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New Policy of "Financial Sale-and-Lease-back": An Icebreaker for Financial Leasing Business?

By David Yu and Clare Lu

Since the value added tax ("VAT") reform in 2009, the financial leasing business has been severely struck. The industry's appeal has finally obtained response from the competent authority. The State Administration of Taxation ("SAT") on 8 September 2010 issued Announcement No. 13, clarifying the tax treatment on the lessee's sale of a target asset in a finance-driven sale-and-lease-back transaction. Such announcement brought some "warmth" to the "severe winter" from which the financial leasing business had been suffering.

Salient Points

- When a lessee sells a target asset as part of a financial sale-and-lease-back transaction, such sale should fall outside the scope of business tax ("BT") or VAT, as it does not involve transfer of the ownership or the risks and benefits related to ownership of the asset.

- A lessee's sale during the financial sale-and-lease-back transaction should be treated as a financing mechanism. Lessees are not required to recognize any sales income or to pay corporate income tax ("CIT"). Rather, the asset should be depreciated based on the lessees' book value recorded before the sale. Meanwhile, interest expenses paid by the lessees for the financing should be deductible for CIT purposes.

- Announcement No. 13 provides that it becomes effective on 1 Oct 2010. Lessees may seek tax refunds for VAT or BT paid on a basis different from that provided by Announcement No.13.

Our Observation

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- **Applicability of announcement No.13**

Under Announcement No. 13, a “financial sale-and-lease-back” refers to a transaction where, for financing purposes, a lessee sells its assets to an approved financial leasing company and then leases the assets back under a financial leasing arrangement. The eligibility of the lessor is a point worth noting; only approved financial leasing enterprises are eligible. Therefore, sale-and-lease-back transactions without eligible lessors shall not be subject to Announcement No. 13.

- **To avoid additional tax burden for financial sale-and-lease-back after turn-over tax reform**

Before the promulgation of Announcement No.13, the tax implications of a financial sale-and-lease-back transaction were unclear, and such transactions were often treated as separate sales and leases for tax purposes and thus subject to different tax treatments. However, turnover tax reform brought additional tax burden for lessees. One example is the sale-and-lease-back of old equipment. According to the Circular on Several Policies of Value-added Tax and Business Tax (Caishuizi (94) No. 026), units and individuals selling their used fixed assets as goods are temporarily exempt from VAT. Under this circular, a lessee will not incur VAT for the sale during the sale-and-lease-back transactions. However, after the 2009 VAT reform, the abovementioned policy has been practically abolished. Based on the Circular on Certain Issues Concerning National Implementation of the VAT Reform (Caishui 2008 No. 170), the tax authorities in certain regions began to require that lessees pay VAT. This is undoubtedly an additional tax burden to financial leasing businesses.

Under the principle of “tax by substance”, Announcement No. 13 confirms that at the point of the lessee’s sale, “not all the rewards and risks in connection with ownership of assets are fully transferred”. Therefore, it should not be subject to VAT or BT because no de facto sale of assets took place from a tax perspective.

- **Financial sale-and-lease-back could be the preferred mode of financial leasing**

After the VAT reform in 2009, financial leasing companies have been haunted by the fact that they cannot issue VAT invoices and therefore lessees cannot credit against input VAT. Announcement No.13 provides a solution for part of financial leasing projects: lessors are not liable to VAT or BT at the stage of the sales of equipment to financial leasing company, whereby not all benefits and risks attached to ownership of assets are fully transferred. As lessees would have already obtained certificates to substantiate its VAT credit, it is not necessary for lessors to obtain another certificate issued by the financial leasing company. Hence, the difficulty for lessees to credit against input VAT is practically solved. We understand that, for strictly VAT saving purposes, the sale-and-lease-back structure may be the preferred mode under a financial leasing arrangement.

- **Issues to be clarified**

Announcement No. 13 applies substantive tax principles to the sale-and-lease-back transaction, assisting in the development of financial leasing. Such policy deserves applause. However, many aspects call for further clarification:

- According to Announcement No. 13, lessors may deduct the financing interest as financial expense. But the announcement contains no specification on the nature of the financing interest or its specific scope.

- Announcement No. 13 lacks clear instructions on the BT treatment of lessors. Under financial leasing, the balance after the actual costs borne by lessors for the leased goods are subtracted from all the prices and additional expenses (including the scrap value) collected from the lessee are regarded as turnover. In circumstances where there lacks a "transfer of the ownership or the risks and benefits related to ownership of the assets", how “actual costs borne by lessors for the leasing goods” are identified becomes a serious problem.

Conclusion

At present, there remain some gaps between the development of the financial leasing industry in China and its international counterparts. Tax, as one of the key elements of consideration for financial leasing transactions, undoubtedly plays a vital role in the development of the financial leasing industry. Since the VAT reform in 2009, the financial leasing industry has been unexpectedly impacted. Nevertheless, the authorities have begun to solve relevant problems in financial leasing transactions, as mentioned above. We hope further tax reform may effectively resolve the difficulties currently facing the financial leasing business.

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