

Breaking the Ice of Post - VAT Reform

By David Yu and Clare Lu

In order to facilitate the construction of harbours in Tianjin and to encourage vessel exportation under financial leasing, the Ministry of Finance (MOF), the General Administration of Customs (GAC) and the State Administration of Taxation (SAT) jointly promulgated the *Circular on Carrying out Export Tax Refund in Tianjin (Trial) for Vessels Exportation under Financial Leasing Arrangement* (Cai Shui [2010] No. 24, Circular 24) on 30 March 2010. Circular 24 temporarily provides a one-year export tax refund to financial leasing enterprises on financial leasing arrangements whereby ownership of vessels are transferred to offshore enterprises.

Circular 24 Overview

- Entity eligible to tax refund (exemption) on exportation – financial leasing enterprise

Firstly, the eligible entity should be registered in Tianjin, and secondly, the same entity should be a licensed financial leasing enterprise.

- Business model eligible to tax refund (exemption) on exportation – financial leasing with ownership transfer to overseas

The exporter, who exports vessels under the financial leasing arrangement, may apply for export Value Added Tax (VAT) refunds provided that the vessels ownership has been transferred to the offshore lessee after the expiration of the lease term.

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Interpretation and Observation

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The main tax rule regulating financial licensing is the *Circular on Turnover Taxes on Financial Leasing Business*, issued by SAT in 2000. The PRC tax rules stipulated various tax policies based on whether the enterprise was licensed for financial leasing. Specifically, an enterprise licensed for financial leasing should file a Business Tax (BT). An enterprise not licensed for financial leasing should follow two different approaches: (i) when the title to goods is transferred to the lessee, the lessor should compute VAT, and (ii) when the title to goods is not transferred to the lessee, the lessor should compute BT.

Prior to VAT reform, the overall tax burden for enterprises licensed for finance leasing was lower than those unlicensed enterprises. For the lessee, whether the lessor pays BT or VAT does not impact its business decision since it cannot claim input VAT credit even if it obtains VAT invoices from the lessor.

After VAT reform, a general VAT taxpayer who purchases fixed assets may credit the input VAT against the output VAT. However, if the fixed asset is leased from a licensed financial leasing enterprise, neither the lessor nor the lessee may credit the input VAT. This is because the lessor is not a general VAT taxpayer, and the lessee can only get a common invoice rather than a VAT invoice. In practice, in order to compensate the noncredit tax burden on the lessee, the lessor may have to bear at least part of the noncredit tax costs. These are costs that directly render additional operational cost for the financial leasing business.

In the post-VAT reform era, where commercial competition is intense, the financial leasing enterprises may end up in a position of disadvantage. In recognition of this problem, authorities began to consider offering a certain degree of policy support for the financial leasing industry. We consider Circular 24 the dawn of preferential policy long-awaited by financial leasing enterprises.

As early as 2008, in a circular *Opinions on the Financial Promotion of Economic Development*, the State Council requested “to enhance the VAT policy in connection with financial leasing business under VAT reform”. As part of that enhancement that the relevant authorities have made for the financial leasing business, Circular 24 reflects the notion that businesses shall have a brand-new start-up with tax preference.

It is interesting to know that for another envisaged shipping centre – Shanghai – the State Council pointed out that “the relevant authority shall actively research the preferential tax policies on financial leasing companies engaged in international financial leasing arrangement for maritime shipping”. To expedite the process of Shanghai becoming an international financial centre and an international shipping centre, we understand that it is possible and necessary to strive for a similar VAT refund policy for vessels exported under financial leasing arrangements.

The financial leasing business in China lacks regulation. Particularly because of the delay in the promulgation of the *Financial Leasing Law*, companies can only hope to solve problems via practical means within the existing regulatory framework. VAT reform is a necessity for China’s turnover tax reform and, by its nature, is not in conflict with the financial leasing business. We understand that the main objective of implementation of a consumption-type VAT is to lower the tax burden or cost of companies. If the relevant authorities further improve VAT reform then, in addition to other types of companies, financial leasing companies may come to benefit. Furthermore, our understanding is that there has been discussion to further reform the VAT and BT systems. If financial enterprises are included under the scope of VAT taxpayers, then the complicated issue of financial leasing would be readily solved.

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