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CHINA TAX ALERT

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New regulations to implement nationwide expansion of China's VAT pilot program on 1 August 2013

Background

On 24 May 2013, The Ministry of Finance (MoF) and the State Administration of Taxation (SAT) jointly issued Circular Caishui [2013] 37 (Circular 37) setting out new regulations to implement the nationwide expansion of China's VAT pilot program on 1 August 2013.

Circular 37 represents the culmination of the first phase of the VAT pilot program with the nationwide implementation of VAT for the transportation and 'modern services' industries. Once implemented, attention will then shift to the remaining industries yet to transition to VAT – post and telecommunications, construction and real estate, financial services and insurance, entertainment and other services. Each of these industries is expected to transition to VAT before 2015.

KPMG observations

Circular 37 seeks to consolidate a number of previous Circulars implementing, or varying, aspects of the first phase of the VAT pilot program, whilst making a number of modifications to the operation of the VAT pilot program.

Circular 37, which takes effect from 1 August 2013, repeals the following Circulars:

- Circular Caishui [2011] 111 – this was the main Circular introducing the rules for the first phase of the VAT pilot program
- Circular Caishui [2011] 131 – this Circular contained the criteria for zero rating and exemption for exported services
- Circular Caishui [2011] 133 – this Circular contained a number of technical clarifications
- Circular Caishui [2012] 53 – this Circular contained a number of technical amendments and clarifications
- Circular Caishui [2012] 71 – this Circular expanded the pilot program to Beijing and other cities/provinces
- Circular Caishui [2012] 86 – this Circular contained a number of technical clarifications

- Items 16 and 18 of Article 3 of Circular Caishui [2003] 16 – this Circular related to Business Tax (BT).

The vast majority of the content of Circular 37 simply consolidates, without amendment, the rules contained in the above Circulars. As such, the analysis of those rules is not repeated again here. Instead, readers may refer to China alert Issue 40 (November 2011).

Expansion to radio, film and television

The scope of services subject to the first phase of the VAT pilot program in Circular 37 is unchanged from previous Circulars, with one main exception; the expansion of the VAT pilot program to radio, film and television services from 1 August 2013. This was previously announced by China's State Council on 10 April 2013.

Circular 37 provides that the VAT rate for radio, film and television services is six percent. The scope of services to be included within the VAT pilot program consists of production, distribution and broadcast services in relation to radio, films and television services.

The full definition of 'production services' is very broad and encompasses many 'behind the scenes' facets of the radio, film and television industry, including editing, filming, sound recording, audio and video text picture material production, scene layout, post clips, translation, subtitling, titles, credits, trailers, production, special effects, film restoration, and cataloguing. Similarly, 'distribution services' is widely defined to include 'split issuing', buying out, commission, agency and other means of transferring or dealing with broadcasting rights. 'Broadcast services' includes broadcasting through a wide variety of media, such as cinema, theatres, radio, television, satellite, internet, and other wireless or wired devices.

Circular 37 also provides that the broadcast and distribution of radio, films and television programs outside of China, as well as the production for overseas entities, is exempt from VAT.

Changes introduced by Circular 37 which benefit taxpayers

There are a range of new provisions introduced by Circular 37, which clarify previous Circulars, but in a way that is of benefit to taxpayers. The key beneficial changes are:

- Taxpayers who self-use motor vehicles, motor cycles and yachts are eligible to claim input VAT credits for the purchase cost. Previously, such amounts were not eligible for input VAT credits under Circular 111. While this change is beneficial to taxpayers, the reason for it is difficult to understand from a policy perspective. The previous policy appeared to have been designed as a means of safeguarding government revenue and avoiding disputes and uncertainties for taxpayers purchasing or using vehicles partly for private use and partly for business use. It did this by precluding an input VAT credit entirely. While the change is welcomed, it is difficult to understand why this reversal of the previous policy has taken place, and what safeguards will now be introduced to prevent misuse. Furthermore, it is unclear whether it now means these items are potentially fully creditable for VAT purposes irrespective of actual use (similar to the position of fixed assets), or whether apportionment is required (and if so, how that may be proved).

- Lessors who have entered into finance leases (following the commencement of the VAT pilot program) and who are approved by the People's Bank of China, the Ministry of Commerce or the China Banking Regulatory Commission are eligible to deduct certain expenses (which are not yet creditable for VAT purposes) in calculating their VAT liability. Circular 37 includes within the list of deductible items: loan interest (including both RMB loans and foreign exchange loans), customs duty, import consumption tax, installation expenses and

insurance expenses. This clarification, coupled with the entitlement to a refund where the effective tax burden of the lessor exceeds three percent, should alleviate the increased tax burden impact of the reforms on many taxpayers in this sector.

- Taxpayers who provide services, which qualify for both zero rating and exemption, are entitled to apply zero rating. Likewise, taxpayers who provide services, which are eligible for zero rating, or for exemption, are entitled to voluntarily waive this right and choose to apply exemption (if otherwise eligible for zero rating) or pay VAT (in either case). Once chosen, this method must be retained for three years. In practice, waiving zero rating has been useful where the approval requirements were considered by taxpayers to be too onerous relative to the amount of input VAT credits, which would be available.
- Trading companies that provide zero rating services overseas can use the 'exemption refund' method, which is consistent with the method applied to exports of goods, and should therefore alleviate compliance costs.

Consequential changes introduced in Circular 37

With the nationwide implementation of the first phase of the VAT pilot program, a number of earlier provisions catering for the situation where taxpayers in pilot cities provided services to taxpayers in non-pilot cities (and vice versa), become redundant. In particular, Circular 37 removes the entitlement to deduct from output VAT those expenses (net basis method), which were previously deductible under BT, but were not creditable for VAT purposes (because the supplier was not in a pilot city, or because the expense was still subject to BT).

The nationwide implementation of the first phase of the VAT pilot program simplifies a number of issues for businesses in dealing with VAT in some cities and BT in others. However, this is merely the first phase of simplification. Once the VAT reform program is complete such that VAT replaces BT entirely throughout mainland China, a number of complexities and inequities will be eliminated.

Key provisions omitted by Circular 37 (for reasons unknown)

The full impact of the repeal of the previous Circulars on the VAT pilot program, and their replacement by Circular 37, will take some time to come to light. However, one provision, which has been omitted from Circular 37 without any obvious policy change contemplated, is the three percent VAT withholding rate applicable to international transportation services provided by organisations or individuals from countries, which do not have a bilateral transportation treaty in place with the Chinese government. The three percent VAT withholding rate was introduced in Circular Caishui [2012] 53, but this Circular is repealed by Circular 37.

The effect of the repeal of Circular 53, and the failure to introduce a corresponding provision in Circular 37, means that from 1 August 2013, international transportation services which are provided by transportation providers based in:

- China will typically be eligible to zero rate or exempt their services from VAT under Circular 37 (and prior to that, under Circular 131)

- Foreign countries with which China does have a bilateral transportation treaty, will typically be exempt from VAT under the bilateral treaty

- Foreign countries that do not have a bilateral treaty with China, will now be subject to 11 percent VAT withholding.

This places foreign transportation providers from non-treaty countries at a considerable commercial disadvantage to providers from China and from treaty countries. For example, the services provided by a Danish shipping company would not be subject to VAT withholding (given the existence of a treaty), whereas the

services provided by a Swiss shipping company would now be subject to an 11 percent VAT withholding (where no treaty exists).

It is not clear that there was any conscious policy decision by the MoF and the SAT to change the VAT withholding rate in these circumstances from three percent to 11 percent. As such, it is hoped that this is merely an oversight, which may be corrected very shortly. A further adverse impact indirectly affecting the international transportation industry arises from the removal of the 'net' basis method for calculating VAT liabilities repealed by Circular 37. For example, for shipping agency businesses, the 'net' basis method allowed them to deduct the fees paid to international transportation providers from their output VAT, even where those fees were not subject to VAT. Either this is because the providers were Chinese entities qualifying for zero rating or exemption, or due to the operation of a bilateral transportation treaty.

With the removal of the 'net' basis method, shipping agencies will be unable to deduct the fees paid to international transportation providers in calculating their VAT liabilities. The commercial consequence is that when the shipping agencies then seek to charge those fees on to Chinese customers, a six percent VAT applies the international transportation fee.

In effect, the benefit of the VAT concessions applicable to international transportation fees do not flow through the supply chain. This problem needs to be rectified, ideally by ensuring that the international transportation fees do not form part of the shipping agent's revenue for VAT purposes, so as to ensure that policy intent of providing concessional treatment is achieved.

Key areas where future development is awaited with interest

While Circular 37 does seek to clarify a number of areas where uncertainty previously existed, it is fair to say that it does not resolve all uncertainties. In particular, there are three key areas where further clarification is still needed:

- Currently, there is inconsistent implementation on a national basis regarding the rules governing exemption from VAT for exported services. That is because there are no nationwide implementation rules issued (unlike for zero rated services). This has resulted in the situation where taxpayers legitimately exporting services overseas are unable to obtain the benefit of exemption from VAT if they happen to file their VAT returns in certain districts in cities and provinces where the tax authorities are reluctant to act in the absence of a nationwide instruction in the form of implementation rules. Even in those cities and provinces where taxpayers are allowed to claim VAT exemption, many taxpayers have only been allowed to proceed on the basis of 'self-assessing' eligibility for the exemption, which means they are potentially exposed in the event of an audit. Clarity in the form of nationwide implementation rules would assist tax authorities in achieving higher levels of consistency in their approach. It would also help taxpayers understand the documentation requirements they must satisfy, and assist them in accessing any refund entitlements for past periods. Given that the VAT pilot program first commenced almost 18 months ago (in Shanghai), it is hoped that this will be addressed shortly.

- At present, taxpayers can seek approval from the MoF and the SAT to apply VAT grouping to their branches, in accordance with the framework established by Circular Caishui [2012] 84. Currently, the implementation of this framework is limited to the airline industry, as set out in Circular Caishui [2013] 9. With the nationwide expansion set to take effect from 1 August 2013, this should remove many of the impediments currently preventing a wider range of businesses from grouping together for VAT purposes.

- The rules governing the VAT pilot program contain detailed definitions of the scope of services, which are subject to VAT. We have seen a number of instances where the same fact situation has been interpreted differently between different tax officials – some officials take a narrow view of the

services, which are included within the scope of the VAT pilot program, while others take more of a broader 'purposive' approach. Examples include funds or wealth management services, the conduct of professional training, and sales commission services. A key issue for many businesses is when the VAT pilot program will be expanded to catch all residual businesses still paying BT.

Further information

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.

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