

# CHINA TAX ALERT

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## Framework for VAT grouping for branches released

### Regulation discussed in this issue:

- Provisional Measures on Head Offices and Branches Eligible for Grouping for Value Added Tax Purposes (Caishui [2012] 84)

The Ministry of Finance (MoF) and the State Administration of Taxation (SAT) jointly issued Circular Caishui [2012] 84 ("Circular 84") (dated 31 December 2012) setting out the substantive framework under which head offices and branches may be eligible to group for Value Added Tax (VAT) purposes. This Circular will be beneficial to companies with multiple branches in different cities and provinces across mainland China, and for multinational and other large companies wishing to exercise greater controls over the indirect tax compliance of their branches. It will also be beneficial to businesses with branches with excess input VAT credit balances.

The general position in China is that separate VAT filing and payment obligations exist for each branch and head office of a legal entity in China. This can mean that a single legal entity in China may have multiple VAT filing and payment obligations across a range of different cities and provinces. Each city or province may also impose different administrative requirements, and adopt their own interpretation of the VAT rules. This can result in significant additional compliance costs for businesses.

Circular 84 sets out the framework under which grouping will be allowed for VAT purposes. The specific implementation rules under which this framework will be operational at an administrative level are yet to be introduced (except in respect of the airline industry, which is the subject of Circular Caishui [2013] 9). However, with the release of the framework rules contained in Circular 84, businesses subject to the VAT pilot program can start to consider whether they will choose to group for VAT purposes, and if so, how grouping will affect them.

### Background

Circular Caishui [2011] 111 ("Circular 111") contains the rules for the implementation of the VAT pilot program, which currently applies to the transportation and modern services industries ("pilot industries") in the following locations ("pilot locations"):

- Shanghai
- Beijing
- Jiangsu and Anhui
- Fujian (including Xiamen) and Guangdong (including Shenzhen)
- Tianjin, Zhejiang (including Ningbo) and Hubei.

It is expected that the VAT pilot program will shortly be expanded to other industries and pilot locations throughout China during the course of 2013 and beyond.

Circular 111 helpfully includes a general provision allowing taxpayers under the VAT pilot program to seek approval from the MoF and the SAT to group. However, that general provision contemplates that more detailed rules will be promulgated by the MoF and the SAT, which outlines how grouping may occur. Circular 84 contains those detailed rules.

### **Scope of application**

Circular 84 only effectively applies to taxpayers in industries subject to the VAT pilot program. At present, this means that Circular 84 applies to businesses in the transportation and modern services industry where their head office is located in a pilot location. The grouping rules then apply to all of their branches – that is, those branches paying VAT (in a pilot location) and those paying Business Tax (BT) (in a non-pilot location).

Importantly, Circular 84 does not apply to VAT taxpayers in respect of the sale or importation of goods, processing, repair and replacement services.

### **Filing and payment obligations of head office**

Circular 84 provides that the head office of a taxpayer calculates the VAT payable both in respect of itself, and its branches, on a grouped basis. The VAT on a grouped basis is paid by the head office to the SAT at the location (i.e., the city or province) where the head office is located. This means that the head office effectively discharges both the filing and payment obligations on a grouped basis.

### **Calculation of VAT payable by head office**

Under Circular 111, the amount of VAT payable by a general VAT taxpayer in any period is calculated on the basis of the following formula:

$$VAT\ payable = output\ VAT - input\ VAT$$

Where:

$$Output\ VAT = sales\ revenue \times applicable\ VAT\ rate$$

In broad terms, these principles also apply on a grouped basis, except for the fact that in calculating output VAT on a grouped basis, it is necessary to deduct any VAT which must still be paid by branches in pilot locations in accordance with the 'advance tax rate method' (set out below), as well as any BT paid by branches in non-pilot locations. This effectively ensures there is no double taxation.

More specifically, in undertaking this calculation on a grouped basis, Circular 84 provides that the grouped sales revenue of a head office is the sum of:

- The sales revenue of the head office and its branches located in the pilot areas from business activities which are subject to the VAT pilot program. In other words, all the VAT payable in respect of transportation and modern services in pilot locations of the head office and its branches is grouped.
- The sales revenue of branches which are located in non-pilot areas derived from business activities which are in the scope of the VAT pilot program. In other words, all the BT payable in respect of transportation and modern services carried out by branches in non-pilot locations is grouped. There is a slight variation in the calculation of the sales revenue of branches in non-pilot areas, such that the following formula applies:

$$\text{Sales revenue} = \text{turnover of taxable services} \div (1 + \text{applicable VAT rate})$$

Essentially, this calculation simply aggregates the appropriate amount of revenue for VAT purposes of the head office with the VAT and BT revenue of its branches.

The calculation of grouped input VAT is considerably easier. The grouped input VAT is simply the sum of the input VAT of the head office and the branches in pilot locations in respect of services which are subject to the VAT pilot program. Any input VAT referable to branches in non-pilot locations cannot be taken into account on the basis that such amounts are not creditable at the branch level.

The only real complication in calculating input VAT is in circumstances where a business provides services which are subject to the VAT pilot program, as well as selling or importing goods, or providing processing, repair or replacement services. In that situation, the business would need to apportion its input VAT between those activities, with only the input VAT referable to the services which are subject to the VAT pilot program being eligible for grouping.

### **Calculation of VAT payable by branches using the advance tax rate**

While grouping for VAT purposes means that the head office discharges the filing and payment obligations of its branches, Circular 84 does not completely absolve the branches of their obligations. In particular, Circular 84 provides that the branches are still required to pay VAT in accordance with a relatively simple calculation methodology. That is, they must pay VAT as follows:

$$\text{VAT payable} = \text{sales revenue} \times \text{advance tax rate}$$

Where:

*Advance tax rate is a rate which is prescribed and adjusted from time to time by the MoF and the SAT.*

The apparent objective of this methodology is to provide a means by which the branches pay an amount of VAT to their local province or city. Circular 84 does not set out the filing obligations which may still be required of the branches in order to pay VAT under the advance tax rate method.

Importantly, Circular 84 is currently silent on the methodology used by the MoF and the SAT to determine the advance tax rate' for each branch. In a Corporate Income Tax (CIT) context, SAT Announcement [2012] 57 sets out methodologies for allocating provisional CIT liabilities amongst branches on the basis of the relevant proportion of revenue, salaries and wages, and assets each branch bears to the total. This methodology has proved reasonably complex to apply. It is hoped that the MoF and the

SAT have taken on board the experiences with CIT, and will apply a simpler methodology to arrive at the advance tax rate’.

### **Calculation of BT payable by branches**

Those branches which are located in non-pilot locations are still required to continue to file BT returns and pay BT to their local tax bureau in accordance with the BT rules. In effect, this means that branches in non-pilot locations do not really gain any administrative benefit from grouping. However, with the VAT pilot program for the transportation and modern services industry expected to be expanded throughout the rest of China during 2013, this provision is likely to be of relevance only for a limited period.

### **KPMG commentary**

In many other countries with a VAT (or goods and services tax), grouping effectively involves the simple aggregation, filing and payment of the net VAT payable of a single economic entity. In China, the position was always going to be more complex given the fact that tax filing and payments are handled at a provincial level, with VAT revenues benefiting both the central government (75 percent) and local governments (25 percent). The exception to this is the revenue from those industries subject to the VAT pilot program, which belongs to local governments (100 percent). Additional complexity also arises because the VAT pilot program has not yet extended to all locations throughout China. In those cities and provinces where BT still applies, obligations need to be effectively maintained given that 100 percent of this revenue goes to local governments. An understanding of those revenue sharing arrangements provides the key to unlocking the complexity of Circular 84.

Notwithstanding some of the complexity in Circular 84, it begs the question as to whether companies with branches across several locations in China should seek approval to group. The answer to this question would generally be yes for the following reasons:

1. Circular 84 would seem to allow businesses with branches with excess input VAT credits to apply those credits against the VAT payable of other branches (see below).
2. Circular 84 overcomes the need to prepare VAT returns for each branch. While payment obligations still continue for each branch, the calculation method for those branches is very simple.
3. Circular 84 overcomes many of the difficulties in having to deal with officials in different locations adopting a different interpretation of substantive provisions. Instead, the company should be able to resolve all of its interpretational issues with their in-charge tax official at the head office location.
4. Businesses wishing to exercise greater oversight of the VAT compliance of their branches, may wish to group as a means of achieving more transparency and stronger tax controls.

Importantly though, Circular 84 still has several limitations to it, including:

- Grouping in the context of Circular 84 only applies to the branches and head office of a single legal entity. Separate legal entities, including wholly-owned subsidiaries, are not permitted to group with the head company for VAT purposes.
- Circular 84 currently only allows for grouping of those services subject to the VAT pilot program. Given the different revenue sharing arrangements in place between the central government and local governments, businesses selling or importing goods, or providing

repair, processing and replacement services cannot benefit from these grouping rules. It is hoped that once the VAT pilot program has extended to all industries, and across China, that more broadly based grouping rules will be enacted.

- Circular 84 is described as containing 'provisional measures' only. Presumably, the 'provisional' nature of Circular 84 exists because the VAT pilot program has not yet been applied across the whole of China. Once that has occurred, we anticipate that Circular 84 may be modified.

### Unresolved issues

There are still many unresolved questions arising from Circular 84. They include:

- If the output VAT and the input VAT of a head office are grouped with that of its branches, is it necessary to account for output VAT and input VAT in respect of transactions between the head office and the branch, or between branches? The VAT legislation in many other countries with grouping provisions allows these transactions to effectively be ignored. Circular 84 does not expressly address this question. Arguably, the implication is that such transactions must still be accounted for from a VAT perspective.
- It would appear that any excess input VAT credits of one branch can be offset by positive VAT amounts from other branches when grouping occurs. This implication is drawn from Circular 84 because the calculation methodology requires the separate aggregation of output VAT from input VAT, with these two amounts only being set-off on a grouped basis. If this interpretation is correct, Circular 84 potentially provides a powerful means by which to overcome problems of 'wasted' VAT credit balances in underperforming branches.
- Each branch will still have a 'advance tax rate' assessed. No guidance is provided in Circular 84 about how that advance tax rate will be determined. If a branch has a history of nil or negative VAT balances, then logically the advance tax rate should be nil. It would be helpful if the implementation measures clarify the methodology used in calculating the advance tax rate, so as to give certainty to businesses in deciding whether to group. Furthermore, consideration will need to be given to the allocation of new advance tax rates when new branches are established, or old branches cease operation.
- Circular Caishui [2011] 131 contains a range of zero rating and VAT exemptions for exported services, with special implementation procedures required for accessing zero rating (see SAT Announcement [2012] No.13). It is unclear whether those procedures will need to be satisfied by head office for the benefit of a branch once grouping occurs, or whether the branches are still required to undertake those compliance procedures.
- The system of managing VAT compliance in China is very documentation driven. For example, input VAT credits can only be claimed if special VAT invoices are obtained, and those special VAT invoices must be verified either by scanning them through approved computer systems purchased by taxpayers, or by taking them to the local tax office for verification. Circular 84 is silent on the question of whether the supporting special VAT invoices must be verified by the branches, or sent by the branches to head office for verification. The inference from Circular 84 is the latter given that head office claims the input VAT credits of the branches. Even then, there may be practical verification issues given the special VAT invoices will show the identification details of the branch, rather than head office. These



issues will need to be very carefully dealt with in the implementation rules because the control over special VAT invoices is a key risk issue for any business.

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