cutting through complexity

VAT reforms in China
What it means for multinational companies

September 2012

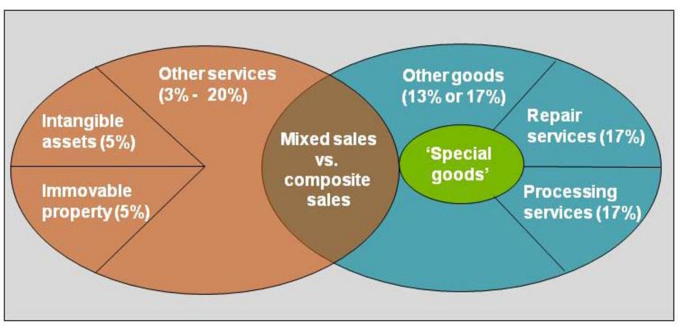
During 2012 and 2013, the Chinese Government is embarking upon one of the most ambitious tax reform programs in recent history. The program commenced in January 2012 with the introduction of a pilot program in Shanghai, replacing Business Tax (BT) with a Value Added Tax (VAT) for the transportation, asset leasing and modern services sectors. This is the first step in an overall plan to replace BT with VAT across the whole services sector in mainland China.

This change, which is intended to promote the development of the services sector in China as part of the Government's 12th Five-Year Plan, has significant ramifications for multinational companies doing business in, or with, China.

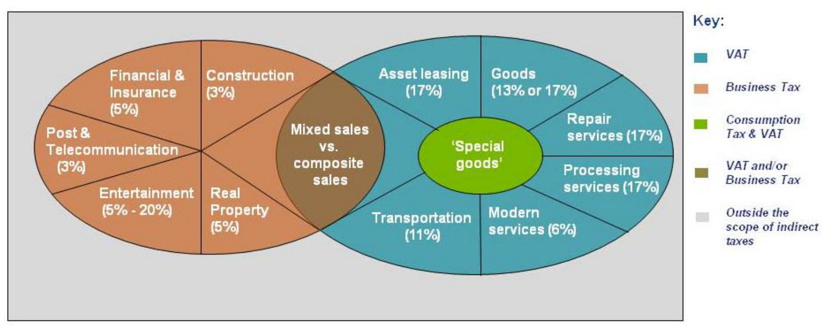
Background

For many years, China has operated a dual system of indirect taxes, with VAT applicable to the sale and importation of goods, typically at the rate of 17 percent. By contrast, most services have been subject to BT at rates of either 3 percent or 5 percent. These reforms are taking place because BT is an inefficient turnover tax, which taxes business – that is, it effectively taxes each stage of a supply chain, irrespective of the profit or 'value added' by each business in that supply chain. By contrast, VAT is a tax collected by business, but effectively only borne by the end consumer.

Pre-reforms



Post-reforms



Proposed expansion

On 1 January 2012, China commenced a VAT pilot program for the transportation and modern services industries in Shanghai, replacing BT, and in the process, introducing two new VAT rates – 6 percent (modern services) and 11 percent (transportation). The pilot program is progressively expanding throughout mainland China during the second half of 2012, before subsequent expansion to other service industries from 2013.

Commencing from 2013, the VAT reforms are expected to apply to financial services, insurance, real estate and construction, and post and telecommunications and entertainment services, thereby fulfilling the Government's objective of replacing BT entirely with VAT. The changes will unify the VAT system applicable to the goods sector with that of the services sector, and in so doing, remove inefficiencies in each system.

Key benefits for multinational companies

The VAT pilot program has widespread implications for multinational companies, many of which are beneficial to them. In particular:

Cross border services

Previously:

- 5 percent BT applied to most services which were either exported from, or imported into, China

Now:

- Exports of services may be zero rated or exempt from VAT
- Imports of services will be subject to VAT withholding; but recipient may claim an input VAT credit

Applies to:

- Intercompany service arrangements, transfer pricing arrangements, royalties for intellectual property rights, back office support services, management services and many more.

Goods in China - sale and importation

Previously:

- No input VAT credits could be claimed for the purchase of services because they were subject to BT

Now:

- Input VAT credits may be claimed for the purchase of services

Applies to:

- Businesses selling goods (e.g. manufacturers, wholesalers, retailers) as well as importers.

Service providers in China

Previously:

- Were ineligible to claim input VAT credits for the purchase of goods, fixed assets and services used in their business

Now:

- Entitled to claim input VAT credits for the purchase of goods, fixed assets and services used in their business

Applies to:

- All service providers in China who register as general VAT taxpayers.

How we can help

We can assist your business to take advantage of the reforms with our tailored services:

	Your needs	Our services
1	Understand the impact on your revenue, expenses, profits and cash flow	Financial impact assessment
2	Adjust internal control processes and/or information technology (IT) systems to deal with VAT invoice management and controls, and interface with the Golden Tax System	Provision of assistance in design or adjustment of internal control processes and IT systems
3	Evaluate the treatment of cross border services, including between related parties	For outbound services, advice and assistance in securing zero rating or exemption from VAT, including reviewing/amending contracts and intercompany agreements, satisfying procedural requirements, and liaising with the tax authorities. For inbound services, advice and assistance with VAT withholding and eligibility for VAT credits
4	Rules for certain industries and transactions are ambiguous, or assistance is required in applying for tax concessions/preferential treatments	Provision of assistance in consulting with tax authorities, clarification of unclear issues and applying for tax concessions/preferential treatments
5	Understand when an input VAT credit can be claimed, cannot be claimed and when it must be apportioned	Advice on when an input VAT credit can and cannot be claimed in relation to purchases, including when apportionment is required
6	Review/evaluate the effectiveness of existing supply chain, which may have been designed under the BT regime	Provision of tax planning services regarding supply chain evaluation and adjustments to achieve efficiencies
7	Ensure your staff, including finance teams, gains VAT knowledge and an understanding of key requirements, risks and opportunities	Provision of training to explain the operation of the VAT pilot scheme, practical implications, local interpretations and implementation issues
8	Ensure you can pass on VAT under contracts with your key customers. Need to ensure you can extract cost savings under contracts with your key suppliers	Contract reviews to determine if VAT can be passed on, or drafting of appropriate VAT gross up clauses. Provisions reviewed or inserted to ensure cost savings may be realised.
9	Identify and rectify any potential errors made in VAT filings, including improvements to be made after the implementation of the VAT pilot program	Post-implementation health checks

Contact us

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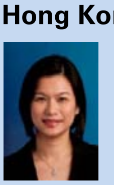

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Next steps

The VAT reforms present many indirect tax saving opportunities for multinational companies doing business in China. The services described above are intended to highlight the breadth of services we are currently providing to our clients. We have a broad range of options available to meet a broad spectrum of client needs – from those with limited internal resources requiring a more hands-on approach, to those with limited budgets and a desire to manage most of the reform implementation in-house.

If you would like further information on the operation of the pilot program and access to our indirect tax publications and resources please refer to KPMG China's dedicated Indirect Tax site.

Our credentials

KPMG has a dedicated Centre of Excellence for Indirect Taxes in China. Our team is experienced in implementing similar reforms, both internationally and locally. KPMG partners were appointed to the panel of experts assisting the Chinese Government with the VAT reforms. We are also currently advising China's Ministry of Finance and other government agencies on a number of crucial aspects of the VAT reforms.