Comprehensive interpretation of the new VAT accounting regulations

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In brief

In order to further standardise VAT accounting treatments and facilitate the implementation of the transformation from Business Tax (BT) to Value Added Tax (VAT) (the “B2V Reform”), the Ministry of Finance (MOF) issued the <Notice Regarding the Regulations on the Accounting Treatment of VAT> (Caikuai [2016] No. 22, hereinafter referred to as “Circular 22”) on 3 December 2016, after wide public consultation. Circular 22 re-standardises the accounting treatments for VAT-related transactions, which cover not only common VAT relevant business activities but also certain special ones, such as VAT calculation on a net basis, VAT treatment during transition period, export tax refund, tax incentives for small and thin-profit enterprises, etc. It also clarifies the reporting of such items on the statutory financial statements. Meanwhile, the VAT accounting treatment of any transaction occurred during the period from 1 May 2016 to 3 December 2016 has to be adjusted retroactively to conform to Circular 22 if Circular 22 would impact the amount of assets, liabilities, etc. recorded in the accounting books. Moreover, previous relevant VAT accounting regulations are abolished by Circular 22 simultaneously.

In this News Flash, we will introduce the new requirements for the set-up of VAT accounts, relevant accounting treatments and reporting on financial statements stipulated in Circular 22. We will analyse the significant changes from an accounting and tax perspective, as well as certain unclear tax issues and share our insights and recommendations.

In detail

New requirements on the set-up of VAT accounts

The major changes to VAT accounts stipulated in Circular 22 are listed below. Please refer to Appendix for the comparison table:

- Under the “tax and surcharge payable” account, general VAT payers should add six new sub-accounts, i.e. “prepaid VAT”, “output VAT to be recognised”, “VAT calculated with simplified method”, “VAT payable for trading of financial products”, “withholding VAT” and “input VAT to be verified”.

- Under the sub-account of “tax and surcharge payable - VAT payable”, general VAT payers should add a new column entitled “output VAT deduction” and remove the column of “output VAT deduction for B2V reform”.

- Under the account of “tax and surcharge payable”, small-scale VAT payers should set up three sub-accounts, including “VAT payable”, “VAT payable for trading of financial products” and “withholding VAT”.

Interpretation of the revised and newly added accounts and the relevant accounting treatments

- “Input VAT to be credited” is used to record input VAT of purchases with eligible VAT invoices verified by the tax authorities, which is allowed to be credited from output VAT in future period by general VAT payers. For example, according to the prevailing VAT regulations, input VAT for immovable properties acquired after 1 May 2016 and accounted for as fixed assets or construction in progress acquired after 1 May 2016 by a general VAT payer is creditable over two years from the date of acquisition. The input VAT allowed to be credited in the subsequent period should be debited to this sub-account.

- “Input VAT to be verified” refers to input VAT which is not verified and thus cannot be credited in the current period. After the verification, general VAT payers should debit
“tax and surcharge payable - VAT payable (input VAT)” and credit this sub-account. On the contrary, for input VAT not eligible for deduction, debits should be made in the relevant costs and expenses or assets account while credits should be made in “tax and surcharge payable - VAT payable (input VAT transferred out)” account. It is important to note that in the situation that a general VAT payer has received purchased goods, verified and put them in storage but has not received the VAT invoices and settled the payment, it should temporarily estimate the amount to be booked in the accounts at the end of the month based on the price specified on the list of goods or relevant contract, while the corresponding input VAT should not be booked.

- **“Prepaid VAT”** is used to account for the VAT amount paid in advance for the transfer of immovable property, provision of real estate leasing services, provision of construction services, pre-sales of self-developed real estate projects and other situations where prepaid VAT is specified in VAT regulations. For example, after prepaying the VAT, a real estate development enterprise should debit this sub-account and thereafter transfer it to “tax and surcharge payable - unpaid VAT” when the tax obligation is crystallised.

- **“VAT calculated with simplified method”** covers the activities of a general VAT payer adopting the simplified VAT calculation method, including accrual, deduction, prepayment, settlement, etc. If the VAT obligation arises earlier than the recognition of accounting revenue, the relevant VAT payable should be debited to “accounts receivable” and credited to “tax and surcharge payable - VAT payable (output VAT)” or “tax and surcharge payable - VAT calculated with simplified method”. When it is time to recognise the income or gains according to the relevant China Accounting Standards, such revenue should be determined based on the total receivable after deducting the output VAT.

- **“VAT payable for trading of financial products”** is for VAT liability from transfer of financial products. In details, the gains or loss from financial products trading should be credited or debited to this sub-account accordingly. When VAT liability is settled, debits should be made to this sub-account and credits should be made to “cash in bank”. At the end of the year, if there is any remaining balance on the debit side of this sub-account, it should be transferred to the account “investment income” or other equivalent accounts.

- **“Withholding VAT”** is to record VAT withheld for overseas entities or individuals who do not have any operating establishment in China in relation to purchases of taxable activities from these entities or individuals. For example, when a domestic buyer purchases taxable services from an overseas entity or individual who does not have any operating establishment in China, it should be the VAT withholding agent for the seller. The buyer should debit “tax and surcharge payable - VAT payable (input VAT)” for the creditable amount and credit this sub-account for the amount of VAT to be withheld. When the withholding VAT liability is actually settled, the relevant balance of this sub-account should be offset.

- **“Output VAT to be recognised”** is used for the situation where the recognition of accounting revenue is earlier than the recognition of VAT obligation, general VAT payer should first credit this sub-account and transfer the balance to “tax and surcharge payable - VAT payable (output VAT)” or “tax and surcharge payable - VAT calculated with simplified method” when the VAT obligation actually arises.

- **“VAT payable (output VAT deduction)”** is used for general VAT payers to book the amount of reduced output VAT due to deductions from the sales amount in accordance with current VAT regulations. Where certain costs and expenses are allowed to be deducted from the sales amount, upon receipt of eligible tax invoices and the occurrence of the VAT obligation, the deductible VAT amount should be debited to this column or “tax and surcharge payable - VAT calculated with simplified method” and credited to the relevant cost or asset accounts.

- **“Un-credited VAT carryover”** is applicable to the situation where original VAT taxpayers have un-credited input VAT carryover at the time of the implementation of the B2V Reform and such carryover amount is not allowed to be credited against the output VAT from sales of services, intangible assets and immovable properties according to the existing VAT regulations, such un-credited input VAT should be debited to this sub-account and credited to “tax and surcharge payable - VAT payable (input VAT transferred out)”. When such un-credited input VAT is allowed to be credited in the future, debits should be made to “tax and surcharge payable - VAT payable (input VAT)” and credits should be made to this sub-account based on the deductible amount.

**Accounting treatment during transition period:** in the situation where the revenue was recognised before the B2V Reform but BT was not accrued since the BT obligation has not arisen, enterprises should recognise the output VAT and offset that against revenue in the current period at the time the VAT obligation occurs. For those enterprises that have already accrued but have not settled the BT, when the VAT obligation arises, they should debit “tax and surcharge payable - BT payable”, “tax and surcharge payable - urban maintenance and construction tax and surcharge payable”, “tax and surcharge payable - education surcharge payable” and other sub-accounts, and credit “main business revenue” account. They should also credit “tax and surcharge payable - output VAT to be recognised” with the amount calculated based on the adjusted revenue and offset that against the adjusted revenue.

**Changes to be presented on financial statements**

- The ending balance on the debit side of the sub-accounts under “tax and surcharge payable”, such as “VAT payable”, “unpaid VAT”, “input VAT to be credited”, “input VAT to be verified” and “un-credited VAT carryover” etc. should be reported under the items of “other current assets” or
“other non-current assets” on the Balance Sheet when necessary.

- The ending balance on the credit side of “tax and surcharge payable-output VAT to be recognised” should be reported under the items of “other current liabilities” or “other non-current liabilities” on the Balance Sheet when necessary.

- Taxes and expenses relevant to the business operation of an enterprise, such as consumption tax, urban maintenance and construction tax, resource tax, education surcharges, property tax, land use tax, vehicle and vessel use tax, stamp duty etc. should now be reported under "taxes and surcharges" on the Profit and Loss Statement, which was previously called "business taxes and surcharges".

Key tax implications and uncertainties

Apart from re-regulating the accounting treatments of VAT, Circular 22 may also bring tax impacts as well as the uncertainties on how to align certain accounting treatments with tax treatments to enterprises, including:

- Enterprises could easily identify qualified invoices which are not verified yet through the “input VAT to be verified” account, which could help them to avoid failing to verify those VAT invoices within the prescribed period and cut down on human errors.

- Circular 22 clarifies the accounting treatments when the timing of revenue recognition from accounting perspective is different with the timing of recognition of the VAT obligation due to the difference between accounting and tax regulations.

- According to Circular 22, income derived from trading of financial products in the current period that are subject to VAT should be debited to “tax and surcharge payable -VAT payable for trading of financial products”, and credited to “cash in bank”. However, following the rules in the VAT returns, income from the trading of financial products would not directly create VAT payable. It would be an output VAT and only become VAT payable after setting off against input VAT. As such, enterprises should pay close attention on how the accounting treatment under Circular 22 and the rules in VAT returns converge.

- The sub-account of “prepaid VAT” is used for four types of pre-payment of VAT in Circular 22. However, real estate development enterprises are allowed to carry forward the “prepaid VAT” only upon occurrence of the relevant VAT obligation. In this regard, it still remains to be clarified whether real estate development enterprises should calculate their VAT on a project basis.

- Regarding “un-credited VAT carryover”, given SAT Public Notice [2016] No.75 has already lifted the relevant restriction to general VAT taxpayer before B2V Reform, therefore, this accounting item may no longer be relevant.

The takeaway

We noticed that Circular 22 has set out higher requirements for enterprises to handle accounting and tax compliance work which would be a huge challenge to them. It is suggested that enterprises should get well prepared from the following perspectives:

- Fully understand the changes specified in Circular 22, conduct a comprehensive review on their current VAT accounting treatments and assess whether retroactive adjustments are necessary.

- Update the relevant VAT accounts in enterprises’ accounting software depending on different situations, adjust the items reported on financial statements, and amend the existing accounting operation procedure.

- For those foreign investment enterprises, it is important to communicate with the headquarters in a timely manner, obtain authorisation to adjust the relevant accounts, and update the linkage with the group’s accounts.

- It is necessary for enterprises to extract accurate data from the financial records in order to perform VAT filing correctly. Especially for those enterprises adopting internal system to automatically complete VAT filing, such system should be upgraded as soon as possible.

We will closely follow the implementation of Circular 22 and share our observations and suggestions with you timely.

Endnote

Appendix

Summary of changes to the VAT accounts and its sub-accounts (the summary)

Note:
- The summary only includes the changes relevant to VAT accounts under “tax and surcharge payable”. Other taxes and surcharges accounts are not included.
- The summary is prepared based on the changes of VAT accounting treatments after the issuance of Circular 22, which is only for general reference. In the event of any policy changes, the latest regulations released by relevant authorities prevail.
Let’s talk

For a deeper discussion of how this issue might affect your business, please contact a member of PwC’s Accounting and Payroll Service Team:

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PwC’s Accounting and Payroll (“A&P”) Services Team is a specialised team within the Tax Department, and is made up of more than 100 professionals in China who provide services to a wide range of clients – from multinational corporations to domestic enterprises – and across many different industries including high-tech, investment banking, pharmaceutical, retail, private equity fund, auto, media & entertainment, green energy, etc. Our team works to deliver value to clients by serving as an open platform covering all back office functions, with core business in accounting and payroll services. Being the driver and project manager for cross functional activities, we enhance the service delivery efficiency and value. In addition, we are able to create accounting infrastructure to enable data classification at transaction levels and hence mitigate the period end compliance pressure and enhance better resources deployment. We would also take the best practice of the industry into consideration and hence would save unnecessary time for creating the same tasks. On the other hand, our strong capabilities on the set up of financial system would facilitate our clients to optimize their global system to fulfil the local requirements, or simply build their own PRC local system on a parallel basis.