

China Tax Alert

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China's SAT sets out the VAT Treatment of Prepaid cards in Announcement 53

Regulations discussed in this issue:

- Announcement [2016] 53

Background

On 18 August 2016 China's State Administration of Taxation (SAT) released Announcement [2016] 53 (Announcement 53) which sets out new Value Added Tax (VAT) rules applicable to prepaid cards (also known as vouchers or gift cards). The new rules took effect on 1 September 2016 and apply to sales of prepaid cards on or after 1 September 2016.

In very simple terms, the new VAT rules provide that the sale of prepaid cards is subject to VAT at the time of their redemption, not at the time of their issuance. This reverses the position which had generally applied previously in China, though the previous position was not as clearly established in the rules.

The VAT treatment of prepaid cards often, at first glance, appears straightforward. However, the experience in many other countries around the world with VAT systems highlights the enormous difficulties they have posed for tax authorities in terms of their VAT treatment. For example, in the European Union (EU) there have been instances of tax avoidance and abuse, together with inconsistencies between countries within the EU, leading to recent proposals by the EU Commission for harmonization. Interestingly, the position which has been adopted in the EU is effectively the opposite of that in China – namely, in the EU the VAT on the sale of single-purpose prepaid cards (where all information regarding the taxable status of the ultimate supply is known at the time of issuance), is accounted for at the time of issuance, not redemption.

The position in China, whilst likely to be welcomed by businesses, will still cause complexity and gives rise to many uncertainties, as discussed further below.

Announcement 53 effectively defines prepaid cards as being a medium of prepaid value which may be used for the purchase of goods or services. It then distinguishes between "single-purpose" prepaid cards being those that can be redeemed within the same brand or franchise, and "multi-purpose" prepaid cards that are issued by a card issuing organization approved by the People's Bank of China and can be redeemed in multiple stores. A common example of a multi-purpose prepaid card would be a card which allows a customer to purchase goods or services in any store in a particular shopping mall. Though perhaps more relevantly, with the proliferation of e-commerce platforms and digitized payment systems in China, a prepaid card would include virtual cards in the form of passwords, string codes, graphics, biometric information, etc...

In the below table we summarise the VAT treatment of single purpose and multi-purpose prepaid cards.

	Single-purpose prepaid cards	Multi-use prepaid cards
Sale of prepaid cards not subject to VAT at the time of sale	No VAT is payable when the seller (the card issuer) sells the prepaid card or when the cardholder tops up/recharges the card	No VAT is payable when the payment organization approved by the People's Bank of China to issue prepaid cards (the card issuer) sells the prepaid card or when the cardholder tops up/recharges the card
Handling and administrative fees subject to VAT	Income derived by the seller (the card issuer) in relation to the sale of prepaid cards such as handling, administration, service, management and settlement fees are subject to VAT	Income derived by the payment organization (the card issuer) in relation to the sale of prepaid cards such as handling, administration, service, management and settlement fees are subject to VAT
General VAT invoice issued by the prepaid card issuer	The seller (the card issuer) can only issue a general VAT invoice to the purchaser of the prepaid card (the cardholder); however no special VAT invoice can be issued	The payment organization (the card issuer) can issue a general VAT invoice to the purchaser of the prepaid card (the cardholder); however no special VAT invoice can be issued
VAT is payable when the prepaid card is redeemed	Output VAT is paid by the entity providing the goods or services to the cardholder (the redeeming entity) when the prepaid card is used to purchase goods or services. No VAT invoice can be issued to the cardholder.	Output VAT is paid by the entity providing the goods or services to the cardholder (the redeeming entity), which has entered into an agreement with the payment organization (the card issuer), when the prepaid card is used to purchase goods or services. No VAT invoice can be issued to the cardholder.
Invoices issued to seller or payment institution by the redeeming entity providing the goods or services to the cardholder	If the entity providing the goods or services to the cardholder (the redeeming entity) differs from the entity that sold the prepaid card (the card issuer), then the redeeming entity should issue a general VAT invoice to the seller (the card issuer) and state "prepaid card settlement amount received" on the invoice. The card issuer should retain the invoice as proof that they were not required to pay VAT when they sold the prepaid card. No special VAT invoice should be issued.	The entity providing the goods or services to the cardholder (the redeeming entity) should issue a general VAT invoice to the payment organization (the card issuer) and state "prepaid card settlement amount received" on the invoice. The payment organization should retain the invoice as proof that they were not required to pay VAT when they sold the prepaid card. No special VAT invoice should be issued.

KPMG observations

As noted, the experience in many other countries around the world highlights how a transaction as simple as selling a prepaid card can give rise to extraordinary complexities in a VAT context. Announcement 53 is an attempt by the SAT to provide clarity, and to hopefully learn from the experiences of other countries.

We provide some brief observations below on Announcement 53 which respond to many of those complexities which have arisen internationally.

What constitutes a prepaid card?

Announcement 53 was introduced in conjunction with a new regulatory framework governing single purpose prepaid cards, administered by the Ministry of Commerce, and entitled the “Administrative Measures on Single-Purpose Commercial Prepaid Cards (Trial Implementation)”. Separately from this, multi-use prepaid cards are administered by the People’s Bank of China (the PBOC) under the “Administrative Measures for Prepaid Cards Business of Payment Institutions” (collectively “the Administrative Measures”).

Generally speaking, it is understood that the VAT treatment given to prepaid cards in Announcement 53 only applies to prepaid cards which are regulated by either the Ministry of Commerce or the PBOC (as applicable).

The Administrative Measures for single use prepaid cards define “prepaid cards” widely so as to include “physical cards in the form of magnetic stripe cards, chip cards, paper coupons, etc. as well as virtual cards in the form of passwords, string codes, graphics, biometric information, etc.”

As noted, with the advent of digitization, “prepaid cards” are no longer restricted to physical cards but will frequently now be in the form of digitized prepaid card systems, such as digital gift cards.. Announcement 53 seeks to describe prepaid cards in terms of them being a prepayment which may be used to pay for goods or services, irrespective of the specific medium and form. This definition should go some way to ensuring that the VAT treatment of “prepaid cards” will apply well into the future as new digitized payment systems arise.

Having said that, one area of uncertainty with Announcement 53 is whether the rules apply to prepaid cards which entitle the holder to specific goods or goods (for example, a prepaid card to purchase a new appliance), rather than simply prepaid cards which entitle the holder to spend specific funds (for example, a prepaid card with value up to RMB 100). Similarly, another area of uncertainty is in terms of the VAT treatment applicable to prepaid cards where the card issuer has not complied with the filing and other regulatory requirements set out in the Administrative Measures.

What are the implications of accounting for VAT at time of redemption rather than issuance?

The primary objective of Announcement 53 is to provide that VAT is payable when prepaid cards are redeemed, not when issued. Given that a prepaid card effectively represents a prepayment for goods and services, the position in Announcement 53 is in reality concessionary. It is concessionary because the obligation to account for output VAT is deferred until the later time that the prepaid card is redeemed. As such, it is especially important to determine whether something qualifies as a "prepaid card" or not, because it may alter the timing of when to account for VAT and whether a special VAT invoice may be issued.

The requirement to pay VAT at the time of redemption of prepaid cards does solve one significant issue in China – the issue it solves is that if VAT was instead payable at the time of issuance, it would be difficult to know what VAT rate to apply where the prepaid card could be redeemed for a variety of goods and/or services with different VAT rates. Instead, by applying VAT at the time of redemption the seller will know the applicable VAT rate to use.

Businesses which sell prepaid cards will need to ensure they adapt their systems and processes to account for VAT at the time of redemption, not at the time of issuance. For many businesses, the liability to account for VAT at the time of redemption is more likely to align with their current accounting treatment.

The release of Announcement 53 also raises a question about how to manage the transition from the previous approach (where VAT was payable on issuance of the prepaid card) to the new approach (where VAT is payable on redemption of the prepaid card). Specifically, if a prepaid card was issued prior to 1 September 2016 but redeemed after that date, there is a risk of double taxation. Logically, if VAT has been accounted for on issuance of the prepaid card, then it should not be accounted for again on redemption.

What happens if a prepaid card is gifted?

The implications of Announcement 53 for loyalty reward programs need to be carefully considered. For example, if a loyalty reward program operator provides rewards to their customers in the form of prepaid cards for goods or services from third parties, arguably the gift of the prepaid card may not be regarded as a deemed sale for VAT purposes because Announcement 53 provides that the VAT is only payable on redemption of the prepaid card (where the VAT is payable by the third party). An alternative view is that Announcement 53 simply does not apply because it deals with the 'sale' of prepaid cards. Furthermore, it is doubtful if most loyalty reward program operators are complying with the Administrative Measures.

Likewise, if an employer purchases prepaid cards from a third party merchant to provide to their staff as gifts, then arguably the VAT is payable by the third party merchant upon redemption of the prepaid card, and not as a deemed sale by the employer. From a policy perspective, this should still produce the correct economic outcome because the employer would not be entitled to claim an input VAT credit on the purchase of the prepaid card.

What happens to the value of unredeemed or expired prepaid cards?

Announcement 53 is silent on the question of whether VAT is payable on the value of any unused or unredeemed prepaid cards. For example, a customer may purchase a prepaid card which expires before they use it, or the customer may purchase goods or services for a lesser amount than the prepaid card has been issued for and they effectively forego the difference. Some countries have specific rules which require this income to be taxed for VAT purposes when the value of unused or unredeemed income is recognized for accounting purposes.

What happens if a prepaid card is sold at a discount to its face value?

If a prepaid card is sold at a discount, it is unclear if VAT would be payable on the face value of the prepaid card, or the discounted value. This issue has not been addressed in Announcement 53. Take for example a cardholder who purchases a prepaid card for RMB 190, which represents a 5% discount on the face value of RMB 200 for the card. If the cardholder then redeems the prepaid card to purchase goods or services worth RMB 200, it is unclear if VAT would be payable on RMB 200, or RMB 190. This issue has been the subject of litigation in the EU, with the European Court of Justice ruling in the Argos Distributors case that the VAT should be based on the value actually obtained by the issuer upon the sale of the prepaid card, being RMB 190 in this example. There is no guarantee that same outcome would apply in China.

What should be stated on the general VAT invoice issued by the card issuer to the card holder?

As stated above, the card issuer can only issue a general VAT invoice to the purchaser of the prepaid card; no special VAT invoice can be issued.

While Announcement 53 is silent on the point, the general VAT invoice should state that what has been sold is a prepaid card, rather than the goods or services for which the prepaid card may be used to purchase. Notwithstanding this, there has been some disagreements between card issuers and card purchasers, with the latter often preferring a different description on the general VAT invoice so as to aid reimbursement of their costs, especially where the card is purchased for later gifting purposes.

What happens if prepaid cards are sold through a supply chain involving Business-to-Business transactions?

Announcement 53 provides that neither the card issuer nor the entity providing the goods or services (the redeeming entity) can issue special VAT invoices. Therefore, general VAT taxpayers would be unable to claim an input VAT credit for the purchase of prepaid cards. It is therefore suggested that prepaid cards should be used in business-to-consumer (B2C) transactions.

Where prepaid cards have to pass through an earlier supply chain, such as from a card issuer to a distributor, any 'value added' could be dealt with through the imposition of administration or other fees for which VAT applies, and where special VAT invoices can be issued.

Concluding comments

While Announcement 53 is helpful in providing some clarity, and the approach adopted is generally concessionary for business, there are clearly a number of issues which are yet to be worked through. It is likely that local practices will evolve over time, and those practices may well vary between tax authorities in different locations.

For businesses issuing or gifting prepaid cards, or operating rewards programs, it is strongly recommended to seek specific advice on these new rules from your KPMG tax advisor.

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