China alert

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VAT reforms become a reality for 2012 pilot program

Background

On 17 November 2011, the Chinese government took a giant step forward in its quest to apply a Value Added Tax (VAT) across both its goods and services sectors.

In joint circulars issued by the Ministry of Finance (MoF) and the State Administration of Taxation (SAT), Caishui [2011] No.110 and No.111, detailed implementation and transitional rules (referred to below as 'the rules') were released to give effect to a pilot program in Shanghai to replace business tax (BT) with a VAT, commencing on 1 January 2012. While the pilot program is limited to Shanghai and to particular industries only, the implementation and transitional rules are likely to serve as a roadmap to the way the reforms will ultimately be implemented across the whole of China.

Reforms of this magnitude will undoubtedly give rise to many short-term issues and potentially some unintended outcomes for business. Fundamentally though, the replacement of BT (a tax on business) with a VAT (a tax collected by business, but effectively borne by the end-consumer), is a welcome change for business. With over 150 countries around the world having now implemented a VAT, these reforms should also more closely align China's system of indirect taxes with the world's best practice.

The breadth of detail contained in the rules, and the desire to disseminate this information very quickly, means that this particular KPMG China alert serves as a summary only. Further details will be provided via industry specific seminars conducted by KPMG China, or by contacting your local KPMG contact.

Key conceptual elements

It is tempting, given the breadth of the rules that have been issued by the MoF and the SAT, to become so immersed in the detail that one risks losing sight of the objectives, which those rules seek to implement. Given this, it is worthwhile reiterating some important conceptual elements:

- BT is a tax which applies to each transaction in a supply chain. By contrast, VAT is a tax which, although applying to each transaction in a supply chain, effectively only taxes the final price paid by the end-consumer. As such, a comparison of the rate of BT with the rate of VAT is a false comparison.

- Businesses that have been paying VAT have effectively had BT embedded in the price of services they acquire. Businesses that have been paying BT have effectively had both VAT and BT embedded in the price of goods and services they acquire. By merging the two systems, these embedded taxes largely disappear.

- BT is a tax collected and administered by local tax bureaus. VAT is a tax collected and administered by State tax bureaus. While these bureaus are one and the same in Shanghai, the merger of the two taxes should significantly simplify administration for businesses when the reforms are implemented in other regions.

- BT is a tax which applies to both the import and export of services. By contrast, VAT regimes globally do not generally tax the export of services by businesses. In relation to the import of services, offsetting VAT credits can ordinarily be claimed by business.

- These reforms are initially being implemented by way of a pilot program. The use of a pilot program enables the government to identify the effects of these reforms, and to make changes where necessary.

- During the period in which the pilot program operates (that is, until such time as these reforms are implemented nationally), there is likely to be short-term impacts across certain industries, competitive tensions between suppliers subject to the pilot program (and those outside it), and even some confusion and uncertainty. However, international experience has shown that these short-term impacts dissipate and that businesses generally benefit long-term.

- From a legislative design perspective, the rules seek to apply, to the extent which is practicable, the existing VAT regulations to those services subject to the pilot program.

With these conceptual issues in mind, we now turn to consider some of the more important details.

Industries and rates

The following industries in Shanghai will be subject to the pilot program commencing on 1 January 2012, with VAT applicable at the rates set out below:

Leasing of tangible movable property	17%
Transportation services	11%
Research and development (R&D) and technical services	6%
Information technology (IT) services	6%
Cultural and creative services	6%
Logistics and ancillary services	6%
Certification and consulting services	6%

One of the first areas that businesses will need to consider is the scope of their services. In particular, identifying which services will be subject to the pilot program, and which services will remain within the BT regime. The rules contain very detailed definitions, which explain the scope of each of these services in more precise terms. Set out below is a brief summary only of key aspects of those definitions:

- **Leasing of tangible movable property** – this includes both finance leasing as well as operating leasing of tangible movable property.

- **Transportation services –** this includes land, sea, air and pipeline transportation. It includes road transportation, passenger and cargo transportation as well as time charter services and wet-lease operations.

- **R&D and technical services –** this includes R&D services, as well as technology transfer services and technical consulting services (such as feasibility studies, contract energy management services and engineering exploration services).

- **IT services –** the processing of information using computers, communication networks and other technologies, including software services, circuit design and testing services, information system services, business process management services.

- **Culture and creative services** – this includes design services, trademarks and copyright transfers, intellectual property services, advertising services, and convention and exhibition services.

- **Logistics and ancillary services** – this includes air services, port services, freight and passenger transportation (excluding railway) terminal services, salvage rescue services, freight forwarding services, customs clearance services, warehousing services and materials handling services.

- **Certification and consulting services –** this includes certification and verification services, general consulting services such as legal, tax, accounting services as well as internal management and business process services.

Financial services, real estate and construction services have, as we anticipated, remained outside the scope of the pilot program. Likewise, insurance services and post and telecommunications services will remain subject to BT (for the present time). Interestingly though, the rules make provisions for financial and insurance services as well as consumption oriented service industries (not defined) to be included in the VAT regime at a future time under what is referred to as a 'simplified VAT calculation method'.

The VAT rate applicable to the transportation sector is 11 percent. Given the current rate of BT on transportation services is three percent, with general VAT taxpayers eligible to claim a seven percent input VAT credit, the real cost of transportation services (even in a business to business context) is likely to increase. This increase in rates is likely to create a significant focus on compliance in this industry – many contractors may now need to register as general VAT taxpayers and issue special VAT invoices to limit the cascading or multiplying of VAT throughout the supply chain. Having said that, as a special concession, general VAT taxpayers are entitled to claim a seven percent input VAT credit on the purchase of transportation services from pilot small scale taxpayers.

Pilot scheme application – 'in Shanghai'

Quite clearly, one of the major issues arising in a pilot program of this nature is how to limit the program to businesses in Shanghai. Set out below is a table which highlights when VAT will apply, and when BT will apply to affected services:

Supplier – location of business unit	Where service takes place?	VAT or BT?
In Shanghai	In Shanghai	VAT
In Shanghai	Elsewhere in China	BT, but credit allowed against VAT payable
Elsewhere in China	In Shanghai	BT
Elsewhere in China	Elsewhere in China	BT

A business will be "in Shanghai" if the unit is in Shanghai providing services in the specific industries set out above. The concept of a "unit" is not the same as that of a legal entity, with the consequence that a single legal entity may have multiple units in different locations, some of which will now pay VAT (i.e. those in Shanghai) and others of which will continue to pay BT (i.e. those elsewhere in China).

These rules will undoubtedly raise occasional questions about how to determine the location where the service takes place. This is most pertinent in relation to dealings in intangible assets, services delivered electronically, and even leasing activities.

Exports and imports of services

Crucially, the rules provide that the export of services will be subject to either zero rating or VAT exemption, however, they do not specify the criteria to apply. This clarification will be welcomed by businesses. Indeed, one of the key inefficiencies of the BT system is that it effectively taxes the export of services. To the extent that the export of services is not subject to output VAT, this represents a significant cost saving for business.

The rules regarding the import of services largely mirror the existing rules regarding the import of goods. That is, if the supplier does not have a business establishment in China, then the withholding agent or recipient will pay VAT if they are established or reside in Shanghai. The rules also make clear that the recipient in these circumstances will be entitled to an input VAT credit, so that VAT is not a real cost, provided certain documentation requirements are met.

It is also worth noting that if services are provided by foreign entities to entities in China, VAT will not apply where the service is fully consumed outside of China. Likewise, the lease of tangible movable property by foreign entities to entities in China is not subject to VAT if the property is entirely used outside of China.

The effect of these reforms is that many businesses should now seek to revisit transfer pricing policies, given that cross-border service flows covered by the pilot program may no longer generate BT liabilities, or irrecoverable VAT liabilities. However, to achieve this result, they will need to ensure the services being provided fall within the specific description of services covered by the pilot program, and the documentation requirements for input VAT credits are closely followed.

Registration as general VAT taxpayers and invoicing

Many businesses in industries affected by the pilot program will need to consider whether to register as general VAT taxpayers, noting the requirement that registration is compulsory for businesses with RMB 5 million of annual sales income. This threshold is much higher than the existing VAT threshold of RMB 800,000, and it is possible the threshold may be reduced after the pilot program has been completed.

For businesses with sales income below the RMB 5 million threshold, they may still register as general VAT taxpayers, provided they have sound and complete accounting records in place. Once registered, those businesses will also need to purchase invoicing systems so as to enable them to issue special VAT invoices.

The use of a relatively high RMB 5 million compulsory registration threshold will now mean that many businesses are faced with a choice as to whether to register as general VAT taxpayers, or remain as small scale VAT taxpayers paying at the rate of three percent.

Given the short time period before the pilot program commences, it is recommended that businesses give this issue very high priority. KPMG is aware that some businesses in the pilot program have already been approached by tax bureaus in Shanghai to conduct training for this purpose. It is also worth reiterating that businesses should ensure their key suppliers register and are ready to issue special VAT invoices.

Exemptions

The rules retain a number of exemptions frequently relied upon by businesses as part of the BT regime. These include:

- Technology transfers by pilot taxpayers (based on similar criteria set out in Caishuizi [1999] No.273)

- Offshore outsourcing services provided by business registered in Shanghai until 31 December 2013 (based on similar criteria set out in Caishui [2010] No.64).

This is consistent with one objective of the new rules, which is to grandfather existing BT preferential policies. There are other exemptions applicable in a diverse range of circumstances, including copyright transfers by individuals, services provided by people with disabilities, service of pesticide spray by airlines, and transportation revenue generated by Taiwanese shipping companies generated in mainland China. In addition, services provided by qualified energy service conservation companies in implementing contracted energy management projects are also exempt.

However, it is important to recognise that these activities are 'exempt' from VAT, which simply means that no output VAT is payable. However, input VAT incurred on items used in making these transfers, or providing these services, will not be eligible for credits. This outcome is, in many ways, undesirable for businesses. It highlights the fact that 'exemptions' from VAT are not as beneficial as 'zero rating' (where input VAT credits can generally be claimed). In these circumstances, it may be preferable for some businesses not to claim exemption so as to be eligible for input VAT credits.

Leases over tangible movable property

Where businesses subject to the pilot program have entered into leases over tangible movable property prior to 1 January 2012, then those leases will remain subject to BT. This will be a welcome relief for leasing companies in Shanghai who may be locked into contracts which make no provision for VAT.

Interestingly though, this relief would seem to only protect the lessor, not the lessee. In other words, if the lessee is in Shanghai and subject to the pilot program, they may prefer that the lease be subject to VAT (where they would qualify for input VAT credits), rather than having to bear the lessor's BT liabilities embedded in the lease costs. Presumably, they could seek to negotiate a new lease with the lessor in these circumstances.

The rules do not seem to provide transitional relief for any other contracts. This highlights the need for affected businesses to undertake reviews of their contracts, and where applicable, engage in negotiations to ensure VAT can be recovered.

Finally, by aligning the VAT rate on the sale of goods with the VAT rate applicable to operating leases and finance leases over goods, it ensures that businesses can make these commercial decisions without tax consequences being a significant factor.

Multiple rates, multiple services and mismatches

Some businesses will potentially have both BT and VAT services being conducted simultaneously. This gives rise to the need to potentially apportion or track input VAT credits to output VAT liabilities, as well as dual invoicing systems. This will also occur where businesses have units both within Shanghai, and outside of Shanghai.

The pilot program will also now result in the regular usage of at least four different VAT rates – six percent, 11 percent, 13 percent and 17 percent. Goods and services which may be quite similar may be taxed very differently. As such, it is imperative in contract negotiations and drafting to ensure clarity in terms of describing what is being supplied, and the price or prices being paid for those supplies.

The use of multiple rates also gives rise to potential mismatches of output VAT with input VAT. For example, a logistics business will generate output VAT liabilities at the rate of six percent, but they may have input VAT credits on transportation services they acquire at 11 percent. Likewise, some service providers will have output VAT liabilities at the rate of 11 percent, but acquire goods which generate input VAT credits at the rate of 17 percent. Where these mismatches occur, significant opportunity costs may arise because the loss is simply carried forward (albeit available to use indefinitely). In China, there is no entitlement to a refund of excess input VAT credits.

Crossover rules

There are a number of specific transitional or crossover rules applying as a result of merging two different taxes into one. As an example:

- Businesses already registered as general VAT taxpayers do not need to reapply for registration (for services now covered by the pilot program)
- Businesses with input VAT balances (from goods) as at 31 December 2011, cannot offset that balance against output VAT generated from services subject to the pilot program
- Businesses who pay BT on a net basis cannot generally deduct input VAT on services acquired from pilot program participants.

As a general proposition, the rules seek to apply many of the existing VAT concepts to the industries subject to the pilot program.

VAT levy first and refund later

In a limited range of industries, a VAT levy first and refund later policy applies to certain pilot program taxpayers that provide these services:

- Domestic cargo transportation, warehousing and related services provided by pilot taxpayers registered in Yang Shan Port Bonded Zone

- Enterprises which employ the disabled (subject to conditions)

- Pipeline transportation services with respect to the effective VAT burden in excess of three percent

- Approved finance leases with respect to the effective VAT burden in excess of three percent.

Key opportunities – pilot program businesses

For businesses subject to the pilot program, 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 credits 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 that 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.

International experience would also suggest that many businesses may cease engaging with other businesses that do not register as general VAT taxpayers and therefore cannot issue special VAT invoices.

Key opportunities – businesses already registered as general VAT taxpayers

Those businesses already selling or importing goods that are subject to VAT should not be impacted by these reforms in terms of their output VAT liabilities. However, there will be significant advantages in purchasing services from participants subject to the pilot scheme, given they would then be ordinarily eligible for input VAT credits.

In practice, it may be noted that many general VAT taxpayers generate some service flows upon which they have been paying BT – whether it is in the form of intercompany services, or otherwise. The potential now exists for input VAT credits to be claimed on those services if they are subject to the pilot program.

Key opportunities – all other businesses not subject to the pilot program

For those businesses not subject to the pilot program, it would be worthwhile to carefully review their list of suppliers and to potentially price in the difference between paying a higher (irrecoverable) VAT as compared to a lower (irrecoverable) BT. At the very least, they may consider using this differential as a negotiating point.

'VAT Prepare'

Quite clearly, businesses subject to the pilot program need to actively engage both internally with key stakeholders, and externally with their advisers, to prepare for the reforms. To assist those businesses, KPMG has developed the 'VAT Prepare' pictogram, which highlights a number of key components needed to be ready for these reforms.

KPMG has also developed its 'VAT Prepare' service offering to assist businesses to be ready for these important reforms. Please ask your KPMG contact for any assistance in preparing and implementing these reforms in your business.

Preparation checklist

As noted in KPMG China's China alert 2011 Issue 34, there are some tangible steps that businesses should take to prepare for the reforms. Many of those steps can now be implemented:

1. **Identifying those parts of your business which are directly impacted by the pilot program, and those parts which are indirectly impacted.** This will involve a line-by-line characterisation and location analysis of service flows and revenues from those services, followed by a line-by-line characterisation and location analysis of expenses from purchases of services.

2. **How would the reform process impact 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? Where does my business purchase services from – within Shanghai or outside? Should my transfer pricing policies be reviewed with a view to minimise BT and/or VAT?

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? Does my business have tax codes which are suitable for a multi-rate VAT and the retention of BT in some industries?

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**? How does my business ensure that it receives payments from customers before it is required to remit VAT, and equally, minimise the timeframe between paying VAT on purchases and claiming input VAT credits?

9. **How will many of my suppliers, either current, or potential, be classified as 'small scale taxpayers' and therefore, be 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 is 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 3438
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

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

Wade Wagatsuma
Tel. +852 2685 7806
wade.wagatsuma@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