B2V Reform (II) – Financial Service sector has been included in the VAT chain

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In brief

On March 24, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) issued Caishui [2016] 36, (“Circular 36”) on the Comprehensive Roll-out of the B2V Transformation Pilot Program, under which the financial service industry will be transformed from Business Tax (BT) to Value Added Tax (VAT) (“B2V Reform”) starting from 1 May 2016 (“expansion date”). The key points of the B2V Reform for financial service include: the financial service sector will be subject to the general VAT method with a tax rate of 6%; the “Financing Sale and Leaseback Model” will be reclassified from “Tangible Movable Property Leasing Services” to “Financial Services”; input VAT on lending services received by the borrower (interest cost) cannot be creditable; the taxable sales amount of each trading transaction of financial product will be the balance of the sales price less the purchase cost; the previous BT preferential policies for the financial service sector will be largely retained; certain specific cross-border financial services provided by pilot taxpayers will be entitled to the export VAT exemption treatment.

Pilot taxpayers should be familiar with Circular 36 and understand the various administrative provisions. They should also pay close attention to the subsequent follow-up measures, analyse the impact and react accordingly.

We introduced the overall objective, layout and directions of the B2V Reform in our News Flash entitled “B2V Expansion Measures Released — VAT is now completed for all industries” published on 24 March 2016. In this Issue, we will provide our observations and views on some practical issues faced by the financial service industry during the initial stage of this final round of B2V Reform.

In detail

Objective of the B2V Reform and pilot taxpayer’s responding strategies

It is not common internationally for the financial service industry to be included in the VAT chain. We believe some provisions are still in the course of exploration. Financial services have been subject to BT since the tax reform in 1994 and are eligible for a netting taxation basis and a series of tax incentives. However, there are substantial differences between BT and VAT in tax principle, VAT credit chain, invoice management and etc. Taxpayers in the financial service industry should prepare thoroughly to deal with the opportunities and challenges arising from the B2V Reform.

As a key structural tax reduction measure of the country, the objectives of the B2V Reform are to expand the VAT credit chain, solve the multiple taxation issue, optimize the taxation system and accelerate industrial upgrading. For taxpayers in the financial service industry, they pay attention to the impact of the B2V Reform based on its own circumstances and focus on the following three areas:

• Preventing tax risk. Pilot taxpayers should make sure that they will be in compliant with the tax rules under the B2V Reform. From an accounting perspective, the characteristics of price-tax separation in VAT will bring enormous challenges to the financial service industry, therefore it is critical for taxpayers to upgrade or revamp its IT system within a short time period to make sure that the accounting results and statements are correct. From a tax filing perspective, there is also a pressing need to timely upgrade or revamp the IT system as the VAT tax return is more complex.
and difficult to complete and financial service enterprises would prefer to rely on the IT system to collect data for tax filing purpose rather than doing it manually. From the perspective of issuing VAT invoices, financial service taxpayers with massive business volume should make sure that VAT invoices can be timely issued according to the VAT rules.

- Monitoring the reduction of tax burden. For financial service industry taxpayers, the applicability of preferential tax policies, the timing of the purchasing of assets and the business cycle of the enterprise will have an impact on the VAT burden. Although VAT will not be on an enterprise’s income statement, it will still have an impact on the income statement through items such as income, cost, expense, taxes and surcharges. The accounting method of tax-price separation will also affect the corporate income tax, surtaxes, etc. of taxpayers in the financial service industry. As a consequence, pilot taxpayers should make full use of the policy reasonably, monitor the reduction of tax burden and fully consider the impact to all taxes and surcharges (e.g., corporate income tax, urban construction and maintenance tax and educational surcharge), in estimating the changes in the overall tax burden in order to evaluate the overall impact of the B2V Reform on the business operation.

- Enhancing business development. VAT has the characteristic of recovering input VAT at every stage of the business cycle. After the B2V Reform is completed, goods, labour service and other services will all be included in the VAT credit chain and every industry would be more closely connected with its upstream and downstream industry. Financial service industry taxpayers should make use of the characteristics of the VAT system to enhance business development through appropriate commercial arrangements and pricing strategy.

**Taxable scope and tax rate**

Circular 36 stipulates that financial services include lending services, financial services with direct charge, insurance services and trading of financial products. Financial services will be subject to the general VAT method with a VAT rate of 6%. If the simplified VAT method is applicable, the levy rate is 3%. According to Caishui [2011] No.110, financial services shall be subject to the simplified VAT method in principle. It was mainly for the purpose of facilitating tax collection, administration and compliance. Now, by adopting the general VAT method, part of the financial services will be included in the VAT credit chain which gives rise to a set of higher compliance requirement for taxpayers.

**Financial Business Analysis**

We will analysis the practical issues for certain common financial businesses as follows:

- **Lending services**

According to Circular 36, lending service refers to the lending of funding to others in return for interest income. This definition is similar to that under the BT regime. In addition, Circular 36 has a list of income derived from the usage and borrowing of funds that shall be subject to VAT under the category of lending services, including: interest income derived during the holding period of financial products (including principal-protected product with guaranteed return, remuneration, funding usage fee, compensation, etc.), credit card overdraft interest income, interest income arising from purchase and resale of financial products, securities margin trading interest income, interest on financing sale and lease back, documentary bills, discount bills, default interest, on-lending interest income, etc. Along with the development of more and more financial products, no matter how the product is named, taxpayers should look at the characteristics of the usage of funds to assess whether the service belongs to lending services.

Circular 36 stipulates that input VAT incurred on interest paid to the lender (e.g., banks) for lending services and other directly related financing advisory fee, commission, consultancy fee, etc. should not due can be temporarily not subject to VAT until it is received.

**Financial services that are not included in the taxable scope**

According to Circular 36, financial advisory service is classified into the category of consulting service and financial agency service is classified into the category of agent service. Both of these services belong to the modern service industry tax item. In addition, the net basis method is applicable to the agency services (including financial agency) and the taxable turnover is net of governmental fund or administrative charges collected from and paid on behalf of the client.
be creditable. Considering the administrative burden and cost of issuing invoices for the massive volume of lending business, taxpayers may consider using electronic invoices and using service platform to convert the trading information by batches into invoice information and pass them onto downstream customers. It enables taxpayers to lower their costs in relation to issuing manual prepared invoices, printing, storing, and delivering invoices, etc.

Furthermore, according to Circular 36, deposit interest is exempted from VAT, which is inherited from the BT regime. However, deposit interest is not clearly defined in Circular 36. It is not clear whether it should be narrowly defined as interest on current savings and deposit with a fixed term or broadly defined to cover financial products that have the nature of deposit. Taxpayers should pay close attention to the follow-up measures in this regard.

**Financial leasing**

There are two financial leasing models, direct financial leasing and financing sale and leaseback. Financing sale and leaseback is a business transaction whereby the lessee, for the purpose of obtaining financing, sells assets to a company in the business of financing sale and leaseback and that company leases the assets back to the lessee. Hence, it is in substance a kind of financing activity. Before the first round of B2V Reform, financial leasing is subject to BT under the category of financial services. It has been subject to VAT under the category of leasing services since the first round of B2V Reform was rolled out. Due to the adjustment in Circular 36, direct financial leasing will still be subject to VAT of 17% under the category of leasing services, whereas financing sale and leaseback would be taxed under the category of financial services, which matches with its economic substance.

For the lessee of financing sale and leaseback of tangible movable properties, input VAT on the interest portion of the rental payment was creditable previously. After Circular 36 is effective, it will no longer be creditable as input VAT on lending services is not creditable.

Besides, other important measures regarding financial leasing industry include:

- Since insurance premiums and installation costs are now included in the input credit chain, these expenses will be removed from the netling scope of direct financing leasing.
- Since financial sale and leaseback is subject to VAT under the category of financial services, the principal portion of the rental payment received from the lessee would not be included in the taxable turnover of the lessor.
- Pilot taxpayers can elect to use the transitional policy for financial sale and lease back contracts of tangible movable properties concluded prior to the effective date of Circular 36 till the expiry date of the contract.

**Direct fee charging financial services**

According to Circular 36, direct fee charging financial services refer to fee charging services relating to monetary financing and other financial transaction, including currency exchange, accounts management, E-banking, credit card, letter of credit, financial guarantee, asset management, trust management, fund management, financial transaction places (platforms) management, fund settlement, fund clearance, financial payment, etc. Its taxation scope is more specific as compared with the previous one under the BT regime. Direct fee charging financial services is a catch-all provision for financial services. The taxable turnover would be the gross amount of charges received for the various types of services. The service recipient can claim input credit for VAT incurred for such services.

**Insurance services**

According to Circular 36, insurance services refer to commercial insurance activities where an insurance applicant pays an insurance premium to an insurer under an insurance contract and the insurer undertakes to pay insurance benefits to compensate for the property loss caused by certain incidents specified in the insurance contract or upon meeting certain conditions specified in the contract. Insurance services include life insurance services and property insurance services.

Circular 36 does not have any specific rule for calculating the VAT liabilities of insurance services, thus pilot taxpayers would be subject to the general rules in calculating the VAT liabilities. In addition, Circular 36 does not have clear guidelines on the treatment for the following specific activities in insurance services. Pilot taxpayers should pay attention to see whether they will be addressed in the follow-up measures:

- Re-insurance business. Circular 36 does not provide any specific rules for re-insurance business which has received a lot of attention. Under the BT regime, there may be to a certain extent double taxation on re-insurance business. Under the VAT regime, according to the general VAT principles, if reinsurers can issue VAT special invoices to insurers on the ceded insurance premium, the double taxation issue can then be avoided. Thus, taxpayers should pay attention to the follow-up measures as to whether re-insurance business is allowed to use the VAT general rules.

- Direct compensation claim and compensation claim without invoices. Insurance premiums received by insurance services providers are taxable turnover and their costs mainly consists of insurance liabilities which they have to bear. In practice, insurance companies can only obtain certificates for claiming VAT credit purpose for some of the direct compensation claims. For the rest the compensation claim that are
without invoices, the insurance companies would not be able to obtain valid certificates and hence these reasonable expenditures cannot be reflected in the VAT calculation. Circular 36 has not compensation claim without invoices in the net basis method, taxpayers shall pay attention to the follow-up measures in this area.

- **Trading of financial products**

According to Circular 36, trading of financial products refers to the transfer of the ownership of foreign exchange, marketable securities, non-goods futures and other financial products. Circular 36 continues to adopt the BT treatment for the trading of financial products, that is, the taxable turnover of each trading transaction shall be the balance of the sales price less the purchase price; and the positive and negative balances of the trading transactions can be offset within the same tax payment period. Where there is still a negative balance after offsetting losses against profits, the negative balance may be carried forward to the subsequent tax filing period. However, when there is still a negative balance at the end of the year, it cannot be carried forward to the subsequent fiscal year. The timing of VAT liability arises on the day the ownership of the financial product is transferred.

The tax refund rule under the current BT regime is not retained by Circular 36. According to Caishui [2003] No.36, there is an annual consolidated clearance of BT liabilities at the end of the year for the trading of financing products. If the consolidated amount of BT payable is less than the amount of BT that has been paid, taxpayers can apply for BT refund. However, according to Circular 36, there will not be an annual VAT consolidated clearance, therefore taxpayers cannot apply for a VAT refund even if the amount of VAT paid for the whole year is more than the consolidated amount of VAT payable in that year. It may have a relatively big impact on some pilot taxpayers. Taxpayers should pay attention to this change and may have to adjust its business accordingly.

There is essentially no difference between the VAT treatment and BT treatment for the trading of financial products. However, since VAT is price exclusive, the accounting treatment would be different. After the B2V Reform, there will no longer be an account item called “BT and cost” to record the BT amount calculated based on the net trading gains of financial products. There are certain issues that taxpayers need to pay attention to in the follow-up measures such as whether the “investment profits” account should be the corresponding account for the amount booked in the “VAT payable” in relation the trading of financial products; whether the VAT paid should be allocated to each kind of investment or even each and every trade.

**The takeaway**

Circular 36 will be effective from 1 May 2016 leaving the pilot taxpayers very short time to prepare and respond. It is suggested that pilot taxpayers should prepare the following work in the remaining one month:

- Taxpayers should touch base with the in-charge tax bureau to apply for consolidated tax filing (within the same province) according to its own organizational structure.
- Taxpayers are recommended to actively cooperate with the in-charge tax bureau on a series of tax administration activities to prepare for the upcoming B2V Reform, including providing supplementary information for tax registration, performing general VAT taxpayer registration, applying for VAT invoices, obtaining appliance for issuing VAT invoices, attending training, record filing for various VAT incentives, record filing for tax eligibility, obtaining access right to the online filing system and timely filing VAT returns.
- Taxpayers are recommended to conduct a comprehensive assessment on the change in profit and other impacts in revenue and cost/expenses brought by the B2V Reform, and analyse the impact of input VAT on cash flow and financing cost. It is also advised that taxpayers should investigate supplier’s profile and improve supplier management.

- Taxpayers should work on the solutions for the transitional period, focus on the tasks that should be completed before 1 May and prioritize the remaining tasks. Taxpayers should also adjust the commercial contract terms template based on the detailed B2V implementation rules and upgrade the business model accordingly.
- Taxpayers should adjust the working procedure and refine the process, revamp the system to separate price and VAT to meet the VAT accounting requirements, pay attention to risk control on VAT management, adjust the system on matters such as reasonable allocating non-creditable input VAT, interconnection between the accounting system and the tax filing and upgraded invoice system.
- Taxpayers should modify VAT management flow and procedure and compile a VAT operating manual to ensure compliance, be familiar with the requirement of the upgraded VAT system and properly issue VAT invoices, understand the usage of VAT invoices and the time period for claiming input VAT credit so as to ensure that the full amount of input VAT can be claimed.
- Taxpayers should pay close attention to follow-up measures of the B2V Reform, study the various policy interpretation and detailed implementation rules, and timely analyse the relevant impact and act accordingly.

We will be preparing relevant analysis on the follow-up measures and different sectors of the financial services industry. Please stay tuned for our China Tax and Business News Flash and other publications.
News Flash — China Tax and Business Advisory

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