Further clarification of asset management VAT regulation

July 2017

Synopsis

On 30 June 2017, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly released Caishui [2017] No. 56 ("Circular 56") to further elaborate on Article 4 of Caishui [2016] No.140 ("Circular 140", i.e., Notice regarding clarifications on certain VAT related policies under the VAT pilot arrangements) and Caishui [2017] No.2 ("Circular 2").

Circular 56 further clarifies VAT policy and levy issues regarding asset management products, and stipulates that the effective date will be 1 January 2018.

Circular 56 and EY Analysis

Circular 56 is of high significance to the asset management industry. Below is our initial interpretation and observation of the key provisions of the circular for your reference.

Article translation for reference purposes only	EY Interpretation
With respect to any VATable activities in the course of managing asset management products, managers of the asset management products ("Managers") could be temporarily subject to the simplified VAT calculation method and thus liable to VAT at 3%.	► The simplified VAT calculation method is aimed to solve the input VAT dilemma under the general VAT calculation method, e.g., how could a Manager issue VAT invoices to the asset management products (i.e. the Manager) for input VAT recovery, how to segregate input VAT amongst products, etc. ► The simplified VAT calculation method is considered as a preferential treatment with a lower tax burden, considering there would be limited input VAT incurred on products' expenses under general VAT calculation method. ► The simplified VAT calculation method is stated as a temporary taxation method and this leaves room for the possibility to change back to a general VAT calculation method in the future which is of a tax-neutral nature.
Managers include banks, trust companies, public fund management companies and their subsidiaries, securities companies and their subsidiaries, futures companies and their subsidiaries, private fund management companies, insurance asset management companies, professional insurance asset management institutions and pension insurance companies. Asset management products include banks' asset management products, trust funds (including collective trust funds and single trust funds), property trusts, public securities investment funds, specific client asset management plans, collective asset management plans, designated asset management plans, private investment funds, debt investment plans, equity investment plans, equity / debt hybrid investment plans, asset-backed plans, portfolio insurance asset management products and pension management products. Other managers or asset management products as prescribed by the MOF and SAT.	► It is said that the scope of Managers and asset management products was provided by industry regulatory authorities and broadly cover existing types of Managers and asset management products in the market. ► That Circular 56 enumerates the scope of asset management products and Managers would be of help in ensuring universal enforcement level by tax authorities and higher certainty in taxpayers' VAT assessment. ► The saving clause is set out to cater any new types of asset management product or any special cases identified in daily tax enforcement.
For managers entrusted by investors, trust providing management services in respect of the entrusted assets, or Managers providing other VATable services except those stipulated in Article 1, such services should be subject to VAT according to the prevailing VAT rules.	► Management services should be considered as "other business" and should be subject to VAT at 6% pursuant to Caishui [2016] 36.

Article translation for reference purposes only	EY Interpretation
Managers should separately account for the sale revenue and VAT payable with respect to the income arising from asset management products and other business. If they are not separately accounted for, income arising from asset management products should not be eligible for the treatment prescribed under Article 1 of this Notice.	► If Managers could not separately account for asset management products and other business, income derived by asset management products could not be subject to the simplified calculation method, and would then be subject to the general calculation method and the applicable rate should become 6%, which may possibly mean a higher tax burden. ► Furthermore, Managers would have to face the issues of input tax credit such as VAT invoices handling and also input tax credit allocation amongst different products.
Managers can opt for separate or consolidated computation for sales revenue and VAT payable with respect to the asset management products.	► If consolidated computation is adopted, gains from one product should be able to be offset by loss from another, subject to offset limitation (loss will expire by 31 December every calendar year). ► Managers would need to consider whether consolidation complies with regulatory requirements.
Managers should perform consolidated VAT filings with respect to the income arising from the asset management products and other business according to the VAT filing timeline.	► Income arising from asset management products and other business is subject to the same VAT filing timeline. ► The current VAT return format enables Managers to report VAT in one return for income from asset management products and other business respectively.
This Notice will be effective on 1 January 2018.	► The implementation of VAT on asset management products has been postponed to 1 January 2018, giving more time to Managers to prepare for the VAT implementation, which could include complex work such as determination of VAT treatment of underlying investment of asset management products which could be complicated in structure and unclear in existing VAT regulations.
With respect to VATable income arising from asset management products prior to 1 January 2018, if no VAT has been paid previously, no VAT will be payable; if VAT has been paid previously, the previously paid VAT can be used to offset against the VAT payable of the Managers.	► The use of previously paid VAT to offset VAT payable would be subject to local practices of tax authorities, e.g., verification procedures of the overpaid taxes might be required.

EY observations

Further to the previously issued circulars, the recently released Circular 56 elaborates the definition of asset management products and Managers, the specific taxation method of income arising from asset management products and effective date of this Circular (i.e. 1 January 2018). Circular 56 is aimed to resolve a number of taxation issues in relation to the income arising from asset management products. However, based on our experience working with Managers and custodians, we understand that industry players have certain concerns on Circular 56. We hereby set out a number of key issues that the industry should be aware of:

Defining income arising from asset management products for VAT purposes

Taking into consideration the complexity of asset management product arrangements, we suggest Managers sort out the income arising from asset management products pursuant to relevant VAT rules and assess the corresponding tax, financial and operational impacts.

Please note that minor variations of a product's arrangements would result in different VAT treatments. One example is that for some pre-agreed equity repurchase arrangement, Managers may view the gains of their equity investment as not subject to VAT, but if the arrangement is set in a way that could be viewed by tax authorities as a debt arrangement, the gain could be viewed as interest and subject to VAT. In this respect, contract review would be of importance in determining the nature of income arising from a product and coming up with the corresponding VAT treatments. According to our experience working with Managers in previous months, such contract review and income determination work requires tremendous time, manpower and VAT technical input.

Enhancing accounting mechanism respectively for asset management products and other business for VAT compliance purposes

The significance of separate accounting and the consequence of failing to meet the requirement has been easily overlooked. Pursuant to Circular 56, income arising from any asset management product should not be eligible for the VAT rate at 3% if they are not separately accounted for from other business. In this case, the higher rate of 6% may be triggered, and the need to take into account of input tax credit and the associated invoice management would arise again.

Even though Circular 56 presents the general principle that VATable revenue and output VAT on asset management products should be separately accounted for, the details are not set out. We are of the opinion that the Managers' overall accounting and management process and system should be set in a very tightened manner to ensure the "separately accounted for" requirement could be met to avoid risk of higher tax cost. We have set out a few examples below for reference purposes:

- **Accurate allocation of costs:** costs on asset management products should be separately accounted for from those on other business.
- **Accurate distinction of income:** Manager's income from investment and transfer of financial products (i.e. capital gain) should be accounted for separately from that of the products.
- **Due invoice management:** Given a product is not a registered taxpayer, but a Manager is considered as the taxpayer for the products, any invoices that should have been issued to/from the products should be issued to to/from the Manager. With an aim to mitigate unnecessary queries from tax authorities, invoices should be separately issued with clear notes indicating who is the contractual party (i.e., either the Manager or the specific product), especially when the Manager and any of the products deal with the same counterparty.

As mentioned above, Circular 56 has not clearly provided particular VAT requirements on how one product should be separately accounted for from another product. We would suggest Managers pay attention to any regulatory updates on the requirements or any instructions from local tax authorities.

Attending to a potential tax burden

Though Circular 140 particularly provides that a Manager shall be considered as the taxpayer for the products, the tax burden in essence should be ultimately borne by the investors, which would result in a decrease of yield rate of the products. Furthermore, foreseeing the possible practical issues such as tax-accounting timing differences, Managers should be careful with how such a tax burden could be smoothly and reasonably undertaken by each investor.

There are certain aspects that Managers should pay attention to in this respect:

- **Contract provision:** Tax elements such as taxation basis, calculation method, ultimate tax bearers, tax payment arrangements, provisions on changes of tax laws/regulations, etc., should be duly provided in the contract and duly agreed with investors. This is to ensure investors are well informed and are in consent of the potential tax burden and the financial impact on returns by such tax burden, with an aim to mitigate any potential legal risks due to dispute in investment return calculation.

- **Calculation of taxes:** Managers should be very careful with VAT and surcharges calculation so as to make sure the tax burden be accurately borne by diffident investors. Given that taxes should be reported and paid in a fixed time period whilst redemption might occur prior to tax payment, there should be a proper calculation and accounting mechanism to address such issues and to ensure sufficient funds be reserved for tax payments. Moreover, as mentioned above, such a calculation mechanism should be duly provided in the contract.

- **Reminder to investors:** Given the tax related arrangements and/or provisions have not been agreed before, Managers should take due actions to ensure investors are aware of and are in agreement with such arrangements/provisions.

Potential risks if Managers adopt consolidated computation method for different asset management products

Where a Manager adopts a consolidated computation method for different products, there would possibly be differences between taxes borne by different investors and the actual tax payables for a period. If the Manager fails to keep thorough records to account for the differences and to explain the differences to the investors, there might be compliance risks (against regulators) and legal risks (against investors) regarding the distribution of tax burden amongst investors and also between investors and managers.

System based implementation

The operation of asset management products is relying heavily on information systems. A system based VAT solution should be developed and implemented prior to 1 January 2018. According to our experience, the systems should at least be equipped with the following functions:

- To separately compute and account for VATable revenue and VAT payables of asset management products from other business;

- To separately compute and account for VATable revenue and VAT payables of one asset management product from another;

- To compute actual and potential taxes assumably borne by investors and to indicate the impacts on the net asset value and yield rate.

Epilogue

In short, introducing a simplified VAT calculation at 3% and postponing the effective date appear to be the authorities' intention to relieve Managers' stress with respect to VAT compliance. We would suggest that Managers to grasp the chance of the extended window of time to take due actions in the coming half year to fulfill VAT compliance requirements, such as product income determinations, accounting mechanism enhancement, contract review, communication with investors, system upgrade, etc. We will keep you posted for any updates. Should you have any questions, do not hesitate to reach out to our professional team,

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