

## Tax

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# Tax Analysis

## New VAT Guidance Issued on Industry-Specific Issues

Authors:

### Beijing

**Charles Gong**

Partner

Tel: +86 10 8520 7527

Email: charlesgong@deloitte.com.cn

### Ru Zhang

Manager

Tel: +86 10 8512 5478

Email: ruzhang@deloitte.com.cn

China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) issued guidance (Circular 58) on 11 July 2017 to address certain industry-specific VAT issues. Circular 58 applies retroactively as from 1 July 2017, except for the rules applicable to bill discounting, which will apply as from 1 January 2018.

### Construction sector

#### 1. Simplified VAT calculation method

Under Chinese law, there are two methods for calculating VAT payable: the general calculation method and the simplified calculation method. The general method typically applies to general VAT payers and the latter to small-scale VAT payers. One difference between the two methods is that a taxpayer is entitled to offset input VAT against output VAT under the general calculation method, but a taxpayer may not credit input VAT and a lower VAT rate applies under the simplified calculation method.

Circular 58 limits the use of the general VAT calculation method for certain construction services. According to the circular, where a general contractor provides construction services for the foundation and/or key structures of a building, but the project owner provides some or all of the relevant materials (i.e. steel, concrete, masonry materials, precast components), the general contractor must use the simplified VAT calculation method to calculate its VAT liabilities. Previously, a general VAT payer in the above situation was permitted to use either the general or the simplified calculation method.

However, Circular 58 will not apply to the following construction services:

- Services provided for projects of non-building structures, e.g., roads, bridges, tunnels, dams, etc.;
- Services provided for projects where the project owner purchased and provided only non-specified construction materials; and
- Services provided by subcontractors.

## 2. Taxation of advance payments

Circular 58 abolishes the rules that the VAT liability on construction services arises when a service provider receives an advance payment from the service recipient. However, the construction service provider still should pay an advance VAT at a rate of 2% or 3% when it receives an advance payment:

<b>How to calculate advance VAT</b> <sup>#1</sup>	General calculation method: $(\text{Advance payments received by the taxpayer} - \text{subcontracting payments made by the taxpayer}) / (1 + 11\%) \times 2\%$
	Simplified calculation method: $(\text{Advance payments received by the taxpayer} - \text{subcontracting payments made by the taxpayer}) / (1 + 3\%) \times 3\%$
<b>Where to pay advance VAT</b> <sup>#2</sup>	Construction services provided in counties (cities, districts) other than the place where the taxpayer is registered: Advance VAT is to be paid to the tax authorities where the services are provided.
	Construction services provided in the same county (city, district) where the taxpayer is registered: Advance VAT is to be paid to the tax authorities where the taxpayer was registered.

<sup>#1</sup> Formulas are partially extracted from SAT Bulletin [2016] No. 17.

<sup>#2</sup> Circular 58 newly introduces the advance VAT payment requirement for taxpayers that provide construction services only in the county (city, district) in which they are registered.

Previously, general VAT payers providing construction services were subject to an immediate 11% VAT under the general calculation method when they received advance payments. Since advance payments may be received before the construction work commences, a service provider could be detrimentally affected where it has to pay VAT if it has not yet incurred sufficient input VAT to offset its output VAT. Circular 58 is expected to alleviate this situation by only requiring the taxpayer to pay a 2% or 3% advance VAT upon the receipt of advance payments.

However, Circular 58 is silent on when a taxpayer has to calculate and settle its final VAT liabilities. Assuming the general rules would apply, the final VAT liabilities should be calculated and settled on the earlier of:

For more information, please contact:

### Asia Pacific Indirect Tax Services Leader

#### Hong Kong

##### Sarah Chin

Partner

Tel: +852 2852 6440

Email: sachin@deloitte.com.hk

### Northern China

#### Beijing

##### Yi Zhou

Partner

Tel: +86 10 8520 7512

Email: jchow@deloitte.com.cn

### Eastern China

#### Shanghai

##### Liqun Gao

Partner

Tel: +86 21 6141 1053

Email: ligao@deloitte.com.cn

### Southern China

#### Guangzhou

##### Janet Zhang

Partner

Tel: +86 20 2831 1212

Email: jazhang@deloitte.com.cn

### Western China

#### Chongqing

##### Frank Tang

Partner

Tel: +86 23 8823 1208

Email: ftang@deloitte.com.cn

- The date on which the construction services were provided, and the service provider and recipient agree on the progress and service amount as evidenced by relevant documents and/or accounting treatment; and
- The date on which VAT invoice is issued.

For practical purposes, the service provider could again experience financial difficulties if it has to pay VAT due to a request for a VAT invoice by the service recipient when there is insufficient input VAT available for offset. It is unclear whether the SAT will issue exceptions to the rules so that issuing a VAT invoice will not necessarily lead to an immediate VAT obligation.

## Financial services

### Bill discounting

When a non-financial institution party sells a bill of exchange to a financial institution (notably a bank) for proceeds that are less than the par value before the maturity date of the bill (i.e. bill discounting), the difference between the proceeds and the par value (i.e. "discount") currently is considered interest income, which is subject to a 6% VAT for the financial institution. However, the interest income may not be effectively earned by the financial institution because the bill could be further sold to other financial institutions before the bill matures, and the other financial institutions then would be exempt from VAT for any interest income they earned from holding the bill. Therefore, the VAT burden on the discount is wholly borne by the first financial institution that purchased the bill.

Circular 58 modifies this practice. As from 1 January 2018, where a financial institution purchases a bill from a non-financial-institution party and then sells it to other financial institutions, each financial institution in the chain will be subject to the VAT for the interests accruing during the period in which it held the bill. As a transitional rule, if a bill is sold to a financial institution before 1 January 2018, with all VAT on the discount paid by the first financial institution that purchased the bill, other financial institutions that subsequently purchase the bill may be exempt from VAT for their interest income earned from holding the bill.

The introduction of Circular 58 should be welcome by financial businesses since it is designed to achieve fairer taxation of bill discounting. By amending the current rules, which discourage financial institutions from further selling bills, Circular 58 is expected to stimulate the development of the bill of exchange market. Nevertheless, some issues remain unclarified, such as:

- Whether Circular 58 will apply to other financial transactions that have analogous practices, e.g. forfaiting, factoring;
- Whether the net gains derived from selling a bill also will be subject to VAT; and
- When a non-financial-institution party sells a bill to a financial institution, can the financial institution issue an invoice showing the full amount of the discount, though it may not be subject to the VAT for the same amount after Circular 58 comes into effect?

### Global Financial Service Industry National Tax & Legal Leader Hong Kong

#### Patrick Yip

Partner

Tel: +852 2852 1618

Email: patyip@deloitte.com.hk

### Deputy Leader / Northern China Beijing

#### Natalie Yu

Partner

Tel: +86 10 8520 7567

Email: natyu@deloitte.com.cn

### Eastern China Shanghai

#### Johnny Foun

Partner

Tel: +86 21 6141 1032

Email: jfoun@deloitte.com.cn

### Southern China (Mainland) Shenzhen

#### Shanice Siu

Partner

Tel: +86 755 3353 8389

Email: shsiu@deloitte.com.cn

### Southern China (Hong Kong) Candy Chan

Partner

Tel: +852 2852 5886

Email: cancha@deloitte.com.hk

#### Anthony Lau

Partner

Tel: +852 2852 1082

Email: antlau@deloitte.com.hk

#### Jonathan Culver

Partner

Tel: +852 2852 6683

Email: joculver@deloitte.com.hk

### Western China Chongqing

#### Jun Li

Director

Tel: +86 23 8823 1205

Email: juncqli@deloitte.com.cn

## VAT grouping

According to the general rules of the VAT reform, two or more VAT payers could request the approval of the MOF and the SAT to form a group to be treated as a single VAT payer. Circular 58 abolishes the grouping rule, so it appears that this treatment will no longer be available after 1 July 2017. The reason of the elimination of the grouping rules is still unknown. It is worth noting that the abolition will not impact the situation where a head office and its branches request combined VAT filing treatment from the tax authorities in the place where the head office is located.

## Rural land for agriculture

Circular 58 provides that taxpayers that provide rural land to other parties for agricultural production purposes (i.e. by subcontracting, leasing, selling, making a capital contribution, etc.) are exempt from VAT. Such transactions were exempt from business tax before the VAT reform, so Circular 58 effectively mirrors the exemption to support agriculture.

## Comments

Circular 58 provides further guidance to address certain industry-specific VAT issues. Affected businesses should stay updated on the regulatory changes, assess the impact of the new rules, and develop and implement appropriate actions. Although VAT reform has been rolled out in all industries since 1 May 2016, more guidance is expected to be issued in the future.

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#### Beijing

##### Andrew Zhu

Partner  
Tel: +86 10 8520 7508  
Fax: +86 10 8518 1326  
Email: andzhu@deloitte.com.cn

#### Chengdu

##### Frank Tang / Tony Zhang

Partner  
Tel: +86 28 6789 8188  
Fax: +86 28 6500 5161  
Email: ftang@deloitte.com.cn  
tonzhang@deloitte.com.cn

#### Chongqing

##### Frank Tang / Tony Zhang

Partner  
Tel: +86 23 8823 1208 / 1216  
Fax: +86 23 8859 9188  
Email: ftang@deloitte.com.cn  
tonzhang@deloitte.com.cn

#### Dalian

##### Bill Bai

Partner  
Tel: +86 411 8371 2816  
Fax: +86 411 8360 3297  
Email: bilbai@deloitte.com.cn

#### Guangzhou

##### Victor Li

Partner  
Tel: +86 20 8396 9228  
Fax: +86 20 3888 0121  
Email: vicli@deloitte.com.cn

#### Hangzhou

##### Qiang Lu / Fei He

Partner  
Tel: +86 571 2811 1901  
Fax: +86 571 2811 1904  
Email: qilu@deloitte.com.cn  
fhe@deloitte.com.cn

#### Harbin

##### Jihou Xu

Partner  
Tel: +86 451 8586 0060  
Fax: +86 451 8586 0056  
Email: jihxu@deloitte.com.cn

#### Hong Kong

##### Sarah Chin

Partner  
Tel: +852 2852 6440  
Fax: +852 2520 6205  
Email: sachin@deloitte.com.hk

#### Jinan

##### Beth Jiang

Partner  
Tel: +86 531 8518 1058  
Fax: +86 531 8518 1068  
Email: betjiang@deloitte.com.cn

#### Macau

##### Raymond Tang

Partner  
Tel: +853 2871 2998  
Fax: +853 2871 3033  
Email: raytang@deloitte.com.hk

#### Nanjing

##### Frank Xu / Rosemary Hu

Partner  
Tel: +86 25 5791 5208 / 6129  
Fax: +86 25 8691 8776  
Email: frakxu@deloitte.com.cn  
roshu@deloitte.com.cn

#### Shanghai

##### Eunice Kuo

Partner  
Tel: +86 21 6141 1308  
Fax: +86 21 6335 0003  
Email: eunicekuo@deloitte.com.cn

#### Shenyang

##### Jihou Xu

Partner  
Tel: +86 24 6785 4068  
Fax: +86 24 6785 4067  
Email: jihxu@deloitte.com.cn

#### Shenzhen

##### Victor Li

Partner  
Tel: +86 755 3353 8113  
Fax: +86 755 8246 3222  
Email: vicli@deloitte.com.cn

#### Suzhou

##### Maria Liang / Kelly Guan

Partner  
Tel: +86 512 6289 1328 / 1297  
Fax: +86 512 6762 3338  
Email: mliang@deloitte.com.cn  
kguan@deloitte.com.cn

#### Tianjin

##### Andrew Zhu

Partner  
Tel: +86 22 2320 6688  
Fax: +86 22 8312 6099  
Email: andzhu@deloitte.com.cn

#### Wuhan

##### Gary Zhong

Partner  
Tel: +86 27 8526 6618  
Fax: +86 27 6885 0745  
Email: gzhong@deloitte.com.cn

#### Xiamen

##### Jim Chung / Charles Wu

Partner / Director  
Tel: +86 592 2107 298 / 055  
Fax: +86 592 2107 259  
Email: jichung@deloitte.com.cn  
chwu@deloitte.com.cn

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#### National Tax Technical Centre

Email: ntc@deloitte.com.cn

#### National Leader

##### Southern China (Hong Kong)

##### Ryan Chang

Partner  
Tel: +852 2852 6768  
Fax: +852 2851 8005  
Email: ryanchang@deloitte.com

##### Northern China

##### Julie Zhang

Partner  
Tel: +86 10 8520 7511  
Fax: +86 10 8518 1326  
Email: juliezhang@deloitte.com.cn

#### Eastern China

##### Kevin Zhu

Director  
Tel: +86 21 6141 1262  
Fax: +86 21 6335 0003  
Email: kzhu@deloitte.com.cn

#### Southern China (Mainland/Macau)

##### German Cheung

Director  
Tel: +86 20 2831 1369  
Fax: +86 20 3888 0121  
Email: gercheung@deloitte.com.cn

#### Western China

##### Tony Zhang

Partner  
Tel: +86 23 8823 1216  
Fax: +86 23 8859 9188  
Email: tonzhang@deloitte.com.cn

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