



Issue 13 | 1 Sept 2016

## China Alert

## Full Transformation from Business Tax to Value Added Tax in China

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On 23 March 2016, China's Ministry of Finance ("MOF") and State Administration of Taxation ("SAT") jointly issued tax circular Caishui [2016] No. 36 "Notice on the Comprehensive Roll-out of Business Tax to Value Added Tax Transformation Pilot Program" ("Circular 36"). Circular 36 clearly defines from 1 May 2016 onward, transformation of Business Tax to Value Added Tax ("B2V") would be implemented comprehensively in China with the scope of Value-Added Tax ("VAT") extended to construction, real estate, financial services and lifestyle services and the current VAT rules for transportation services, modern services, postal and telecommunication services would be amended. Circular 36 also clearly defines the cross-border tax exemption and zero rate policy for sectors newly included in B2V. With China's implementation of VAT to cover all goods and services, the long-established Business Tax ("BT") will officially come to an end in history.

Circular 36 is composed of the notice and the following four appendices:

1. Implementing Measures for B2V Pilot Program
2. Provisions on Matters Concerning B2V Pilot Program
3. Provisions on the Transitional Policies for B2V Pilot Program
4. Provisions on VAT Zero Rate and Tax Exemption Policy Applicable to Cross-Border Taxable Activities

Circular 36 took effect from 1 May 2016, superseding Caishui [2013] No. 106.

Highlights of Circular 36 are as below:

### 1. Taxpayers and charging scope

According to Circular 36, entities and individuals who sell services, intangible assets or immovable properties within China are defined as VAT taxpayers.

Circular 36 adjusted the charging scope of VAT with two newly introduced categories, sales of intangible assets and immovable properties. The category of sales of services is further divided into seven sub-categories, namely transportation services, postal services, telecommunication services, construction services, financial services, modern services and lifestyle services.



Circular 36 further defines the previous annotation of the charging scope of each item of the sales of services, intangibles and immovable properties which include

- Reclassifying “Technology Transfer and Technology Consulting” from “R&D and Technology Services” to “Sales of Intangibles” and “Verification and Consulting Services” respectively;
- Reclassifying “Freight Forwarding and Customs Agency” from “Logistics Auxiliary Services” to the new category named “Business Auxiliary Services”;
- Moving “Valued-added Information System Services” from “Business Process Management” to a separate new chapter;
- Reclassifying “Financial Sale and Leaseback” from “Tangible Movable Property Leasing Services” to “Financial Services”;
- Redefining some of the services in “Logistics Auxiliary Services” as “Non-carrier Transportation Services” and reclassifying them into “Transportation Services”

It is worth noting that Circular 36 gives a detailed explanation of current intangible assets to include franchise right, membership, virtual goods of internet games, domain names, etc. in the scope of VAT.

According to Circular 36, taxable activities refer to sales of services, intangible assets or immovable properties with compensation. Compensation refers to currency, goods or other economic benefits acquired. Sales of services, intangible assets or immovable properties in non-operating activities do not belong to taxable activities arisen and therefore not subject to VAT.

Clause 12 of Appendix I of Circular 36, the “Implementing Measures for B2V Pilot Program” defines sales “within China” as follows:

- where the seller or the purchaser of the services (except for leasing of immovable properties) or intangible assets (except for using rights of natural resources) are located in China;
- where the immovable property which is being sold or leased, is located in China;
- where the natural resources of which using rights are being sold, are located in China; and
- other situations as provided by the MOF and SAT.

Circular 36 also lists the following cases which are not considered as sales of services or assets “within China”:

- where the services sold by overseas entities or individuals to entities or individuals in China fully take place outside of China;
- where the intangible assets sold by overseas entities or individuals to entities or individuals in China are exclusively used outside of China
- where the movable and tangible assets leased by overseas entities or individuals to entities or individuals in China are exclusively used outside of China; and
- other situations as provided by the MOF and SAT.

To close the loopholes of tax levy, Circular 36 stipulates that free services provided by entities or sole proprietorship businesses and free transfer of intangible assets or immovable properties conducted by entities or individuals are all included in “deemed sales” taxable activities. To encourage philanthropy, community charity events or public oriented activities are excluded from “deemed sales” taxable activities.



## 2. VAT Rates and Collection Rates

Circular 36 stipulates that the VAT rates for taxable activities are 6%, 11% and 17%.

Apart from a 5% collection rate applies to specified provisions and certain sales and lease of immovable properties on basis of transitional rules, the taxable activities arising from small scale VAT taxpayers and the specified taxable activities arising from general VAT taxpayers are levied at a 3% VAT rate.

In addition, complying with specified requirements, a zero rate or tax exemption treatment will apply to the cross-border taxable activities of entities and individuals inside China. For zero-rated sales of services or intangible assets conducted by entities and individuals inside China, the taxpayers concerned may abandon the zero rate treatment and choose tax exemption or pay VAT as prescribed. Taxpayers are not allowed to apply for the zero rate treatment within 36 months after giving it up.

## 3. VAT taxpayers and the timing of tax obligation arising

VAT taxpayers can be classified as general and small scale taxpayers with the taxable activities arisen and annual taxable turnover as criteria. The “Provisions on Matters Concerning B2V Pilot Program” clearly define taxpayers with taxable annual turnover exceeding RMB 5 million as general VAT taxpayers, and taxpayers with taxable annual turnover not more than RMB 5 million as small scale VAT taxpayers.

Timing of the VAT payment / withholding obligation are as below:

- a. If taxpayers sell services, intangible assets and immovable properties, the VAT obligation shall arise on the date when the taxable activities occur and the taxpayers receive the payment for sales amount or evidence of obtaining sales amount. If VAT invoices were issued before the aforesaid, the VAT obligation shall arise on the invoice issuance date.

Receipt of payment for sales amount refers to payment received by taxpayers during the process or after completion of sales of services, intangible assets and immovable properties.

The “date” on which evidence of obtaining sales amount refers to the payment date confirmed in the written contract. If no written contract is concluded or no payment date is specified in the contract, the “date” should be the date on which the services, transfer of intangible assets are completed or the ownership of immovable properties changes.

- b. If taxpayers adopt the prepayment method for the provision of construction services and leasing services, the VAT obligation shall arise on the date when receiving the prepayment.
- c. If the taxpayers are engaged in transfer of financial commodity, the VAT obligation shall arise on the date when the ownership of financial commodity is transferred.

- d. If deemed sales occur, the VAT obligation shall arise on the date when the services and transfer of intangible assets are completed or the ownership of immovable properties changes.
- e. VAT withholding obligation shall arise on the date when the VAT obligation of taxpayers occurs.

#### **4. Withholding VAT on foreign entities and individuals with taxable activities occurred in China**

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Foreign entities or individuals sell services, intangibles or immovable properties in China without setting up any operational establishments within China, the VAT withholding agents should calculate the amount of withholding VAT based on the following formula:

Amount of withholding VAT = Price paid by purchaser ÷ (1 + tax rate) x tax rate

##### **Example**

A foreign company without setting up any operational establishments inside China provides consulting services to a domestic taxpayer and the contract price is RMB 1 million. Since services purchaser is the VAT withholding agent, purchaser should compute the amount of withholding VAT as follows:

Amount of withholding VAT = RMB1 million ÷ (1+6%) x 6% = RMB 56,600

Regarding VAT withholding agent, the Provisional Regulations of the PRC on Valued-Added Tax and Caishui [2013] No. 106 stipulate that entities or individuals outside China who have not set up operational establishments but have agents inside China, the agents are regarded as withholding agents for taxable activities. Entities or individuals outside China who do not have agents inside China, the purchasers/recipients of taxable services are VAT withholding agents. Circular 36 further defines the withholding agents, given that entities or individuals outside China have not set up operational establishments within China, no matter they have agents or not, the purchasers are regarded as VAT withholding agent.

#### **5. Concurrent operation and mixed sales**

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Circular 36 provides rules regarding concurrent operation and mixed sales. In concurrent operation where a taxpayer is engaged in sales of goods, services, intangible assets and immovable properties that are subject to different VAT rates or collection rates, the taxpayer should separately account for the sales revenue attributable to items of different rates; otherwise, the highest rate will apply. Where a transaction involves both sales of goods and services, it is regarded as mixed sales. For taxpayers of entities and sole proprietorship business engaged in manufacturing, wholesale or retails of goods, or mainly engaged in the aforesaid operation, the mixed sales will be treated as sales of goods for VAT; for other taxpayers, the mixed sales will be treated as sales of services for VAT.





## 6. Reasonable commercial purpose

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Circular 36 stipulates that tax authorities have the right to determine the sales amount of taxable activities provided by a taxpayer where it is obviously high or low and without reasonable commercial purpose. The term “without reasonable commercial purpose” refers to the pursuing of tax benefits as the primary objective and through the use of artificial arrangements to reduce, exempt, defer VAT payments or increase VAT refund.

## 7. Input VAT credit

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Circular 36 added the following input VAT items that are not creditable:

- In case of abnormal loss of an immovable property, the input VAT on the acquisition of the immovable property, and the goods, design and construction services consumed in such immovable property;
- In case of abnormal loss of construction-in-progress (“CIP”) for an immovable property, the input VAT on the acquisition of the goods, design and construction services consumed in such CIP;
- Input VAT on the acquisition of loan service, catering service, resident daily service and entertainment service, including input VAT incurred on investment/financing advisory fees, commission charges and consulting fees directly related to the loan borrowed in the loan service.

Circular 36 also includes immovable properties in input VAT creditable items. When a VAT general taxpayer acquires an immovable property after 1 May 2016 and classifies the immovable properties as fixed assets for financial accounting purposes or acquires an immovable property CIP after 1 May 2016, the input VAT incurred may be credited 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. But the above-mentioned policy will not apply to real estates self-developed by real estate developers and immovable properties acquired through finance lease.

## 8. Net basis method

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Circular 36 introduces special rules for certain industries, allowing financial leasing, air transportation, brokerage and agency, tourism business, etc. to compute the VAT payable amount based on the balance resulted from the gross sales amount less certain specified expenditures.

## 9. Special rules for construction services

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According to Circular 36, the construction sector shall be subject to the general VAT method with 11% VAT rate. The rules stipulate that a taxpayer may opt to pay VAT under the simplified taxation method for the following items:

- A general taxpayer who provides construction services in the form of contracting labour services arrangement
- A general taxpayer who provides construction services under a model where the project owner purchases all or part of the equipment, materials and energy;
- A general taxpayer who provides construction services for old projects (i.e. projects with a work commencement date no later than 30 April 2016);

A general taxpayer who provides construction services in a city (county) that differs from its registration location and applies for a general taxation method, shall prepay VAT at the location where the construction services take place on a basis of the total price and additional charges net of subcontracting payments made to subcontractors, with a 2% prepayment rate, and then file VAT to the tax authorities at its registration location.

A general taxpayer who provides construction services in a city (county) that differs from its registration location and opts to apply for a simplified taxation method, or a small scale taxpayer who provides construction services in a different city (county) than its registration location, shall prepay VAT at the location where the construction services take place on a basis of the total price and additional charges net of subcontracting payments made to subcontractors, with a 3% collection rate, and then file VAT to the tax authorities at its registration location.

VAT exemption applies to construction services and engineering supervision services provided outside the territory of China.

## 10. Special rules for real estate sector

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According to Circular 36, the real estate sector shall be subject to the general VAT method with 11% VAT rate. For real estate developers who are general VAT taxpayers, the sales amount for VAT purpose of selling self-developed real estate projects (except for old projects elected to be taxed under the simplified method) is the balance of the total price and additional fees received less the land cost paid to the government.





### Transitional policy for sales and lease of immovable properties

Circular 36 formulates transitional policy for real estate sector. When a general taxpayer sells immovable properties which were acquired on or before 30 April 2016, it may opt to apply for a simplified taxation method and deduct the original purchase price of the immovable property from the total price to prepay VAT with a 5% collection rate at the location of the immovable property, then file VAT to the tax authorities of its registration place. When a general taxpayer sells a self-developed immovable property on or before 30 April 2016, it may opt to apply for a simplified taxation method with a 5% collection rate to compute VAT.

Table 1 : Transitional policy for non-real estate developers with general taxpayer status selling an immovable property

Taxpayer	Nature and time of immovable property disposal	Taxation method	VAT prepayment at the location of immovable property	File VAT to tax authorities at the registration place
Non-real estate developers with general taxpayer status	Non self-developed; acquired on or before 30 April 2016	May opt for simplified method; Sales amount=Total revenue; Total price and additional charge; less original purchase price of the immovable property	Prepayment at a 5% collection rate	5%
Non-real estate developers with general taxpayer status	Self-developed on or before 30 April 2016	May opt for simplified method	Prepayment at a 5% collection rate	5%

For a real estate developer with general taxpayer status, it may compute VAT with the simplified taxation method at 5% collection rate for sales of self-developed old real estate projects (projects with a work commencement date no later than 30 April 2016 written in the Building Construction Permit). Where a real estate developer receives advance payments for sales of real estate, it must prepay VAT at a 3% collection rate. A general taxpayer leasing an immovable property acquired on or before 30 April 2016 may opt to prepay VAT at a 5% collection rate.



Table 2 : Transitional policy for real estate developers with general taxpayer status selling immovable properties and general taxpayer leasing immovable properties

Taxpayer	Project nature and time	Taxation method	VAT prepayment at the location of immovable property	File VAT to tax authorities at the registration place
Real estate developers with general taxpayer status	Sales of self-developed old real estate projects (projects with a work commencement date no later than 30 April 2016 written in the Building Construction Permit)	May opt for simplified method	Prepay VAT at a 3% collection rate on advance payments received for sales of real estate	5%
General taxpayer leases immovable property	Immovable property acquired on or before 30 April 2016	May opt for simplified method	Prepayment at a 5% collection rate	5%

### General policy for sales of immovable properties

A general taxpayer selling an immovable property (excluding a self-developed one) acquired after 1 May 2016 should adopt the general taxation method, to deduct the original purchase price of the immovable property from the total sales amount, to prepay the VAT at a 5% collection rate at the location of the immovable property, and then to file VAT to the tax authorities at its registration place. Where a general taxpayer sells an immovable property which is self-developed after 1 May 2016, it should use a 5% collection rate to compute VAT.

When a real estate developer receives advance payments in selling real estate, it must prepay VAT at a 3% collection rate, and then file VAT to tax authorities at its registration location. For real estate developers who are general taxpayers, the VAT sales amount of selling self-developed real estate projects (except the old projects elected to be taxed under simplified method) is the balance of the total sales price and additional charges less the land cost paid to the government. The prepaid item cannot be excluded from the sales price.



### Sales of residential properties by individuals

In Beijing, Shanghai, Guangzhou and Shenzhen, sales of residential properties held by individuals will be subject to a 5% collection rate on the full sales amount if the residential properties are sold within 2 years of purchase; for residential properties that are sold 2 years or more after purchase, the sale will be subject to a 5% collection rate on the balance of sales amount less purchase amount if the property is a non-ordinary residential property, and will be exempt from VAT if it is an ordinary residential property that is sold 2 years or more after purchase. In regions outside of these four cities, sales of residential properties held by individuals will be subject to a 5% collection rate on the full sales amount if they are sold within 2 years of purchase, and exempt from VAT if sold 2 years or more after purchase.

### Operating lease for immovable properties

Operating lease for immovable properties is subject to an 11% VAT rate or a 5% collection rate if the simplified taxation method applies. When a general taxpayer leases out an immovable property which is acquired after 1 May 2016, it should prepay VAT at a 3% collection rate at the location of the immovable property, and then file VAT to the tax authorities at its registration place. When an individual leases out an immovable property, a 5% collection rate less 1.5% shall be used to compute VAT.

## 11. Special rules for financial services sector

Financial services shall be subject to the general taxation method with a 6% collection rate. Financial services refer to operation of financial / insurance business, including loan service, direct fee paying financial service, insurance service and financial commodity transfer.

The sales amount of loan services shall be total amount of interests and income in the nature of interest.

Financial sale and leaseback is classified as lending services and subject to a 6% VAT rate. Financial sale and leaseback is a business transaction whereby the lessee, for the purpose of obtaining financing, sells an asset to an enterprise in the business of financial sale and leaseback and that enterprise leases the asset back to the lessee.

Financial commodity transfer refers to business activities transferring the ownership of foreign exchange, marketable securities, non-goods futures and other financial commodities. The transfer of other financial commodities refer to the transfer of assets management products and financial derivative products, including fund, trust, wealth management products. The sales revenue of financial commodity transfer shall be the balance of the sales price less the purchase price, where there are positive or negative balances in the trading transactions, the total sales revenue should be the balance after offsetting the losses against profits. If there is a negative balance after offsetting, the balance can be carried forward to the subsequent tax filing period; however, a year-end negative balance cannot be carried forward to the next fiscal year.

The following items of financial services are exempt from VAT

- Interest revenue on saving deposits
- Insurance claimed by the insured

In addition, Circular 36 implements VAT exemption on certain income items of the financial sector which include interests from inter-bank transactions and national bonds complying with requirements, financial commodity transfer income complying with requirements, cross-border direct financial services income complying with requirements, and premium income from life insurance products with a term of more than one year.

## 12. Special rules for lifestyle services sector

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Lifestyle services shall be subject to the general taxation method with a 6% VAT rate. Lifestyle services involve a wider spectrum of industries and cover services activities aiming at meeting people's daily demand which include cultural and sports service, education and medical care service, tourism and entertainment, catering and accommodation service, resident daily service and other lifestyle service. Since some customers of lifestyle services sector, to a great extent, are individual consumers, it is rather difficult to discern the services rendered are for commercial purpose or personal consumption. In view of this, catering service, resident daily service and entertainment service in the lifestyle services sector are not included in the scope of input VAT credit.

In addition, Circular 36 allows some items of lifestyle services to qualify for VAT exemption such as tourism services provided outside of China, education services, education services provided by schools engaging in academic credential education, child care and education services provided by nursery, funeral and interment services, etc.





### Conclusion

In the Report on the Work of the Government, Chinese Premier Li Keqiang stated that China would comprehensively implement B2V starting from 1 May and ensure “tax burden shall not increase for all industries”. To realize the pledge of “tax burden shall not increase for all industries”, in this Circular 36, the tax authorities based on the situation of the VAT pilot scheme to define the applicable VAT rate and the input VAT credit scope, as well as to add more preferential provisions to avoid increasing tax burden to the existing industries. The preferential policy under BT regime shall in principle be continued for new pilot industries and the transitional measures will be adopted for specified industries.

Circular 36 proposes the transitional solution, adopting simplified VAT method for old projects to avoid tax burden increase for construction and real estate industries after B2V. The rate of the VAT simplified method will remain unchanged. Since BT is a tax included in price and VAT is excluded from the price, the simplified VAT method can effectively reduce tax burden.

By including construction, financial and lifestyle services in the VAT scope, it accomplishes the complete VAT chain and expands the input VAT credit scope for taxpayers. It is worth noting that not all VAT for newly added taxable activities are creditable. For instances, loan service, catering service and resident daily service cannot be claimed for the input VAT credit. The creditable items may not be credited on basis of tax rate or one-off in nature. For example, for immovable properties or immovable properties CIP acquired after 1 May 2016 with applicable general VAT method, the input VAT incurred is required to be credited over a period of two years. Hence, B2V taxpayers need to grasp the scope and rules of the input VAT credit and choose appropriate suppliers based on their actual needs. Taxpayers should also note that the items of lifestyle services which are not specified as non-creditable items, may also not be creditable; many items cannot be deducted as they may belong to collective benefits or individual consumption. Enterprises should differentiate the creditable and non-creditable items to avoid tax risk.

Moreover, Circular 36 adjusts the categories of taxable activities which will pose impacts on VAT items and applicable VAT rate. Apart from the newly added taxable activities, modern services have experienced the most substantial changes in tax levy after VAT reform. Taxpayers providing the B2V taxable services above should file tax based on the new applicable VAT rate or corresponding collection rate.

It is worth noting that when taxpayers have concurrent operation activities including sales of goods, provision of labours and services, intangible assets or immovable properties, they should separately account for the turnover of each activity with different applicable tax rates or collection rates according to the relevant tax rules. The accounting treatment should be consistent in both format and substance to avoid the highest VAT due to non-separated or unclear separated calculation.

China’s full implementation of B2V Pilot Program is a significant measure of the country’s tax reform. During the B2V transitional period, we suggest taxpayers and foreign investors doing business with China should deeply understand and practicably execute the related tax policy of B2V. They should consult China tax experts, understand the related compliance requirements and seek professional advice to minimize related tax risks.

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