by Real Estate Development Enterprises (Bulletin of the SAT [2016] No. 18 or Bulletin 18).

All the interim measures will take effect from 1 May 2016. These measures summarize the key policies set out in Caishui [2016] No. 36 (Circular 36) and provide some clarifications in relation to the VAT reform for the real estate and construction sectors.

### Bulletin 14 - Sales of real estate

- Documentary requirement: In the situation where a taxpayer is allowed to deduct the acquisition cost of the real estate from the gross revenue to determine the taxable base for VAT purposes, the taxpayer must provide valid documents to support the acquisition cost; otherwise no deduction will be allowed. The valid documents refer to:
  - § Invoices produced under the supervision of tax authorities;
  - § Court verdict, ruling and mediation, as well as arbitral award and notarized debt instrument; and
  - § Other documents as prescribed by the SAT.
- Tax calculation: A taxpayer who is subject to the 5% provisional VAT must calculate the provisional VAT payable according to the below formulas:

*Where the taxable base is determined according to the gross revenue,*

Provisional VAT payable = Total sales price and additional charges / (1+5%)\*5%

*Where the taxable base is determined by deducting the acquisition cost from the gross revenue,*

Provisional VAT payable = (Total sales price and additional charges - original acquisition cost) / (1+5%)\*5%

The provisional VAT paid at the location where the real estate is situated may be offset against the total VAT payable of the current period. If the provisional VAT paid exceeds the total VAT payable of the current period, the excess may be carried forward to the next period for offsetting.

- Invoice management: In the situation where a small-scale taxpayer sells real estate and is unable to issue VAT invoices by themselves, it may apply to the local tax bureau where the real estate is located for issuing the VAT invoice on the taxpayer's behalf. However, if the real estate is sold to an individual (other than an individual industrial and commercial household), no VAT special invoice is allowed to be issued.
- Tax administration and penalty: In the situation where a taxpayer fails to discharge the provisional VAT payment (to the local tax bureau at the location of the real estate being sold) for more than six months from the month when the provisional tax is due, the national tax bureau at the location of the taxpayer's registration may take recovery actions according to the law of tax administration and collection and its relevant regulations.

#### Bulletin 15 - Credit of input VAT on real estate

- Scope of application: The two-year input VAT credit policy stated in Circular 36 applies to the situation where the real estate is acquired on or after 1 May 2016 and is recorded as fixed assets for financial accounting purposes; and it also applies to the situation where the work of construction in progress of real estate takes place on or after 1 May 2016. However, such policy will not be applied to the input VAT incurred on the following items (regardless of the timing of acquisition of the real estate):
  - § Self-developed real estate projects by real estate developers;
  - § Immovable property acquired under finance leasing arrangement; and
  - § Temporary building and structures at the construction site.
- Input VAT eligible for the credit: In the situation where the real estate is acquired by self-construction (or self re-construction), Bulletin 15 specifies that the input VAT incurred on or after 1 May 2016 for purchasing the goods, design service and construction service that are used for the following projects are eligible for the two-year input VAT credit policy:
  - § Newly constructed real estate; and
  - § Re-construction, expansion, repair and renovation of real estate whereby the original value of the immovable property is increased by more than 50%.

The aforementioned goods refers to the materials and equipment that form part of the real estate property, including decor material, equipment and facilities related to sewage, heating, sanitation, ventilation, lighting, communication, gas, fire control and safety, central air conditioning, elevator, electricity, smart-home facilities and related automation devices.

In addition, taxpayers must obtain valid documents (e.g. VAT special invoices) that are issued on or after 1 May 2016 in order to claim the credit.

- Timing for credit: In general, 60% of the qualifying input VAT is creditable at the month upon receipt of the valid documents to support the input VAT, while the remaining 40% input VAT is creditable at the 13th month after the documents are acquired.

Bulletin 15 also specifies the timing for credit under the following special situations:

- 1) Where the input VAT incurred for goods and services has been fully credited at the time when they were acquired, and subsequently the intended purpose of their usage changes to a real estate project under construction, 40% of the input VAT that has been claimed for credit must be added back to the VAT payable of the period in which such change takes place, and only be allowed to be credited at the 13th month after the change takes place.

- 2) During the two-year input VAT credit period, if the relevant real estate (or its construction in progress) is sold or the taxpayer is deregistered for tax purposes, any input VAT that is eligible for the two-year input VAT credit policy is allowed to be credited in the period when the sale or deregistration clearance takes place.
- Input VAT "transfer out": In the situation where the input VAT associated with a real estate has been claimed for credit, and subsequently such input VAT becomes uncreditable because there is an abnormal loss of the relevant real estate or there is a change in the intended purpose of usage for the real estate (e.g. the real estate was actually used in a business subject to a simplified taxation method, VAT-exempt business, or used for group welfare or personal consumption purposes), such input VAT must be "transferred-out" (i.e. being excluded from the creditable input VAT and possibly added back to the VAT payable) according to the below formulas:

Input VAT to be transferred-out = (Input VAT that has been credited (i.e. the 60% portion) + Input VAT to be credited (i.e. the 40% portion)) \* Ratio of net real estate value

Ratio of net real estate value = (Net value of real estate / original value of real estate) \* 100%

If the amount of input VAT to be transferred-out is less than the input VAT that has been credited (i.e. the 60% portion), such amount must be added back to the VAT payable of the current period when the aforementioned change takes place; if the amount of input VAT to be transferred-out is greater than the input VAT that has been credited, the amount of the input VAT that has been credited must be added back to the VAT payable of the current period when the aforementioned change takes place, and the excess must be deducted from the input VAT to be credited (i.e. the 40% portion) accordingly.

In case of abnormal loss of real estate construction-in-progress, the input VAT associated with the consumed goods and related design and construction services that have been claimed for credit, must be transferred out in the current period, and the remaining 40% input VAT that has not been credited yet will not be allowed for future credit.

- Financial accounting:
  - § Input VAT to be credited (i.e. the 40% portion) must be separately recorded and accounted for different real estate projects by a taxpayer.
  - § A taxpayer must set up separate accounts for each of the real estate projects, record the respective costs and expenses, input VAT credit, etc. and maintain the relevant documents properly. This requirement also applies to real estate projects whose input VAT are not allowed to be credited (e.g. projects used for business subject to a simplified taxation method, VAT-exempt business, group welfare or personal consumption purposes).
- Tax administration and penalty: Where a taxpayer fails to comply with the measures in relation to the credit of the input VAT incurred on real estate projects, the relevant national tax bureaus reserve the right to take recovery actions according to the law of tax administration and collection and its relevant regulations.

#### Bulletin 16 - Operating lease of real estate

- Scope of application: Bulletin 16 indicates that the tax treatments contained therein are not applicable to the highway operation and management business.
- Place of tax payment: In general, where the places of real estate for lease and taxpayer's registration are not located in the same county (city, district), the taxpayer must pay provisional VAT to the relevant national tax bureau at the location of the real estate, and then file and settle VAT with the respective national tax bureau at the taxpayer's place of registration. However, in the situation where the places of real estate and taxpayer's registration are not located in the same county (city, district) but in the same municipality which are directly under the central government (i.e. Beijing, Chongqing, Shanghai and Tianjin) or the same city which are separately listed in the State plan (i.e. Dalian, Ningbo, Qingdao, Shenzhen and Xiamen), the relevant municipality-/city-level national tax bureau is allowed to decide at their discretion whether the provisional VAT is required to be paid at the location of the real estate.
- Tax calculation: A taxpayers who is required to pay the provisional VAT must calculate the provisional VAT payable according to the below formulas:

*Where the general taxation method is used,*

Provisional VAT payable = VAT-inclusive sales amount / (1+11%) \* 3%

*Where the simplified taxation method is used,*

Provisional VAT payable = VAT-inclusive sales amount / (1+5%) \* 5% or 1.5%

The provisional VAT paid at the location where the real estate is situated may be offset against the total VAT payable of the current period. If the provisional VAT paid exceeds the total VAT payable of the current period, the excess may be carried forward to the next period for offsetting.

- **Timing of tax payment:** Where the provisional VAT payment is required according to Bulletin 16, the taxpayer must pay the provisional VAT in the month following the month in which the rental was obtained, or within any period prescribed by the national tax bureau at the location of the real estate.
- **Invoice management:** Where an entity with small-scale taxpayer status or an individual (i.e. an industrial and commercial household or other individual) leases out real estate and is unable to issue VAT invoices by themselves, it may apply to the national tax bureau where the real estate is located for issuing the VAT invoice on the taxpayer's behalf. However, if the real estate is leased to an individual (other than an individual industrial and commercial household), no VAT special invoice is allowed to be issued.
- **Tax administration and penalty:** In the situation where a taxpayer fails to discharge the provisional VAT payment (to the national tax bureau at the location of the real estate being leased) for more than six months from the month when the provisional tax is due, the national tax bureau at the location of the taxpayer's registration may take recovery actions according to the law of tax administration and collection and its relevant regulations.

#### Bulletin 17 - Cross-county (city, district) construction services

- **Place of tax payment:** In general, where a taxpayer provides construction services in a county (city, district) outside of its registration location, it must make provisional VAT payment to the national tax bureau at the location where it provides the construction services, and then file and settle VAT with the national tax bureau at its registration location according to Bulletin 17. However, in the situation where the places of construction service and taxpayer's registration are not located in the same county (city, district) but in the same municipality which are directly under the central government or the same city which are separately listed in the State plan, the relevant municipality-/city-level national tax bureau is allowed to decide at their discretion whether the provisional VAT is required to be paid at the location where the construction services are provided.
- **Documentary requirement (to support deduction of subcontracting payments):** In the situation where a taxpayer is allowed to deduct the subcontracting payments from the gross revenue to determine the taxable base for VAT purposes, the taxpayer must provide valid documents to support the deduction; otherwise no deduction will be allowed. The valid documents refer to:
  - § Construction business tax invoices obtained from subcontractors and issued on or before 30 April 2016, where such invoices can *only* be used to support the deduction by 30 June 2016;
  - § VAT invoices obtained from subcontractors and issued on or after 1 May 2016, where the county (city, district) in which the construction service is rendered as well as the name of the real estate project must be indicated in the remarks column of the VAT invoice; and
  - § Other documents as prescribed by the SAT.
- **Tax calculation:** Based on Bulletin 17, a taxpayer who is required to pay the provisional VAT must calculate the provisional VAT payable according to the below formulas:

*Where the general taxation method is used,*

Provisional VAT payable = (Total sales price and additional charges - Subcontracting payments) / (1+11%)\* 2%

*Where the simplified taxation method is used,*

Provisional VAT payable = (Total sales price and additional charges - Subcontracting payments) / (1+3%) \* 3%

If the balance of total sales price and additional charges after deducting subcontracting payments is negative, it may be carried forward to the next period for deduction.

The taxpayer must separately calculate and pay the provisional VAT by different projects.

The provisional VAT paid at the location where the construction services are rendered may be offset against the total VAT payable of the current period. If the provisional VAT paid exceeds the total VAT payable of the current period, the excess may be carried forward to the next period for offsetting.

- Documentation management: When taxpayers make provisional VAT filings and payments, they must fill in the "Provisional VAT Payment Form", and submit the original and photocopy of the relevant construction contracts and subcontracting contracts, together with the original and photocopy of invoices acquired from subcontractors.

The taxpayer also must maintain the records of each revenue, subcontracting payments paid/deducted, invoice number for the subcontracting payments, provisional VAT paid, tax certificate number for each provisional VAT payment, etc. for each project in different counties (cities, districts).

- Tax administration and penalty: Where a taxpayer provides construction services in a county (city or district) other than its place of registration but fails to discharge the provisional VAT payment (to the national tax bureau at the location where the construction services are provided) for more than six months from the month when the provisional tax is due, the national tax bureau at the location of the taxpayer's registration may take recovery actions according to the law of tax administration and collection and its relevant regulations.

#### Bulletin 18 - Sales of self-developed real estate projects by real estate developers

- Scope of application: Bulletin 18 applies to the sale of self-developed real estate projects by real estate development enterprises. The self-development activities refer to the developers' acquisition of land use rights and construction of basic infrastructure and buildings on the land whose use right they acquired. Bulletin 18 also applies where a real estate developer took over an uncompleted real estate project for further development in its own name.
- Taxable base: For real estate developers who are general VAT taxpayers and opt for general taxation method, the corresponding land cost may be deducted from the total sales amount and additional charges in the current period to determine the taxable base. The calculation formulas are as follows:

Taxable base = (Total sales price and additional charges - Land cost allowed to be deducted in the current period) / (1+11%)

Land cost allowed to be deducted in the current period = (Construction area of real estate project sold in current period / Total saleable construction area of real estate project) \* Land price paid

In the above formulas-

Construction area of real estate project sold in the current period refers to the construction area that corresponds to the sales amount to be reported for VAT in the current period.

Total saleable construction area of real estate project does not include construction area of public and supporting facilities which are not separately accounted for when the real estate project is sold.

Land price paid refers to the acquisition cost of land use right which has been directly paid to the government, the land administration department or the authorized institution that collects the payment on behalf of the government. The taxpayers must obtain valid receipts to support the land price paid and maintain relevant records. The land price which has been deducted from the sales for VAT calculation purpose cannot exceed the total land cost which has been paid by the taxpayer.

- Old real estate projects: For old real estate projects that are eligible for the simplified taxation method, Bulletin 18 modifies the definition under Circular 36 to have it aligned with the definition of "old construction projects". The modified old real estate project refers to:

- § A real estate project whose contract commencement date stipulated on the Construction Permit is not later than 30 April 2016; or
- § A real estate project whose commencement date stated on the construction engineering contract is not later than 30 April 2016, if the contract commencement date is not specified on the Construction Permit or the Construction Permit is not obtained.

- Tax calculation: Circular 36 stipulates that real estate developers who receive advance payments for pre-sale of self-developed real estate project must pay a provisional VAT at 3%. The calculation formula is:

Provisional VAT payable = Advance receipts / (1 + Applicable VAT rate of 11% or VAT collection rate of 5%) \* 3%

The provisional VAT paid may be offset against the total VAT payable of the current period. If the provisional VAT paid exceeds the total VAT payable of the current period, the excess may be carried forward to the next period for offsetting.

- Timing of tax payment: Where the provisional VAT payment is required, the taxpayers must pay the provisional VAT in the month following the month in which the advance payment is received, or within any period prescribed by the tax authority.
- Apportionment of input VAT: For general taxpayers who sell multiple self-developed real estate projects subject to different input VAT treatment (e.g. input VAT incurred for VAT-exempt projects or projects subject to the simplified taxation method is uncreditable, while input VAT incurred for other projects is generally creditable), the input VAT commonly incurred for these projects must be apportioned by reference to the data of construction area specified on the relevant Construction Permit:

Uncreditable input VAT = Input VAT commonly incurred in the current period \* (Construction area of VAT-exempt projects and projects subject to the simplified taxation method / Total construction area of all projects)

- Invoice management:

§ General taxpayers who sell self-developed real estate projects may issue VAT invoices by themselves.

§ Where taxpayers sell self-developed real estate projects, for any pre-sale advance payments which have been received by 30 April 2016 and reported for business tax purposes but the business tax invoice has NOT been issued, the VAT general invoices may be issued; however, no VAT special invoice is allowed to be issued in this situation.

§ No VAT special invoice is allowed to be issued where a taxpayer sells self-developed real estate projects to an individual (other than an individual industrial and commercial household).

§ Small-scale taxpayers who sell self-developed real estate projects may issue VAT general invoices. If the buyer need VAT special invoices, the small-scale taxpayer may apply to the competent national tax bureau to issue the VAT special invoice on its behalf.

- Tax administration and penalty: Where a real estate developer sells self-developed real estate projects but fails to pay VAT (including the provisional VAT), the competent national tax bureau may take recovery actions according to the law of tax administration and collection and its relevant regulations.

## Comments

**Timing of acquisition of real estate:** While the interim measures adopt a broad definition of "acquisition (of real estate)" which includes acquisition of real estate by means of purchase, donation, investment, self-building, repayment of debts, etc., it is unclarified on how to determine the point of time when a real estate is considered as being acquired. The timing of acquiring a real estate is critically important to distinguish between new and old real estate as it will have direct impact on whether a taxpayer is eligible to opt for transitional rules for a particular real estate.

Assuming a taxpayer signed a real estate purchase agreement and made full payment on 1 November 2015, and obtained the key of the real estate and used it on 1 March 2016, yet the property certificate is received on 20 July 2016. Bulletin 14 does not clearly specify on which date the real estate is considered being acquired by the taxpayer.

It is also unclarified whether Bulletin 16 applies to a sub-leasing arrangement and if so, how to determine the time point of acquisition of the real estate for the lessors other than the original owner of the real estate; in particular, whether it is the date on which the original owner acquires the real estate, or the date on which the relevant leasing contract is signed or the lessor acquires the use right.

Assuming Company A purchased and acquired the real estate on 10 March 2016, and subsequently leased the real estate on 20 May to Company B, which further sub-leased it to another entity on 21 May. Company A may either apply for simplified taxation method or general taxation method for the VAT treatment on its leasing income on the basis that Company A acquired the real estate before 30 April (i.e. old real estate). However, if Bulletin 16 is considered applicable to Company B's sub-leasing income, different interpretation to the timing of acquiring the real estate will have different tax impacts on Company B:

- If 10 March was considered the acquisition date for Company B, it may be given the same discretion as Company A to opt for its VAT taxation method. Therefore, Company B may align its taxation method with Company A. However, this treatment may be practically difficult to implement if there are multiple sub-leasing arrangements.
- If 20 May was considered the acquisition date for Company B, it may only apply the general taxation method for its sub-leasing income. Further, when company A opts for simplified taxation method, it may be a challenge for Company B to pass on the tax burden due to the big difference between the tax rates and calculation mechanism under the two taxation methods.

**Two-year credit of input VAT on real estate:** Bulletin 15 provides various clarifications from practical perspective on the implementation of the two-year input VAT credit policy related to acquisition of real estate after 1 May 2016. Although the policy is significantly favorable to the business, it is worth noting that tax authorities lay down some stringent rules in relation to the input VAT management in Bulletin 15. Taxpayers are required to set up separate accounts for each of the real estate project and maintain the relevant records to claim the credit. Therefore, these taxpayers may face challenges from compliance and management perspectives. They are recommended to fully understand the relevant requirements and take the requirements into consideration when designing or modifying their VAT accounting system.

**Obligation for provisional VAT payments:** The VAT reform policy introduces a provisional VAT payment mechanism for real estate and construction sectors. This mechanism could increase the management burden and compliance risk of taxpayers, though the overall tax burden may not be increased. Bulletin 14, 16 and 17 specifically mentioned that a taxpayer could be subject to penalties if it fails to pay the provisional VAT for more than six months. According to the relevant laws and regulations, such penalty ranges from 50% to 500% on the amount of tax overdue. Therefore, taxpayers should not only focus on the overall tax burden but also on the obligations for provisional VAT payments.

In addition, certain municipality or city level tax bureaus may have discretion to decide whether the provisional VAT payment is required in their jurisdictions. Taxpayers in the relevant locations (e.g. Beijing, Shanghai, etc.) should monitor the development of relevant policy and practice to seek the possibility to have the provisional VAT payment obligations waived in order to reduce the compliance burden.

**Invoice and relevant document management:** Bulletin 14, 15, 16 and 18 provides certain guidance in relation to the VAT invoice management. The guidance is aligned with the existing regulations of VAT on goods (e.g. a small-scale taxpayer is normally unable to issue VAT special invoices; if being requested to issue a VAT special invoice, the taxpayer has to apply to the tax authorities to issue the VAT special invoice on the taxpayer's behalf). Nevertheless, VAT invoice management is new to taxpayers in the real estate and construction sectors and it is essential for these taxpayers to be aware of the associated risks at the beginning of the VAT reform implementation.

On the other hand, as provided in Bulletin 14, 17 and 18, certain items are allowed to be deducted from the gross revenue to determine the taxable base for VAT purposes. The deduction must be supported by valid documents. Therefore, the affected taxpayers must ensure the validity of the documents in order to claim such deductions.

While the interim measures have provided clarifications on the VAT treatments in relation to real estate and construction businesses, there are still some open issues where further guidance are needed. It is recommended that relevant taxpayers should closely monitor the future development and maintain communication with the tax authorities. Taxpayers should also take immediate actions to make appropriate adjustments in their financial and accounting systems so as to ensure they have fully complied with the relevant requirements of the VAT reform regulations.

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