

CHINA TAX ALERT

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VAT pilot program enters Phase II –expanded scope and significant changes

Background

On 12 December 2013, China's Ministry of Finance (MoF) and the State Administration of Taxation (SAT) jointly issued Circular Caishui [2013] No. 106 ("Circular 106") to implement the expansion of the VAT pilot program to the railway transportation industry and postal services industry from 1 January 2014. The telecommunications sector, which had previously been expected to be brought within the VAT pilot program concurrently, is now expected to transition to VAT from 1 April 2014. In addition, Circular 106 further expands the scope of the VAT pilot program in some existing industries which are already subject to VAT.

Importantly, Circular 106 also makes significant changes to the VAT treatment of a number of areas which are already subject to the VAT pilot program and have been problematic for businesses in those industries – specifically, international goods transportation agency services and the finance leasing industry. Finally, Circular 106 extends certain preferential policies such as offshore outsourcing services VAT exemption policies.

From the beginning of the VAT pilot program, the MoF and the SAT have been adjusting the VAT policies for certain industries. This started with the release of Circular Caishui [2011] No. 111 ("Circular 111"), which contained the original rules for the VAT pilot program. Circular 111 was replaced by Circular Caishui [2013] 37 ("Circular 37") upon the expansion of the VAT pilot program nationwide from 1 August 2013. Now, less than five months later, Circular 37 is to be replaced (from 1 January 2014) by Circular 106. The VAT policies for certain industries have been altered with each subsequent change. The extent (and speed) of change in the VAT reform policies has been very challenging for taxpayers in those industries.

From an overall policy perspective, a number of key trends are emerging:

1. As new industries join the VAT pilot program, the expansion is occurring on a national basis, not a province-by-province basis as had previously occurred.

2. New industries joining the VAT pilot program are more likely to be subject to an 11 percent VAT rate, rather than the lower 6 percent VAT rate. This will potentially affect industries such as telecommunications, real estate and construction, and financial services and insurance, which are yet to join the VAT reforms.
3. The policy of using multiple VAT rates can be problematic, with similar services often being subject to VAT at different rates. There is also an impact on businesses claiming input VAT credits, with different types of expenses generating different levels of credit.
4. The sooner the VAT reforms are expanded to all services sectors, the better. The current approach of having to determine whether services fall within the scope of VAT, or whether they remain subject to Business Tax (BT), is problematic.

Part 1 of this China Tax Alert examines the expansion of the VAT pilot program to new industries, and to new services. Part 2 examines the key changes to the operation of the VAT pilot program for existing sectors already subject to VAT.

Part 1 - Expansion of the scope of the VAT pilot program

Circular 106 not only expands the scope of the VAT pilot program to the railway transportation industry and postal services sectors, but also clarifies certain VAT service types that will be included in the scope of the VAT pilot program from 1 January 2014. The reason for this clarification is that in the first stage of the VAT reforms, both tax officials and taxpayers were unsure whether certain services should be included in the scope of the industries subject to the VAT reforms. The chart below summarises the related service types and applicable tax rate.

Existing scope of VAT pilot program in Circular 37	VAT rate
Transportation services (not included railway transportation)	11%
Leasing of tangible movable property	17%
Research and development (R&D) and technical services	6%
Information technology (IT) services	6%
Cultural and creative services	6%
Logistics and ancillary services	6%
Certification and consulting services	6%
Production, broadcast and publication of radio, film and television programs	6%
Services added to the scope of the VAT pilot program in Circular 106	VAT rate
New industry sectors	
Railway transportation services	11%
Postal services	11%
New sub-service types	
Aerospace transportation services	11%
Technical forecasting and technical training services	6%
Engineering survey and exploration services provided after mining construction	6%
Auditing and tax management based on computer information technology	6%
Internal data analysis, internal data extraction, and internal data management based on computer information technology	6%
Receipt and distribution services	6%
Aviation training services	6%
Translation services	6%

Below we examine some of the more significant new industries and services.

Railway transportation services

Railway transportation services were previously subject to BT at the rate of 3 percent. From 1 January 2014, railway transportation services will become subject to VAT at the rate of 11 percent. Service providers in those industries should generally be eligible to claim input VAT credits for their expenses.

Scope of taxation

Based on Circular 106, railway transportation services incorporate the transportation of both goods and passengers.

Circular 106 also provides that certain auxiliary services in relation to railway transportation (such as goods packaging services, railway line usage services, railway carriage services, special train dispatch services, and railway arrival and transit services) shall be categorised as “logistic auxiliary services”, which are subject to VAT at the rate of 6 percent.

The distinction between auxiliary services in relation to railway transportation and railway transportation services is intended to reflect the principle that the applicable tax rate is not determined by the industry of the business providing the service, but rather, by the service which is actually provided. Nonetheless, as the history of the VAT pilot program has already shown, different VAT rates for similar services, such as transportation (11 percent) and logistics (6 percent) can lead to complexities.

Preferential policies

- Railway transportation services provided free of charge according to the instruction of the government would be treated as services provided for public welfare purposes and not subject to VAT.
- The Qinghai-Tibet railway transportation services are exempted from VAT.
- Zero rating applies to international transportation services and Hong Kong, Macau and Taiwan transportation services. Circular 106 provides that waterway transportation, highway transportation and air transportation can enjoy zero rating only when the supplier of the service obtains related qualification documents. Otherwise, such services can only benefit from VAT exemption. Unfortunately, Circular 106 does not specify what kind of qualification documents railway companies need to obtain in order to be entitled to zero rating. Consequently, further implementation rules may be expected in the near future. .

Implications on tax burden

For typical railway transport enterprises, the indirect tax impact before and after the VAT pilot program may be analysed as follows:

Major revenue items	Before VAT pilot program	After VAT pilot program
Freight revenue	3% BT	11% output VAT
Less: Payment to other transportation enterprises for associated freight transportation	Tax levied on net basis income, 3% BT	11% input VAT credit
Less: Payment for rent of railway wagons	Tax levied on net basis income, 3% BT	17% input VAT credit
Major expenditure items	Before VAT pilot program	After VAT pilot program
Raw materials, fuel and power	non-deductible	17% VAT input credit
Labour costs	Non-deductible	Non-creditable

Depreciation and amortisation	Non-deductible	Fixed assets purchased creditable
National Railway Line charges	Non-deductible	May not be creditable
Security expenditures to railway police	Non-deductible	May not be creditable
Reconditioning fee	Non-deductible	Creditable depending on whether it is a repair and replacement service or construction service
Labour protection fee and office expenditures	Non-deductible	May not be creditable

As the above table shows, after the VAT pilot program, rail transportation companies would ordinarily be expected to be eligible to claim input VAT credits in relation to the purchase of fuel and other VAT taxable services. Furthermore, over the past two years, many rail transportation companies incurred significant expenditure in purchasing new fixed assets; however, Circular 106 does not provide any transitional policies that would allow input VAT credits to be claimed (either in whole or in part) for fixed assets purchased before the commencement of the VAT pilot program.

Railway freight charges are typically determined by the government, so the precise impact of the introduction of an 11 percent VAT rate will depend on the extent to which prices may be adjusted, as well as the specific cost structure of those railway transportation companies.

KPMG observations

- The railway transportation sector was excluded from the initial scope of the VAT reforms. The expansion of the VAT reforms to the railway transportation sector from 1 January 2014 is intended to complete the process of having all forms of transportation services subject to VAT.
- Prior to the commencement of the VAT pilot program, a special rule allowed purchasers of railway transportation services to claim a 7 percent input VAT credit if they were registered as a general VAT taxpayer. Following the commencement of the VAT pilot program, an 11 percent input VAT credit can be claimed. Assuming that railway freight fees remain unchanged, these policies should therefore lead to a reduction in railway freight costs.
- There are some uncertainties in Circular 106, such as when trains of local railway transportation enterprises use railways belonging to the previous Ministry of Railway and its branches (such as the Beijing Railway Bureau or the Taiyuan Railway Bureau railway). When this occurs, the local railway transportation enterprises are required to pay National Railway Line charges. The question of whether the local railway transportation enterprises can claim input VAT credits (and if so, at what rate) for the National Railway Line charges remains unclear. In addition, according to Circular Tiejiahan [2011] No. 58 *Notice regarding Railway Companies Bearing the Expenses of the Railway Police*, it is similarly unclear whether railway companies can claim input VAT credits for railway police expenses.

Postal services

Postal services were previously subject to BT at the rate of 3 percent. Circular 106 provides that the applicable VAT rate for postal services is 11 percent.

Given that many postal service providers can claim input VAT credits for their expenses, as well as a range of VAT exemption policies introduced for postal services by Circular 106, the indirect tax burden for the postal industry may be similar to, or perhaps even lower than before the implementation of

VAT.

Scope of taxation

According to Circular 106, postal services comprise services provided by China Post Group and its subordinate postal enterprises including mail delivery, postal remittance, confidential communications and postal agency services.. Postal services are divided into three categories: common postal services, special postal services and other postal services.

Common postal services	Special postal services	Other postal services
Mail and package delivery, stamps, newspaper and magazines publications, and postal remittances.	Conscripts, ordinary letters, confidential communications, reading for the blind and the postal services for revolutionary martyrs relics.	Sales of stamp albums and other postal products and postal agents

Preferential policies

Generally speaking, the preferential policies previously applied to the postal services sector under the BT regime are carried over to the VAT regime by Circular 106. These include:

1. Common postal services and special postal services provided by China Post Group and its subordinate postal enterprises are exempted from VAT.
2. From 1 January , 2014 to 31 December , 2015, certain services provided by China Post Group and its subordinate postal enterprises to China Courier Service Corporation Inc. ("EMS") and its subsidiaries (including branches at all levels) are exempted from VAT. The VAT exempted income includes the agency fees for express delivery agents, logistics, and international parcel, express delivery parcel, as well as the agency fees for financial and insurance services agents.
3. Postal services provided for exporting goods are exempted from VAT.

KPMG observations

Interestingly, the first two of the preferential policies listed above are transitional policies, which may not apply in the longer-term.

A key issue for postal enterprises is the need to distinguish taxable from non-taxable services. Input tax for non-taxable services cannot be credited, and it is expected that some apportionment issues will arise. In the longer-term these postal enterprises will need to prepare for when the tax exemption policies are abolished.

Courier services

When the VAT pilot program was first introduced, there was some uncertainty about whether courier services were included within the scope of either transportation or logistics services, and therefore subject to VAT. On the other hand, Circular Caishui [2003] 16 provided that courier services should be categorised as postal and telecommunication sectors and therefore subject to BT at the rate of 3 percent. This leads to the complexity in practice.

Circular 106 now provides that "receipt and distribution services" fall within the scope of the VAT pilot program at the rate of 6 percent. This impacts the courier services sector. As an alternative, couriers providing receipt and

distribution services are entitled to use a 3 percent simplified VAT method in which output VAT is payable at the rate of 3 percent, but no input VAT credits can be claimed.

Scope of taxation

“Receipt and distribution services” comprises services performed for consignors consisting of receiving, sorting and delivering letters and parcels within agreed timeframes. Circular 106 clarifies the definition of “receiving, sorting and delivery services” as follows:

- **Receiving services:** receive letters and parcels from consignors, and distribute them to the distribution centre within the same city with consignors
- **Sorting services:** service providers sort and deliver letters and parcels in the distribution centre
- **Delivery services:** service providers deliver letters and parcels from the distribution centre to consignees in the same city.

Based on the above definition, delivering letters and parcels between distribution centres in different cities is not categorised as a receipt and distribution service, but is within the scope of transportation services as stipulated in Circular 106.

KPMG observations

Since the commencement of the initial VAT pilot program, some courier businesses have paid VAT at the rate of 11 percent (as a transportation service), others have paid VAT at the rate of 6 percent (as a logistics service), while others have paid BT at the rate of 3 percent (as a postal service). Given the uncertainties with the VAT treatment of courier services, Circular 106 has sought to clarify the position, but in the process of doing so, new problems may emerge.

Receipt and distribution services and transportation services across provinces provided by courier enterprises are categorized as logistic auxiliary services (with VAT at 6 percent) and transportation services sector (with VAT at 11 percent) respectively. However, in practice, splitting courier services by the nature of the service may cause difficulties. For example, how to separate revenue from those services, and how to issue invoices with multiple VAT rates. Furthermore, there is a general provision in the VAT regulations which requires VAT to apply at the higher rate where the revenue cannot be accurately separated. The extent to which this will apply will depend on the detail of the systems and pricing mechanisms used in the industry.

Part 2 – Changes to the existing VAT pilot program

International goods transportation agency services

The indirect tax treatment associated with the international transportation of goods has been subject to a number of changes over the past two years. Circular 106 introduces yet further changes.

These changes impact providers of international transportation services, such as shipping lines and airlines, as well as downstream providers such as their agents in China, representatives offices in China, freight forwarders, and the businesses and end-consumers of those services.

To understand the impact of these changes, it is necessary to briefly explain the history:

- Under the BT system, international goods transportation agency services

were subject to BT at the rate of 5 percent. The BT liability was assessed on a 'net basis' – that is, on the revenue received less transportation expenses paid to other enterprises and individuals.

- From 1 January 2012 to 31 July 2013, VAT was applied to transportation services and logistic auxiliary services progressively around mainland China. International transportation agency services were subject to VAT at the rate of 6 percent, and during this transition period, the previous "net basis method" was continued.
- From 1 August 2013 to the present, the VAT reform pilot program has been expanded nationwide. Circular 37 removed the "net basis method", which meant international goods transportation agency service providers were required to calculate their VAT liability on the gross revenue received (inclusive of overseas freight charges, port charges and handling charges), and could not deduct amounts previously deducted under the old BT system. In practice, this meant that when overseas transportation providers invoiced agents in China for their services (or invoiced through their representative offices in China), the effect of any exemption from VAT for those international transportation services was lost. When the agents or representative offices invoiced for their services, VAT applied to the total invoiced amount at the rate of 6 percent. This resulted in a range of responses by the industry, such as price increases, settling payments outside of mainland China, and in some cases, changes to the terms of trade.

Restoration of "net basis method"

Circular 106 effectively restores the 'net basis method' which had been in place until 1 August 2013. It does this by providing that the sales amount of general VAT taxpayers providing international goods transportation agency services is the revenue received less the international freight charges paid for international transportation services.

Circular 106 further defines "international goods transportation agency services" very broadly. An agency service includes the acceptance of the goods of the consignee, the consignor, their agents, or a transportation owner or lessee, where the service is either performed in the name of the principal or in the agent's own name. The agency services for which the net basis method applies encompasses all business activities associated with arranging the international transportation of goods (except the provision of the actual transportation service itself), including arranging pilotage, berthing, loading and unloading of cargo and related procedures.

VAT exemption of international goods transportation agency services

Circular 106 further provides that agency services provided for international goods transportation, as well as transportation between mainland China and Hong Kong, Macau, and Taiwan, are entitled to VAT exemption.

In order to benefit from VAT exemption, all the international goods transportation agency services income and the freight paid to international transportation services providers must be settled through financial institutions. If requested, the international goods transportation agent should issue general VAT invoices to the consignor. Cash settlements should not be eligible for VAT exemption.

Importantly, this change in regulation is effective from 1 August 2013. This means that for services invoiced between 1 August 2013 and the date of issuance of Circular 106, if the taxpayer has issued special VAT invoices, they can benefit from the retrospective change in policy upon collection back of the special VAT invoices issued. This effectively ensures no mismatch between the (reduced) output VAT liability of the agents under the policies in Circular 106, and the input VAT credit which may have originally been claimed.

KPMG observations

Following the release of Circular 106, it is expected that the re-introduction of the net basis method will go a long way towards addressing the problems which have been directly experienced by shipping and airline agents and representative offices in China, and indirectly (in the form of higher prices), by freight forwarders, and other recipients of international transportation services. KPMG played a leading role in representing industry participants adversely affected by the former policy.

The retrospective application of Circular 106 will be particularly welcomed by industry. However, the practicalities of unwinding these arrangements may be challenging, including collecting special VAT invoices previously issued, ensuring transactions are settled through financial institutions, and potentially refunding the overpaid VAT through the supply chain.

While the changes introduced by Circular 106 are welcome, the net basis method does have some uncertainties, including:

- Circular 106 provides that the amount upon which VAT is levied is the revenue less international freight paid to international transportation enterprises. It implies that only agencies which make payments to international transportation providers (i.e. airlines and shipping companies) directly can use the net basis method. This seems to be inconsistent with the principle in Circular 106 that broadly defines “international goods transportation agency service providers”. If the taxpayers eligible to benefit from these policies are only those who pay directly, the tax burden of freight forwarders providing international goods transportation agency services may still be adversely affected.
- If taxpayers use the net basis method, they will face practical difficulties in issuing invoices. If they issue invoices on a ‘net basis’, they may be disclosing sensitive pricing information highlighting the international transportation fees incurred.

A further issue with Circular 106 is that it may exacerbate the competitive disadvantage of international transportation providers located in countries without international transportation treaties or agreements with China. Their agencies will need to withhold VAT at the rate of 11 percent on behalf of the providers of those services, and given the agents’ services are exempt from VAT, they would not be able to claim an input VAT credit.

It is difficult to understand the rationale for the continuation of these policies which differentiate between Chinese providers of international transportation services (which benefit from zero rating), international providers of transportation services from countries with which China has treaties or agreements (which benefit from exemption), and international providers of transportation services from countries with which China has no treaty or agreement (subject to 11 percent VAT withholding).

Finance leasing industry

The finance leasing industry is another industry that has been similarly affected by a number of changes to the VAT treatment of their services. Thankfully, the release of Circular 106 is a source of good news.

Again, to understand the impact of Circular 106 on the finance leasing industry, it is necessary to provide a brief history:

- Under the BT system, SAT Announcement No.13 of 2010 applied to finance lessors and lessees using the ‘sale and lease back’ method. Under this method, lessors paid BT on the interest income they received. The sale of the assets by the lessee to the lessor was effectively

ignored for VAT purposes. This approach reflected the economic substance of these transactions as a financing arrangement.

- From 1 January 2012 to 31 July 2013, the approach in SAT Announcement No. 13 of 2010 continued under the VAT regime. That is, the lessor paid VAT on the interest income only. The sale of the assets by the lessee to the lessor was effectively ignored for VAT purposes. The lessee, if they were a general VAT taxpayer, would ordinarily have claimed an input VAT credit for the purchase of the asset.
- From 1 August 2013 Circular 37 was released. It listed those items of expenditure which finance lessors could deduct from their gross revenue in calculating their VAT liability. Excluded from the list of deductible items was the equipment cost, which effectively meant that their VAT liability was assessed on the sum of the interest income and the equipment cost. This approach was criticised on the basis that it neither followed the legal form or the economic substance of the arrangements.

Circular 106 effectively reverts to the position which was in place prior to 1 August 2013. That is, under Circular 106, the lessor is eligible to deduct the purchase price of the equipment in calculating its VAT liability. In effect, the VAT is assessed on the interest income only.

In addition, bond interest expenses and vehicle purchase tax are included in the “deductible items” in Circular 106. However, Customs Duty and Consumption Taxes payable on importation can no longer be deducted since these may be already included in the cost of imported equipment.

The comparison of deductible items between Circular 37 and Circular 106 are as follows:

Business Model	Deductible Items	
	Circular 37	Circular 106
Sales and lease back business	Customs Duty, Consumption Tax, freight, installation fees, insurance expenses and loan interest expenses incurred in acquiring the leased asset	Purchase price of tangible movable asset received from lessee, loan & bond interest expenses incurred in acquiring the leased asset
Other finance leases		Installation fees, insurance expenses and loan & bond interest expenses incurred in acquiring the leased asset and vehicle purchase tax

In Circular 106, the MoF and the SAT has also added a threshold for registered capital of RMB 170 million for finance leasing companies, and this amount is in accordance with the Ministry of Commerce’s minimum requirement on registered capital of finance leasing companies. The detailed requirements in Circular 106 are as follows:

- If the registered capital of a finance company reaches RMB170 million by the end of 2013, it can adopt the net basis method in calculating its output tax liability from 1 August 2013
- If the registered capital of a financial company reaches RMB170 million after 1 January 2014, it can adopt the net basis method in calculating its output tax liability from the next month of the registered capital increase.

In Circular 106, the MoF and the SAT also made it clear that the VAT preferential treatment of VAT ‘levy first and refund later’ policy for the finance leasing industry will end by the end of 2015. Under this policy, VAT

was initially levied at the rate of 17 percent, but a refund of the effective tax burden exceeding 3 percent was allowed. A threshold for registered capital of RMB 170 million is also applied to the VAT levy first and refund later policy.

KPMG observations

Circular 106 stipulates that lessors will need to obtain valid invoice from the lessee to deduct the equipment cost when calculating its output VAT liability for sale and lease back transactions. This requirement will be difficult to implement in practice because Announcement 13 is still valid, and there is no legal basis for the lessee to issue an invoice for the sale of tangible assets from the lessee to the lessor. Furthermore, no invoice could be issued if the lessee is a hospital.

Circular 106 provides that lessors who enter into sales and lease back transactions, should issue general VAT invoices rather than special VAT invoices to lessees for the receipt of the purchase price of the asset. Since the purchase price of the asset is deducted from the sales amount of the lessor under the net basis method, if the lessor issues a general VAT invoice showing a 17 percent VAT rate, there may be a risk that the purchase price of the asset may be taxed at 17 percent instead of being ignored for VAT purposes.

Circular 106 also does not clarify how lessors deal with the overlap between Circular 106 and Circular 37 if the company has filed its VAT returns based on Circular 37 during the period from 1 August to 31 December 2013. Consequently, two aspects of uncertainty exist:

- For finance leasing companies whose registered capital reaches RMB 170 million by the end of 2013, is a retrospective adjustment needed for the VAT filed under Circular 37 from 1 August 2013 to the present?
- For financial leasing companies whose registered capital does not reach RMB170 million by the end of 2013, can the net basis method can be applied before 31 December 2013?

Extension of preferential policies for offshore outsourcing services

The previous BT regime contained an exemption for offshore outsourcing services. That exemption was preserved under the VAT system until 31 December 2013. Circular 106 effectively extends the exemption from VAT to 31 December 2018.

Engaging in offshore outsourcing services is defined to mean the services provided by enterprises, pursuant to contracts signed by them with overseas organisations, to provide information technology outsourcing (ITO) services, technical business process outsourcing (BPO) services or technical knowledge process outsourcing (KPO) services for overseas organisations (either by themselves or through their direct subcontractors). The definition of offshore outsourcing services set out in Circular 106 is consistent with Circular Caishui[2010]No. 64.

General KPMG observations

Circular 106 will be welcomed by many taxpayers in expanding the scope of the VAT pilot program to the railway transportation industry, postal services industry and receipt & distribution services of the courier industry. Those VAT taxpayers will be eligible to claim input VAT credits for the purchase of goods, fixed assets and services following the commencement of VAT, which may reduce their overall tax burden and that of businesses in receipt of their services.

Circular 106 also changes the VAT policies applicable to international goods transportation agency services and sales and lease back transactions entered into by the finance leasing industry. While a number of challenges in terms of unwinding transactions retrospectively will arise, going forward, these changes represent positive improvements on the current position.

KPMG assisted a number of leading companies in the transportation, logistics, and financial leasing industries to raise concerns with the previous policies and to explore solutions with the MoF and the SAT. The new policies contained in Circular 106 are broadly consistent with the representations made by industry. Following the issuance of Circular 106, many businesses engaged in these sectors will need to review past transactions and potentially seek to unwind the VAT treatment so as to secure VAT refunds.

The railway transportation industry, postal services industry and receipt & distribution services of the courier industry will need to review and clarify their business processes, start to upgrade their information technology systems, and set up VAT invoice management procedures in preparation for the implementation of VAT. KPMG can give assistance in implementing the changes from the BT regime to the VAT regime. For further information, please see refer to our [VAT Reform Service Offerings](#) brochure.

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