CHINA TAX ALERT

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Nationwide expansion of China's VAT pilot program on 1 August 2013

Background

On 10 April 2013, China's State Council announced that the Value Added Tax (VAT) pilot program, currently in force in selected cities and provinces across mainland China, will be expanded nationwide on 1 August 2013.

This major expansion will complete the first stage of the rollout of the VAT pilot program across China to the transportation and modern services sector. China's State Council also announced that the VAT pilot program would expand to include the production, broadcast and publication of radio, films and television programs, as well as foreshadowing the expansion to the railways, post and telecommunications industries in the near future.

In a recent speech delivered in Beijing on 24 March 2013, the Secretary-General of the Organisation for Economic Cooperation and Development (OECD) described the importance of these reforms as follows:

> *"China is also implementing reforms to strengthen its tax system, replacing Business Tax with a Modern VAT. These reforms are important given that indirect taxes currently make up more than* 60% *of the total tax revenues, substantially more than in OECD countries. Moreover, some of them are particularly distortive, as they cascade from one company to another. While this process may imply revenue losses at first, the rolling out of this reform across China will surely deliver efficiency gains."*

This is consistent with the State Council's announcement that the reforms will reduce the overall tax burden by about RMB 120 billion in 2013.

KPMG observations

Expansion to new cities and provinces

The VAT pilot program is currently operational in Shanghai, Beijing, Tianjin, Jiangsu, Zhejiang, Anhui, Fujian, Hubei and Guangdong province.

The announcement by China's State Council now ensures that the first stage of the VAT pilot program will be operational throughout the whole of mainland China. Practically, this is likely to have the most impact in cities such as Chongqing, Chengdu, Qingdao and Kunming, each of which have strong or newly emerging services sectors, with industries such as the IT industry, research and development centres, and international trade generally growing at a considerable rate.

The expansion of the pilot program to the rest of mainland China is likely to be welcomed by the business community, especially multinational companies and other larger businesses. During the transition period between the commencement of the pilot program in Shanghai on 1 January 2012 and the national rollout on 1 August 2013, the complexity of having VAT apply in some locations, and Business Tax (BT) in others, created some confusion and uncertainties. With the nationwide expansion soon to be complete, some of the competitive advantages in sourcing services from pilot cities will soon be replaced by a more level playing field.

Many medium and larger services businesses located in the above cities and provinces will be required to register as general VAT taxpayers where their turnover exceeds RMB 5 million of annual sales income. In addition to paying output VAT on their services, they will be eligible to claim input VAT credits for the goods, fixed assets and services they purchase from other VAT taxpayers. Small-scale taxpayers will also benefit from a reduction in their tax burden from five percent BT to three percent VAT, which will be well received.

Businesses providing services which are subject to the VAT pilot program will be eligible to claim VAT zero rating or exemption for certain types of services which are exported in accordance with Circular Caishui [2011] 131. This compares favourably with the existing position under which the export of services is generally subject to five percent BT. Likewise, where services are provided from overseas parties to businesses in mainland China, which are registered as general VAT taxpayers, VAT withholding obligations apply. However, input VAT credits may now be claimed for the purchase of these services so as to offset any real VAT cost impact. It is hoped that detailed implementation rules will be issued nationwide to facilitate the effective access to these VAT concessions, particularly in relation to the export of services.

Some of the other major beneficiaries of the expansion of the VAT pilot program will be manufacturers, wholesalers, retailers and importers of goods. Whereas previously the purchase of services such as transportation, consulting and IT services in their business generally incurred an irrecoverable BT cost, now they should be eligible to claim input VAT credits. This is an intended purpose of the Chinese government's policy of seeking to replace BT with VAT to avoid indirect taxes 'cascading' throughout the supply chain. This beneficial change will be a welcome development in a country which is already heavily geared towards manufacturing, while at the same time, facilitating a more efficient and competitive services sector. Ultimately, it may lead to the expansion of the services sector in regions such as Northern China, which have traditionally been manufacturing based.

Expansion of 'modern services'

The State Council also announced that the scope of 'modern services', which fall within the VAT pilot program, will be expanded to include the production, broadcast and publication of radio, films and television programs ("the new categories").

In accordance with Circular Caishui [2011] No. 111, we anticipate that the VAT rate applicable to the new categories of 'modern services' will be six percent for general VAT taxpayers. We expect the State Administration of Taxation to confirm this by way of a further Circular shortly.

Expansion to other industries

The State Council has foreshadowed that the next industries to join the VAT pilot program will be postal services, telecommunications and railways services. The date that the VAT pilot program will be expanded to these industries has not been announced. However, we expect that expansion to occur in the latter half of 2013.

It has been widely speculated that the telecommunications industry will be subject to 11 percent VAT, compared with the existing three percent BT. Again, an announcement is expected on this in the next few months.

Once this expansion has occurred, the key sectors yet to transition from BT to VAT are the construction and real estate sectors, financial services and insurance, and entertainment services. International experiences suggest that these sectors may present the most complex challenges for policy-makers in transitioning to VAT.

Further information

In previous China Tax Alerts, we set out a detailed explanation of the operation of the pilot program rules in Shanghai. The rules to apply in the remaining cities and provinces joining the VAT pilot program from 1 August 2013 are expected to be the same as those applicable in Shanghai, based on Circulars Caishui [2011] 110 and 111, and Caishui [2012] 71. Further analysis is contained in China alert Issue 40 (November 2011).

The steps that businesses should consider to implement the VAT reforms are also set out in China alert Issue 16 (July 2012).

For the types of assistance that KPMG can provide with the implementation of the VAT reforms, please refer to our VAT Reform Service Offerings brochure.

KPMG cutting through complexity

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