China alert

Issue 39 – October 2011

VAT reforms coming in 2012

Matter discussed in this issue:

- Tangible steps towards implementing significant value added tax reforms

Background

On 26 October 2011, China's State Council took the first tangible steps towards implementing significant value added tax (VAT) reforms in China.

In an announcement issued by Premier Wen Jiabao, the Chinese government indicated its desire to replace business tax (BT) with VAT incrementally, commencing with a pilot program in 2012.

Although the details of the pilot program are relatively scant, set out below is a brief snapshot of the information released by the government.

Details released

Commencement date: 1 January 2012

Scope: The transportation sector and certain "modern services industries" in Shanghai

Rates: Two new VAT rates of 11 percent and six percent will apply. The announcement does not specify which services will be subject to these new rates. These rates supplement the existing general VAT rate of 17 percent, and the reduced rate of 13 percent applicable to some goods.

Goal: To incrementally replace BT with VAT nationwide. The timeframe for the expansion of the program beyond the pilot program is not specified.

Analysis

At first glance, some taxpayers may question how an increase in the tax rate on services from a three percent or five percent BT to a six percent or 11 percent VAT may actually benefit them. The answer lies in the different way in which BT applies as compared with VAT. In many cases, the change will be a benefit to the business given that BT is a turnover tax, which cascades throughout a supply chain. Whereas VAT is generally creditable in business to business transactions so that in real terms, it only applies to the price charged to the end-consumer.

The inclusion of the transportation sector in the pilot program is not unexpected. Transportation is already subject to special rules, which allow for input VAT to be claimed on freight charges at the rate of seven percent, even though transportation services are subject to BT at the rate of three percent. The imposition of BT on transportation services has long been a source of concern for industry, particularly since the changes in 2009, which resulted in BT applying to inbound and outbound transportation services, and the practical difficulties in offsetting sub-contracting costs in calculating BT.

Perhaps the biggest question raised by the government's announcement is the scope of the services in Shanghai, which will become subject to VAT. Unfortunately, the answer to this will have to wait until further details are released. However, as a general proposition, the change from a BT regime to a VAT regime is likely to be welcomed by affected businesses in the service industry in Shanghai. While a VAT rate of 11 percent is clearly higher than the BT rate of three percent or five percent paid on most services, the changes are most likely to benefit businesses subject to the pilot program which:

- Provide services to other businesses subject to the pilot program (i.e. B2B transactions), where the service recipient should now be eligible to claim input VAT on the purchase of these service

- Have significant service inputs to their business, irrespective of whether they are in the goods or services sector. Those service inputs should no longer have embedded BT costs

- Have significant fixed assets, which should now be eligible for input VAT credits.

Perhaps the businesses which may potentially suffer from these changes are those businesses in the services industry that both provide their services to end-consumers, and have relatively few inputs for which VAT credits could be claimed. The likely result is that the final price charged to end-consumers is likely to increase.

While the theory of a VAT is that the tax should be able to be passed on to the final end-consumer, these changes may temporarily disadvantage some Shanghai businesses in the period before the reforms are expanded across China. Based on experiences with similar reforms in Australia back in 2000, those businesses with price elastic demand from consumers may suffer from a period of stagnant sales. By contrast, those businesses with price inelastic demand may find that they can simply incorporate the full effect of the tax change into their prices once it takes effect.

Ultimately though, international experiences have highlighted that these types of reforms affect business and consumer behaviour buying patterns, potentially creating either a pull-forward or pull-back of demand.

Unresolved issues

KPMG would expect the State Council's announcement to be followed up soon with further details of the pilot program. Some key questions which are yet to be resolved:

- The precise scope of services in the "modern services sector" in Shanghai, which will be subject to the pilot program. KPMG has previously speculated that construction, real estate and financial services may not be included in the pilot program, particularly because the VAT treatment of the items has proven to be complex internationally, and we see no reason why that prediction should change.

- How the pilot program will be limited to Shanghai. As recently noted by us in our KPMG China alert 2011 Issue 34, it is still unclear whether the pilot program will apply only to businesses headquartered in Shanghai, or also to branches operating in Shanghai.
- Whether the new VAT rates will apply to services provided from Shanghai to outside Shanghai, and if so, whether the service recipient will still be eligible for an input VAT credit.
- Whether BT will continue to apply to services provided from outside Shanghai to businesses located in Shanghai.
- Whether VAT or BT will apply where vouchers are sold outside Shanghai, for redemption in Shanghai (and vice versa).
- Whether the export of services will be subject to zero rating, and if so, the refund rate(s) applicable to those services.
- Whether the importer of services from overseas will be eligible to claim input VAT to offset the output VAT they must pay on the purchase of services, under what is commonly known in many other jurisdictions as a "reverse charge".
- Whether services which are currently exempt from BT, such as R&D services (Caishui [2011] No.88), offshore outsourcing services (Caishui [2010] No.64), asset restructuring (State Administration of Taxation Announcement [2011] No.51) and technology transfers (Caishuizi [1999] No.273) will be zero rated when VAT applies.
- Whether service providers who would qualify as "small scale taxpayers" under VAT (if VAT applied), would be entitled to account for VAT at a flat rate of three percent once the reforms take effect.

Key opportunities

For businesses affected by these reforms, there are a number of tangible steps they may wish to take in preparation for the reforms. These include:

- Deferring the purchase of fixed assets so as to qualify for input VAT on fixed assets purchased once the reforms commence. Caution should be exercised before artificially terminating existing contracts or purchase orders, or returning fixed assets recently acquired.
- Deferring the purchase of non-essential services to ensure that any new services being acquired are subject to VAT. This is especially true in the case of related party services. Importantly though, it may not be sufficient to simply defer payment if there is a contract, which provides for an earlier payment date.
- Considering whether it is preferable to acquire services from other businesses in Shanghai (for which an input VAT credit may apply) in preference to acquiring services from businesses outside Shanghai (for which irrecoverable BT is likely to apply). This preference is only likely to apply for the period until the reforms are expanded across China.

Preparation checklist

As noted in KPMG China alert 2011 Issue 34, there are some tangible steps that businesses should take to start preparing for the reforms:

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 the government.**

KPMG is convening groups of interested clients in late November and early December 2011 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 viewed as 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 operating in China currently have structures 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 within 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. **Taxpayers currently subject to the BT regime are unable to claim input credits for fixed assets used in their business.** To what extent should my business consider deferring fixed asset purchases to potentially qualify for tax credits?

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 will many of my suppliers, either currently, or potentially, 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?

Contact us

Khoonming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Qingdao
Vincent Pang
Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Hangzhou
Martin Ng
Tel. +86 (571) 2803 8081
martin.ng@kpmg.com

Chengdu
Anthony Chau
Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Guangzhou
Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen
Jean Jin Li
Tel. +86 (592) 2150 888
jean.j.li@kpmg.com

Shenzhen
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong
Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

Northern China
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Vaughn Barber
Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

Roger Di
Tel. +86 (10) 8508 7512
roger.di@kpmg.com

John Gu
Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Jonathan Jia
Tel. +86 (10) 8508 7517
jonathan.jia@kpmg.com

Paul Ma
Tel. +86 (10) 8508 7076
paul.ma@kpmg.com

Vincent Pang
Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Michael Wong
Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Irene Yan
Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Tracy Zhang
Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

Abe Zhao
Tel. +86 (10) 8508 7096
abe.zhao@kpmg.com

Catherine Zhao
Tel. +86 (10) 8508 7515
catherine.zhao@kpmg.com

Kevin Lee
Tel. +86 (10) 8508 7536
kevin.lee@kpmg.com

Jesse Wang
Tel. +86 (10) 8508 7514
jesse.wang@kpmg.com

Central China
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Anthony Chau
Tel. +86 (21) 2212 3206
+86 (28) 8673 3916
anthony.chau@kpmg.com

Cheng Chi
Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Dawn Foo
Tel. +86 (21) 2212 3412
dawn.foo@kpmg.com

Chris Ho
Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Lily Kang
Tel. +86 (21) 2212 3359
lily.kang@kpmg.com

Sunny Leung
Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Martin Ng
Tel. +86 (21) 2212 2881
+86 (571) 2803 8081
martin.ng@kpmg.com

Yasuhiko Otani
Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

John Wang
Tel. +86 (21) 2212 3208
john.wang@kpmg.com

Jennifer Weng
Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

Lachlan Wolfers
Tel. +86 (21) 2212 3515
lachlan.wolfers@kpmg.com

Grace Xie
Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Zichong Xu
Tel. +86 (21) 2212 3404
zichong.xu@kpmg.com

Leonard Zhang
Tel. +86 (21) 2212 3350
leonard.zhang@kpmg.com

William Zhang
Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

Cheng Dong
Tel. +86 (21) 2212 3605
cheng.dong@kpmg.com

David Huang
Tel. +86 (21) 2212 3605
david.huang@kpmg.com

Yong Yong Ng
Tel. +86 (21) 2212 3440
Yongyong.ng@kpmg.com

Amy Rao
Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Michelle B. Zhou
Tel. +86 (21) 2212 3458
michelle.b.zhou@kpmg.com

Southern China
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Angie Ho
Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Jean Jin Li
Tel. +86 (755) 2547 1128
+86 (592) 2150 888
jean.j.li@kpmg.com

Jean Ngan Li
Tel. +86 (755) 2547 1198
jean.li@kpmg.com

Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Kelly Liao
Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Bin Yang
Tel. +86 (20) 3813 8605
bin.yang@kpmg.com

Hong Kong
Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR
Tel. +852 2826 7165
ayesha.lau@kpmg.com

Chris Abbiss
Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern
Tel. +852 2826 7166
darren.bowdern@kpmg.com

Alex Capri
Tel. +852 2826 7223
alex.capri@kpmg.com

Barbara Forrest
Tel. +852 2978 8941
barbara.forrest@kpmg.com

Ken Harvey
Tel. +852 2685 7806
ken.harvey@kpmg.com

Nigel Hobler
Tel. +852 2143 8784
nigel.hobler@kpmg.com

Charles Kinsley
Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos
Tel. +852 2685 7457
john.kondos@kpmg.com

Alice Leung
Tel. +852 2143 8711
alice.leung@kpmg.com

Curtis Ng
Tel. +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman
Tel. +852 2143 8777
kari.pahlman@kpmg.com

John Timpany
Tel. +852 2143 8790
john.timpany@kpmg.com

Jennifer Wong
Tel. +852 2978 8288
jennifer.wong@kpmg.com

Christopher Xing
Tel. +852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

kpmg.com/cn