

Tax Analysis

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VAT Reform - Lifestyle Services Sector

On 24 March 2016, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly published 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 such as construction, real estate, financial services and lifestyle services. Circular 36 takes effect from 1 May 2016.

We covered, in our earlier Tax Analysis, impact of implementation of Circular 36 on real estate and financial services sectors. In this newsletter, we will focus our discussion in the lifestyle services sector covered in this rollout.

Highlights of Circular 36 related to lifestyle services sector

Starting from 1 May 2016, lifestyle services will be brought into the scope of VAT. The tax rate is 6%. Lifestyle services have a broad coverage to include a variety of services which are to meet the daily needs of the residents. The services are classified into culture and sports services, education and medical services, tourism and entertainment services, catering and accommodation services, resident daily services and other lifestyle services. Whereas:

Culture and sports services

	Culture services	Sports services
Definition	Various services in meeting the cultural needs of the community such as creation, performance and contests of art and literature, library services (lending of books and information/materials), management of documentaries, protection of cultural relics and heritage, organization of religious, cultural or science and technology events and provision of tour facilities	Organization of sports competitions, sports performance, sports activities and provision of sports training, guidance and management services
Taxation base	Total price and additional charges received, unless otherwise regulated by the MOF and SAT	

Culture and sports services (continued)

Culture services		Sports services
Examples of VAT-exempt items	<ul style="list-style-type: none"> • Fees for the first entry for cultural and sports services provided in the premises of memorial, museum, cultural center, heritage protection management institute, art center, exhibition center, calligraphy and paintings exhibition center and library; • Entrance fees for cultural and religious events organized in monastery, temple, mosque and churches; • Ticket sales of Science Promotion Unit and science promotion events launched by the provincial level or above Communist Party Unit and Science and Technology Association before 31 December 2017; and • Cultural and sports services provided outside the territory of China 	
Miscellaneous	General taxpayers providing cultural and sports services may choose to adopt the simplified taxation method to compute VAT payable.	

Education and medical services

Education services		Medical services
Definition	<p>Activities in providing the following services:</p> <ul style="list-style-type: none"> • Academic education services: teaching organized based on the admission and teaching plans confirmed and recognized by designated education administration and management bureaus; with the awards of corresponding academic certificates, including primary education, elementary secondary education, advanced secondary education, tertiary education, etc. • Non-academic education services: pre-school education, other types of training, speech performance, press conference, etc. • Education assistance services: education assessment, examination, admission, etc. 	Provision of services of medical check-up, diagnosis, treatment, prevention, health care, labouring, family planning, immunization, etc., and the related drugs, medical supplies and device, ambulance service, ward accommodation and meals
Taxation base	Total price and additional charges received, unless otherwise regulated by the MOF and SAT	
Examples of VAT-exempt items	<ul style="list-style-type: none"> • Academic education services provided by schools and universities (limited to prescribed income) • Childcare and education services provided by nursery and kindergarten (limited to prescribed income) • Education services provided outside the territory of China 	<ul style="list-style-type: none"> • Qualified medical services provided by medical institutions • Agricultural irrigation and drainage, pest control, plant protection, agricultural and husbandry insurance and related technical training; breeding and prevention from diseases of poultry, livestock and aquatic animals • Medical services provided outside the territory of China

Tourism and entertainment services

Tourism services		Entertainment services
Definition	Organization of transportation, touring, accommodation, catering, shopping, entertaining, business activities, etc., according to the needs of tourists	Provision of entertainment facilities and related services including singing and dancing hall, night club, bar, billiard room, golf club, bowling alley and other recreational activities (shooting, hunting, horse racing, video game, bungee jump, Go-Kart, hot air balloon, paramotor, archery, darts, etc.)
Taxation base	Taxpayers may choose to compute the VAT output based on the total price and additional charges received, less the expenses of accommodation, catering, transportation, visa, entrance ticket and tourism where such expenses are collected from the tourism service recipients and paid to other entities or individuals (for the aforesaid expenses collected from the service recipients, taxpayers cannot issue special VAT invoices but general VAT invoices)	Total price and additional charges received, unless otherwise regulated by the MOF and SAT
Examples of VAT-exempt items	Tourism services provided outside the territory of China	
Miscellaneous		Input VAT incurred in the acquisition of entertainment services is not creditable by a taxpayer.

Catering and accommodation services

Catering services		Accommodation services
Definition	Provision of food and drink at the catering facilities	Provision of accommodation and associated services, including hotels, hostels, guest houses, resorts and other accommodation facilities
Taxation base	Total price and additional charges received, unless otherwise regulated by the MOF and SAT	
Miscellaneous	Input VAT incurred in the acquisition of catering services is not creditable by a taxpayer.	

Resident daily services

Resident daily services	
Definition	Services in meeting daily individual and family needs of the residents, including community administration and management, housekeeping, wedding, elderly care, funeral, caring and healing, aid and relief, beauty and hair salon, massage, sauna, oxygen bar, foot treatment, bathing, laundry, filming, printing, etc.
Taxation base	Total price and additional charges received, unless otherwise regulated by the MOF and SAT

Resident daily services (continued)

Resident daily services	
Examples of VAT-exempt items	<ul style="list-style-type: none">• Income from housekeeping services provided by employees of housekeeping services companies• Elderly care services provided by elderly care institutions• Caring and support services provided by disability welfare institutions• Funeral services
Miscellaneous	Input VAT incurred in the acquisition of resident daily services is not creditable by a taxpayer.

Comments

Lifestyle sector involves a wide variety of businesses and covers different types of services closely related to the daily consumption of residents. It is expected that further rollout of the VAT reform will have a significant impact to businesses in this sector.

General observation

For the purpose of ensuring a smooth transition to the VAT regime, when drafting Circular 36, many of the existing Business Tax (BT) policies have been inherited. That includes certain special rules to determine the taxable base (i.e. sales) for indirect tax purposes under the BT regime (such as the method for the tourism services), and certain tax exemption treatments (such as medical services provided by medical institutions, etc.). Majority of the lifestyle services entities have been subject to BT at the rate of 3% or 5%. After the VAT reform, they will generally be subject to VAT at 6%. Although there is an absolute increase in the applicable tax rate, general taxpayers at the same time can claim input VAT credit, which may help to offset against the negative impact on the output VAT charged on the revenue at a higher applicable tax rate.

For culture and sports industry where the increase in the applicable tax rate is significant (original BT rate is 3%), Circular 36 provides that general taxpayers in this industry may choose the simplified method of taxation (where the VAT collection rate is 3%). This measure is to maintain stability during the transition and ensure the overall tax burden of this industry will generally not increase.

Many of the taxation items have been re-categorized under the VAT reform. As a result, the tax burden of some of the businesses may change. Taking education as an example, this business sector is not separately itemized under the existing BT regime. In practice, education services provided by many non-academic education enterprises may have been classified as training activities under "other cultural business" category and subject to BT at 3%. After the VAT reform, education business will be separated from cultural business, therefore it will not be able to enjoy the simplified taxation method as available to cultural business. General taxpayers carrying on non-academic education business will be taxed at 6%, which could result in an increase in tax burden of businesses within this category.

On the other hand, customers of some of the lifestyle services (such as catering, resident daily services and entertainment services) are mainly individual consumers and it is difficult to differentiate consumptions of business or private consumption purposes. Therefore, Circular 36 required that input VAT incurred in acquisition of such lifestyle services will not be creditable. In addition, Circular 36 specifically states that taxpayers are not allowed to claim input credit for individual consumption of entertainment. However, it is pending further clarification of the definition of "entertainment" in this context.

Since a lot of customers of lifestyle services are individual consumers, they will not be able to claim the input VAT. If the lifestyle service enterprises try to increase the price so as to pass along the VAT cost to the customers, the individual customers may have to bear the additional cost.

Increasing demand in tax compliance

As compared with BT, VAT regime implemented more stringent and complicated rules of tax reporting and control, especially in the management of issuance of VAT invoices. Taxpayers within the lifestyle sector are numerous, of different scales and significant gaps in the financial reporting capability. Therefore, it may be a big challenge for many lifestyle service providers to ensure compliance in the new VAT rules and requirements.

Small-scaled VAT payers (who are normally taxpayers generating annual taxable revenue of not more than RMB 5 million) may adopt the simplified taxation method, under which the VAT payable is calculated at 3% of the sales, without any input VAT being allowed to be credited. This method is similar to the one adopted under the existing BT regime. At the same time, small-scaled VAT payers will not be able to issue special VAT invoices by themselves (if needed, they may apply for issuance of such invoices by the in-charge tax authorities). In such circumstance, tax compliance requirements applied to small-scaled VAT payers are less stringent.

However, general VAT payers (who are the taxpayers generating annual taxable revenue exceeding RMB 5 million, or those taxpayers generating annual taxable revenue of not more than RMB 5 million but having a sound financial reporting system to provide accurate tax information) must accurately calculate the output VAT and the credit of input VAT such that the VAT payable can be ascertained. Therefore, a higher demand for tax compliance apply to these taxpayers. On the other hand, if the customers of lifestyle businesses can credit the input VAT incurred on the acquisition of the related services, the enterprises may face a big challenge of meeting the tremendous needs of issuing special VAT invoices to the customers (mainly enterprise customers). It is therefore important for these taxpayers to ensure the efficiency in issuing the invoices and compliance with the relevant invoice management requirements.

Challenges to diversified or cross-region business models

In the lifestyle sector, many entities adopted a diversified business models. Taking hotel operation as an example, apart from accommodation, income from services such as catering, entertainment (e.g., karaoke), sales of gifts, conference events and car parking, etc., will also be generated. According to the VAT regulation, in calculating the tax payable, the entity needs to segregate income generated from each of the service categories and apply the respective VAT rates. Entities with this diversified business model will have to adopt a more comprehensive financial reporting system in order to meet the needs.

At the same time, tax treatments of the service recipients for acquisition of the different types of services may also impact the tax administration of the entities. With the hotel operation example, customers acquiring catering and entertainment services will not get an input VAT credit but input VAT on other types of services (such as accommodation) is still creditable. As such, hotel operating entities may need to issue different types of VAT invoices for different services. This will complicate the tax/invoice management of the entities.

Moreover, many businesses in the lifestyle sector have multiple locations of operation such as hotel chain, restaurant chain, association of education institutes, etc. It may be a big challenge for them to ensure a consistent implementation of internal control policy and cross-region coordination for better management of tax compliance of various member entities among the group.

Recommendations

As there are significant differences in the tax administration and collection between VAT and BT regimes, the VAT reform will bring significant tax impact to entities and create challenges to business operations as well as internal control. As the final rollout will take place in less than a month, we suggest lifestyle service enterprises should prioritize and focus on the following key actions:

Evaluate the impact of VAT reform and formulate an action plan

Lifestyle service enterprises should evaluate the impact of VAT reform from the aspects of income, profits, cash flow, etc., based on which an action plan should be formulated. For example, whether there is a need to adjust the sales price such that the VAT cost can be passed on to the customers; how the acquisition of services should be administered in order to maximize the input VAT credit (choosing the right suppliers, delaying purchase plan after 1 May, etc.). Entities should communicate with the suppliers and customers about the impact of VAT reform and, where necessary, re-negotiate or modify the business contracts. If the aforesaid analysis and evaluations have already been done, a re-assessment of such is recommended based on the new regulation so that necessary adjustments can be made and the final measures can be properly implemented (based on previous communications with the suppliers and customers, entities may ultimately confirm changes in the terms of business and signing of new contacts).

Design and implement tax compliance measures

From 1 May onwards, lifestyle service enterprises will be subject to VAT. They should formulate a plan to ensure full tax compliance and implement the measures. The recommended actions include:

- Communicate with the in-charge tax authorities and fully understand the tax administration matters and procedures (e.g. registration as general VAT payer, purchase of special VAT invoices and tax control machines, etc.), designate suitable personnel as contact with the authorities and complete the necessary tax compliance tasks;
- Learn and understand the new regulations, and in case of uncertainty, consult with the tax authorities and professional advisors;
- Provide training to personnel involved in financial reporting, tax management, business operation (purchase/sales) and legal so that they can fully understand the impact of VAT reform on the business operation and financial performance; and
- Formulate compliance work plan to rectify inconsistencies between entities with the same group, effectively communicate within the group and evaluate the implementation.

Update information system and workflows

Entities should re-assess the current financial and other related systems and adjust where necessary (such as new ledger items, functions of VAT calculation and tax rate table, etc.) in order to meet the needs after the VAT reform.

Internal control workflows should also be evaluated based on the requirements of the new rules. Additional checkpoints should be added including management of invoices, tax reporting timetable, etc., in order to assist the entity to timely and properly complete the routine tax reporting tasks. Entities are also recommended to prepare a VAT compliance handbook for reference by the responsible personnel.

Optimize tax efficiency and explore tax planning opportunities

After transitioning to the VAT regime, taxpayers should review the systems and workflows (for example after 3 months of operation) and to evaluate the effectiveness. Where necessary, further adjustments and optimization should be done.

At the same time when there are more certainties in interpreting the new rules and more guidance will be provided by the tax authorities, entities should formulate a plan based on own circumstance, such as restructuring, operation realignment, in order to optimize the overall tax efficiency.

Additionally, MOF and SAT will continue to issue circulars and notices in order to supplement the implementation of Circular 36. Taxpayers should keep an eye on further development in the tax policy and take the appropriate actions.

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