China alert

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Part 2: VAT for transportation and logistics sector – key impacts, issues and solutions

Application of the pilot program to specific types of service providers

In early May, KPMG China published Part 1, which featured in Issue 7 of our China alert series. This looked at the scope of the Value Added Tax (VAT) pilot program for the transportation and logistics sector.

Part 2, featured in this issue, considers the application of the pilot program rules to specific service providers in the transport and logistics sector. Importantly, given that a single movement of goods from point A to point B may utilise several different suppliers or transport modes, these issues cannot be considered in isolation.

Airlines

The VAT pilot program currently only applies to specific airlines headquartered in Shanghai, such as China Eastern Airlines, China Cargo Airlines and Spring Airlines. According to Circular Caishui [2011] No.133, all other airlines including foreign and non-Shanghai airlines with branches or offices in Shanghai, are required to continue applying the Business Tax (BT) rules.

As noted earlier, the international transportation of passengers and cargo by licensed operators will be zero-rated. Only domestic transportation will be subject to VAT. Interestingly though, Caishui [2011] 133 also provides that frequent flyer and other mileage reward schemes are not subject to VAT. Similarly, revenue derived from customers who miss their flights or cancel their bookings is not subject to VAT. This concessionary approach is seemingly at odds with the position for BT purposes, which applies BT to revenue from similar activities such as cancelled hotel bookings.

Domestic shipping companies with branches in Shanghai

International transportation services provided by branches of domestic shipping companies based in China have historically enjoyed exemption from BT pursuant to Circular Caishui [2010] 8. That concession has been extended further in a VAT context, so that the provision of international transportation services by general VAT taxpayers who hold international transportation operation licences are eligible to zero-rate these services. In other words, not only do they have no output VAT on their services, but they may also claim input VAT credits on their expenses.

In this context, international transportation refers to the movement of cargo or goods or passengers from China to another country, from another country to China, or outside China entirely.

Where zero-rating is used, those suppliers are required to use the 'exempt, credit and refund' (ECR) mechanism, which has historically been applied to exported goods. That is, those services are (1) 'exempt' from tax; (2) input tax on expenses incurred in exporting are first 'credited' against output tax on domestic sales; and (3) any excess input tax is 'refunded'. Under the ECR mechanism, the refund rate is the same as the applicable VAT rate, so there should not be any VAT leakage.

Shipping companies with branches in Shanghai also need to consider a range of other issues, including:

- What types of expenses qualify for input VAT credits; and what types of expenses are deductible under the deemed input VAT credit method?
- How should they undertake their accounting for VAT in circumstances where deemed input VAT credits may be claimed in relation to deductible expenses subject to BT?
- How should they invoice for VAT where the VAT is effectively assessed on a net basis, but invoiced to customers on a gross basis?
- What documentation is needed to support a claim for zero-rating or exemption for international transportation services?

International shipping companies

The VAT treatment relating to the international transportation of goods, particularly for international shipping companies, presents many practical difficulties.

Set out below is a checklist of some of the key issues to be considered:

- Various tax and shipping treaties entered into by China with other jurisdictions contain exemptions from specific taxes, such as for BT. The range of taxes covered by those treaties needs to be carefully considered to determine whether an exemption from VAT now applies. It is likely to take many years before those treaties are updated.
- If a treaty contains an exemption from VAT, it is also necessary to consider whether the various fees and charges relate to services, which fall with the scope of the exemption under the treaty. For example, freight charges may be exempt from VAT under the treaty, but in some cases the payment of a profit share or royalty may not qualify. The shipping company may also wish to reflect on how it treated these fees and charges

previously under BT.

- If a treaty does not contain an exemption from VAT, or if there is no treaty, then potentially there is a withholding obligation imposed on either the local shipping agent or the customer. In this instance, it is necessary to ensure that the withholding obligation is properly implemented, and moreover, if the customer is eligible for an input VAT credit, the appropriate documentation to support the credit is made available to them. The parties may also need to consider whether to adjust the price for VAT purposes, particularly where the customer can claim an offsetting input VAT credit.

- International shipping companies incur various port charges and other charges in bringing cargo into a port in Shanghai. An issue is whether those charges qualify for exemption from VAT based on the exemptions contained in Circular Caishui [2011] 131. Furthermore, if the port and other charges are invoiced to the local shipping agent in Shanghai, then this can create some confusion about whether VAT should be remitted.

Shipping agents in Shanghai

Many international shipping companies establish a separate legal entity or appoint an independent entity to act as their agent in Shanghai. Practically speaking, these agents need to manage many of the VAT compliance obligations relating to the activities of international shipping companies, as well as their own VAT obligations. For example, the agents may need to consider:

- their obligations to register for VAT purposes under the pilot program, noting that their services may fall within the scope of the pilot program and be subject to a six percent VAT rate

- whether there is an obligation to withhold VAT on services which are provided by the international shipping company to a customer in Shanghai

- what documentation may need to be given to the customer to support a claim for an input VAT credit

- whether the services provided by the agent to the international shipping company qualify for exemption from VAT

- how to separate the VAT treatment applicable to revenue, which is collected by the agent in their own right versus the revenue collected on behalf of the international shipping company but invoiced to the agent.

Freight forwarders in Shanghai

The provision of freight forwarding services is subject to VAT as a logistics service and taxed at six percent. Many of the issues, which impact on both shipping companies and shipping agents also affect freight forwarders. In addition:

- freight forwarders providing services to overseas entities qualify for exemption from VAT, which will necessitate the transfer out or effective apportionment of certain input VAT credits

- where freight forwarding services are exempt from VAT, providers will need to consider the documentation requirements, which are yet to be clarified

- where freight forwarding services are outsourced to overseas affiliates, then it will be necessary to consider any withholding obligations, and moreover, whether the fee should be grossed up for VAT

- where freight forwarding services are outsourced to overseas affiliates, it is necessary to consider whether the income tax withholding obligations apply to the VAT-inclusive amount or the VAT-exclusive amount of the fee

- where freight forwarding services are subcontracted to other vendors in China as potentially different treatments apply depending on whether the subcontractor is based in Shanghai, elsewhere in mainland China, or is a small-scale provider.

Road transportation

For general VAT taxpayers in the road transportation industry, the issue faced by many of them is that while output VAT at 11 percent is applied to their services in Shanghai from 1 January 2012, their most significant input (typically the purchase or lease of a truck or other vehicle) will not qualify for an input VAT credit until such time as the truck is replaced or a new lease entered into. As such, there can be a significant time lag between the payment of output VAT and the benefit of input VAT credits.

The challenges for road transporters in China are more practical than technical. For example, one of the major expenses is fuel costs. The ability to claim input VAT credits for fuel costs depends on their ability to obtain the correct supporting documentation, such as special VAT invoices. Practically, this can be challenging. Another major expense is toll costs, which are not subject to VAT and cannot be deducted for BT or VAT purposes.

The further complication for road transporters is the diversity of the industry. Large-scale operators may be contracted to provide a transportation service and will be registered as a general VAT taxpayer, and then subcontract components of the local service to smaller operators, with less sophisticated levels of compliance. Cascading of VAT can readily occur, thereby eroding profit margins.

Warehousing services

Warehousing services fall within the pilot program as an ancillary logistics service. However, generally those service providers are not eligible to use the 'net basis' of VAT calculation if they were not previously eligible to account for BT on a net basis.

One of the issues affecting warehousing service providers is the extent to which they can claim input VAT credits for the purchase of fixed assets and equipment to be used in the warehouse. While the purchase of a warehouse itself would not qualify (on the basis that it is a purchase of real estate, which is subject to BT), and the purchase of construction services would also not qualify (on the same basis), there may exist the potential to claim input VAT credits for fixed assets and equipment.

The other commonly occurring issue for warehousing services is that many contracts exist on a longer-term basis. As such, the ability for the supplier to pass on VAT may be limited by the contract.

How we can help?

It should be evident from the above that the transport and logistics sector faces many complex issues in implementing VAT. These complexities are likely to continue for some time as the VAT pilot program expands across mainland China, and until a number of technical issues are resolved.

Based on our experience working with a large number of clients in these sectors in implementing the VAT reforms in Shanghai, there are some key areas where assistance is often needed. This includes:

- providing a detailed analysis of key revenue and expense items to ascertain the likely financial impact of the reforms, and any necessary adjustment to prices

- undertaking scenario analyses, so that the business can understand and apply the correct VAT treatment to many commonly recurring fact patterns

- providing technical input to management or project teams implementing the reforms as well as conducting training to key staff.

Further details on how KPMG China is assisting its clients in implementing the VAT reforms may be found here.

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