

Tax

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Tax Analysis

VAT on Asset Management Products Postponed

China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) issued guidance (Circular 56¹) on 30 June 2017 that clarifies the VAT treatment of asset management products and asset managers and postpones the introduction of the new rules to 1 January 2018. Circular 56 provides that the simplified VAT method at a rate of 3% will apply on VAT-able activities relating to asset management products.

Although historically VAT or Business Tax has not been levied on VAT-able activities relating to asset management products, the SAT issued a circular (Circular 140²) in December 2016, which provided that asset managers of asset management products would be the VAT taxpayers for VAT-able activities relating to asset management products, with retroactive effect to 1 May 2016 (the date the VAT reform took effect).

The circular caused widespread concern throughout the industry, with asset managers arguing that the VAT could have a negative impact on the industry, give rise to double or multiple taxation and significantly increase administrative costs. In response to complaints raised by asset managers in the sector, the MOF and the SAT issued further guidance in January 2017 (Circular 2), which granted a 14-month postponement on the imposition of VAT on asset management products, to 1 July 2017. Circular 56 has further delayed the introduction of the rules for another six months, to 1 January 2018, giving taxpayers more time to take steps to prepare for the new rules.

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¹ See full text in Chinese: http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201706/t20170630_2635146.html

² See Deloitte Tax Analysis on Circular 140:

<https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2016/deloitte-cn-tax-tap2542016-en-170106.pdf>

Highlights of Circular 56

Scope of covered asset management products and asset managers

Circular 56 broadly defines asset management products and asset managers to include the following:

Asset management products	Bank financial products, trust funds (including collective and single trust funds), property right trusts, public securities investment funds, asset management plans for specific customers, collective asset management plans, targeted asset management plans, private equity investment funds, debt investment plans, equity investment plans, debt-equity combination investment schemes, asset-backed securities investment plans, asset management products issued by insurance asset management companies and pension management products
Asset managers	Banks, trust companies, public-funds management companies and their subsidiaries, securities companies and their subsidiaries, futures companies and their subsidiaries, private equity fund managers, insurance asset management companies and pension insurance companies

Circular 56 seems to apply regardless of the legal form of the asset management product, although it generally is believed that the circular is targeted at products that are established on the basis of contractual arrangements without forming entities (e.g. companies or partnerships). It may be necessary for the authorities to clarify whether Circular 56 applies to certain investment products (notably certain private equity funds) that are established in such vehicles as companies or partnerships.

Given the rapid development of the asset management industry and the proliferation of products, Circular 56 also provides that the scope of the guidance could be further expanded by the authorities to encompass products not listed above.

Simplified VAT calculation method

The simplified VAT calculation method will apply to VAT-able activities relating to asset management products, at a rate of 3%. One main difference between the simplified VAT calculation method and the general VAT method is that input tax may not be deducted under the simplified method.

Transaction structures in the asset management industry are by their very nature complicated. The industry has expressed concerns that the introduction of VAT could lead to double or multiple taxation (e.g. with VAT applying on gains or income from the holding of the underlying assets in a fund or trust, and then again when distributed to investors). There also is potential for practical issues to arise if a 6% financial services VAT is applied under the general VAT calculation method (e.g. whether the manager can

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issue an invoice to itself (since it is the taxpayer for VAT purposes) for the management services it provides to the product, how the input VAT relating to the services shared by multiple products should be apportioned among these products, etc.).

The introduction of the lower rate (3% versus. 6%) may help to mitigate the negative impact of double or multiple taxation and the simplified VAT method should reduce the compliance burdens on asset managers that otherwise would exist under the general VAT calculation method. Since little input VAT normally is incurred on asset management products, it is likely that the VAT burden under the simplified VAT calculation method could be lower than that under the general method.

Tax accounting

The 3% VAT under the simplified VAT calculation method will apply only to the VAT-able activities relating to asset management products. Therefore, an asset manager will need to separately account for the taxable revenue and VAT payables of VAT-able activities relating to asset management products and that from other business activities (e.g. management services provided by the manager to the products). Otherwise, the 3% rate will not be available.

As a result, an asset manager may have to apply a different calculation method to different business activities. Where an asset manager has general VAT payer status, the VAT-able activities relating to asset management products will be subject to the 3% VAT under the simplified VAT calculation method; however, the asset management income earned by the manager still should be subject to the 6% rate under the general VAT method.

VAT calculation for multiple products

An asset manager typically manages multiple products, which could create challenges for VAT purposes. Issues may arise, such as whether gains and losses from the transfer of financial instruments derived by different products can be offset, or how relevant taxable gains should be allocated among different products. Circular 56 provides a flexible approach, by allowing asset managers to elect whether to calculate taxable revenue and VAT payable for multiple products on an aggregate basis or on a product-by-product basis.

VAT filing

Circular 56 provides that the asset manager should file the VAT return for asset management products along with its return for the manager's own business, and the filing period for asset management products will be the same as that for the manager's business. In other words, VAT returns will have to be filed on a quarterly basis for asset management products managed by banks and trust companies, while the returns for products managed by other types of entities generally will have to be filed monthly.

Implementation date

To provide additional time for the industry to prepare, Circular 56 pushes back the implementation date to 1 January 2018. No VAT will be imposed on VAT-able activities relating to asset management products before that date, and if an asset manager has paid VAT on such activities, the tax may be offset against the manager's future VAT payable.

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Observation and recommendations

The indirect tax treatment of asset management products has been a grey area with little guidance available even before the VAT reform. The issuance of Circular 140 generated considerable controversy with its mandate that managers of asset management products should be VAT payers for VAT-able activities relating to asset management products. Some practitioners even question the legitimacy of having asset managers be VAT payers in these cases because the products are held and managed by the manager on behalf of investors in many situations. Another concern is the negative impact of potential double or multiple taxation as a result of the complicated transaction structures.

Circular 56 should be welcome by the industry to some extent, since the introduction of a simplified VAT calculation method may help simplify the asset managers' VAT management responsibilities, and the adoption of a lower rate could mitigate the effects of double/multiple taxation. Finally, delaying the introduction of the rules to 1 January 2018 provides the industry with more time to review existing contracts, make adjustments to take the VAT into consideration and generally prepare for the new taxing environment.

Nevertheless, asset managers should be aware of the following:

- *Drafting of legal instruments:* Some practitioners have expressed their concern about a potential conflict between Circular 140 and other laws. For example, the Law on Securities Investment Funds provides that any tax arising from an investment made by fund assets should be borne by the fund investors, and the fund manager only can act as the tax withholding agent, not the taxpayer. Asset managers must take care when drafting tax-related terms of legal instruments (e.g. investment contract, legal declarations, etc.) for asset management products to address the risk of potential legal disputes in relation to the VAT burden.
- *Equitable taxation of products:* Fairness of taxation among different types of products is another concern. Securities investment funds are exempt from VAT on gains derived from the disposal of stock or bonds and interest from certain financial bonds. However, other asset management products may not enjoy the same treatment. It also is unclear whether the redemption of non-fixed term products would be treated the same as fixed-term products (if held to maturity) for VAT purposes. Asset managers should monitor developments carefully since the government may update its policies in this area.
- *NAV calculation and disclosure:* The introduction of VAT will affect the calculation and disclosure of net asset value (NAV) of asset management products, where NAV normally plays a key role in helping investors make decisions to invest the product. This will be a challenge for managers of products whose NAV must be calculated frequently and disclosed (e.g. on daily basis), and who are advised to develop a reasonable calculation method that is consistent with industry practice.
- *Products established before 2018:* Issues remain open for asset management products that are established and issued before 1 January 2018; for example, where the funds of a product were used to grant a loan before 1 January 2018, but all interest on the loan is received after that date, will VAT be imposed on all of the interest or just that accrued after 1 January 2018? Where funds are used to purchase stocks or bonds before 1 January 2018, but the securities are to be sold thereafter, how should the manager determine the deductible cost (i.e. the original purchase price or the market value of the securities on 1 January 2018 as if they were purchased on that date) when computing the VAT-able revenue? Can a loss incurred on the disposal of securities before 1 January 2018 be used to offset taxable gains derived thereafter?
- *Automated solutions for VAT management:* Asset managers commonly manage a variety of products. Given the complex VAT implications for asset management products, asset managers should consider setting up automated solutions with system tools to achieve effective and efficient VAT compliance management. According to the VAT reform experience in financial industry, the government is expected to issue further guidance to address specific issues, and hence the manager must ensure the scalability and flexibility of its system to accommodate these changes in the future. Also, the development of system tools calls for close collaboration among various departments, such as finance, sales, IT, etc.—affected managers should plan ahead.

Overall, the next six months will be crucial for the asset management industry to prepare itself for the introduction of VAT on asset management products. Asset managers should consider the following steps:

- Review existing asset management contracts/products and determine the relevant tax treatment and/or whether and how the VAT burden will be shared;
- Update legal documents of asset management products, including product contracts, memorandum, asset management contracts, etc. by taking VAT implications into account;
- Draft communication documents with counterparties (e.g. custodians, investors, lawyers, investment advisors, etc.), where necessary;
- Establish VAT accounting process and adjust the valuation models of products accordingly;
- Design appropriate VAT invoice management process for asset management products;
- Develop a VAT management process for asset management products; and
- Develop automated VAT compliance solutions and update existing systems in areas such as product valuation, tax accounting, invoice management, tax filings. etc.

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