

# Research on Tax Treatment for PPP Projects

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**Abstract:** As the PPP mode sees wider application across all industries, to establish a scientific funding mechanism becomes a prerequisite to ensure smooth capital flow and a driving force for innovation in taxation policies and strategies. Through case studies of tax treatment under different funding mechanisms in PPP projects, this research analyzed the operational environment, standards and tax treatment of PPP projects.

## 1. Introduction and development status quo of PPP mode

The PPP mode refers to a cooperative mode between the government and social capital, in which the government manage, operate and invest social capital into public services by way of competition. By signing contracts in projects, the government conduct negotiations with the social capital on an equal footing, and in PPP projects, the social capital first provides public services before the government evaluate the services it provides and make payment accordingly. In other words, it is the government who buys services from the social capital. Common funding mechanisms for PPP projects include user funding, government funding and viability gap funding.

In the user funding mechanism, the end users pay for the products or services, that is, the end user pays directly to the project team, and the project team makes profit through legitimate operation and cost control during the project. In PPP projects, the user funding mechanism is highly operational. For example, in urban infrastructure projects like construction of light railways, subways, high-speed railways and high-speed roads, the public service providers charge the consumers directly to gain economic benefits. As the economic benefits can be quantified, the government can control the price of these projects to ensure the rights of consumers and the project teams<sup>[1]</sup>.

The government funding mechanism is applicable to public welfare projects, in which the government pays directly for public services and goods. Examples of such projects include projects related to urban construction and development, such as waste disposal projects, sewage treatment projects, urban traffic management projects and urban greening initiatives. One salient feature of the government funding mechanism is that the project itself can generate no or little financial income, and the government's capital investment accounts for the major source of income for public services. The major reason why the government funding mechanism comes into being in PPP projects is that it is difficult to estimate the social and economic efficiency of public facilities. Thus, the users or beneficiaries of public services do not make direct payment to the project enterprises and the effect of the public services can only be assessed by the government. In other words, government funding is the major source of operational income of project enterprises that provide public services.

When the payment by consumers cannot cover the cost and investment of a project, the governmental financial department can provide grants to a project, which gives rise to the viability gap funding mechanism. This mechanism is scientific and efficient to avoid risks because it ensures a win-win scenario in projects. Though this mechanism can fill the gap of capital in a project and ensure that the project enterprise can cover its cost and make profit, it does not mean the enterprise can make large profit from the project. For instance, the government can offer price subsidies or investment grants to the construction enterprise for the public services or public goods they provide, or issue preferential policies for the enterprise to ensure the project's efficiency and the enterprise's profit<sup>[2]</sup>.

After the financial crisis broke out at the end of 2008, the Chinese government released a series of policies to stimulate domestic demands and invested more into large infrastructure projects like railways, roads and water conservancy projects. Despite the large investment into these projects to

fuel domestic demands, the government did not have a financial basis strong enough to afford such large amounts of infrastructure projects. In this case, the PPP mode which could make the best of private investors emerged as an irresistible trend. The PPP mode can be applied to all kinds of industries and allows different ways of operation, so its funding mechanism varies. The tax treatment under different funding mechanisms become a major challenge in management of project construction and investment as it has direct impact on the final profit. The risks involved in that process will affect the result of tax treatment<sup>[3]</sup>.

According to previous studies and analysis, it can be concluded that many risk factors will influence the effect of the PPP mode when it is put into practice, but the influence of one factor varies from another's. For example, Wang Hui et al. divided the risks into controllable risks and uncontrollable risks according to the level of risk control. Sha Ji et al. divided the PPP tax treatment risks into non-commercial risks, commercial risks and force majeure from the perspective of economics. Sun Zhiyuan et al. divided the risks into systemic risks and non-systemic risks according to the risk control capacities of project participants. The PPP mode can be applied to different kinds of infrastructure projects such as construction of roads, hydropower stations, bridges and airports. As a wide range of realms are involved and each realm has its uniqueness, the methods of tax treatment differ. When choosing the proper way of tax treatment for a project, we need first to identify its funding mechanism and conduct tax treatment accordingly<sup>[4]</sup>.

## **2. Tax Treatment under Three Funding Mechanisms in PPP Projects**

### **2.1 Data Sources**

The raw research samples include PPP policies, statistics about projects in the government project database and the development trend of PPP projects from 2014 to 2017 in China. These raw samples are processed by excluding incomplete projects, projects devoid of data, cancelled projects and projects that failed to pass the acceptance check. Policies issued by the Chinese government in 2017 was mainly about legislation and securitization of PPP capital. In February 2017, Shanghai Stock Exchange, Asset Management Association of China and Shenzhen Stock Exchange issued documents to support securitization of PPP capital. In March 2017, legislation of PPP projects was included into the 2017 Work Plan by the State Council. By the end of June 2017, there were 13,554 projects approved by the government, with a total investment worth 1.63 billion RMB. Among all these projects, municipal administration projects, traffic projects and tourist projects ranked top three, accounting for 54% of the total. Sewage treatment, road construction and waste disposal projects occupy the top three among the under-construction municipal administration projects that belonged to the secondary industry, accounting for 55% of the total municipal administration projects. As people's awareness of environmental protection increases, they pay more attention to ecological improvement. In December 2016, the governmental document "Goal and Assessment Standard of Ecological Improvement" was released, which identified the goal of ecological conservation and the assessment standards of ecological improvement. Meanwhile, the advanced deleveraging financing mechanism that the government adopted to ensure economic growth was more and more widely used in infrastructure construction projects, which also facilitated ecological improvement initiatives. As the government's support for the PPP mode increases, this mode has continued to expand in China. PPP projects under construction and those listed in the government project database have been increasing, and the corresponding investment and the number of PPP projects in the government project database have been in an increasing trend. By the end of September 2017, there were 2,388 contracted projects under construction, 14,220 projects listed in the government project database, and the investment amount reached 1.78 billion RMB. The rate of conversion from project proposals to construction reached 35%. PPP projects listed in government project database and under construction had three types of funding mechanism: user funding, government funding and viability gap funding. Under different funding mechanisms, the method of income confirmation varies, so the tax treatment method should also differ.

## 2.2 Tax Treatment under Different Funding Mechanisms

### 2.2.1 Tax treatment under user funding mechanism

Tax treatment under the user funding mechanism mainly involves two types of taxes – the value added tax and the enterprise income tax. Under the user funding mechanism, the project enterprise charges the users directly by providing services or products, and this behavior was considered as selling, so the enterprise needs to pay the value added tax according to the taxation policies. For instance, the ticket income for Beijing Metro Line 4 needs to pay value added tax according to the local traffic services, and the tax rate is 11%. According to taxation policies, any general taxpayer providing public transportation services can select a simple tax calculation method and pay the tax at a tax rate of 3%. Under the user funding mechanism, the project enterprise that charge the users needs to pay the enterprise income tax. As most PPP projects are public projects, the project enterprise will enjoy preferential taxation policies which could be summarized as “three-year exemption, three-year reduction by half” and tax credits for special equipment investment. If the investment enterprise is engaged in a project included in the “catalog of public infrastructure projects with preferential policies for enterprise income tax”, the enterprise will not need to pay the enterprise income tax in the first three years since it receives the first batch of operational income from the project, but it needs to pay half the amount of the enterprise income tax from the 4<sup>th</sup> year to the 6<sup>th</sup> year. According to the regulations of the State Taxation Administration, any enterprise engaged in new types of projects included in the Catalog enjoy the preferential taxation policies of “three-year exemption, three-year reduction by half”. If the PPP project investment enterprise is engaged in an environmental protection-related project included in the Catalog, the enterprise is also entitled to enjoy the preferential taxation policy mentioned above. Besides, for any project enterprise that invests in specific equipment included in “Catalog of Energy Saving and Water Saving Equipment with Preferential Enterprise Income Tax Policies”, “Catalog of Environmental Protection Equipment with Preferential Enterprise Income Tax Policies” and “Catalog of Safe Production Equipment with Preferential Enterprise Income Tax Policies”, 10% of its investment can be deducted from the annual enterprise income tax. If the amount of deduction exceeds the tax the enterprise needs to pay that year, the deduction can continue to be used in the following five years.

### 2.2.2 Tax treatment under government funding mechanism

Under the government funding mechanism, the government buys public services or products from project enterprises. In other words, the government is a client of the project enterprise and their transactions are selling behaviors. For the income that the project enterprise obtains from the public services they provide, the enterprise needs to pay value-added tax according to taxation policies. Among PPP projects that entered government project databases, municipal administration projects accounted for the majority, including waste disposal projects, road construction projects and sewage treatment projects. Projects that meet the standards of integrated resource utilization and energy conservation can enjoy rebates of value added tax according to regulations. For instance, the 4<sup>th</sup> waste-to-energy power station in Chongqing which combusts wastes to generate electricity meets the standards of integrated resource utilization, so it can enjoy rebates of value added tax as stipulated in preferential taxation policies. Electricity belongs to the category of integrated utilization of resources and hence enterprises selling electricity can also enjoy preferential policies of rebates of value added tax, and the rebate ratio is 100%.

### 2.2.3 Tax treatment under viability gap funding mechanism

The major objective of the viability gap funding mechanism is to ensure that the profit of an enterprise falls into a proper range. Diverse forms of subsidies can to some extent add to challenges of tax supervision. There are many forms of subsidies for PPP projects, so tax supervision of PPP projects must start from the project enterprise. One major challenge to subsidize PPP projects under the viability gap funding mechanism lies in confirmation and collection of the value added tax. Whether the project enterprise needs to pay value added tax for the subsidies relies on the type of subsidy it receives. Whether the enterprise that invested in a PPP project needs to pay value added tax for the subsidies it receives relies on whether the subsidies are administered by the national Ministry of Finance. If so, the enterprise does not need to pay the value added tax for the subsidies. According to

the current regulations on value added tax, the subsidies a taxpayer receives from the national Ministry of Finance do not belong to income that needs to pay value added tax, so the enterprise does not need to pay value added tax for the subsidies. In this case, to judge whether an enterprise needs to pay value added tax for a subsidy, we need first to identify the type of subsidy it receives. When the enterprise's income and subsidies are not correlated to dutiable goods and services, it does not need to pay value added tax for the subsidies it receives; but it needs to pay the value added tax for the subsidies it receives due to technological innovation.

It's controversial whether the enterprise needs to pay the value added tax for the subsidies it receives in projects under the viability gap funding mechanism. The tax collection department needs to refer to the "Notice of Enterprise Income Tax Treatment for Capital for Specific Purposes Issued by the State Taxation Administration" to judge whether the subsidies received by an enterprise meet the standard to exempt from the value income tax. If the subsidies do not meet the standard of exemption, the enterprise needs to pay the value added tax in compliance with the law.

### **3. Conclusion**

The PPP mode is a product of cooperation between the government and the social capital based on contracts, and such cooperation has diverse forms. Scientific and proper funding mechanisms can broaden the way of development of PPP projects, and standard taxation policies under different funding mechanisms provide guarantee for long-term stability of PPP projects. The taxation policies need to be determined according to the funding mechanism and the features of the project. Only with a good taxation environment can PPP projects achieve long-term and stable development.

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