

Tax Analysis

PRC Tax

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VAT Reform - Construction 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 including construction, real estate, financial services and lifestyle services, effective from 1 May 2016. All the industry sectors that used to fall within Business Tax (BT) regime will all be unified under VAT system upon implementation. Further to our previous publications that respectively cover an overview on Circular 36 and our industry-specific analysis to real estate, financial and lifestyle services, we will, in this newsletter, focus on the detailed rules on construction sector, as well as the related implications and the implementation actions.

Highlights of Circular 36 related to construction services

From 1 May 2016, the VAT reform is extended to construction services (that used to pay BT at the rate of 3%). Upon implementation, general taxpayers that engaged in construction services may generally be subject to VAT at the rate of 11%, whereas small-scale taxpayers are subject to VAT at the rate of 3% under simplified taxation method.

Scope of construction services

Construction service refers to construction, repair, decoration of all kinds of buildings, structures and attached facilities; and installation and other engineering activities related to pipelines, equipment, facilities etc. Construction service includes:

- *Engineering service* - It refers to construction or reconstruction of buildings and/or structures, including installation or furnishing of various types of equipment, pillars and platforms that are connected to the building structures, as well as engineering work related to kilns and metal structures.
- *Installation service* - It refers to assembling and placement of equipment and/or facilities in relation to production, power supply, lifting, transportation, transmission, medical laboratory, etc., including platforms, ladders, balustrades, etc. that are connected to the equipment being installed, as well as insulation, anti-corrosion, heat preservation and painting, etc. that are connected to the equipment being installed. Installation fee, initial fee, activation fee, expansion fee, and other similar charges received by the operators from the customers in connection with landline phone, cable TV, broadband, water / electricity / gas / steam supplies, etc. are under the category of installation service for VAT purpose.

- *Repair service* - It refers to repair, reinforcement, maintenance and/or improvement of buildings and structures, for the purpose of restoring the original function or extending the lifespan thereof.
- *Decoration service* - It refers to modification and/or renovation to buildings and structures for better appearance or a particular purpose.
- *Other construction service* - It refers to various engineering work other than the abovementioned, such as drilling (drilling wells), demolishing buildings or structures, leveling the land, landscaping, dredging (excluding channel dredging), moving of buildings, setting up scaffold, dynamiting, mine perforation, peeling and cleaning surface-adherent objects (including rock formations, soil formations, sand formations), etc.

Applicability of simplified taxation method

According to Circular 36, construction service providers applying for a simplified taxation method are allowed to deduct subcontracting charges from the total price that they receive to reach the sales amount (i.e. taxable base) for VAT purpose.

In addition to the situation where small-scale taxpayers that engaged in construction services are eligible to apply for the simplified taxation method, Circular 36 also clarifies that, general taxpayers that engaged in construction services, in the following situations, may opt for being taxed under simplified taxation method at 3% VAT rate. The aim of the introduction of this provision is to reduce the VAT burden for taxpayers in the following situations, where such taxpayers may have less input VAT to credit against their output VAT (e.g. it is very likely for a construction enterprise to incur few input VAT under a "pure-service project" (see below) since the major cost of the enterprise will be the labor cost for which no input VAT is incurred).

- The taxpayer provides construction service for a *pure-service project*, which refers to a project where the construction service provider does not purchase any construction materials or only purchases auxiliary materials needed for construction work, and charges construction fee based on the labor, management and/or other cost incurred.
- The taxpayer provides construction service for a construction project whereby the project owner provides all or part of the needed equipment, materials and power supply.
- The taxpayer provides construction service for an *old construction project*, which refers to:
 - § a construction project where the contract work commencement date stated on the Construction Permit is on or before 30 April 2016; or
 - § where the Construction Permit is not available, a construction project where the work commencement date stated on the construction contract is on or before 30 April 2016.

If a general taxpayer that engaged in construction services opts for the simplified taxation method, the input VAT incurred would not be allowed for credit. However, Circular 36 does not particularly address the question on whether or not a general taxpayer who opts for the simplified taxation method is able to issue special VAT invoices by itself, or needs to apply from the relevant tax authorities to issue the special tax invoice on the taxpayer's behalf. Further clarification is therefore required to address this matter.

Cross-county/city construction services

The construction service sector generally has a higher mobility as it often comes across the situation of providing construction services in a county or city other than where the taxpayer is registered. Under the existing BT regime, taxpayers who provide construction services should report and pay BT to the tax authority at the place where the services are rendered. After the implementation of VAT reform, taxpayers who provide construction services should pay provisional VAT to the tax authority at the place where the services are rendered, and then file and settle VAT with the respective tax authority at the taxpayer's place of registration. The detailed provisions are summarized below:

Place of services rendered (Pay provisional VAT)		Place of taxpayer's registration (Report and settle VAT)		
	Tax base of paying the provisional VAT	Provisional rate/Collection rate	Sales amount	VAT rate/Collection rate
General taxpayers (General method)	Total price and additional charges after deduction of payments to subcontractors	2%	Total price and additional charges	11%
General taxpayers (Simplified method)*	Total price and additional charges after deduction of payments to subcontractors	3%	Total price and additional charges after deduction of payments to subcontractors	3%
Small-scale taxpayers	Total price and additional charges after deduction of payments to subcontractors	3%	Total price and additional charges after deduction of payments to subcontractors	3%

*The simplified taxation method may be applied to general taxpayers in certain situations (e.g. providing construction services to old construction projects).

Impacts to construction business

Construction and real estate businesses play important roles in national economy, and therefore these sectors generally attract more attention from the society. As the upstream of real estate business, VAT matters related to construction business such as VAT rate determination, invoice issuance, tax payment, signing contracts, etc. would have significant impacts to the property business as a whole.

Future pressure on profitability

After the implementation of VAT reform, there is clearly a significant increase from BT rate at 3% to VAT rate at 11% under the general taxation method. If such construction taxpayers are unable to pass on the tax burden to their customers through price adjustment (e.g. where the construction fees received by the construction service provider remain unchanged), their VAT-exclusive revenue could drop significantly as compared to the net revenue (i.e. the revenue after BT being deducted) that they used to receive. On the other hand, since labor and material costs are the major components for construction business and the fact that it is sometimes practically difficult to obtain the corresponding special VAT invoices for claiming input VAT credits, the impact on tax rate increase may not be adequately relieved by the input credits. Given the current profit margin for construction business as a whole is already relatively thin, taxpayers under the general taxation method, at least in the short run, may face further profitability pressure after VAT reform.

Also and upon implementation of the VAT reform, the input VAT would be excluded from the gross market price of raw material and fixed assets for accounting purpose, leading to a decrease and structural change in the book value of assets as a whole.

New challenges - Cost and tax management

After the implementation of VAT reform, whether or not input VAT credits can be obtained for each of the expense item may affect the overall cost of the construction business. It follows that the construction company needs to carefully estimate the availability of input VAT credits for coming up a more accurate budget, and thus increasing the complexity for future bidding process. Given the complications in the prevailing business environment for construction sector, taxpayers that engaged in construction business may find it practically difficult when estimating their VAT-related cost in the bidding process.

On the other hand, there will be a higher demand in the tax management requirement after the implementation of VAT reform. Comparing to BT regime, the accounting and tax management requirement for VAT are generally more meticulous and complex, especially the risks associated with invoice management have to be addressed. In the event where false issuance of VAT invoices were occurred, the relevant parties will be penalized for serious cases, and the supervisor and personnel directly in-charge of invoice issuance may also have to assume criminal responsibilities. Therefore, a sound VAT management system and operational guidelines supported by computerized system for managing and preventing the risks aforementioned would then become a necessity for construction business.

Recommendations

Review and revisit of the current situation

Taxpayers should review the VAT-related business flows, identify the risk areas, complete the collection and classification for suppliers' information, and make appropriate election of taxation method (if applicable) as soon as possible, so that the taxpayers would be more equipped for formulating appropriate strategies to tackle with future challenges. Taxpayers should also review their own operation model, income streams and cost structures (including materials and equipment, financing, design, labor, major taxes and other costs), and to evaluate whether valid VAT invoices would be received to support input VAT credits.

Screening and management of suppliers

After the implementation of VAT reform, construction taxpayers should not only focus on pricing but also to pay more attention to the VAT taxpayer status of the suppliers. When evaluating and selecting the suppliers, taxpayers should consider whether the supplier is a general or a small-scale VAT taxpayer, so that they would be able to better assess their overall VAT cost burden.

Contract management

Construction businesses should revisit the contract terms which were negotiated under the BT environment, and appropriately amend the relevant payment terms to reflect the change from BT to VAT regime when they enter into new contracts. Considering the change of the tax calculation mechanism, undefined or unclear terms in relation to the service consideration would probably create disputes in the future. Therefore, construction businesses should review and undertake necessary adjustments to the contract terms. From practical perspective, taxpayers should distinguish the different needs between the procurement and sales processes, so as to reasonably determine the bidding procedure and payment terms.

VAT training

It is important to conduct VAT trainings to business and finance personnel, as these people should be more familiar with BT system and generally have less understanding to VAT mechanism. Depending on its own business needs, construction taxpayers should provide regular VAT updates to their finance, business and management personnel. Practically speaking, the management and in-house personnel may not be able to fully absorb the tax concepts from one, single tax training, so segregate the VAT trainings by different phases and stages could be sometimes more effective.

We set out below the training objectives for different teams and management:

Finance personnel - Basic introduction on VAT rules and regulations, the accounting requirements, the reporting obligations, the tax points, tax filing and payments, management of special VAT invoices, rules related to input VAT credit, and other matters to be noted for VAT management process

Business personnel - Standardized approach or practice for formulation of contractual terms, price negotiation and determination with suppliers or customers, implications to contractual terms after the VAT reform, pricing components, strategies to respond to the price adjustments proposed by suppliers, and details in relation to valid tax invoices and input credit mechanism

Management personnel - Methodologies for effective tax management, the latest tax rules/policies development, financial impacts from VAT reform, etc.

Setting up of tax function

Construction taxpayers should observe the VAT compliance and management requirement, and consider to set up tax function / posts for handling VAT filing and related compliance matters.

Compilation of VAT manual to ensure tax compliance

VAT management manual should cover the major VAT risk areas and the corresponding control measures, timing for income recognition, tax treatment for additional charges and deemed sales, scope of input VAT credits, verification and supporting document for input VAT credits, etc. The day-to-day VAT management system should be more focused on the suppliers' and customers' information, accounting, tax reporting, as well as VAT invoice management.

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