

Insurance Tax Highlights – Asia Pacific China

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The VAT reform – a wake-up call for the China insurance sector

Unlike many other jurisdictions, China does not currently have a comprehensive Value-Added Tax (“VAT”) system which applies uniformly to the provision of both goods and services. Since 1994, China has adopted two indirect tax regimes in parallel

- one being the VAT system on supply of movable goods, and the other being the business tax (“BT”) regime on supply of services. Since 2012, China started to roll out the VAT pilot programme to gradually replace the BT regime for various service sectors, with a view to transforming the BT regime to a VAT system (“B2V”) in its entirety by the end of 2015.

Given the complexities and significance of the insurance sector in China, it is anticipated that it would be amongst the last industries to join the Chinese B2V programme. Whilst it is unlikely that the insurance sector’s B2V reform would happen in 2014, the general expectation is that it would be launched by December 2015.

This article provides a snapshot of the anticipated flurry of new VAT issues insurers in China may face as the insurance sector’s B2V reform draws near.

Questions on the upcoming B2V reform raised by insurers in China include:

- When will the Chinese policy makers complete their drafting of the VAT rules for the insurance sector, and make an announcement to the market?
- How long will the transition period be, to allow insurers adequate time to prepare for the B2V reform?
- What would the insurance VAT system look like? For example, what would be the applicable VAT rate, the allowable credit, etc.?

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- Would there be any concessions/exemptions or grandfathering provisions for particular business segments of the insurance sector?
- Would the B2V reform result in any unfavourable tax consequences or financial impacts on our insurance business?
- How would the insurance B2V reform affect our existing operations and business processes?
- What kind of advance training should we offer to our tax and finance staff to prepare for and/or adjust to the insurance B2V reform?
- So far the reform has allowed a very short transition period for industries that have already joined the B2V reform. As it would be more difficult for the insurance sector to transition, how can one plan for the reform when the rules are still uncertain, and the deadline is approaching?

The above makes B2V reform planning difficult, but not impossible.

The current state

Life insurers are currently exempt from BT in China whereas property and casualty (“P&C”) insurers are subject to 5% BT on gross premium income. On the other hand, reinsurers are not required to pay BT on their reinsurance premium income. As a result, both life and P&C insurers are unable to raise VAT invoices to their customers. Accordingly, their customers are not eligible to claim input VAT credits for the insurance premium paid.

Meanwhile, insurers (including life, non-life and reinsurers) are not eligible to claim input VAT credits (for the fixed assets, goods and services used in their business) against the BT payable. Insurers in China providing cross-border insurance services to overseas customers are not eligible for the BT exemption.

The dream versus reality

Ideally, the B2V programme for the services is designed to reduce the overall indirect tax burden of the Chinese economy, by allowing indirect tax to smoothly pass through the supply chain to reach the end-consumer.

BT is a tax on gross receipts, and is reflected in the profit and loss accounts of the insurers. In comparison, VAT appears to be a balance sheet item, collected by insurers but ultimately passed to the end-consumer in an economic sense. In theory, insurers can be better off with the B2V regime if they can pass their VAT burden along the value chain to the next level.

However, in anticipation of the effects the B2V reform may have on insurers, a list of factors need to be considered.

For life insurers, it is anticipated that the Chinese government will allow a VAT exemption on life premium income as an extension to the current BT exemption for life businesses. However, it is unlikely that life insurers will be granted a zero-rated treatment under the new VAT regime. If this is the case, life insurers would suffer from the loss of all input VAT credits on the purchase of fixed assets, goods and services that they use in their businesses. This creates heavy irrecoverable VAT burden when all business vendors and service providers (including insurance agents, brokers, intermediaries as well as real estate landlords) become subject to VAT and charge VAT on their invoices to the insurers. Under the B2V reform, the new VAT rate may be higher than the original BT rate on the assumption that there will be input credits.

For P&C insurers which are currently subject to 5% BT, any new VAT system which narrows the scope of taxation on P&C insurers would create a revenue gap to the government. The Chinese B2V policy drafters have indicated their intention to impose VAT to replace BT to the P&C sector. Meanwhile, they have conducted various international tax surveys on insurance VAT rules of



other jurisdictions and organised industry group meetings to understand the insurers' wish list on this subject. Tentatively, they are leaning towards a possible VAT rate for P&C insurers of 11%, which is significantly higher than the current 5% BT. With this in mind, it is anticipated that the Chinese policy drafters would set out an effective mechanism to enable insurers the ability to recover the input credits on settlement of the claims and other purchases to alleviate the proposed high 11% VAT. The question is how to support this. China uses a "Golden Tax System" to control VAT, which relies on paper-based VAT invoices. The question of how to get the VAT invoice for the settlement has yet to be resolved. (Please see below for further discussion on the "Golden Tax System".)

For the reinsurance sector, the Chinese government is also inclined to introduce different VAT treatments for life and P&C businesses in the B2V reform. In a nutshell, the Chinese policy drafters may propose an exemption on reinsurance premiums for life businesses to align with their proposal to offer VAT exemption on life premiums. However, the reinsurance of P&C businesses is expected to follow the same VAT proposal for P&C insurers in that they will become transactions liable to VAT. In addition, reinsurance activities in China may involve the participation of offshore reinsurers, which means that Chinese policy drafters will also have to consider and decide on the right regime for the cross-border reinsurance transactions, and the possible VAT withholding mechanism on reinsurance premiums paid overseas.

Insurers manage the proceeds of their insurance premium through investing in fixed income, equity and other alternative assets. Currently, investment income such as interest income, dividend and capital gain are generally subject to BT, with concessions and exemptions granted to some categories of investment, such as government bonds. It is expected that the insurance services B2V reform may cause significant changes to the landscape of the indirect tax treatment of the insurers' investment income.

P&C insurers may also wish to consider the impending inclusion of the banking sector into the B2V pilot programme. This is likely to occur in tandem with the inclusion of the insurance sector. If banking services are

eventually subject to VAT, banks may be able to issue special VAT invoices when the insurers pay them a commission for bancassurance services. The P&C insurers can then claim an input VAT credit on such purchases, which could lower their current costs,



depending on whether the banks adjust the level of their service fee.

The Golden Tax System

China has an unique VAT invoice administration system widely known as the "Golden Tax System", which imposes strict controls over invoicing in China as a key measure to combat VAT fraud. Essentially, this is a highly regulated invoicing system under which all general VAT taxpayers must use to issue valid VAT invoices to their customers. The system consists of hardware, software and IC cards approved by the Chinese tax authorities. IC cards would be used by taxpayers to ensure that the tax authorities can reconcile every invoice issued under the Golden Tax System with the VAT return filed by the issuers. Meanwhile, the recipients of the VAT invoices are also required to use the Golden Tax System to validate these invoices in order to claim input VAT credits.

One of the key challenges for the insurers in the upcoming B2V reform is to connect their existing management information system, accounting processes and tax compliance procedures to the Golden Tax System - in particular, to deal with the rigidity and complexity of the VAT invoicing regime in the future. Tailored software has to be developed to link the insurers' transactions under their ERP system to the Golden Tax system. Another challenge faced by the

insurers is the potential huge volume of invoices which will be raised when customers who are general VAT payer would demand VAT invoices from the insurers to claim VAT input credits. As mentioned above, how an insurer can obtain VAT invoices on the settlement and other payouts to support its input VAT claim is a big question mark. Electronic invoicing may be a future solution to replace voluminous paper invoicing. However, e-invoicing in China is currently still in its infancy.

The way forward

2015 is expected to be an important milestone for Chinese insurers. We anticipate that the B2V reform would cause impactful changes to the tax operating environment of Chinese insurers. During the reform, insurers would need to devote significant resources to transform its business processes, reconfigure its systems and realign their tax relationship with their customers, business partners, agents and service providers. Recent experience from various other industries show that China may only grant a short transition period for the B2V reform after the new VAT rules have been formally announced. Insurers would therefore need to plan well ahead to prepare for the B2V reform. Gap analyses, B2V

impact studies, scenario reviews and related workshops are some immediate actions insurers can undertake at the initial stage. They represent the first phase of preparation for insurers to understand the potential impact of this B2V reform so that the various stakeholders, including the business unit heads, finance, IT, operations and legal teams are fully aware of the upcoming changes to their operating environment. Insurers may also start to set aside resources to monitor the B2V development, such as setting up steering committees and project teams which can immediately react to and mobilise resources on B2V planning and upcoming implementation compliance.

Taking this a step further, one may wish to predict what the future insurance VAT rules will be, based on the current BT treatment on the insurance products, current VAT model and any other available information/indication, and develop strategies and implementation plans to handle the different situations. This will allow one to take action swiftly when the rules are eventually available.

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