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# Tax Analysis

## New VAT Guidance Addresses Industry-Specific Issues


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**On 21 December 2016, China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) issued Circular 140 (i.e. Caishui [2016] No. 140[1]) to clarify certain VAT issues resulting from the VAT reform that became effective in 2016. In particular, the tax treatment of industries, such as financial services and real estate, required additional guidance. On 24 December, the SAT issued a supplementary circular (i.e. SAT Bulletin [2016] No. 86 or Bulletin 86)) that provides additional guidance on the implementation of Circular 140.**

### Financial services

**1. Income derived from the holding of financial products**

**Interest (including income of the same nature, but called a different name, such as principal-guaranteed return, fund usage fee, etc.) derived from the holding of financial products is subject to VAT under the category "loan services." Circular 140 clarifies that "income of the same nature but called principal-guaranteed returns, fund usage fees" refers to income where it is agreed in the contract that the principal can be fully recovered when the financial product matures. The income, therefore, will not be considered interest income and no VAT will be levied if the recovery of principal cannot be guaranteed.**

**This clarification should provide more certainty to taxpayers and standardize the practice in determining whether income derived from the holding of financial products should be treated as interest for VAT purposes. However, it remains to be seen whether and how the financial accounting treatment will impact this issue, since in practice, some tax authorities tend to determine the nature of**

[1] See full text in Chinese: http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201612/t20161221_2494189.html

**income by reference to its accounting treatment. Disputes potentially could arise for certain income that is recorded as "interest income" in a taxpayer's books even if the recovery of the principal cannot be guaranteed according to the relevant contract.**

**Similarly, the main guidance on China's VAT reform (i.e. Caishui [2016] No. 36 or Circular 36) provides that if the investment income is fixed or guaranteed, the income should be considered interest income and thus subject to VAT. However, it is not entirely clear how to determine whether income is "fixed or guaranteed." For example, if the income is computed based on a floating interest rate, will the income be considered fixed or guaranteed and will its accounting treatment be taken into consideration?**

**2. Held-to-maturity financial products**

**A long-disputed issue is whether a redemption of financial products (e.g. bonds) when they mature should be considered a "transfer of financial products" that could trigger a 6% VAT. Circular 140 clarifies that such a redemption is not a transfer of a financial product for VAT purposes, although a taxpayer still should be subject to the 6% VAT for any interest income derived from holding the financial product.**

**3. Overdue interest**

**Circular 36 generally provides that VAT liability will arise when an interest payment becomes due. However, if the interest is overdue for at least 90 days, interest accrued after the 90-day period will be subject to VAT when it is actually received by qualified financial enterprises (e.g. notably banks).**

**Circular 140 expands the scope of "qualified financial enterprises" to include securities firms, insurance firms, finance leasing companies, securities investment funds, fund management companies and other enterprises that are authorized to engage in a financial business by one of the four government regulators (i.e. People's Bank of China, China Banking Regulatory Commission, China Securities Regulatory Commission and China Insurance Regulatory Commission).**

**It is worth noting that certain taxpayers, such as micro credit companies and pawnshops, are permitted to provide loan services by government departments other than the above regulators. Technically, these taxpayers cannot apply for the above VAT treatment.**

**4. VAT payers of asset management products**

**Circular 140 provides that the asset manager of an asset management product should be considered the VAT payer for the product.**

**An asset management product generally refers to an investment plan where an asset manager will manage the investment on behalf of investors that subscribe to the plan. Although the plan may be in the form of a trust or a simple contractual arrangement where no legal entity will be established, the assets and income/expenses of the plan must be accounted for separately from those of other plans, or the asset manager. There has been no clear guidance on which party should be considered the VAT payer of the plan and be responsible for handling the various VAT filing issues in the operation of the plan. The clarification made by Circular 140 seems to significantly increase an asset manager's VAT compliance burden.**

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**Nevertheless, there are some outstanding VAT issues:**

- **Even if the asset manager is considered the VAT payer of an asset management product (i.e. an investment plan), should the product (or the plan) be regarded as an entity distinct and separate from other plans (managed by the same manager) or the manager itself for VAT purposes? If so, the output VAT of a plan cannot be offset by input VAT incurred by other plans (managed by the same manager) or the manager.**
- **Should the VAT invoices of professional firms (e.g. law firms or accounting firms) or underwriters that provide services to the plan be addressed to the plan or to the manager? Should VAT invoices for management service fees charged by the asset manager to the plan be issued by the manager to itself; and if so, can the input VAT be credited by the manager?**
- **Should the investment income be subject to VAT in the hands of the investors after the distribution?**

**5. Pre-reform losses from trading of financial products**

**According to Circular 140, any losses incurred on the trading of financial products during the period January through April 2016 (in which Business Tax, instead of VAT, still applied) may be carried forward to offset the trading gains derived during the period May through December 2016 for VAT purposes.**

**Before the VAT reform, the taxable base of trading of financial products for Business Tax purposes was calculated by offsetting the gains and losses of each taxable period within the same calendar year. It is unclear whether the same method applies after VAT reform. In particular, Circular 140 does not address the following situations:**

- **If a taxpayer derived trading gains during the period January through April 2016, and incurred losses during the remainder of 2016, can the taxpayer apply for a refund of Business Tax by offsetting the gains and losses for the two periods?**
- **If a taxpayer derived trading gains during the period January through November 2016 and incurred losses in December, can the taxpayer apply for a refund of VAT by offsetting the gains and losses?**

**6. Finance leasing business**

**According to Circular 36, finance leasing companies whose establishment are approved by the competent government authorities (e.g. the People's Bank of China, China Banking Regulatory Commission, Ministry of Commerce, etc.) are allowed to deduct certain items from their gross revenue for VAT purposes. Due to the recent regulatory relaxations, formal approval may not be required to set up a finance leasing company; instead, a filing (i.e. reporting) requirement with the relevant government authorities may apply. Circular 140 confirms that these companies are eligible for the above VAT treatment even though they have not received approval for their establishment.**


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## Real estate sector

**1. Deductible land acquisition costs**

**According to Circular 36, a real estate developer that is a general VAT payer is allowed to deduct the land acquisition costs from its gross revenue to calculate the VAT-able sales.[2] In addition to deducting the purchase price of the relevant land use right, Circular 140 provides that the following two items will be considered deductible land acquisition costs:**

- **Relocation compensation and initial land development fees paid to the government; and**
- **Relocation compensation paid to other parties when the developer acquires the land use right.**

**Because these items represent a significant portion of the land acquisition costs of real estate developers, Circular 140 is favorable to developers whose VAT-able sales may be significantly reduced by the deductions.**

**2. Entity entitled to deduction**

**After a real estate developer (or multiple developers, if a consortium is formed) pays the purchase price for a land use right to the government, the original developer(s) often sets up a new company to assume the future development work. There has been no guidance on whether the new project company (instead of the original developer(s)) can deduct the land acquisition costs from gross revenue for VAT purposes. Circular 140 confirms that the new project company may deduct the costs if all of the following conditions are satisfied:**

- **The original developer(s), the new project company and the government conclude a supplementary contract in which they agree to change the acquiring party of the land use right to the project company;**
- **No changes are made to the use, the development plan or purchase costs of the land; and**
- **The new project company is wholly owned by the original developer(s).**

**3. Timing of deduction**

**According to Bulletin 86, if the newly clarified deductible items have not yet been deducted, taxpayers may start taking the deduction as from December 2016.**

4. **Real estate leasing services**

**Bulletin 86 clarifies that the "deemed sales" rule should not apply to a rent-free period.**

## Miscellaneous

**1. Takeaway food by restaurants**

**Before the VAT reform, restaurants normally were subject to the 5% Business Tax, except for sales of takeaway food, which was subject to VAT under the category the "sale of goods" (for which the tax rate is 13% or 17%). Circular 140 clarifies that, after the VAT reform, the sale of takeaway food by restaurants should be subject to VAT under the category "catering services" (taxed at a rate of 6%). Therefore, a restaurant (with general VAT payer status) no longer will have to separately account for its general catering services and sales of takeaway food, since both are subject to a 6% VAT.**

**However, Circular 140 does not specifically indicated whether takeaway food that was not prepared by the restaurant still can qualify for catering services treatment. If the takeaway food is not made by the restaurant, it appears that the tax authorities could treat the food as goods and, therefore, a 13% or 17% VAT would be applied.**

**2. Convention and exhibition services**

**Where a hotel or resort operator provides meeting venues and relevant support services to conference events, Circular 140 clarifies that the operator should be subject to VAT under the category "convention and exhibition services."**

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[2] **No deduction is allowed for certain old projects if the taxpayer opts for a simplified taxation method.**

### 3. Education assistance services

**Circular 140 provides that a general VAT payer may elect to adopt the simplified taxation method at a 3% VAT collection rate for revenue derived from education assistance services (e.g. services relating to assessment, examination or college admissions).**

## Implementation of new guidance

**Most articles in Circular 140 apply retroactively as from 1 May 2016. Any overpaid VAT resulting from the retroactive implementation may be offset against future VAT payable. However, for activities that are not subject to VAT according to Circular 140 but VAT has been accounted for and paid and the relevant VAT special invoices were issued, the retroactive adjustment will be allowed only if the VAT special invoices are withdrawn and cancelled.**

**If a taxpayer applied a VAT rate higher than the rate provided under Circular 140, the overpaid VAT output may be offset against future VAT output. On the contrary, if a previously applied VAT rate is lower than the rate provided under Circular 140, no retroactive adjustment is necessary and the taxpayer should apply the correct rate starting from December 2016.**

**Circular 140 is silent on whether a refund (instead of the offsetting against future VAT payable) is allowed for overpaid VAT due to the retroactive adjustments. This could be an issue if the amount of overpaid VAT is significantly higher than the future VAT payable. Affected taxpayers may wish to discuss the issue with the tax authorities to assess the feasibility and practicability of a refund of overpaid VAT.**

## Comments and recommendations

**The two circulars generally should be welcome by businesses since they clarify certain typical industry-specific VAT issues. Some clarifications are favorable to taxpayers (e.g. the expansion of deductible land acquisition costs and the inclusion of sales of takeaway food as catering services), while some may increase the VAT compliance burden of certain taxpayers (e.g. asset managers).**

**With the rollout of VAT to all sectors of the economy, undoubtedly more issues will emerge and require clarification. The MOF and SAT are expected to issue more guidance so taxpayers should continue to monitor developments.**

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