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CHINA TAX ALERT

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SAT clarifies VAT taxable sales revenue of Direct Sales Enterprises

Regulation discussed in this issue:

- State Administration of Taxation Announcement [2013] No.5

  Announcement regarding the taxable sales revenue of direct sales enterprises for VAT purposes

Background

The State Administration of Taxation (SAT) issued Announcement [2013] No.5 ('Announcement 5') on 17 January 2013, clarifying the Value Added Tax (VAT) treatment of the sales revenue of direct sales enterprises (DSE). Announcement 5 provides the key to resolving long-standing uncertainties faced by DSEs when filing and settling VAT.

In non-technical terms, a DSE refers to an organisation which engages sales agents or promoters to market and sell products to consumers, typically away from any fixed retail location, e.g., through one-on-one demonstrations, party plans, or other personal contact.

The *Administrative Rules on Direct Sales* issued by the State Council in 2005, provide that DSE, established upon approval by the commercial administrative department of the State Council, may recruit individual Sales Promoters (SP) to sell their products directly to end consumers outside of their fixed place of business. DSEs commonly carry on their business operations through one of the following transaction modes:

- **Mode I:** SPs place purchase orders for the products they would like to buy with DSEs at wholesale prices. The SPs then on-sell the products to the end consumers, either at or below retail prices designated by the DSEs. The difference between the wholesale price and the retail price is the reward due to the SP.

- **Mode II:** The relationship between DSEs and SPs is one of commission agency, whereby SP, as commission agent sells the DSE's products to end consumers based on the requirements of the DSE. In essence, DSEs sell products through SPs to the end consumers at retail prices, and in return, pay SP an agency commission.

Announcement 5 clarifies the method for recognising VAT taxable sales revenue under the two different business modes as follows:

1. Where DSEs sell products to SPs and SPs on-sell the products to end consumers, the taxable sales revenue of the DSEs for VAT purposes is the wholesale sales price, which includes any extra charges collected from the

SP. When on-selling the products to end consumers, SPs are liable for VAT in accordance with the prevailing tax regulations.

2. Where DSEs sell products through SPs, but receive payment directly from the end consumers, the taxable sales revenue of the DSEs for VAT purposes shall be the entire retail sales price including any extra charges collected from the end consumers.

Prior to the issuance of Announcement 5, a number of disputes occurred between DSEs and tax authorities regarding how the taxable sales revenue for VAT purposes should be determined under Mode I. These disputes mainly arose from differing interpretations of the special business modes used by DSEs.

Some tax authorities sought to deem the wholesale price as a kind of 'discounted price' under Mode I. Under this rationale, if the DSE does not state the retail price and the amount of the 'discount' on the same invoice (tax authorities consider the difference between wholesale price and retail price as a 'discount' offered by DSE to the end users), the 'discount' will not be deducted from the sales price for the purposes of the DSEs calculating their output VAT liability.

The conflicting view held by many DSEs has been that their output VAT liability should be calculated on the basis of the wholesale price of sales to SPs only. This view is based on the following rationale:

- The relationship between DSEs and SPs is one of a buy-sell transaction. The ownership of the products is transferred when t SPs purchase products from the DSE. DSEs have no control over what SPs do with the products once they purchase them from the DSE, i.e., SPs may choose to on-sell the products, keep them for self use, or even dispose of them. DSEs view the buyers of their products as being SPs, not the end consumers.

- Where a retail price is designated by the DSE, in practice, SPs may still offer a discount to end consumers, unbeknownst to the DSEs. That is, DSEs cannot control the final retail sales price that SPs charge to the end consumers.

- DSEs typically do not issue VAT invoices to SPs, and SPs (usually being individuals) do not ask for them.

Prior to the issuance of Announcement 5, Beijing, Guangzhou and Anhui issued local regulations in respect of the tax collection and administration of DSEs. However, these regulations mainly focus on the Business Tax (BT) treatment of the agency commission received by SPs under Mode II, but do not clarify how to determine the taxable sales revenue for VAT purposes under Mode I.

Announcement 5 clarifies that under Mode I, DSEs shall be liable to pay VAT on wholesale prices rather than retail prices, and that SPs shall be liable to pay VAT on retail sales prices to end consumers. Under Mode II, however, DSEs shall be liable to pay VAT on retail prices.

Announcement 5 is effective from 1 January 2013. Any unsettled matters that occurred prior to the promulgation of this announcement are to be settled in accordance with Announcement 5.

KPMG commentary

Announcement 5 is a welcome development in resolving uncertainty in this important area affecting DSEs and SPs.

Notwithstanding the certainty provided by Announcement 5 regarding the recognition of taxable sales revenue for VAT purposes, we recommend that the supporting documents retained by DSEs be consistent with the nature of their business mode. In reality, confusion regarding the mode of transaction usually arises because of a lack of any clear written contract between DSEs and SPs, or mismatches between the content of contracts and the invoices (or lack thereof). For example, some DSEs sign 'sales promotion' contracts, rather than 'sales' contracts with SPs, although the relationship between DSEs and SPs is intended to reflect a buy-sell transaction. Similarly, a 'grey area' can start to emerge where the contracts between DSEs and SPs give SPs an unconditional right to return any goods previously purchased from DSEs, and where the substance of the arrangements deviate from their intended legal form. As such, it is important to have proper written contracts in place, and for the parties to act in accordance with those contracts.

Although Announcement 5 clarifies the method for recognising taxable sales revenue for VAT purposes under the two different business modes, there are still some unresolved questions.

Announcement 5 does not clarify whether SPs shall be liable for BT on the agency commission they receive under Mode II. Given that the provision of agency services does not generally fall within the scope of the VAT pilot program at the current stage, SPs shall continue to pay BT on such agency commission.

Currently, Announcement 5 only stipulates that SPs charge VAT according to prevailing tax regulations when they on-sell products to end consumers. Practically, it will be difficult for the tax authorities to supervise and enforce VAT collection from individuals like SPs, who typically operate without a fixed base. A further question is the extent of a DSEs obligations to inform SPs of their VAT filing and payment obligations. In order to effectively collect tax revenues, the tax authorities may require the cooperation of DSEs when collecting VAT from SPs.

According to Announcement 5, where DSEs sell products through SPs, but receive payment directly from end consumers, the taxable sales revenue of DSEs for VAT purposes is the entire retail sales price including any extra charges collected from the end consumers. How is the phrase 'receive payments directly from the end consumers' to be interpreted? Based on a literal reading, it seems that, for this provision to apply, payment shall not be collected through SPs. If SPs, as commissioned agents, collect payments and pass them onto the DSEs, will this proviso be satisfied? The lack of clarification may result in tax authorities formulating different interpretations. As a result, DSEs with branches across China may still face inconsistent tax treatment in relation to the same business, and consequently, their compliance costs may increase.

It is expected that the SAT will clarify these unresolved issues and provide practical guidance to both tax authorities and taxpayers.

For further assistance in relation to the VAT reforms in China, please contact a member of KPMG's Indirect Tax Centre of Excellence or your preferred KPMG advisor:

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