China alert

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VAT reform pilot scheme will be rolled out in Shanghai

Matter discussed in this issue:

- VAT reform pilot scheme in Shanghai

Background

Indirect taxation in China is a significant issue. In 2010, revenues from indirect taxes (including customs duties) accounted for approximately 75 percent of China's total tax revenue collection. As such, the reform of indirect taxes in China is likely to have a major impact on businesses and consumers.

While the reforms are due to commence in early 2013, they are likely to be accelerated for businesses in Shanghai, with a pilot program that may commence in early 2012.

In this issue, we examine some of the ways in which the reforms may operate. We also provide a preliminary guide for businesses regarding the steps they should take to prepare for the reforms.

Current system

China has two main systems of indirect taxes - a value added tax (VAT) and a business tax (BT).

VAT generally applies at the rate of 17 percent to the sale of goods in China, the provision of repair, processing and replacement services, and the importation of goods into China. China's VAT exhibits many of the same features as the VAT / GST applicable in most of the world's major trading countries, in the sense that it taxes the 'value added' by allowing business taxpayers a credit for the tax embedded throughout the supply chain.

By contrast, BT is a turnover tax, which is applicable to the provision of all other services, the transfer of intangible property and immovable property. The rates of BT range from three percent to five percent (with the exception of entertainment services, which can be as high as 20 percent). BT potentially cascades through a supply chain, given that input tax credits are not available for costs incurred in relation to transactions which are subject to BT.

The context of the reforms

The Chinese Government is proposing to reform its system of indirect taxation, and its scheduled date for commencement is 2013, with a Shanghai pilot program, which may commence in 2012.

The reforms have the potential to achieve considerable economic benefits in removing the inefficiencies on businesses currently subject to cascading of BT, and in reducing the level of ambiguity, duplication and uncertainty in maintaining two separate, yet quite different forms of indirect taxation. The reforms are also consistent with the Government's recent 12th Five Year Plan, in which the promotion of the services sector is being highlighted as a key goal.

While the precise form in which the reforms will take is not yet certain, the Government has consulted widely with international experts, and draft legislation has been prepared, with KPMG experts providing input.

The Shanghai pilot program

The Government may be conducting a pilot program in early 2012 in Shanghai for taxpayers in the services sector. Although precise details of the pilot program have not yet been publicly released, we note:

- The pilot program is expected to apply to all services currently subject to BT, with the exception of financial services and real estate

- Previously it was expected that the pilot program would be limited to the transportation sector. That plan seems to have changed in recent weeks, and the pilot program may now have a broader focus

- The exclusion of financial services and real estate from the pilot program would seem logical, given that the experience of other countries has shown these to be very contentious areas of VAT. Moreover, real estate in China is already subject to a multitude of different types of taxation

- It is understood that the central government is in the final stages of negotiation with local governments in Shanghai about the revenue split under the pilot program, given that the abolition of BT will have a significant revenue loss for local governments

- It is not clear whether the pilot program will apply only to businesses headquartered in Shanghai, or to any branches of an organisation operating in Shanghai. It is also not clear how the pilot program will be contained within Shanghai, given that taxpayers in Shanghai purchase services from businesses outside Shanghai, and supply services to both businesses and customers outside Shanghai. For the pilot scheme to be effective in only taxing the 'value added' by Shanghai businesses, it will be necessary for there to be:

  - a deemed VAT credit granted for the purchase of services from businesses outside Shanghai; and/or

  - a reduced rate of output VAT (equivalent to current BT rates) where services are supplied by businesses in Shanghai to those outside of Shanghai.

- There will be a number of transitional issues, which will require careful consideration such as: the impact of the new tax on contracts entered into prior to the commencement of the pilot program; the ability to claim credits for new or existing fixed assets used in the services industry; documentary requirements for special invoices; and new filing requirements

- Unless careful consideration is given to these issues, the pilot scheme risks operating in a punitive way for businesses in Shanghai relative to other businesses not subject to the scheme.

Status update on the reforms

Outlined below is a table summarising what is known about the reforms, what is generally expected based on official and unofficial indications from the relevant authorities, and what is not yet reliably known.

What is reliably known	**The reforms are intended to be revenue neutral**
	The planned commencement date is 2013, although some delay may now occur.
What is generally expected	Industries currently subject to BT may be migrated into the VAT system over time.
	The Government may be conducting a pilot program in Shanghai in 2012 for all businesses in the services sector, with the exception of financial services and real estate. The pilot program is intended to test the effect of the proposed reforms on particular industries. It is not clear how the pilot program will operate in practice, given that businesses in Shanghai will buy goods and services from, and sell their services to, taxpayers outside Shanghai.
What is not yet reliably known	The rate or rates of taxation under the new regime. Managing the revenue consequences of the merger of VAT (ordinarily 17 percent, but creditable to business) with BT (ordinarily three percent to five percent, but not creditable to business) is challenging. This is precisely why the Government will look to use the pilot program to gauge the revenue consequences, and to enable them to make changes as necessary.
	Currently, the central government retains 75 percent of revenues from VAT, while local governments retain 25 percent of VAT revenues and nearly 100 percent of BT revenues. The way in which both the financial arrangements and administrative collection arrangements will be reworked as between the central government and local governments is not yet known.
	Currently, 'small scale taxpayers' pay VAT on sales of goods at a flat rate of 3 percent, but are ineligible for credits on purchases. It is unclear whether the distinction between 'small scale taxpayers' and 'general taxpayers' will be extended to the services sector too. If so, this would go some way to alleviating the impact of the reforms for many small businesses.
	The current system of indirect taxation is heavily paper based. The extent to which the reforms will embrace modern technologies, and better facilitate electronic invoicing, is not yet known.
	Financial services in many jurisdictions are either exempt from VAT (e.g. EU countries and Australia), zero rated in terms of B2B transactions (e.g. New Zealand) or subject to specific rates for different types of transactions (e.g. Singapore). The proposed treatment of financial services is not yet known, and the Government is likely to be cognisant of the economic impact any taxation decision would have on its desire to create Shanghai as a world financial centre.
	Currently, imports and exports of services are generally subject to BT. It remains to be seen whether exports of services will be zero rated as a result of the reforms, to conform to the treatment of goods under the existing VAT reforms, and furthermore, whether full tax refunds for exported goods will be provided.
	As a result of reforms in 2009, general taxpayers subject to VAT became eligible for input tax credits for the purchase of fixed assets. It remains to be seen whether this same treatment will be extended to taxpayers currently subject to BT once the reforms commence.

What do I need to do?

As noted previously, the reforms are not scheduled to formally commence until 2013 (for businesses in China generally) and 2012 (maybe for the Shanghai pilot program). However, while that deadline is still some time away, there are a number of reasons why businesses need to start considering the shape of the reforms. Points to consider include:

1. **Identifying those aspects of the current system of indirect taxation, which create inefficiencies, or result in significant compliance costs and risks, and become involved in dialogue with Government.** KPMG is proposing to convene groups of interested clients to ensure that their concerns are brought to the attention of senior officials of the Ministry of Finance. The ability for corporate groups, or even branches of the one corporate entity to consolidate is a critical issue that needs to be overcome for businesses operating in China.

2. **How would the reform process impact on my business model?** Many businesses currently operating in China have structures, which are designed to minimise the cascading of BT – would that still be necessary once the reforms commence? Is my business model still the most efficient model?

3. **What impact would the proposed reforms have on prices of the goods and services that my business supplies?** Would the reforms create a bringing forward of demand (if prices are to increase), or would there be a deferral of demand (if prices are to fall)? Would my business have the resources to cater for changes in demand? Would my business have the legal and commercial negotiating power to ensure that any price reductions are passed on by my suppliers?

4. **Is my business entering into contracts now, which potentially span the introduction of the reforms?** If so, are there contractual provisions in those contracts, which would allow me to pass on the impact of a new tax? If my business is entering into contracts for the purchase of goods and services, does the contract enable my supplier to pass on the impact of any changes in tax rates arising from the reforms?

5. **Do my IT and accounting systems adequately cater for a new tax?** Do they enable recognition and claiming of input taxes on purchases that my business makes?

6. **To what extent should my business consider deferring fixed asset purchases to potentially qualify for tax credits?** This issue arises because taxpayers currently subject to the BT regime are unable to claim input credits for fixed assets used in their business, but may be expected to be eligible once the reforms take effect.

7. **Do my invoicing and cash register systems recognise output tax liabilities?** Do they enable me to issue special invoices so that my business customers can potentially claim input taxes?

8. **How would my cash flow position be affected by the reforms, particularly for BT taxpayers where the rate is likely to increase**?

9. **How many of my suppliers, either current, or potential, would be , classified as "small scale taxpayers" and therefore unable to claim input taxes?** Would I cease doing business with them once the reforms are introduced, in favour of businesses that are able to provide me with special invoices upon which I can claim input taxes?

10. **How proficient are my staff in dealing with tax issues?** Will my accounts payable staff have the capacity (and training) to ensure that invoices comply, and to code invoices accordingly? What policies or procedures might we put in place to cater for this?

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