

Tax

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SAT Clarifies Post-VAT Reform Land Appreciation Tax Issues

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China's State Administration of Taxation (SAT) issued guidance (SAT Bulletin [2016] No. 70¹ or Bulletin 70) on 10 November 2016 relating to various land appreciation tax (LAT) issues following the rollout of the VAT reform in May 2016. Bulletin 70, which serves as supplementary guidance to Circular 43² (i.e. Caishui [2016] No. 43), applies as from the date of issuance.

Highlights of Bulletin 70

1. Taxable base for LAT purposes

1) Computation of taxable revenue of LAT

Circular 43 provides that the taxable revenue for LAT purposes must be VAT-exclusive. Bulletin 70 further clarifies that,

- Where the general VAT taxation method is applied, taxable revenue for LAT purposes should exclude the amount of output VAT; and
- Where the simplified VAT taxation method is applied, taxable revenue for LAT purposes should exclude the amount of VAT payable.

It is worth noting that a taxpayer may be allowed to deduct certain items (e.g. the purchase cost of land and buildings) from gross revenue to account for its output VAT (or VAT payable) arising from its sales of real estate. However, despite the guidance provided in Circular 43 and Bulletin 70, ambiguities still remain on whether the output VAT (or VAT

¹ See full text in Chinese: <http://www.chinatax.gov.cn/n810219/n810744/n2048831/n2059355/c2393295/content.html>

² See full text in Chinese: <http://www.chinatax.gov.cn/n810219/n810744/n2048831/n2059355/c2102680/content.html>

payable) refer to the amount computed based on the gross revenue before or after deducting the items.

For example, assume a company sold a building for CNY 3.15 million. The company acquired the building for CNY 2.1 million before 30 April 2016. Therefore, the company can opt for the simplified taxation method, with a 5% VAT rate. There could be two interpretations concerning the computation of taxable revenue for LAT purposes:

- CNY 3.15 million / (1+5%) = CNY 3 million
- CNY 3.15 million – CNY 0.05 million = CNY 3.1 million wherein, the VAT-inclusive sales revenue (for VAT purposes) is CNY 1.05 million (i.e. CNY 3.15 million minus CNY 2.1 million), and the VAT payable is CNY 0.05 million (i.e. CNY 1.05 million / (1+5%)*5%).

2) Taxable base for LAT prepayments for real estate developers

Prior to the VAT reform, real estate developers were subject to Business Tax (BT) and LAT, where a prepayment mechanism applied to the collection of both taxes. The advances received from buyers served as the base to compute both the BT and LAT prepayments. Following the VAT reform, although a prepayment mechanism still applies to the collection of VAT and LAT, the base to compute the prepayments is different.

Bulletin 70 provides that the taxable base for LAT prepayments should be computed as follows:

Taxable base for LAT prepayments = Advances received from buyers – VAT to be prepaid

Therefore, the taxable base for LAT prepayments will be reduced after the VAT reform.

For example, assume a real estate developer received an advance of CNY 1.11 million from buyers and applies for the general taxation method for VAT purposes.

Taxable base for VAT prepayments: CNY 1.11 million / (1+11%) = CNY 1 million

VAT to be prepaid: CNY 1 million x 3% = CNY 0.03 million

Taxable base for LAT prepayments: CNY 1.11 million – CNY 0.03 million = CNY 1.08 million

2. Deemed sales

1) Taxable revenue

Where a real estate developer transfers the ownership of real estate it developed to other parties for purposes such as employee benefits, investment, distribution to shareholders or investors, repayment of debt, exchange for another party's non-monetary assets, the developer should be deemed to be carrying out sales and, therefore, be subject to LAT. Bulletin 70 confirms that the previous guidance (i.e. article 3 of Guoshuifa [2006] No. 187) continues to apply after the VAT reform so that the taxable revenue for deemed sales should be determined by reference to:

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- a. the average price of same type of real estate of the developer sold in the same area and same year;
- b. the market price or assessed value of the same type of real estate in the locality in the same year assessed by the competent tax authorities, if the price in a) is not available.

2) Relocation compensation

Where a real estate developer paid relocation compensation to other parties by providing real estate it developed, Bulletin 70 confirms that the previous guidance (i.e. Guoshuihan [2010] No. 220) is still applicable, i.e. the deemed sales rule should apply and the taxable revenue should be determined according to 1). Meanwhile, the same amount should be added to the relocation compensation, which is deductible for LAT purposes. If additional cash compensation is paid by the developer, that compensation also should be deductible, but if the developer received cash boot from the party that received the compensation, a reverse adjustment should be made.

3. Deduction of taxes related to real estate transfers

1) VAT

"Taxes related to real estate transfers" is one of the deductible items for LAT purposes. Bulletin 70 clarifies that VAT is excluded from the taxes related to real estate transfers.

According to Circular 43, for input VAT incurred on other LAT-deductible items, if the input VAT may be credited against output VAT, the input VAT cannot be deductible for LAT purposes; otherwise, the input VAT also may be deductible for LAT purposes.

2) Urban maintenance and construction tax (UMCT) and education surcharges

The UMCT and education surcharges generally are considered surtaxes that are computed based on the amount of actual VAT payments. They are taxes related to real estate transfers and are deductible for LAT purposes. Bulletin 70 provides that, if a real estate developer is able to account for the UMCT and education surcharges on a project basis, the developer can deduct the UMCT and education surcharges that are actually incurred and paid; otherwise, the developer can deduct only the UMCT and education surcharges that relate to its VAT prepayments arising from buyer advances.

Under the general taxation method, the VAT payable is computed by deducting input VAT from output VAT. Therefore, to account for the UMCT and education surcharges on a project basis, a developer first must account for the output and input VAT for different projects, which may be a challenge for the accounting system, particularly if the developer also derives income from sources (e.g. leasing, sales of materials, interest income, etc.) other than the sale of real estate.

4. LAT settlement

If a project satisfies certain conditions (e.g. the project is completed and most of the project has been sold), a LAT settlement must be conducted by computing the LAT for the entire project and determining the final LAT owed to or from the tax authorities. According to Bulletin 70, the total taxable revenue and deductible taxes related to real estate transfers for a project that started before 30 April 2016 but which is settled after the date, should be computed as follows:

- Taxable revenue (for LAT purposes) = Revenue derived from real estate transfers before the VAT reform + VAT-exclusive revenue derived from real estate transfers after the VAT reform (see discussion in Section 1)
- Taxes related to real estate transfers = BT, UMCT and education surcharges paid before the VAT reform + UMCT and education surcharges incurred and deductible after the VAT reform (see discussion in Section 3).

5. Construction invoices

After the VAT reform, taxpayers that provide construction services must specify the location where the construction services were provided and the name of the building project on their VAT invoices. Bulletin 70 provides that a real estate developer must ensure the relevant information is accurately reflected in the construction service invoices it receives; otherwise, the relevant construction cost will not be deductible for LAT purposes.

6. Deduction for transfer of used buildings

For the transfer of a used building, the taxpayer may deduct the assessed value of the building from the sales price to compute the LAT. If the assessed value is not available, the taxpayer alternatively may deduct an amount calculated according to a base value (which is the purchase price shown on the original invoice obtained by the taxpayer when acquiring the building) and the number of years from the date of acquisition to the date of the transfer. Bulletin 70 provides that, after the VAT reform, the base value should be determined by reference to:

- The BT-inclusive price shown on the original invoice if the invoice was obtained before the VAT reform;
- The VAT-inclusive price shown on the original invoice if the invoice was a VAT general invoice obtained after the VAT reform; or
- The VAT-exclusive price shown on the original invoice, plus any uncreditable input VAT, if the invoice was a VAT special invoice obtained after the VAT reform.

Comments and recommendations

While Bulletin 70 clarifies certain LAT issues that arose in the context of the VAT reform, which should provide more certainty to taxpayers, issues remain, so taxpayers should continue to monitor regulatory and practice developments.

For real estate developers, the computation of LAT liability is complicated as it is generally involves two stages, i.e. prepayments when buyers' advances are received, followed by a final settlement when the project satisfies certain conditions. The VAT reform should make the above process more cumbersome. Developers should be prepared by considering the following actions:

1) Improve accounting and project cost management

Enterprises should familiarize themselves with the relevant tax and accounting rules (notably the VAT accounting regulation (Caikuai [2016] No. 22³) issued by the Ministry of Finance on 3 December 2016) and their impact, identify new control points to be introduced or improved in existing systems, and maintain accurate records of LAT prepayments on a project basis to support the computation of final VAT settlement in the future.

2) Enhance VAT invoice management

Since the imposition of VAT is still new for real estate developers, they should understand the potential risks relating to VAT invoice management (e.g. loss of input VAT credit or LAT deduction arising from failure to comply with the invoice requirements), and review invoice-related terms in existing contracts to ensure appropriate revisions can be made.

³ See full text in Chinese: http://kjs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201612/t20161212_2479869.html

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