China alert

Issue 16 – July 2012

Major expansion of VAT reforms progressively from 1 August 2012

Background

On 25 July 2012, China's State Council decided that the Value Added Tax (VAT) pilot program, currently in force in Shanghai, will be expanded progressively from 1 August 2012.

The VAT pilot program is to be expanded to Beijing, Tianjin, Jiangsu, Zhejiang, Anhui, Fujian, Hubei, Guangdong, Xiamen and Shenzhen ('the 10 locations') between 1 August 2012 and 31 December 2012. The precise dates for implementation in each location have not been specified. However, we anticipate that specific announcements will now be issued by the tax authorities in each of the affected locations confirming the precise implementation date.

The decision by the State Council, as reported by Xinhua News Agency, has confirmed that the industries subject to the pilot program in the 10 locations named will be the transportation and modern services industries. These are the same industries that the Shanghai pilot program has applied to since 1 January 2012. Therefore, we would expect that the same, or substantially the same, rules currently in force in Shanghai will apply.

The State Council decision also confirms that the pilot program will be expanded to other cities and provinces, as well as to other industries, during 2013.

This decision to expand the pilot program to major commercial centres around mainland China during 2012 is testament to the early success of the Shanghai pilot program, and reflects a commitment to achieving substantial reform of the indirect tax system in China.

According to the National Bureau of Statistics, approximately 70 percent of businesses in Shanghai have so far benefited from a reduction in their tax burden as a result of the pilot program. If this trend continues on a national basis, then these changes will be welcomed by the business community, particularly during this period of global economic instability.

In its simplest form, the VAT reforms seek to replace Business Tax (BT) with a VAT. 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 businesses. 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 best practices globally.

Same same but different

KPMG recently issued several China alerts, which explain the operation of the pilot program rules in Shanghai. Given that the rules for the 10 locations are expected to be substantially the same as Shanghai, we will not repeat the analysis here. Instead, if you would like further information on the operation of the pilot program, please refer to KPMG's China alert Issue 40 – November 2011, which provides a detailed summary of the rules in Shanghai. Please also refer to two further China alerts, which examine the operation of the VAT concessions for exported services: China alert Issue 1 – January 2012 and China alert Issue 6 – April 2012.

While the pilot program rules for Shanghai and the 10 locations are expected to be substantially the same, there will be some differences in implementation and administration, which need to be carefully considered. For example:

- In Shanghai, there is a single tax authority, which collects both VAT and BT. In the 10 locations, the central and local tax bureaus are different. As such, taxpayers who previously paid BT to the local tax bureau will now deal with different tax officials in respect of VAT. It may take some time for them to develop an understanding of your business.
- Where a taxpayer in one of the 10 locations has previously benefited from a particular concession or exemption from BT, the pilot program rules effectively provide for the continuation of that concession or exemption under VAT. However, unlike the position in Shanghai, there will be different tax officials in the 10 locations assessing the entitlement to use that concession or exemption under VAT as compared with under BT, which could potentially lead to differences in approach. In short, businesses benefiting from a concession or exemption under BT should not take it for granted that the same approach will necessarily be accepted for VAT purposes.
- The types of industries, which are dominant in the services sector in the 10 locations are not necessarily the same as those in Shanghai. For example, in Beijing, the cultural and creative sector as well as the high technology sector, is more prevalent, and moreover, there is a higher concentration of State Owned Enterprises in Beijing. The tax officials interpreting the rules for those sectors or organisations may encounter new, untested, issues.

  Finally, the pilot program rules contain some special provisions applicable to Shanghai only e.g. in respect of the Yangshan Port, and the operations of China Eastern Airlines and other Shanghai headquartered airlines. Similar policies will need to be released to ensure equivalent treatment of businesses in the 10 locations.

Experiences from Shanghai

Given that the 10 locations are the next in line to implement the VAT reforms, there is considerable interest in learning from the experiences with the VAT pilot program in Shanghai. Below is a snapshot:

Implementation tips

- Businesses in Shanghai were only given six weeks within which to prepare for the reforms. In the 10 locations, they may have either less time (for those implementing shortly after 1 August 2012) or more time (for those implementing later in 2012). Either way, with the State Council decision now announced, and with the rules expected to be the same, or substantially the same, there is no reason to delay preparation. Implementation of these reforms will place significant demands on the internal resources of most businesses, and on the tax authorities.
- KPMG's recommendation is to prepare a project plan, which prioritises tasks based on those which need to be managed prior to the changeover from BT to VAT, those which need to be managed prior to the filing of the first VAT return, and those which may be implemented over the course of the next several months. Forming a project management team, together with external advice and assistance, is the recommended strategy for many large businesses.
- For many businesses, the short timeframe for implementation will place heavy demands on tax and finance teams. The best way to overcome resource shortages is to ensure that staff across the business receive training on the VAT reforms. That is because the VAT reforms impact sales, procurement, marketing, IT, legal, finance and tax functions within a business. If the knowledge of how the VAT reforms may affect the business is shared right across the business, it makes implementation more manageable, and reduces the risk of errors.
- Over the next few months, clear communication with key customers and suppliers is absolutely critical so that both parties are familiar with what will happen following the changeover from BT to VAT. For example, there needs to be communication with key customers so they know how your prices will be affected by the reforms. Furthermore, they may need to know if you are registered as a general VAT taxpayer so that input VAT credits may be claimed. Similarly, you will need to obtain the registration details of your key customers in order to issue them with special VAT invoices. In our experience, contractual and other commercial disputes are more likely to arise if you fail to engage proactively with your customers. Finally, businesses need to pay close attention to the transitional issues which arise. For example, determining whether the trigger point for transitioning from BT to VAT should be based on either the time when the contract is entered into, when the services are performed, when the services are invoiced, or when the fee is paid. Moreover, if there are any price adjustments to service fees on or after the commencement date relating to services, which were subject to BT, then businesses will need to ensure appropriate refunds can be accessed. Affected businesses may also need to ensure they retain access to BT fapiao equipment so that BT fapiaos may be issued where customers request them after the changeover date, but in respect of services provided prior to that date.

The devil is in the detail

At first glance, the rules for the pilot program are deceptively simple. However, it is only when you drill down into the finer details that many issues are identified, or uncertainties arise, which require resolution.

The issue is how best to resolve those uncertainties; in this case, many local in-charge tax officials may not have had prior experience with these reforms, and their resources will be stretched in the lead up to the commencement. That is where professional advice may be necessary. KPMG tax professionals have been closely involved in advising on the reforms in Shanghai, in assisting the Chinese government with aspects of the design of the VAT reforms, and internationally with comparable VAT systems. We also maintain Issues Registers, which log issues that may affect broader industry groups, and engage in regular dialogue with senior officials to resolve these uncertainties.

In our experience, many of the major causes of uncertainty with the VAT reforms derive from two underlying principles:

- The first principle is that the pilot program is limited to specific locations – Shanghai, and shortly, in the 10 locations. In some cases, competitive advantages can arise for businesses in those locations because they charge VAT (therefore allowing input VAT credits to be claimed), and competitive disadvantages can also arise because the rate of VAT is generally higher than the rate of BT. This is why the introduction of a pilot program in specific locations can create a ripple effect – businesses in cities or provinces immediately surrounding it are affected. Once the VAT reforms are implemented right across mainland China, and to other industries, these issues will become more manageable.
- The second principle is due to the fact that the pilot program incorporates special rules from the previous BT regime, so as to ensure the transition to VAT is smoother for affected businesses. For example, for those taxpayers that previously paid BT on a net basis, the pilot program rules allow them to continue to pay on a net basis under the VAT regime. Likewise, there were a myriad of special rules or concessions granted to businesses under BT, which may continue. The result is that the current VAT pilot program remains something of a hybrid of the old BT system with the new VAT system. The difficulty is that the concepts underpinning BT and VAT are quite different, and problems with the interaction between the two taxes frequently arise. Again though, once the VAT reforms expand across mainland China, and to all sectors, these uncertainties will largely cease.

Tax burden – increase or decrease?

- Most businesses in Shanghai, which have registered as general VAT taxpayers, have had their tax burden reduced as a result of the reforms, and the same should apply in the 10 locations as well. A reduced tax burden may be protected by taking a few simple steps – (1) ensuring contracts with customers allow VAT to be recovered in addition to the price; (2) ensuring suppliers pass on any cost savings arising from the reforms; and (3) ensuring special VAT invoices are obtained for any expenses where input VAT credits may be claimed.
- The main industries that have suffered from an increased tax burden are in the transportation, logistics and asset leasing sectors. These industries tend to have the most complex implementation issues, so special attention is needed. In Shanghai, the government introduced compensation measures to alleviate the effect of the increased tax burden for affected businesses, and the same is expected in the 10 locations. Businesses in these industries need to carefully consider how the reforms affect the pricing of their services.

Cross-border transactions

Generally, the VAT reforms provide for more favourable treatment of cross-border transactions than under the previous BT regime. For example, the export of many different types of services may be treated as either zero-rated or exempt from VAT, as compared with the previous position where five percent BT ordinarily applied. Furthermore, the provision of services from offshore to a business in either Shanghai or the 10 locations will be subject to VAT (with a withholding of the VAT liability by an agent or the business customer). However, if the business customer is also registered as a general VAT taxpayer, they may be entitled to an input VAT credit. In other words, there is no effective VAT cost.

While the treatment of cross-border transactions is certainly more favourable than under BT, there are a number of issues, which need to be carefully considered to achieve this outcome, including:

- In Shanghai, the tax authorities are yet to release the implementation procedures for taxpayers claiming exemptions from VAT, which is practically limiting the ability of many taxpayers to access these concessions. It is hoped that the implementation procedures for exemptions from VAT will be issued shortly, both for Shanghai as well as the 10 locations.
- The Ministry of Finance (MoF) and the SAT have released the implementation procedures for taxpayers claiming zero-rating of exported services, such as international transportation, research and development and design services. These are set out in Announcement 13 – please refer to KPMG's China alert Issue 6 – April 2012. However, the ability for businesses to zero-rate exported services depends on the business meeting certain approval requirements, and providing certain documentation to the tax authorities.
- Some tax officials in Shanghai have been interpreting the scope of the exported services concessions narrowly. As such, businesses may require assistance with the preparation and presentation of contracts and other documents to ensure that these concessions can be utilised.

Expansion to other industries

Currently, the VAT pilot program only applies to the transportation and modern services industries. Those sectors still paying BT, notably, financial and insurance services, real estate and construction, telecommunications and postal services, and entertainment services, can expect to be brought within the VAT regime in 2013, or possibly later.

KPMG's experience internationally is that the finance and insurance sectors, as well as the real estate, construction and telecommunications sectors, have many of the most complex issues to deal with under a VAT. Various Chinese government agencies are already seeking input as to the most effective way these industries should be included within the VAT regime in China, and KPMG is providing significant assistance.

The clear message for businesses in these sectors is to start preparing now, given that the ideal lead time needed for implementation in many of these sectors is significantly longer than for other industries.

Preparation checklist

There are many tangible steps that businesses should take to prepare for the reforms, which include:

1. **Identifying those parts of your business 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 the 10 locations or Shanghai, or outside? Should my transfer pricing policies be reviewed with a view to minimising 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? What about existing contracts?

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? Are there linkages between my systems and the Golden Tax System?

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?** Will my business be able to obtain the equipment necessary to issue special VAT invoices, and if so, what controls do I need to put in place over the issue of special VAT invoices?

8. **How would my cash flow position be affected by the reforms, particularly for BT taxpayers where the rate has increased**? 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 many of my suppliers, either current, or potential, will 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 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?

How KPMG can assist you

KPMG China has developed a 'VAT Opportunity Check' factsheet and a 'VAT Reform Service Offerings' brochure, to assist your business prepare for these important reforms. Please ask your KPMG contact for any assistance with preparing and implementing these reforms in your business.

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

Leonard Zhang
Tel. +86 (10) 8508 7511
leonard.zhang@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

David Chamberlain
Tel. +86 (10) 8508 7056
david.chamberlain@kpmg.com

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

Eric Zhou
Tel. +86 (10) 8508 7610
ec.zhou@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

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

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

Cheng Dong
Tel. +86 (21) 2212 3410
cheng.dong@kpmg.com

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

Dylan Jeng
Tel. +86 (21) 2212 3080
dylan.jeng@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

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