



CHINA TAX ALERT

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New Tax Regulation Clarifying VAT Treatments on Finance Leasing Business Activities

The State Administration of Taxation's Announcement on Relevant Value Added Tax Issues in Relation to the Transition of Business Tax to Value Added Tax, SAT Announcement [2015] No. 90 (22 December 2015)

The State Administration of Taxation (SAT) has recently issued the "Announcement on Relevant Value Added Tax Issues in Relation to the Transition of Business Tax to Value Added Tax" (SAT Announcement [2015] No. 90, hereinafter referred as "Announcement 90"). Among various clauses, Article 3 and 4 of the Announcement 90 are specifically concerning the Value Added Tax (VAT) issues of finance leasing business, including:

1. Taxpayers who provide finance leaseback services of movable assets could deduct the principal from the VAT taxable income based on the contract amount. In the event there is no contract amount, the deduction could refer to the actual principal repayment amount.
2. Taxpayers who provide finance leasing services of movable assets and transfer their lease income receivables to financial institutions including banks under the factoring arrangement, will still be obligated to issue VAT invoices to lessee and report the relevant VAT taxable income. The factoring arrangement shall not change the business relationship between lessor and lessee.

Announcement 90 will be in force from 1st February 2016. Unresolved matters shall be subject to this new Announcement 90 after it is taking into effect.

Background

The finance leasing industry has long been facing with VAT issues since it was included in the 1st batch of pilot VAT reform on 1st January 2012. The above VAT issues mentioned in the Announcement 90 are typical issues facing by finance leasing industry and these issues could be briefly summarised as follow:

1. Back in 2013, the Circular Caishui [2013] No. 106 allows finance leasing companies, specifically to finance leaseback transactions of movable assets, to deduct principal (together with other deductible items) from the VAT taxable income for the purpose of computing the VAT payable. However, the circular also stipulates that the deduction of principal shall be based on valid invoices issued by lesser. In the past, this invoice requirement has caused practical challenges as lessees may not be able to issue VAT invoice as a Business Tax (BT) payer or they are not willing to issue VAT invoice for various reasons. In the absence of valid VAT invoice to support the deduction of principal, this give rise to potential tax risks to finance leasing companies who are conducting finance leaseback transactions.

2. With respect to factoring arrangement, the VAT treatment in relation to the transfer of lease income receivables to financial institutions including banks were never been clarified. The industry has long been hoping the rules will provide that lessor can still issue VAT invoices even after it transferred lease income receivables to other parties, given that lesser needs valid VAT invoices to claim input VAT deduction on the lease payments, meanwhile those financial institutions like banks are not able to issue VAT invoices as BT payer.

The issuance of Announcement 90 is echoing to the above business needs and will help provide consistent treatment and technical basis to follow by finance leasing companies nationwide.

KPMG's Observations

Message delivered by the regulation

Overall the Announcement 90 delivers the following favourable messages to the finance lease industry:

1. From tax perspective, finance leaseback will be treated as financing transaction. It has been widely viewed by the market participants that finance leaseback in substance is a financing transaction and should have similar treatment as a bank loan. By this token, it is reasonable to exclude the principal repayment amounts from the VAT taxable income even without having the supporting invoices. Now, by way of abolishing the invoice requirements, Announcement 90 has demonstrated PRC tax authority's view now aligns finance leaseback is by nature a financing transaction.
2. The stipulated VAT treatment on factoring transaction could be served as reference with respect to tax treatment of asset securitisation. Currently, the VAT issue has been to some extent a deadlock for off-balance accounting treatment of assets in securitisation transactions. Due to similar business nature (i.e. transferring lease income receivables to other parties), the clarity now provided on VAT treatment in factoring transaction will help finance leasing companies explore similar VAT treatment on the asset securitisation transactions with tax authorities. This will also help finance leasing companies to more accurately reflect the business nature of factoring/asset securitisation transactions in the accounting records.
3. Announcement 90 also demonstrates SAT's intention and action in fine tuning the policy to better reflect business needs during the transition of VAT reform.

Recommended actions

The VAT reform has been witnessed as a big challenging task to finance leasing companies over the past 4 years. This challenging task will still last awhile for finance leasing companies in the backdrop because industries like Financial Services industry will be going through VAT reform in near future. It is recommended that finance leasing companies to consider the following issues as a result of the ongoing VAT reform:

1. Financing cost impact brought by VAT reform in financial services industry. It is expected that the VAT reform in financial services industry will take place in 2016 and the possible VAT rate of 6% will apply to bank loan interest. Finance leasing companies therefore shall look after a number of relevant issues considering the significant amount of financing cost, including: How to deal with the possible pass-on of tax cost by lender (e.g. banks) as a result of VAT reform? Whether companies shall review the current financing structure so as to assess the possible impact from the financial services industry's VAT reform and take proactive actions? How to deal with the possible change to the current direct deduction of interest expenses from VAT taxable income for finance lease businesses as a result of the upcoming financial services industry's VAT reform; etc.
2. Impact on business due to different VAT rates applied in bank loan interest (possible 6%) and lease income (currently 17%).

3. VAT treatment to factoring/asset securitisation transactions and their impact. VAT will be applied to factoring/asset securitisation transactions upon implementation of financial services industry's VAT reform. As a proactive action, finance leasing companies shall evaluate the possible impact to the existing factoring/asset securitisation transactions and work out the action plan, e.g. to add special clauses in legal documents to factor in the VAT reform impact.
4. Impact to existing business models as a result of the VAT reform in industries including financial services, consumer services, etc. Currently, finance leasing companies might have competitive edge in some business models such as finance leaseback business on the basis that finance institutions like banks are still subject to BT. However, in view of the upcoming VAT reform in the above industries, finance leasing companies shall evaluate the sustainability of the current business models and explore new models for maintaining competitive edge.

It is good to see that Announcement 90 has clarified the VAT treatments which shall be favourable to finance leasing companies. However, it can also be expected that finance leasing companies will still face with challenging VAT issues brought by ongoing VAT reform, which will require policy development and companies' proactive actions to minimise the impact on the business. KPMG welcomes finance leasing companies to raise tax issues/concerns together with an aim to jointly tackle the VAT challenges.

