China alert

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China issues administrative guidelines for claiming zero-rated VAT concessions

The Value Added Tax (VAT) pilot program is currently operational in Shanghai, and is expected to be expanded to several other provinces in mainland China during the course of 2012/13. The VAT pilot program applies to the supply of transportation and other modern services industries.

The rules for the pilot program provide that the export of certain types of services may be treated as zero-rated or exempt for VAT purposes. However, in practice, businesses have been unable to access these concessions given the absence of application procedures and documentation requirements being promulgated.

In a joint announcement issued by the Ministry of Finance (MoF) and the State Administration of Taxation (SAT), the Chinese government has now set out the application procedures and documentation requirements for claiming zero-rated VAT concessions for exported services under the VAT pilot program.

SAT Announcement [2012] No. 13 (referred to below as 'Announcement 13') was released on 5 April 2012 and applies to businesses providing the following types of services under the VAT pilot program:

- Providers of international transportation services
- Providers of R&D services
- Providers of design services.

It is important to stress that these administrative measures only apply to those services which are zero-rated under the VAT pilot program. Circular Caishui [2011] No. 131 (see KPMG China Alert Issue 1 – 2012) also contains a number of exemptions from VAT for exported services. A separate Announcement is expected to be issued shortly, which will apply to those categories of exempt services.

The key message for businesses from Announcement 13 is that they need to pay close attention to the application and refund procedures, and maintain robust documentation systems to ensure they can fully take advantage of these concessions. The refund mechanisms in Announcement 13 are modelled on those currently applicable to exports of goods.

Background

Circular Caishui [2011] No. 131 sets out the different categories of exported services, which qualify for VAT concessions, together with the broad technical requirements applicable to those concessions. Generally speaking, the concessions are more beneficial for businesses than those that existed under the previous Business Tax (BT) regime.

The two categories of concessions set out in Circular Caishui [2011] No.131 are:

- Zero-rated services, which means that no output VAT is payable, but input VAT credits can be claimed for related expenses incurred by the business in supplying those services
- Exempt services, where no output VAT is payable, but input VAT credits cannot be claimed for related expenses incurred by the business in supplying those services.

Businesses primarily engaged in the provision of zero-rated VAT supplies need a refund mechanism, if their input VAT credits exceed their output VAT liability in any tax period. Announcement 13 sets out those refund procedures. Those same approval procedures and documentation requirements are intended to apply even where a business may have their output VAT liability exceed their input VAT credit entitlements, such as where exported services represent only a minor part of their overall business.

Approval and documentation requirements

Before an entity providing zero-rated services (referred to below as a 'zero-rated VAT service provider') is able to apply for zero-rated VAT refunds or credits, it must first be granted ' Exempt, credit, refund (ECR) status' (which is a concept discussed further below). ECR status applies generally to exporters of goods.

Once tax-free exporter status has been granted, the entity can commence submitting VAT refund reports and applying for zero-rated VAT refunds or credits. In this regard, Announcement 13 specifies a raft of documents and certificates that must be submitted along with the VAT refund report.

The table below details the documents and certificates that must be submitted to apply for tax-free exporter status and to apply for zero-rated VAT refunds or credits. Different materials must be submitted by different types of service providers.

Services provided	Approval procedures	Zero-rated VAT refund or credit documentation requirements
International transport services		
International water transportation services	• Bank account permit/license • Permit for Operations of International Shipping Services	• ECR Return / Application • Zero-rated Taxable Services (International Transportation Services) Tax-exempt Refund Application Detail Tables (form yet to be released) • Current period VAT return • Tax-exempt Refund Application Official Electronic Data • The following original certificates: - The cargo or passenger manifest for the zero-rated taxable services provided (or other documents capable of reflecting and certifying revenue composition) - Invoice for zero-rated services - Other certificates as requested by the competent tax authorities.
International air transport services	• Bank account permit/license • Permit for Public Air Transport Enterprises (business scope must include 'international air passenger, cargo and mail transportation services')	
International land transport services	• Bank account permit/license • Permit for the Operations of Road Transport Services (business scope must include 'international transport') • Permit for International Vehicle Transport Services	
R&D services	• Bank account permit/license • Registration certificate of technology export contract	• ECR Return / Application • Zero-rated Taxable Services (R&D, Design Services) Tax-exempt Refund Application Detail Tables (form yet to be released) • Current period VAT Return • Tax-exempt Refund Application Official Electronic Data • The following original certificates: - Registration Certificate of Technology Export Contract applicable to the R&D or design services provided to the foreign enterprise (copy only) - The R&D or design services contract pertaining to the zero-rated VAT services provided - Invoice for zero-rated services - Detailed Breakdown of Revenues Received From Providing R&D and Design Services provided to Foreign Entities (form yet to be released) - Other documents capable of reflecting and certifying revenue composition received in relation to the agreed R&D or Design service contracts - Other certificates as requested by the competent tax authorities
Design services	• Bank account permit/license • Registration Certificate of Technology Export Contract	

In addition to these approval and documentation requirements, Announcement 13 also helpfully sets out those areas of focus by the tax authorities in the event of an audit or review. Businesses would be well advised to consider those focus areas to ensure full compliance.

Refund mechanism

Where a business has input VAT credit entitlements exceeding their output VAT liabilities in any given tax period, a refund entitlement may arise.

Announcement 13 provides that the refund methodology is based on the same principle applicable to exports of goods, being the ECR method. Under the ECR method, exported services are:

- 'Exempt' from tax
- Input tax on expenses incurred in exporting are first 'credited' against output tax on domestic supplies
- Any excess input tax is 'refunded'.

This methodology is necessary because businesses in China are not entitled to a refund of VAT where their input VAT exceeds their output VAT on domestic sales. In other words, this mechanism ensures that refunds only apply to the export component.

The following examples highlight how the ECR method operates for different businesses:

	Predominantly local supplier	Predominant export supplier
Facts		
Domestic supply of modern services (VAT exclusive)	1,500	300
Exported modern services	300	1,200
Purchases (VAT exclusive, assume 17 percent VAT incurred)	500	600
ECR Limit[1]	18	72
Calculation		
Output VAT (six percent VAT rate)[2]	90	18
Input VAT[3]	85	102
Net VAT amount	5	(84)
Outcome		
VAT refund amount	-	72
Input VAT carried forward	-	12[4]

It should also be noted that for many trading companies in China exporting goods, they utilise an alternative method known as the 'levy first, refund later' method. Under this method, the trading company pays VAT on the purchase of goods from local suppliers. When the goods are exported, the trading company is not subject to output VAT on the export of the goods, and it can then claim part or all of the VAT on purchases. Announcement 13 provides that businesses must apply either the ECR method, or the levy first, refund later method to the whole of their business – they cannot pick and choose. As a consequence, if the export of services represents only a small proportion of the overall activities of the trading company, it may be preferable for the business to forego those refunds and continue with the levy first, refund later method. Specific calculations should be undertaken.

First time providers of zero-rated VAT supplies or services

Announcement 13 also contains an integrity measure aimed at taxpayers who have never previous supplied zero-rated VAT services.

For those first time providers, Announcement 13 requires them to submit monthly calculations of zero-rated VAT amounts for the first six months of service provision. Refunds will be withheld until the seventh month when, provided the tax authorities are satisfied with each month's calculation, the total accumulated amounts will be refunded at the same time.

Importantly, the tax authorities will deem all taxpayers to be first time providers of zero-rated VAT services unless evidence to the contrary is

[1] Calculated on the basis of the amount of exported modern services x 6% VAT rate.
[2] Calculated on the basis of the amount of domestic supplies of modern services x 6% VAT rate.
[3] Calculated on the basis of the amount of purchases x 17% VAT rate.
[4] Where the Net VAT amount exceeds the ECR limit, then the difference must be carried forward.

produced. As such, it is imperative that taxpayers who have previously provided the same type of services under the BT regime submit documentary evidence to the tax authorities when applying for tax-free exporter status.

Other matters

Announcement 13 also clarifies a number of other issues, including:

- The definition of R&D services refers to research and experimental development activities conducted for new techniques, new products, new technologies and new materials and systems
- Similarly, the definition of design services refers to business activities that transform plans and ideas into graphics and text, including industrial design; model design; fashion design; environmental design; graphic design; packaging design; animation design; exhibition design; website design; mechanical and engineering design; and creative design
- Businesses providing zero-rated services must not issue special VAT invoices for those services
- Services provided to, or from, free trade zones and other special customs zones are not treated as being an export of services for these purposes
- These concessions are effectively backdated to 1 January 2012, so that businesses which are subsequently approved as meeting these criteria may apply for refunds.

Next steps

Businesses should ensure that they are well prepared for the zero-rated exported services approval and documentation procedures by taking the following steps:

- Reviewing eligibility for zero-rated VAT concessions
- Considering the documentation reporting and retention requirements
- Preparing accounting systems to ensure that zero-rated VAT amounts and refunds can be accurately extracted and calculated
- Applying for ECR status (if eligible)
- Submitting documentary evidence of previous BT approvals
- Applying for refunds in respect of the dating period back to 1 January 2012.

Lastly, it should be noted that whilst Announcement 13 specifically applies to entities in the Shanghai VAT pilot program, it is likely that similar measures and procedures will be adopted in other provinces once the VAT reforms are rolled out elsewhere across mainland China.

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