



CHINA TAX ALERT

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VAT EXEMPTION CLAIMS FOR EXPORTED SERVICES

Regulations discussed in this issue:

- *State Administration of Taxation Announcement No. 49 ("SAT Announcement 49") on 27 August 2014*

On 27 August 2014 China's State Administration of Taxation issued Announcement No.49 of 2014 ("SAT Announcement 49") which is a comprehensive statement of the policies for claiming exemption from Value Added Tax ("VAT") under the VAT pilot program in China for exported services. SAT Announcement 49 will become effective from 1 October 2014, but may apply retrospectively.

SAT Announcement 49 will be greeted favourably by taxpayers, particularly multinational companies doing business in China, with a number of the earlier practical impediments to claiming VAT exemption now being resolved, and moreover, paving the way for future exemption claims to be made once the VAT pilot program expands.

Given the developments which have occurred in both the scope of VAT, and in the processes for claiming VAT exemption in China, this KPMG China Alert effectively collates and updates the information contained in previous KPMG Alerts on this topic.

In our experience, the most common situations where VAT exemptions are currently being claimed concern related party arrangements, often involving documentation prepared for transfer pricing purposes.

Background and context

As at September 2014, VAT applies in China to:

- the sale and importation of goods;
- repair, replacement and processing services to goods;
- the provision of modern services such as consulting, logistics, IT services, cultural and creative services, leasing of tangible movable property;
- transportation services; and
- postal and telecommunication services.

In practical terms, the main services which are still subject to Business Tax ("BT") comprise real estate and construction services, hospitality and food and beverage services, entertainment services, financial services and insurance, and a general catch-all comprising 'all other services'. The VAT pilot program is expected to be expanded to those remaining sectors progressively

during 2015, so as to meet the government's stated objective of having BT replaced entirely by VAT by the end of 2015.

From the inception of the VAT pilot program in 2012, exports of certain services from China could qualify for either VAT exemption or zero rating. The difference between VAT exemption and zero rating is summarised as follows:

Category	Output VAT payable	Input VAT credit available for related inputs
Zero rated services	No	Yes
Exempt services	No	No

The categories of zero rated services in China is currently relatively limited – research and development services, design services, and certain international transportation services provided by Chinese domestic carriers. The broader category is that of VAT exemption.

Broadly speaking, the concept which underlies the rules for claiming VAT exemption is to implement the OECD's 'destination principle' of indirect taxation reflected in the OECD's 'International VAT/GST Guidelines' issued on 17-18 April 2014. The 'destination principle' is such that VAT should only apply in the location in which the services are consumed, rather than the location in which the supplier of the services is based.

While many countries already implement the destination principle of indirect taxation, the position in China is complicated by the fact that the process for claiming VAT exemption is not self-executing. That is, taxpayers in China often need to submit quite voluminous documentation to the tax authorities (much of which needs to be translated), often including detailed working papers evidencing the services actually performed. The process for claiming VAT exemption can also differ from province to province. Moreover, the exemption is seen in China as delivering a real benefit to the parties rather than merely a cashflow benefit given that the service recipient, who will invariably be a foreign entity, does not have the ability to register for VAT purposes in China and therefore would be unable to claim an input VAT credit. As such, claims for VAT exemption are scrutinized carefully.

Categories of VAT exemption

For convenience, we have grouped below the different categories of VAT exemption requirements:

Type of services	Industry	Exemption requirements
Exempt if services are provided to overseas entity (Type I)	Telecommunication services	<ul style="list-style-type: none"> • Telecommunications services (both basic and value-added) (i.e. global roaming) provided by Chinese entities to overseas entities
	Cultural and creative services	<ul style="list-style-type: none"> • Trademark and copyright transfer services, intellectual property services provided to overseas entities
	Logistics and ancillary services	<ul style="list-style-type: none"> • Logistics and ancillary services provided to overseas entities (except warehousing services)
	Radio, film and television services	<ul style="list-style-type: none"> • Production of radio, films and television programs for overseas entities

	Information technology (IT) services	<ul style="list-style-type: none"> Software services, circuit design and testing services, business process management services provided to overseas entities.
	Research and development (R&D) and technical services	<ul style="list-style-type: none"> Technology transfer and technology consulting services provided to overseas entities
Type of services	Industry	Exemption requirements
Exempt if the subject matter of the services takes place outside of China (Type II)	Postal services	<ul style="list-style-type: none"> Postal and courier services (i) where the related goods are exported out of China or (ii) consumed entirely outside of China
	Leasing of tangible movable property	<ul style="list-style-type: none"> Leasing of tangible movable property where the asset is being used outside of China
	Cultural and creative services	<ul style="list-style-type: none"> Convention and exhibition services located outside of China Advertising services where the related advertisement is released outside of China
	Logistics and ancillary services	<ul style="list-style-type: none"> Warehousing services where the location of the warehouse is outside of China
	Radio, film and television services	<ul style="list-style-type: none"> Broadcast and distribution of radio, films and television programs outside of China
	Research and development (R&D) and technical services	<ul style="list-style-type: none"> Engineering as well as exploration services with the related project or mineral resources located outside of China
Combination of the service recipient being overseas and the subject matter of the service not being sufficiently connected to China (Type III)	Certification and consulting services	<ul style="list-style-type: none"> Certification, verification and consulting services provided to overseas entities (except for services in relation to goods or immovable property located in the PRC)
	Research and development (R&D) and technical services	<ul style="list-style-type: none"> Energy management services (except where the object of the energy management contract is located in the PRC) provided to overseas entities
Miscellaneous (Type IV)	Transportation services	<ul style="list-style-type: none"> Unlicensed international transportation

For the purposes of claiming VAT exemption, it should be noted that the special administrative regions of Hong Kong and Macau are considered to be 'outside of China' for these purposes. This is a function of those regions having their own taxation systems.

Documentation / process for claiming VAT exemption

The process for claiming VAT exemption is commenced with the tax authorities by way of the 'record filing process'. That is, the lodgement of a form and supporting documents to evidence the availability of the VAT exemption.

The following key documents are required under the record filing process, and while the precise list differs from province to province, this list incorporates the key documentation requirements pursuant to local circulars in both Beijing and Shanghai:-

- Record filing form
- Original and photocopy of the cross border service contract,
- Proof of provision of services outside of China for services which are exempt if the subject matter of the services occurs outside of China (i.e. Type II services)
- Proof that the service recipient is located overseas for services which are exempt if services are provided to an overseas entity (e.g. incorporation certificates of the overseas service recipient)
- Copies of bank statements or bank receipts (to prove that service fees are received from overseas)
- Proof of actual operations for international transportation services
- Any other documents required by the tax authorities

Where any of the above documents are not written in Chinese, a translation must be provided with the signature of the supplier's legal representative or official stamp affixed.

The record filing form is, once approved, followed by the lodgement of monthly VAT returns which include the exempt amount and the input VAT transfer out amount arising from the exemption being claimed.

Importantly, the lodgement and acceptance of documents by the tax authorities as part of the record filing process does not preclude the tax authorities from subsequently denying the exemption through an audit or other review processes.

What's new?

Announcement 49 contains a number of new developments, many of which are beneficial for taxpayers, including:

- The scope of the VAT exemption has been expanded to include exports of those services which now form part of the VAT pilot program. It may be expected that as the scope of the VAT pilot program expands further, categories of exempt services will also expand.
- VAT exemption will be available for postal and courier services which are related to goods exported out of China. This is a new development where certain types of services are exempt if they relate to exported goods. It may be expected that other types of services which directly relate to exported goods may enjoy VAT exemption in the future.
- Announcement 49 resolves the previously unclear practical treatment where taxpayers are eligible for both zero rated treatment and VAT exemption for research and development, design and international transportation services. It now permits a taxpayer to claim VAT exemption if the taxpayer chooses to give up the zero rated treatment.

- The VAT exemption available to time charter services and wet leases has been removed because time charter services and wet leases can already enjoy zero rated treatment under Circular 106.
- Previously, a major issue with claiming VAT exemption is the strict requirement that there between consistency of contract flow, invoice flow and payment flow. That is, the service provider and overseas service recipient needed to be the same parties to the contract, the invoices, and payment had to be made by the service recipient to the service provider. This requirement has been relaxed somewhat in Announcement 49 given that payments made through domestic treasury centres, or domestic cash pooling units can now be made in respect of services provided to overseas entities and yet still qualify for VAT exemption. This is an important concession given how commonly multinational companies make payments through such treasury centres.

Announcement 49 may be applied retrospectively to periods prior to 1 October 2014 where the necessary requirements are met and record filing procedures are completed. Taxpayers previously denied exemption on the basis of the use of treasury centres may wish to resubmit those prior claims.

Notwithstanding those beneficial changes, some challenges still remain. In our experience, the major impediments to claiming VAT exemptions which arise most commonly include:

- Contracts entered into by the headquarters of an entity in China, but the service, invoice or payment is made by the branch (or vice versa). This problem commonly arises because, under the legal systems of many countries, branches do not have independent legal recognition. However, in China branches are seen to be separate taxpayers in their own right. Consequently, close attention is needed where branch structures are involved.
- When faced with VAT exemption claims, some tax officials choose to interpret the scope of the VAT exemptions very narrowly. Yet incongruously, those same services may be regarded as still falling within the scope of VAT. This problem should be rectified once the VAT pilot program is expanded to cover the catch-all category of “other services”. This is expected to occur from early 2015.

Suggested steps for claiming VAT exemption

KPMG’s experiences in preparing VAT exemption claims leads us to the view that the following steps should ordinarily occur as part of any process for seeking exemption:

- **Step 1 – information gathering** – VAT exemption claims generally require the review of the contract(s) under which the services are performed, the invoices being issued, and bank receipts evidencing payment. The contract(s) are the most critical and in many cases, it may be necessary to either supplement or amend the formal terms (particularly for related party arrangements), or obtain further working papers to support the provision of services.
- **Step 2 – assessment of claim** – the tax authorities generally require (or prefer) taxpayers to submit brief written arguments explaining why the VAT exemption rules are satisfied. This often provides an opportunity to clarify aspects of how the contracts may work in practice.
- **Step 3 – submission of documentation / negotiation** – the various documentation will often require translation and submission to the tax authorities. Ordinarily, that process will require more than one meeting with the tax authorities, and potentially the submission of further evidence to satisfy the tax officials, or to clarify areas of uncertainty.

- **Step 4 – verification** – once the VAT exemption record filing is approved, the taxpayer will need to record both the VAT exempt revenue and the input VAT transferred out each time an invoice is issued or paid pursuant to the contract(s) which have been approved. Subsequent changes to the contract(s) require a new application to be prepared. Importantly, taxpayers also need to transfer out any input VAT relating to the services for which exemption is claimed, and the preparation of calculations or a methodology to support such process is highly recommended.

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