KPMG

China Tax Alert

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DOMESTIC MARKET AHEAD
- VAT general tax payer (GTP) status piloted in special customs supervision zones

Reference: **SAT, MOF and GAC Announcement [2016] No. 65**

- Effective date: 1 November 2016
- Also refer to our earlier China Tax Weekly Update on Announcement No.65: Click here

Post-VAT era for special customs supervision zones

Since 2012, China has been steadily expanding the Value Added Tax (VAT) reform pilot programs, starting from a limited geographic area and selected industries and then enrolling more pilots. Effective from 1 May 2016, VAT was rolled out to all remaining industries including Real Estate and Construction Services, Financial and Insurance Services, and Lifestyle Services, and replaced the Business Tax regime.

While all service receipts in China are now eligible for an input VAT credit, enterprises located in special customs supervision zones (in-zone enterprises) found themselves still suffering from VAT cost in receiving services.

In-zone companies are deemed as if they were incorporated outside of China for goods sales and purchases, and thus they were generally not unable to be registered as a VAT GTP in most special customs supervision zones and thus cannot claim input credit. However, they are still viewed as a domestic recipient when purchasing services (and the service provider will incorporate a VAT component in the pricing).

A manufacturing in-zone enterprise may have the following VAT leakage cascading to its operation costs (which otherwise can be claimed as input credit by an out-zone counterpart):

- Property leasing: 5% or 11%;
- General services (such as consulting or qualified lifestyle): 6%
- Construction services (including installation) : 3% or 11%
- Insurance (such as property insurance): 6%
- Transportation: 11%

In addition, the goods sold into the zones are already under a bonded status (the seller outside the zone already claimed export VAT refund). If the goods (or the produced commodities) are subsequently sold back to domestic market, they need to be re-imported. Such “domestic buy-sell” model is not tax-efficient and will create leakages of import taxes and irrevocable VAT costs in export refund.

Currently, in-zone enterprise cannot issue VAT special invoices for its processing fees to out-zone enterprises under a processing consignment. This effectively forced the in-zone enterprise to absorb a 17% output VAT and affected the commercial viability of the transaction. Alternatively, where an out-zone consignor wants to sell to the final commodity to overseas after processing, a direct export route will also face obstacles.

No.65 pilot in selected bonded zones

The above adverse VAT position of in-zone enterprises are mainly caused by their ineligibility to be registered as a VAT GTP and thus a broken VAT chain when transacting with out-zone enterprises. The prevailing VAT and Customs rules, to some extent, hinder the in-zone enterprises' flexibility to serve a growing domestic China market.

To provide an even playground for in-zone enterprises, a few pilot studies from the State Council, the GAC and the SAT (including Shuizonghan [2015] No.699, Guofa [2016] No.27) were initiated since late 2015 to assess the need of granting VAT GTP status to in-zone enterprises conducting trading, manufacturing and processing business.

Announcement 65 jointly-announced by SAT, MOF and GAC stipulates the comprehensive regulatory framework and is rolled-out in 7 selected bonded zones, including comprehensive bonded zones of Kunshan, Suzhou Industrial Park, Chongqing Xiyong, Shenzhen Yantian and Zhengzhou Xinzheng as well as export processing zones of Shanghai Songjiang and Henan Zhengzhou. As a pilot, the selected enterprises are subject to the same tax and customs regulations (covering Customs Duty, VAT and Consumption Tax) comparing with an out-zone domestic enterprise.

We expect the Announcement will facilitate the pilot enterprises in areas of claiming input VAT credits for service purchase, conducting domestic procurement, and developing both overseas and domestic markets.

Get ready for Announcement 65

While there may be more details to be released under Announcement 65, KPMG team have been closely studying and observing this topic. Based on our understanding, the following will be keys to a successful pilot application by an interested enterprise:

I. Decision to participate in the pilot

Announcement 65 allows the enterprise to apply for the pilot on a voluntary basis. Due to the significant change of tax and regulatory rules under the Announcement (rather than a simple “add-on” of a new tax preferential policy to the company’s current business), any interested enterprise is recommended to conduct a detailed business case analysis prior to the business decision. Factors in the analysis shall include incremental benefits (e.g. additional domestic sales, allowed input VAT credits) and potential costs (e.g. surcharges to VAT, irrevocable VAT in export).

In addition, if the enterprise also have bonded import equipment under supervision, the subsequent import tax claw-back pro-rata by export and domestic sales percentage should also be considered.

For those still focusing on international market in procurement and sales, they may retain the existing bonded business status by not applying for the pilot status.

II. Customs and trade compliance

As a highlight under Announcement 65, the pilot enterprises now claims export VAT refund when the exported goods physically leaves China (and other sales qualified for refund). The export refund will be processed by the tax authorities based on the export declaration electronic data from the Customs. However, the current logbook (H-type) used by in-zone enterprises does not have the functionality of export declaration (Rather, H-logbook uses a registration for goods entering into the zone), nor can provide such electronic data. Therefore, we expect that the pilot in-zone enterprises will need to migrate to a E-type logbook (which is currently used by out-zone enterprises conducting processing trade) after obtaining the VAT GTP status. And H-type logbook will still be used for in-zone enterprises who do not apply for the pilot for their processing trade business.

In addition, as non-bonded goods will be delivered to/from bonded zones (treated as VAT-able domestic purchase/sales for tax purposes), we expect the respective bonded zones will still track and monitor the move of non-bonded goods.

III. Tax compliance

From tax perspective, there are generally more complicated business models in a bonded zone. After the pilot, an in-zone enterprise can conduct even more diversified transactions (for example, incurring VAT-able, VAT-exempted and VAT-refundable sales in one tax return). After obtaining GTP status, the enterprise should consider the VAT risk mitigation and compliance issues, and respond in a more adaptive way.

Based on our experience on the desired compliance level of a VAT GTP, the pilot enterprises should consider enhancement of tax risk control environment, such as separate books for bonded and non-bonded transactions, designated tax journal entry and account code, tax rule-driven invoicing management and VAT calculation & return filing, etc.

IV. Technology enablement

Also, in view of the VAT internal control requirement, future tax data reporting and follow-up administration by the tax authorities, it is critical that the submission of VAT returns are correctly calculated. Where the enterprise conducts both bonded and non-bonded business, VAT checkpoints can include an audit trail of tax data covering tax return level, account-balance level and transaction level drilldown.

All the above business and regulatory requirements will point to a comprehensive technology-enabled solution linking both tax and customs data. The solution considers the tax workflow design and interfaces with multiple ERP modules for VAT-related source-data. Designed by a user requirement for VAT compliance management, the solution will enable the pilot enterprises to achieve better tax and Customs compliance under the new business models.

V. Logbook data migration

The pilot enterprises may need to mix the bonded and non-bonded raw materials in the assembly line in processing. During the change from H-type to E-type logbook, data migration to the new logbook also requires technical support to enable a smooth transfer and cut-over.

KPMG support

KPMG service team have actively participated into the pilot program during the recent period. Our focus includes regulatory study, technology support in tax and customs, and solution delivery, etc in support of granting VAT GTP to in-zone enterprises. Collaborated by a cross-function team from Customs, tax and technology, KPMG will provide a holistic implementation roadmap and an end-to-end solution to the business.

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