

Tax Analysis

PRC Tax

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VAT Reform - Financial Services Sector

On 24 March 2016, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly published in the respective official websites Caishui [2016] No. 36 (Circular 36)), which provides the detailed implementation guidance on the further rollout of the Value-Added Tax (VAT) reform to sectors including construction, real estate, financial services and lifestyle services. Circular 36 at the same time modified the current VAT rules for transportation services, modern services, postal and telecommunication services. Circular 36 takes effect from 1 May 2016. We have covered in our earlier publications about the detailed implementation of Circular 36 and discussion of impact on the Real Estate sector. We will discuss, in this Tax Analysis, the implementation of Circular 36 with respect to Financial Services sector (FS Sector).

Highlights of Circular 36 related to FS Sector

Basis of charge

Pursuant to Circular 36, the scope of VAT Reform has been broadened to cover FS Sector and the applicable VAT rate is 6%. For small-scale taxpayers, they are subject to VAT at 3%. Financial services have been defined in Circular 36 to include finance and insurance businesses, i.e., loan services (lending and borrowing), fee-based banking and financial services, insurance and transfer of financial products.

Types	Detailed notes of explanation
Loan services	<p>Loan services refer to lending of funds for the return of interest. All income generated from the provision of usage and lending of funds falls within this category. This income specifically includes:</p> <ul style="list-style-type: none">• Interest from holding of financial products (including income of the same nature but in names of capital-guaranteed return, fund usage fee, etc.);• Interest on credit card overdraft;• Interest from reverse repurchase of financial products;• Interest from margin contracts;• Interest and income of an interest nature generated from sales and finance leaseback, documentary bills, bill discounting, re-lending, etc.; and• Fixed or guaranteed profits from investments with currencies.

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Types	Detailed notes of explanation
Loan services (continued)	The aforementioned "sales and finance leaseback" refers to a situation where an asset is sold by the borrower to and then leased back from the lender for the purpose of financing. For sales and finance leaseback arrangements of tangible and moveable assets entered into before 30 April 2016, income generated therefrom may continue to be subject to VAT based on the category of finance leasing under modern services (rather than the category of financial services) until expiry of the arrangement according to the contract.
Fee-based financial and banking services	Fee-based financial and banking services refer to the provision of different finance and funding services for charges and fees. These services include the services of foreign currency exchange, account management, e-banking, credit card, letters of credit, finance guarantee, asset management, trustee, fund management, management of trading platform, settlement, clearance, finance payment, etc.
Insurance services	Insurance services refer to an arrangement by which an insurance company undertakes to provide a guarantee of compensation for specified loss, damage, death, disability, illness, or at a certain age or point of time in return for payment of a specified premium from the insured person. They include life insurance services and property insurance services.
Transfer of financial products	It refers to transfer of foreign exchange, securities, non-commodity futures or other financial products which include funds, trusts, investment products, asset management products and other financial derivatives.

Taxable base (i.e. sales)

Loan services

- General lending and borrowing: the sales is determined according to the interest income and income of an interest nature generated from the provision of loans.
- Sales and finance leaseback business:
 - § For taxpayers approved by the People's Bank of China, China Banking Regulatory Commission or the Ministry of Commerce to be engaged in finance leasing business: the sales is determined by deducting the loan interest expenses (including foreign currency and RMB borrowing) and debenture interest from the total income and charges (not including principal of the loan).
 - § For taxpayers approved by competent provincial level government authorities in charge of commerce and national economic and technological development zones to be engaged in finance leasing business:
 - if the paid-up capital is not less than Rmb170 million (i.e. the threshold) on or after 1 May 2016, the aforementioned deductions will also be allowed from the month in which the paid-up capital reaches the threshold;
 - if the paid-up capital is less than Rmb170 million but the registered capital reaches the threshold on or after 1 May 2016, the aforementioned deductions will *only* be allowed before 1 August 2016.

Fee-based financial and banking services

The sales is determined according to the amount of handling charges, commission, compensation, management fee, service fee, account opening charge, remittance charge, settlement fee, trustee fee, etc.

Transfer of financial products

The taxable base (i.e. sales) is determined by deducting the purchase price from the sales price. The purchase price may be computed based on a weighted average method or a moving weighted average method. Once the method is selected, it cannot be changed in 36 months.

Loss from transfer of financial products can be used to offset the gain. Any unutilized loss incurred in a taxable period (other than a financial year) can be carried forward to the next period. However, any unutilized loss as of the year end cannot be carried forward to the next financial year.

Items outside VAT scope

Circular 36 states that following items are outside the scope of VAT:

- Interest from deposits; and
- Insurance compensation received by an insurant.

Items exempt from VAT

According to Circular 36, the following items are exempt from VAT:

FS Sector – Major VAT-exempt items

1. Qualified interest income, which includes:
 - interest from small-amount farmers' loans before 31 December 2016;
 - interest from government-subsidized education loans;
 - interest from government bonds;
 - interest from loans lent by the People's Bank of China to other financial institutions;
 - interest received by a leading party from a qualified group financing arrangement in which the leading party in a group borrowed funds from financial institutions or by issuing bonds and the funds were actually used by other group members for business operation, where the leading party charged interest on other group members at a rate not higher than the interest rate charged by the financial institutions or the rate specified in the bonds;
 - interest from inter-bank transactions, which include:
 - § cash transactions between the People's Bank of China and financial institutions;
 - § intra-bank transactions (i.e. cash transactions between different branches in a same bank);
 - § Unguaranteed short-term (i.e. one year or shorter) borrowing and lending between financial institutions within the Inter-bank Borrowing and Lending Market as approved by the People's Bank of China; and
 - § Bill discounting between financial institutions.
2. Qualified income from transfer of financial products, which includes:
 - income derived by QFIIs from purchase and sale of securities in the Mainland China;
 - income derived by Hong Kong investors (including both entities and individuals) from purchase and sale of A shares listed in the Shanghai Stock Exchange through Shanghai-Hong Kong Stock Connect;
 - income derived by Hong Kong investors (including both entities and individuals) from purchase and sale of investment fund units through the Fund Mutual Recognition;
 - income from purchase and sale of shares and/or bonds by close-end and open-end investment funds; and
 - income derived by individuals from transfer of financial products.
3. Insurance premium from life insurance products with a term of more than one year
4. Income from provision of guarantee or re-guarantee by qualified institutions to small and medium-sized enterprises
5. Repayment of liabilities with goods, immovable properties, intangible assets, securities, notes, etc., by deregistered financial institutions

Miscellaneous and tax administration

Input VAT on interest expense: Circular 36 requires that input VAT incurred on the acquisition of loan services is not creditable. This treatment extends to input VAT incurred on the charges which are paid by the borrower to the lender and directly related to the loan such as financial advisory fee, handling fee, consultancy fee, etc.

Non-performing loans: Where the interest payment date is due but the interest has not yet been received, any interest accrued within 90 days from the due payment date ("90-day period") but has not yet been received is still subject to VAT. Any interest accrued after the 90-day period will not be subject to VAT until the time the interest is received.

Cross-border financial services:

- Insurance with respect to exported goods (including both export goods insurance and export credit insurance) is exempt from VAT.
- Income for fee-based financial services provided with respect to financial transactions between overseas enterprises is exempt from VAT to the extent that the services are not relevant to any goods, intangible assets or immovable properties located in the Mainland China.
- Where a domestic party purchased financial services from foreign entities or individuals, the domestic party must withhold VAT; it may credit such VAT provided that it has obtained the VAT clearance certificate from the tax authorities.

VAT reporting period: Banks, finance companies, trust investment companies, credit unions should report VAT on a quarterly basis. Other financial institutions such as insurance companies, fund management companies and securities companies, unless otherwise required by the MOF or SAT, should generally report VAT on a monthly basis.

Place of reporting VAT: Branches and head office located in different counties (cities) should report VAT at their respective locations. If approved by the MOF and SAT, the head office may file the VAT return on a consolidation basis with the tax authorities at the head office's location.

Observations and analysis

General observations

Enterprises in the FS Sector have been subject to Business Tax (BT) since 1994. In view of the complexity of the business activities and unique industry characteristics, it has been a much challenging task to ensure a smooth transition to the VAT regime.

Inheritance of most BT exemptions in VAT regime

In order to avoid an increase in the tax burden to the FS Sector as a result of the VAT reform and to ensure a smooth transition to the VAT regime, Circular 36 inherited most exemption treatments under the original BT regime. Therefore, most BT-exempt items will continue to be exempt from VAT (such as interest from inter-bank cash transactions, certain loans to farmers generated before 31 December 2016, government bonds, life insurance products with a term of more than one year, etc.)

Clarification on scope of tax

Circular 36 explained in detail certain areas of the scope of tax charge which has been unclear under the original BT regime. Taking "loan services" as an example, whether certain "interest income" (e.g. interest on bonds being held to maturity) is taxable or not is always a controversial issue within the industry. Local tax bureaus in different locations hold different views. The continuous development on financial innovations and introduction of different types of financial derivatives further reinforced such uncertainty. As a result of the VAT reform, Circular 36 redefines loan services as "the activities of provision of usage of funds in return of interests," and specifically clarified that certain items in common transactions should be considered interest for VAT purposes. Moreover, it has been confirmed that fixed or guaranteed profits generated from investments will be subject to VAT as interest. It appears that Circular 36 tries to interpret the interest income based on the economic substance, which would help in equalizing the tax burden under different forms of debt financing arrangements.

Areas pending clarification

We noted that there are still certain areas which have not been clarified in Circular 36 and pending further elaboration by the government authorities. For example, it is still not entirely clear on how to differentiate between transfer of financial products and transfer of equity interests, the latter of which is generally not subject to VAT. Circular 36 also did not explain how the purchase cost of the different types of financial products should be calculated, how to determine the VAT-exclusive sales for a transfer of financial products, how inter-bank deposits should be categorized for VAT purpose, etc.

Sub-sectors analysis

Banking

After the VAT reform, interest from bank loans will be subject to VAT. As discussed earlier, under the original BT regime, local tax bureaus and taxpayers in different locations may have different understanding of the definition and taxability of interest income. Such inconsistency resulted in different basis of calculation of tax liability of the banks. Since Circular 36 redefines "interest income," the scope of charge under VAT may be changed in practice and in turn impacts the turnover tax burden of banks.

Taking "inter-bank transactions" as an example, the understanding of the item and practical implementation are inconsistent under the original BT regime. Some taxpayers adopted a relatively broad view and treated any transactions between banks and other financial institutions as BT-exempt, such as repos between banks, and borrowing/lending between banks but not being arranged through the Inter-bank Borrowing and Lending Market. Circular 36 however obviously excludes the aforementioned transactions from the scope of VAT-exempt "inter-bank transactions" (see above "Items exempt from VAT"). At the same time, input VAT incurred on repos and other financing costs is not creditable. Therefore, after the VAT reform, the turnover tax burden may increase for the banks which have been enjoying the BT-exempt treatment on a broad range of transactions between banks and financial institutions. Additionally, Circular 36 states that interest from financial transactions amongst branches/head office in a same bank is exempt from VAT. However, it is still uncertain whether the exemption will be applied in a cross-border situation (i.e. a financial transaction between branches/head office in two different jurisdictions).

From a practical perspective, under the BT regime, unless customers requested, banks seldom issue tax invoices. After the VAT reform, since input VAT on loan interest is not creditable, banks may not be required to issue VAT invoices to borrowers. However, as input VAT can be claimed for handling charges and fees paid (excluding those directly related to loan financing), banks will have to issue huge volume of invoices to a large number of customers within a short period of time. It is no doubt a big challenge for them to ensure tax compliance, efficiency and to meet the customers' needs.

On the other hand, from the perspective of the lender, Circular 36 states that input VAT on loan interest is not creditable. For companies which rely heavily on loan financing, they may not be able to enjoy the benefit of VAT reform and have their financing costs being reduced. As a result from a VAT point of view, the new policy may put loan financing in a less favorable position.

Insurance

After the VAT reform, from the output VAT perspective, insurance premium, handling charges, management fee and investment gain (including the gain from holding of financial products and gain from transfer of financial products) will be subject to VAT at 6%. Nevertheless, premiums from life insurance with a term of more than one year will continue to enjoy the VAT-exempt treatment as currently available under the BT regime.

However, from the input VAT perspective, Circular 36 did not specifically address whether input VAT is available for insurance compensation paid. According to our understanding, as long as the compensation is paid in the form of goods or services purchased from external parties and the relevant VAT invoices are obtained, the input VAT on such goods or services should be creditable.

As a whole, Circular 36 has yet to address a number of issues with respect to the insurance industry. For example, VAT treatment of re-insurance business, whether compensation paid in the form of goods or services purchased from external parties would be considered deemed sales, tax treatment for income received on the non-insurance element, etc. All these will have significant impact on the turnover tax burden and compliance costs of the insurance industry. It is expected that more detailed rules will be released in this regard.

Others (such as securities companies, asset management companies, trust investment companies, etc.)

Most income received by securities companies, asset management companies, trust investment companies and other financial industry enterprises will be subject to 6% VAT as follows: commission and handling fees, custodian fee, investment advisory fee, consultancy fee, etc., which will be generally taxed as "Financial services – fee-based financial services" or "Modern services – business support services (brokerage and agency services – financial agents)"; interest income from capital market intermediary business (e.g. margin trading), which will be taxed as "Financial services – loan services"; income from trading of securities, which will be taxed as "Financial services – transfer of financial products." In addition, there are some types of income whose turnover tax treatment has been disputable; typical examples include interest income from repos and holding of bonds. With the clarification on interest income by Circular 36, the tax burden of some financial enterprises may be impacted.

As an agent for trading of securities, securities companies normally collect handling charges from customers on behalf of stock exchanges, the China Securities Depository and Clearing Co., Ltd and the China Central Depository and Clearing Co., Ltd. It is not entirely clear whether such handling charges could be excluded from the gross proceeds received by the securities companies from their customers for VAT computation purposes. Neither is clear on whether the investor protection funds accrued by securities companies could be deducted from the gross proceeds for VAT computation purposes, where Circular 36 is silent on this point but such deduction has been allowed under the BT regime.

From the investors' point of view, VAT treatment of investment gains from financial products (e.g. the income from holding or transfer of asset-based securitization products or trust products) is also not entirely clear.

Recommendations

In view of the significant difference in the BT and VAT mechanisms and time is running short to 1 May 2016 where VAT reform will be fully implemented, we would recommend companies:

Evaluate tax impact and internal control

Before the issuance of Circular 36, some companies within the FS Sector have preliminarily estimated the potential tax impact and implemented certain measures in refining their business flows, internal controls and operational systems. Now with the release of Circular 36, financial enterprises should conduct another evaluation and where necessary, introduce further adjustments. For those companies that have yet to take any action, a detailed analysis of the potential impact from the tax, financial and internal control perspectives is of the utmost importance.

Assess the compliance support of the current systems

We have observed that large-sized financial enterprises have already taken actions in refining their operational systems. Nevertheless, companies should review their systems to ensure they can support full compliance upon implementation of the VAT reform. In case certain data could not be processed, the respective departments should communicate and work together to formulate system improvement plans and prepare a list of tasks to be completed to ensure a smooth transition to the VAT regime and timely filing of VAT returns. Particular attention should be paid to segregation of revenue and related VAT, VAT provision, manual adjustments of financial data for tax reporting purpose and manual issuance of VAT invoices, etc.

Keep in view of further development in VAT reform

Operations of many financial enterprises are scattered in different locations across the country and administered by different provincial authorities. From a practical perspective, whether consolidated VAT filing can be done by the head office or first-tier branch at the provincial level will have a big impact on the company's VAT invoicing management and tax reporting formalities. Circular 36 requires that with the approval of the provincial level authorities and where the head office and branches are located in the same province, the head office can submit consolidated VAT return. However, based on our understanding from some of the tax authorities, consolidated VAT filing for cross-provincial financial enterprises are generally not allowed. As such, the head office may consider the need of initiating early communication with the in-charge tax authority, exploring the possibility of consolidated VAT filing and understanding the prescribed requirements. For head office and branches located within the same province, companies should clarify the requirements for consolidated VAT filing, including application process, documentation, etc.

Establish VAT management mechanism before 1 May

Under the VAT regime, there are specific requirements in management of special VAT invoices, deemed sales, input VAT claim, etc., and these will all be implemented under Circular 36. Since these requirements will impact the effective tax burden of a taxpayer and demand full compliance of VAT management, we recommend that financial enterprises should consider their own financial and internal control needs, review their operational and management processes and establish an effective VAT invoice management and VAT input deduction mechanism so that benefits of reducing the overall tax which intends to be brought by the VAT reform can be maximized.

Deliver VAT trainings to relevant personnel

This final stage of VAT reform has been long waited but time to implementation is still very limited. We recommend the finance and management personnel of the financial enterprises should arrange training, with particular focus on the changes in financial reporting, operational and management processes, to ensure a successful implementation.

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