



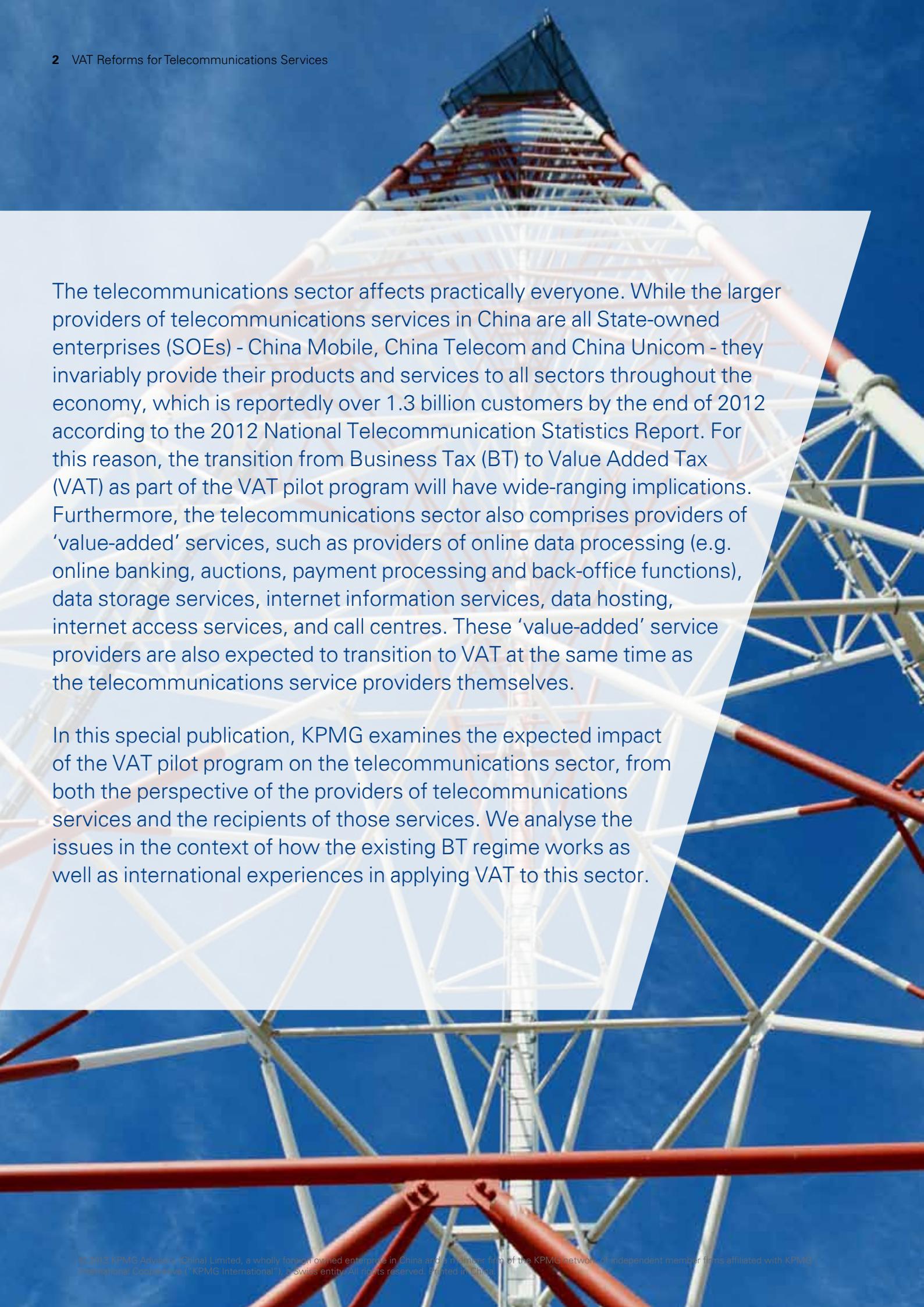
cutting through complexity

TAX

VAT Reforms for Telecommunications Services

June 2013

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The telecommunications sector affects practically everyone. While the larger providers of telecommunications services in China are all State-owned enterprises (SOEs) - China Mobile, China Telecom and China Unicom - they invariably provide their products and services to all sectors throughout the economy, which is reportedly over 1.3 billion customers by the end of 2012 according to the 2012 National Telecommunication Statistics Report. For this reason, the transition from Business Tax (BT) to Value Added Tax (VAT) as part of the VAT pilot program will have wide-ranging implications. Furthermore, the telecommunications sector also comprises providers of 'value-added' services, such as providers of online data processing (e.g. online banking, auctions, payment processing and back-office functions), data storage services, internet information services, data hosting, internet access services, and call centres. These 'value-added' service providers are also expected to transition to VAT at the same time as the telecommunications service providers themselves.

In this special publication, KPMG examines the expected impact of the VAT pilot program on the telecommunications sector, from both the perspective of the providers of telecommunications services and the recipients of those services. We analyse the issues in the context of how the existing BT regime works as well as international experiences in applying VAT to this sector.

Background

As a starting point, it should be noted that as of June 2013, no formal announcement has been made regarding the VAT rate, or the transition date, for the telecommunications sector to join the VAT reforms. However, it has been widely speculated that the telecommunications sector will be subject to an 11 percent VAT rate when the sector joins the VAT reforms soon, most likely in the first quarter of 2014. More recently, there has also been speculation that the VAT rate for 'value-added' telecommunications may be six percent, presumably in recognition of their relatively lower investments in fixed assets. Ultimately, the decision regarding the applicable VAT rate and the commencement date for joining the VAT pilot program will be made by China's State Council. Recent experience has shown that China's leaders are taking an active interest in the progress of the VAT pilot program.

Irrespective of the selected date, we anticipate that when the telecommunications sector joins the VAT reforms, it will be applied on a national basis. Given the interconnectedness of the telecommunications sector (both literally and figuratively), the province-by-province approach to implementation, which has been applied to the first stage of the VAT pilot program, would be ill-suited to this sector.

Also of particular relevance to the telecommunications sector is the likelihood that the Ministry of Finance (MoF) and the State Administration of Taxation (SAT) will be in a better position to make revisions to the VAT rules applicable to this sector as issues emerge. This is because the telecommunications sector is dominated by a small number of large SOEs, making it easier for policy-makers to respond to industry-based implementation issues, which is similar to the position of the airline industry. The MoF and the SAT have also recently amalgamated and modified all of the Circulars containing the rules for the VAT pilot program from 1 August 2013 in Circular Caishui [2013] 37, setting the platform for the nationwide rollout.

Scope of businesses affected

The telecommunications sector in China is heavily regulated. The regulatory environment is segregated between basic telecommunications services - those provided by China Mobile, China Telecom and China Unicom - and 'value-added' telecommunications services. Basic telecommunications services include services requiring telecommunications infrastructure, such as fixed network telephone services, mobile cellular services and voice-over internet protocol services (VOIP).

'Value-added' telecommunications services is an area in which some foreign ownership is permitted with a number of multinational companies entering into Chinese foreign joint ventures.

Current BT system

At present, the telecommunications sector is a subcategory of the 'post and telecommunications' sector, which pays three percent BT.

Ordinarily, BT is levied on the gross revenue, which is derived from the provision of the relevant service. However, for the telecommunications sector, there are a number of situations where BT may be calculated on a 'net' basis, for example:

- Under Circular Guoshuifa [2000] 143, a telecommunications company in one province may provide centralised services to larger corporate customers with operations across China. In that situation, the telecommunications company providing the centralised services need only pay BT on the balance of its turnover after deducting the amounts its distributes to the telecommunications company in other provinces.
- Under Circular Caishui [2003] 16, where a telecommunications company issues stored value telephone cards at a discount and their invoicing systems cannot recognise the discount, they may then account for BT on the balance after the discount amount is reflected in their accounting system.
- Under Circular Caishui [2003] 16, where a telecommunications company cooperates with another entity to jointly provide users with telecommunications and other services, but is the sole billing entity, the balance after subtracting the payments to the partner then represents the turnover for BT purposes.

When transitioning from BT to VAT, the industry will no doubt be seeking the continuation of these policies. However, with the recent abolition of the provision in the VAT pilot program rules, which allowed a reduction in turnover for expenses previously deductible for BT purposes in Circular Caishui [2013] 37, specific transitional rules may be needed to preserve this result for the telecommunications sector. Of course, once VAT applies to all sectors these specific concessions would no longer be needed given the availability of input VAT credits.



Key short-term impacts for domestic telecommunications providers

Assuming that an 11 percent VAT rate is implemented, the tax burden impact on telecommunications providers will be affected in the immediate period following the transition to VAT. The precise impact on their tax burden will likely be a function of three main factors:

- 1 **The extent to which the telecommunications providers are 'price makers'.** That is, the extent to which they can pass on the output VAT liability to their customers without suffering from a reduction in total revenue. Typically, in industries where there is a monopoly or oligopoly with high barriers to entry and a low level of price elasticity of demand, economic theory suggests that most or all of the VAT burden should be able to be passed on.
- 2 **The extent to which the telecommunications providers will be eligible to claim input VAT credits.** In this respect, the telecommunications industry exhibits many of the same characteristics as the transportation sector, which transitioned to VAT across many cities and provinces during stage one of the VAT pilot program. Those characteristics include the use of large items of capital equipment or infrastructure in their business, which have a relatively long useful life. Telecommunications providers that have recently invested significantly in fixed assets may be at a disadvantage compared with providers that need to replace significant fixed assets in the near term, where 17 percent input VAT credits should be available. In other words, it may take some time until the benefit of input VAT credits for the purchase of assets is fully realised.
- 3 **The future expansion of the VAT pilot program to capture industries where BT still applies.** Telecommunications providers currently incur expenditure, which is still subject to BT, e.g., real estate and construction costs. As the remaining industries progressively transition to VAT, telecommunications providers will generate further input VAT credits as more of their costs will increasingly bear VAT instead of BT.

Despite requests by industry, it seems doubtful that the MoF and the SAT will allow input VAT credits for fixed assets held at the time of transitioning to VAT, simply because the financial impact would be too substantial and would give rise to difficult valuation issues.

Ultimately though, experience suggests that the increased tax burden is likely to be greatest only in the short-term. It is expected that after an initial settling in period, customers will become more accustomed to the VAT being passed on, and telecommunications providers will generate input VAT credits as part of their normal capital replacement and new investment activities.

Bundling and other customer incentive arrangements

In the telecommunications sector, it is common to see the sale of mobile phone handsets being bundled with contracts for telecommunications services. Examples include the up-front payment for a new handset being rebated over the two year period of a contract for telecommunications services.

If China has a 17 percent VAT applicable to the sale of goods and an 11 percent VAT rate for telecommunications services, clearly there is an incentive to bundle free or to provide discounted handsets with service contracts. Generally, telecommunications providers do not recognise VAT revenue when handsets are sold, either because the customer purchases the handset directly from the supplier (often at a discounted price) or because telecommunications providers have factored the handset cost into the price of the service contract offered to the customer.

When telecommunications services become subject to VAT, the telecommunications providers will need to review the bundling sales arrangement based on the VAT rules. Most likely, a major consideration for both telecommunications providers and the tax authorities will be whether they need to allocate the price between the value of the handset and the value of the service contract, and if so, how they would undertake that allocation.

Equally, telecommunications providers will need to review other customer incentive arrangements such as the 'free gift with sales' under which customers may be provided with free products, such as toys or cooking oil, simply for purchasing new service contracts. According to Circular Guoshuihan [2007] 1322, the provision of free gifts is not subject to BT, nor is it subject to VAT. Instead, telecommunications providers are required to transfer out input VAT for the purchase of those gifts. This Circular reflects the underlying position that there is no 'deemed sales' rule under the BT regulations. By contrast, there is a 'deemed sales' rule for VAT purposes. When the telecommunications sector transitions to VAT, it will be interesting to see if this Circular continues to be applied or whether 'free gift with sales' become subject to VAT as 'deemed sales'.

Phone cards

VAT regimes in many countries have had to grapple with the technical question of how to ensure the correct amount of VAT is paid in relation to prepaid phone cards. The complexity can arise because phone cards may be taxed either at the time of sale (as a voucher) or at the time of redemption or usage, and they may also be sold at a price, which is discounted from their face value amount.

The current position under the BT system based on Circular Caishui [2003] 16 is that BT is paid on the discounted price of phone cards where the invoicing system of a telecommunications provider cannot recognise the difference. This administrative concession works appropriately under a turnover based system like BT. However, this policy may need to be adapted under a VAT system where general VAT taxpayers may use such invoices for the purposes of claiming input VAT credits. This is to mitigate the risk to the tax authorities regarding the output VAT liability of the telecommunications company being less than the input VAT credit granted to the business customer.

VAT filing entities

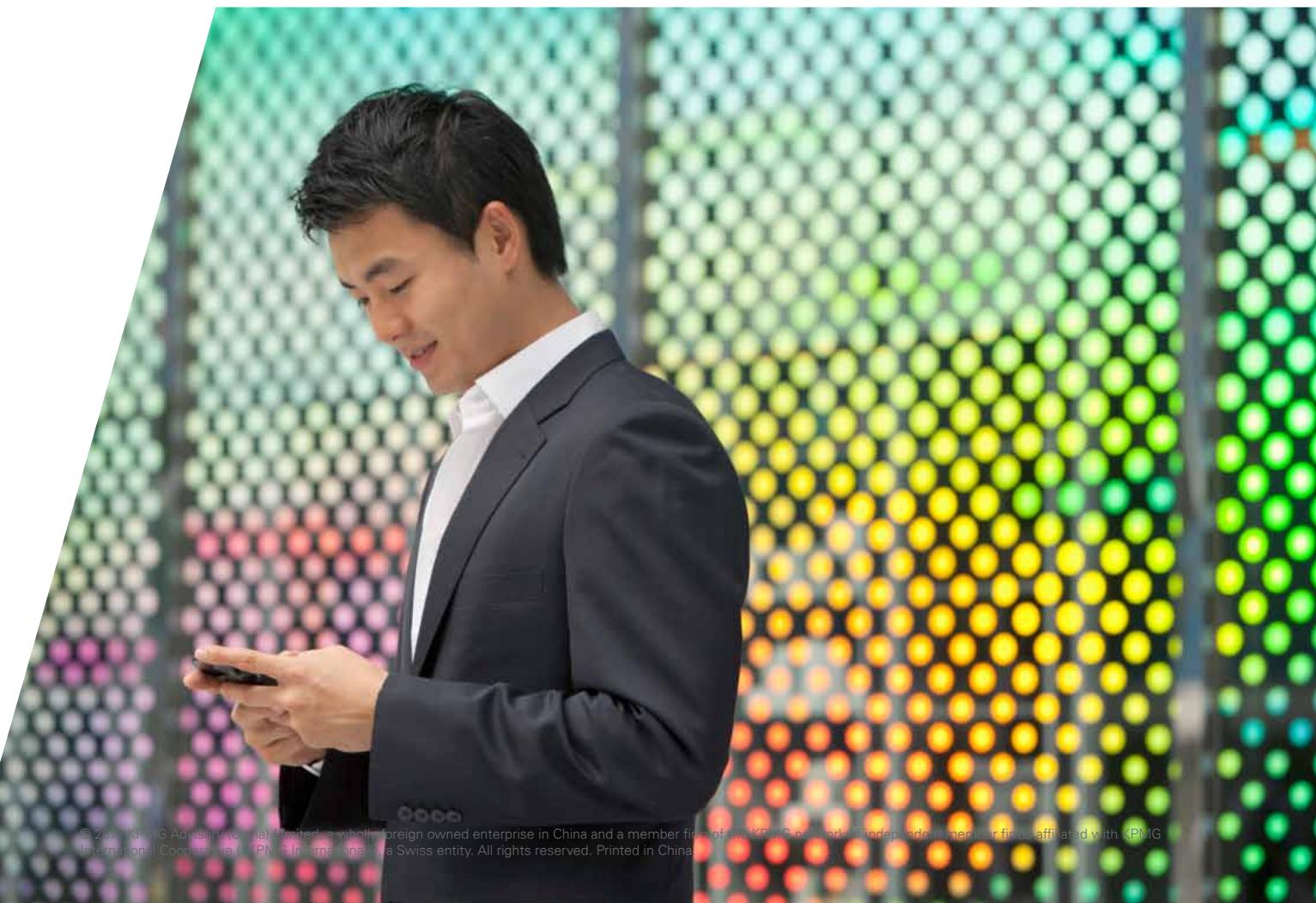
As SOEs, telecommunications providers generally centralise many of their purchases (either for goods or services) at the provincial level due to various management considerations such as the enhancement of bargaining power and the maintenance of controls.

The centralisation of purchases operates well under the BT regime given that input VAT credits cannot be claimed for purchases, which are subject to BT. However, under a VAT system, the centralisation of purchases potentially creates a mismatch between the input VAT credits claimed at the head office or provincial level and output VAT paid on sales at a local level. This could result in the overpayment of VAT and/or 'wasted' input VAT credit balances. To address these concerns, the MoF and the SAT would need to provide flexible consolidated VAT filing options to telecommunications providers.

Issuance of general VAT invoices

China executes very strict controls on the issuance of tax invoices, especially in the case of general VAT taxpayers. There are two main types of VAT invoices in China: special VAT invoices and general VAT invoices. The buyer of goods or services, which are subject to VAT, can claim an input VAT credit if a special VAT invoice is obtained. Those special VAT invoices are issued through the 'Golden Tax System'. By contrast, while general VAT invoices are also issued through the Golden Tax System, they cannot be used for the customer claiming an input VAT credit.

Telecommunications providers have many customers in each province, in some cases literally millions. When transitioning to VAT, the MoF and the SAT would need to consider whether the Golden Tax System is sufficiently robust and efficient to meet the demands of issuing VAT invoices to so many customers on a timely basis. Issuing VAT invoices through the Golden Tax System may prove to be very challenging for telecommunications providers, the IT supplier and the SAT. For example, telecommunications providers will have to plan the physical layout of the VAT issuance equipment in order to accommodate its customers while also ensuring sufficient controls over their issuance. The IT supplier of the Golden Tax System may need to develop new solutions to accommodate the sheer volume of invoices being issued. Alternatively, the SAT may consider allowing general



VAT invoices to be issued under an alternative system, rather than the Golden Tax System, to ease the pressure on a system originally developed to cater for companies operating on a much reduced scale.

Key impacts for international telecommunications

There are two common scenarios which arise. The first is when a customer of a Chinese telecommunications provider travels overseas; the second is when a foreign visitor comes to China. These situations are analysed below.

Chinese customers travelling abroad

When a customer of a Chinese telecommunications provider travels overseas, they may connect 'seamlessly' with an overseas service provider. However, the contractual flow is as follows:



When the supplier is an overseas telecommunications provider without a fixed place of business in China, this raises questions about whether VAT withholding obligations would arise.

According to Circular Caishui [2009] 111, international telecommunication services (including international call services, international mobile phone roaming services, international internet smart phone services, international SMS and MMS services) provided to Chinese entities or individuals by overseas entities or individuals are not subject to BT.

This policy effectively applies to a situation where a Chinese customer travels abroad and is given access by their Chinese telecommunications provider to an overseas network. Access is typically given under the terms of an interconnection agreement between the overseas telecommunications provider and the local Chinese telecommunications provider. In this situation, the exclusion from BT means that the Chinese telecommunications provider would not be required to withhold BT on the payments it makes to the overseas telecommunications provider.

Similarly, in Circular Guoshuihan [2010] 300, the leasing of overseas telecommunications networks, such as overseas circuits, submarine telecommunications cables and satellite repeaters, is not subject to BT. The exclusion from BT ensures there is no BT withholding when payments are made to overseas providers.

These are important policies because without them, overseas telecommunications providers may potentially have BT withheld on their services. The effect of Circulars Caishui [2009] 111 and Guoshuihan [2010] 300 is to implement Article 6.1.3 of the International Telecommunications Regulations (commonly referred to as the Melbourne Agreement), under which taxes on international telecommunications services are ordinarily collected only in respect of international services billed to customers in that country.

Given the effect of these Circulars is common to the VAT systems in many other countries, we would anticipate that these concessions will continue to apply in a VAT context. However, rather than being zero rated, we would expect the concessions to be exempt from VAT. This reflects the underlying policy intent that foreign entities without a physical presence in China are not eligible to claim input VAT credits, or generally to obtain refunds of VAT credit balances for the services they provide.

Finally, while the interconnection service between the overseas telecommunications provider and the Chinese telecommunications provider may be exempt from VAT, the same is not necessarily true of the service to be provided to the end-customer. For instance, the MoF and the SAT may wish to tax the provision of the service to the end customer under a VAT, mainly because it avoids difficult apportionment issues when VAT is applied to some parts of a customer's invoice and not others. By the same token, arguably the service is consumed overseas and therefore from a policy perspective, should not fall within the scope of VAT.

Foreign visitors travelling to China

The second scenario is when a customer of an overseas telecommunications provider travels to China. In this situation, the contractual flow will typically be as follows:



In this situation, the foreign visitor may connect 'seamlessly' with a Chinese telecommunications provider, but it is their overseas telecommunications provider, which contracts with the applicable Chinese telecommunications provider. For example, a Singaporean customer of SingTel visits China and connects to the China Unicom service. There are two supplies made – a service provided by China Unicom to SingTel, and a service provided by SingTel to the Singaporean customer.

The real question for Chinese telecommunications providers in this scenario is whether their services qualify for zero rating or exemption from VAT. In Circular Caishui [2011]131 and Caishui [2013] 37, the instances where the MoF and the SAT have granted zero rating are relatively uncommon. However, one analogous situation is with respect to international transportation services - zero rating applies to Chinese licensed and approved providers whereas exemption applies to unlicensed providers. Likewise, we anticipate that zero rating may be granted to Chinese telecommunications providers who provide their services to overseas telecommunications providers.

If zero rating is granted, this should mean that Chinese telecommunications providers are generally eligible to claim input VAT credits for the vast majority of their inputs. However, if VAT exemption applies, then this may give rise to significant complexities in terms of identifying and tracking their business inputs to those services or revenue, which is exempt from VAT.

Key impacts for customers (including businesses) receiving telecommunications services

The most significant impact for customers receiving telecommunications services will be felt if the rate of indirect tax increases from three percent BT to 11 percent VAT.

It remains to be seen whether an increase in this rate results in higher prices for consumers. The telecommunications sector uses extensive fixed assets in their business, and with the general availability of 17 percent input VAT credits for providers purchasing fixed assets after the transition to VAT, this should mitigate some of the impact.

From the perspective of customers who are general VAT taxpayers (such as manufacturers, wholesalers, retailers, and businesses in the services industry already part of the VAT pilot program), input VAT credits will potentially be available for the purchase of telecommunications services. This is likely to lead to a reduction in the overall cost of telecommunications services once the effect of input VAT credits is considered. It will be interesting to see the extent to which the large telecommunications providers choose to pass on the three percent BT saving before adding VAT. If business customers potentially benefit from a reduction in their telecommunications costs (through the availability of input VAT credits), while individual customers do not, the savings in one sector could be shared with the higher costs in another. In other words, cross subsidisation could occur.

Either way, a critical issue for businesses receiving telecommunications services will be the need to ensure they obtain special VAT invoices to claim input VAT credits. Given the highly regulated and labour intensive manner in which the Golden Tax System operates in China, it may be expected that the transition to VAT will lead to significant systems and operational impacts for telecommunications providers. For example, the need to obtain data from business taxpayers in order to issue special VAT invoices, the volume of invoices being issued, and the need for controls over them, will place enormous pressure on telecommunications providers in the transition to VAT.

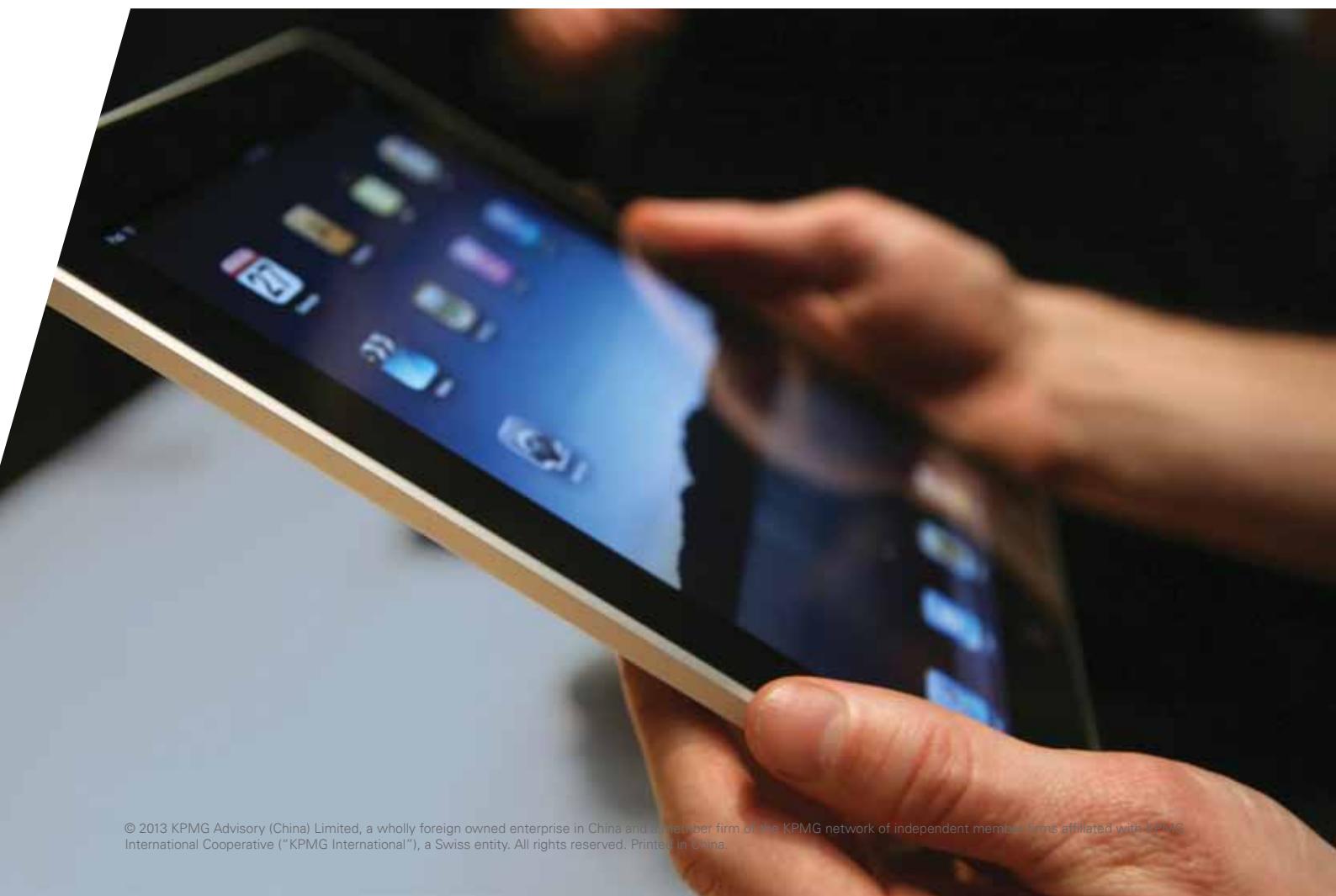
One interesting issue will be how the MoF and the SAT handle situations where businesses purchase telecommunications services for their employees. For instance, it is quite common for businesses to provide mobile phone handsets and accompanying telecommunications services for the benefit of their senior executives. Where those services are used for private purposes, it would be logical that input VAT credits should be transferred out. However, already in several aspects of the VAT pilot program, expenditure that is potentially dual purpose (partly for business use and partly for private use), the approach of the policy-makers has been to deny input VAT credits entirely, e.g., domestic airline transportation. If no equivalent rule exists for the telecommunications sector, then we may potentially see a rise in packaging of mobile phones and other telecommunications equipment.

Key policy issues

The transition to VAT for the telecommunications sector is awaited with interest. While there are undoubtedly a number of technical issues that need to be resolved, the key policy issues affecting telecommunications providers, businesses and consumers are:

- Will the applicable VAT rate for telecommunications services be 11 percent, and if so, what transitional relief may be provided, at least in the short term, to alleviate any anticipated increase in the tax burden impact?
- Will businesses registered as general VAT taxpayers be eligible for input VAT credits for the purchase of telecommunications services? If so, what (if any) controls or restrictions will be introduced to delineate private expenses from legitimate business expenses eligible for input VAT credits?
- Will overseas telecommunications services qualify for exemption from VAT or zero rating? If so, will these concessions only apply to interconnection services between carriers or will they also apply to services provided to Chinese end consumers travelling abroad?

KPMG will issue a China Tax Alert as soon as further details are released on the proposed policies for the transition to VAT for the telecommunications sector.



Steps to transition to VAT

There are many tangible steps that your telecommunications company should take to prepare for the reforms. These include:

1

Identifying those parts of your business that are both directly and indirectly impacted by the pilot program. 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

Examining how the reform process will impact your 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 your business model still the most efficient model?

3

Analysing the impact that the proposed reforms have on the prices of services that your business supplies. Would the reforms result in a bringing forward of demand (if prices are to increase) or would there be a deferral of demand (if prices are to fall)? Would your business have the legal and commercial negotiating power to ensure that any price reductions are passed on by your suppliers? How will the prices you charge for your services be affected? Will they impact on business customers in the same way as individual customers?

4

Checking whether your business is entering into contracts now, which potentially span the introduction of the reforms. If so, are there contractual provisions within those contracts, which would allow you to pass on the impact of a new tax? If your business is entering into contracts for the purchase of goods and services, does the contract enable your supplier to pass on the impact of any changes in tax rates arising from the reforms? What about existing contracts?

5

Investigating whether your IT and accounting systems adequately cater for a new tax. Do they enable recognition and claiming of input taxes on purchases that your business makes? Does your business have tax codes, which are suitable for a multi-rate VAT, and the retention of BT in some industries? Are there linkages between your systems and the Golden Tax System?

6

Considering the extent that your business should defer fixed asset purchases to potentially qualify for tax credits. Taxpayers currently subject to the BT regime are unable to claim input credits for fixed assets used in their business.

7

Inspecting whether your invoicing and cash register systems recognise output tax liabilities. Will your business be able to obtain the equipment and information necessary to issue special VAT invoices, and if so, what controls do you need to put in place over the issue of special VAT invoices?

8

Examining how your cash flow position will be affected by the reforms, particularly for BT taxpayers where the rate has increased. How does your business ensure 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

Identifying how many of your suppliers, either current or potential, will be classified as 'small scale taxpayers' and therefore, unable to claim input taxes. Would you cease doing business with them once the reforms are introduced in favour of businesses that are able to provide you with special invoices that you can claim input taxes?

10

Checking how proficient your staff is in dealing with tax issues. Will your accounts payable staff have the knowledge and capacity (and relevant training) to ensure that invoices comply and they are able to code invoices accordingly? What policies or procedures might you require to cater for this?



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