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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited’s Newsletter Covering Technical Development in Taxation

THE COMPLETION OF VAT REFORM PROGRAM

On 26 October 2011, the Chinese State Council officially announced the launching of a pilot Value Added Tax (“VAT”) reform program (“Pilot Program”) to be carried out in three phases. In phase 1, the initial trial (effective 1st January 2012) was applicable to transportation industry and certain modern services industries (“Pilot Industries”) in Shanghai. In phase 2, the Pilot Program was further rolled out to other regions for the Pilot Industries during the years of 2012 and 2013. The VAT Reform Program now reaches its final stage under which full VAT reform will be rolled out nationwide for all service industries.

On 24 March 2016, China’s Ministry of Finance (“MOF”) and State Administration of Taxation (“SAT”) jointly issued Circular Caishui [2016] 36 (Circular 36) announcing the nationwide rollout of the VAT reform program, which sets out the final implementation rules applicable to all service industries, including expansion of China’s VAT system to several sectors such as real estate, construction, financial services and lifestyle services, which will take effect from 1 May 2016.

In this Tax Flash, we aim to provide you with a summary of the major issues covered by Circular 36.

I. VAT Policies under the Reform Program

Classes of VAT Payers

There are two classes of VAT Payers:

- “General VAT Payers” – Enterprises engaged in the service industries with annual turnover of RMB 5 million or above; and
- “Small Scale VAT Payers” – engaged in the service industries with annual turnover of less than RMB 5 million. Small Scale VAT Payers may voluntarily apply for General VAT Payer status if certain conditions are met.

Applicable VAT Rates

The applicable VAT rates for different classes of VAT Payers under the Reform Program are set out below:

Classes of Taxpayers	Type of Services	VAT Rate
General VAT Payers	- Leasing of movable property	17%
	- Transportation services - Construction services (*) - Real estate (*) - Transfer of intangible assets (*) - Sale of immovable properties (*)	11%
	- Research & Development (“R&D”) and technology services; - Information technology services; - Cultural and creative services; - Logistics auxiliary services - Authentication & consulting services - Financial services (*) - Lifestyle services (i.e. food & beverage, hospitality and other services) (*)	6%
Small Scale VAT Payers	- All services included in the VAT reform program	3%

(*) Types of services newly included under Circular 36

VAT zero rating and VAT exemption

Pursuant to Circular 36, the provision of the following services will be eligible for VAT zero-rating:

- Qualified international and air transportation services
- Provision to overseas service recipient(s) the following services which are entirely consumed outside China :
 - R&D services
 - Design services
 - Production and distribution of broadcasted films and television programs
 - Software services
 - Design and testing of electric circuits
 - Information system services
 - Business process management services
 - Offshore outsourcing services

If the service provider is a General VAT Payer, “Exempt, Credit and Refund Method” or the “Exempt, Refund Method” should be applied. For small scale VAT Payers, the related services will be VAT exempted.

Circular 36 also stipulates that the provision of the following services will be VAT exempted, unless otherwise specified to apply zero VAT rate:

- Engineering and exploration services with the related project or mineral resources located outside China
- Overseas conferencing and exhibition services
- Overseas storage services
- Movable property leasing services for which the object of leasing is located outside China
- Provision of broadcasting services outside China
- Provision of cultural and sports services, education and medical services and travel services outside China
- Provision of postal services, delivery services and insurance services for exported goods
- International transportation services provided without using its carrier
- Provision of financing and other financial services to overseas service recipient(s) unrelated to goods, intangible assets and immovable property located in China
- Unlicensed international transportation services which do not qualify for VAT zero-rating
- Provision to overseas service recipient(s) the following services and intangible assets which are entirely consumed outside China :
 - Telecommunication services
 - Intellectual property services
 - Logistics auxiliary services (except storage services)
 - Certification, authentication and consulting services
 - Professional technology services (e.g. meteorologic services, seismological services, marine meteorologic services, city planning, monitoring of environment and ecology)
 - Business auxiliary services
 - Advertising services where the advertisement shall be released outside China
 - Intangible assets

Cross-border services

The provision of following services would be considered as outside China and the revenue is not subject to VAT:

- Services provided by an overseas enterprise/individual and entirely consumed outside China;
- Intangible assets provided by an overseas enterprise/individual and entirely used outside China;
- Movable property leased by an overseas enterprise/individual and this movable property is entirely used outside China.

II. Highlights of Circular 36

Mixed and multiple sales

A transaction which involves both sale of goods and provision of services is considered as mixed sales. The applicable VAT rates for taxpayers who engage in mixed sales would be determined by the main business activities of the taxpayer. For taxpayers who are mainly engaged in the production, wholesaling and retailing of goods, the income derived from mixed sales will be subject to VAT rate applicable to sale of goods, i.e. 17% or 13%. For other taxpayers, the income derived from mixed sales will be subject to VAT rate applicable to specific types of services.

The taxpayers who are engaged in various types of activities which are subject to VAT, e.g. sale of goods, provision of services, sale or transfer of intangible assets and immovable property, they would be subject to the VAT rate applicable to the specific type of activities, provided that the price has been separately accounted for. If the price has not been separately accounted for, the highest VAT rate would be applied to the entire sales amount.

Net basis method

Certain service industries, e.g. finance leasing services, air transportation services, travel services, agency services, are allowed to deduct certain expenses from the sales amount and report the sales amount on a net basis for VAT purpose.

Input VAT credit for purchase of property

For properties purchased on or after 1 May 2016 which have been subject to VAT at 11%, and the purchaser is registered as a general VAT tax payer, the taxpayer can claim input VAT credit in its VAT return. The input VAT credit has to be spread over a 2-year period following the purchase, with 60% of the input VAT credit claimable in the first year, and the remaining 40% claimable in the second year.

No input VAT credit for lending services consumed

In general, enterprises which are registered as general VAT taxpayers will not be eligible to claim input VAT credits for interest expenses, or for fees and charges relating to loans.

III. Rules Specific to Certain Industries

a. Construction and real estate industry

Transitional relief

For properties whose construction commenced before 1 May 2016, or for properties which are held as at 1 May 2016 and are later sold or leased, the developers could apply the simplified VAT calculation method, under which VAT rate of 5% is imposed on the taxable amount.

Deemed input VAT credit for the purchase of land use rights

When the developers sell properties, they will be eligible to deduct from the sales proceeds the cost of acquiring land use rights from the local government authority in calculating their VAT liability. This calculation method is only applicable to developers which apply 11% VAT rate on its sales.

VAT exemption for sales of owner occupied or residential investment properties

The sales of residential properties held by individuals will be subject to a 5% simplified VAT rate if they are sold within 2 years of purchase, and exempt from VAT if sold 2 years or more after purchase (except for 'high-end' properties located in Beijing, Shanghai, Guangzhou and Shenzhen, where 5% simplified VAT method applies to the gain after 2 years).

b. Financial services industry

The major points applicable to financial services industry are as follows:-

- 6% VAT will apply to major forms of income derived from financial services, including interest income on lending transactions, on general banking, asset management, securities and trust related services.
- No transitional arrangement for financial services industry.
- Input VAT on interest expenses, fees and charges directly related to loan services incurred by general VAT taxpayers will not be creditable.
- Banks, financial companies, trusts, credit cooperatives are allowed to perform VAT filing on a quarterly basis.

c. Lifestyle services industry

The major points applicable to lifestyle services industry are as follows:-

- Lifestyle service is a new type of service introduced in the VAT implementation rules. Lifestyle service includes “cultural and sports services, education and medical services, travel and entertainment, food and beverage, accommodation and citizens daily services”.
- “Citizens daily services” is a new category which includes activities such as home assistance services, wedding planning services, elderly care, funeral services, emergency services, beauty, hairdressing, massage and related spa services.
- No transitional arrangement for lifestyle services industry. 6% VAT will apply to most of the lifestyle services.
- Input VAT credits are only allowed for cultural and sports services, education and medical services as well as travel services.
- No VAT input credit is allowed for food and beverage services, entertainment services and citizens daily services.

Food and beverage services

- Food and beverage services only refer to the provision of food and beverage services to customers in a physical location. The food and beverage service operators which only offer take away or delivery services would be considered as engaging in the sale of food products, which is subject to VAT at 17% or 13%.
- No input VAT credit is allowed for food and beverage services.

Accommodation services

- Input VAT credit is allowed for hotel charges where an individual staying at the hotel for business purpose but not for personal consumption.

Travel services

- Travel services are allowed to deduct certain expenses (e.g. accommodation charges, transportation charges, food and beverage costs, visa fees, entrance fees) from the sales amount and report the sales amount on a net basis for VAT purpose.

IV. Suggested Actions

With the completion of VAT reform program, the growth and development of the service sector shall be enhanced as specialization through multi-level subcontracting would not suffer additional business tax burden and export of services shall enjoy zero-rated or exemption treatment. The implementation rules on VAT reform program will be effective from 1st May 2016, enterprises should now begin to prepare for new rules and requirements, as well as changes to their internal systems that may be necessary such as:-

- Estimate the possible impact on the actual tax burden, especially in cases where the new VAT rates are higher than the current BT rates, e.g. financial services, construction services (for those enterprises not eligible for transitional arrangement);
- Provide sufficient flexibility when drafting tax clauses in commercial contracts and seeking modifications to existing clauses where necessary and feasible;
- Enterprises which conduct mixed or multiple sales should ensure that the price for each type of services are clearly accounted for;
- Enterprises should make good use of the new type of input VAT credit, e.g. input VAT credit for purchase of property; and
- Prepare for new rules and requirements, closely monitoring the development and issuance of the detailed rules and seeking clarification and confirmation from the authorities, where possible.

RSM Tax Advisory (Hong Kong) Limited

RSM Hong Kong's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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