China Tax Alert

Issue 9, March 2016

China's new VAT rates & rules - high level policies and general impacts across all industries

Regulations discussed in this issue:

- Circular Caishui [2016] 36 which contains the VAT rates and rules for the real estate and construction, financial services, and lifestyle services industries under China's VAT, which takes effect from 1 May 2016

Announcement

On 24 March 2016 China's Ministry of Finance (MOF) and State Administration of Taxation (SAT) jointly issued Circular Caishui [2016] 36 (Circular 36) which contains the Value Added Tax (VAT) rates & rules applicable to the expansion of China's VAT system to several key sectors such as real estate and construction, financial services, and lifestyle services, which take effect from 1 May 2016.

While the VAT rules must be implemented in a very short space of time, KPMG is very proud to have been involved in the consultation process for several government agencies since 2008, including the MOF and the SAT, and through our efforts and international and local experience, we have been able to pre-empt with remarkable accuracy many of the rules now released, and in doing so we have successfully assisted a large range of companies to prepare for these changes for some time. In excess of 95% of the rules which have now been released were correctly predicted in publications we issued since 2013.

This KPMG China Tax Alert provides an overview of the high level policies and general impacts across all industries. In addition to this, at the same time we are also issuing specific alerts for each of the three major industries affected by these changes, for ease of reference. Importantly though, each of the alerts should be read together, given that businesses across all sectors may buy, sell or lease real estate assets, and businesses across all sectors may consume lifestyle services as well as financial services. In other words, the industry specific alerts focus not only on the service providers in those industries, but also the consumers of services in those industries.

These alerts have been prepared within an exceptionally short period of time of release of 95 pages of detailed rules contained in Circular 36. As such, they present our preliminary thoughts or impressions only.

Background and context

China's indirect tax system has, for many years now, been a bifurcated system with VAT broadly applying to the goods sector, and Business Tax (BT) applying to the services sector. Given that BT is essentially a tax on business which cascades throughout a supply chain, and which is generally regarded as being an inefficient form of taxation, the Chinese government has been embarking upon a program of progressively replacing BT with VAT since 2012. While the early stages of the VAT reform program involved the VAT rules for certain sectors being implemented progressively on a province by province basis, in more recent times the implementation of VAT has been done nationwide on an industry-by-industry basis.

This final stage represents a 'big bang' approach, with all remaining sectors transitioning from BT to VAT nationwide with effect from 1 May 2016. There are 3 main industries which will transition to VAT from 1 May 2016, and they are:

- Real estate and construction
- Financial services
- Lifestyle services, which encompasses hospitality, food and beverage, healthcare, education, cultural and entertainment services, and a general residual category of any other services which are still subject to BT.

These 3 key industries represent, in policy terms, the most difficult industries to apply a VAT to, and moreover, in financial terms they are the most significant industries contributing to local government revenues. From a policy perspective, they can present challenges in applying a VAT to their services, given that:

- The value added in financial services can be difficult to measure on a transaction-by-transaction basis, which explains why most countries exempt them from a VAT;
- Gains from real estate transactions may arise from passive activity (i.e. simple increases in property values), or from actively improving the property, such as building and construction. The real estate industry also affects a broad range of stakeholders, from experienced developers, to investors, to speculators and private individuals. It is also subject to many other types of taxation already; and
- Lifestyle services can be consumed for business purposes or for private purposes, and differentiating between them can be difficult. In many cases they are also primarily cash based businesses where tax compliance may not be high.

When fully implemented, China's VAT system will be amongst the broadest based systems amongst over 160 countries in the world which have now implemented a VAT (or equivalent tax). China's VAT system will be unique by international standards in applying VAT to virtually all financial services (including interest income), and in applying VAT to real estate transactions involving not only B2B and B2C transactions, but C2C as well – an outcome not known to exist in any other country. It would not be surprising to see other governments follow China's lead and expand their VAT systems, especially if China is able to implement these changes successfully.

Applicable VAT rates for each sector

The VAT rates which KPMG foreshadowed in our China Tax Alert of 5 March 2016 have now been confirmed by Circular 36. Those rates, and a comparison with the current BT rates are set out below:

Sector	Current BT rate	New VAT rate
Construction services	3%	11%
Real estate	5%	11%
Financial services	5%	6%
F&B, hospitality and other services	Generally 5%, though certain services (including entertainment services) are subject to rates from 3% - 20%	6%

Given that VAT is effectively assessed on a net basis (outputs less inputs) while BT is ordinarily assessed on a gross basis (outputs only), a straight comparison between the new and the old rates is not valid.

Part 1 – Key distinguishing features of China's VAT system

China's current VAT system has been in place since at least 1994. It has historically applied to the sale and importation of goods with a general VAT rate of 17%. However, since 2012 the VAT rules have progressively been expanded to the services sector - this latest announcement completes the cycle of VAT applying to all goods and services.

While the VAT for the services sector is relatively new, key features of China's VAT system are not. Given that this China Tax Alert needs to be read and understood by an international audience more so than for many other China tax issues, it is useful to provide some context by setting out key features of how China's VAT system differs from VAT/GST systems commonly used throughout the world. This list is by no means exhaustive, but focuses on the key differentiating characteristics:

Registration	• VAT registration occurs at the branch level, not the legal entity level. Consequently, a single company may have multiple VAT registrations around China. Supplies between branches may be taxable. Consolidated VAT filing between branches of the same legal entity can be difficult to obtain, and between related companies in the same corporate group rarely occurs. One underlying reason for this is that consolidation would alter the share of tax revenues (and budgets) reported by each of the different provinces or cities. • Foreign companies generally cannot register for VAT and claim input VAT credits
Relief	• Excess VAT credits are not generally refundable (except for exports) – instead they are carried forward (without time limit) and used to offset output VAT. If the entity still has excess VAT credits when it is liquidated, those VAT credits will

	be lost. • The Chinese VAT system does not generally provide for bad debt relief. Moreover, input VAT related to abnormal or extraordinary losses must be denied or 'transferred out'.
Invoices	• Businesses in China may only issue special VAT invoices on government issued systems, with invoices purchased from the tax authorities. This is known as the Golden Tax System. The Golden Tax System is separate from a company's own ERP system, which can make reconciliation of transactions difficult, and visibility over indirect tax risks more challenging. • Input VAT credits can only be claimed upon receipt of special VAT invoices which must be verified with the tax authorities on a monthly basis. Electronic invoicing is not widely available.
Rates	• China's VAT system uses multiple VAT rates rather than a single VAT rate for all goods and services – commonly used rates are 3%, 6%, 11%, 13% and 17%.
Cross border	• Exports of goods from China are "zero rated" for VAT purposes. However, zero rating does not mean the same thing as it does in many overseas countries. Instead, the type of goods being exported (determined by reference to the HS Customs code of the goods) will determine the percentage of input VAT refunded based on a scale with 7 different refund rates, ranging from 0% (no recovery) to 17% (full recovery). • Exports of services are generally exempt from VAT, not zero rated (except for R&D, design, certain international transportation services and offshore outsourcing services). Exemption from VAT means that related input VAT credits must be denied or 'transferred out'. The exception to this is fixed asset purchases which may be eligible for full input VAT credits even where used in a business making a mix of taxable and exempt supplies. • Imports of services are subject to VAT withholding, not a reverse charge. VAT withholding means that the recipient of the supply must withhold the VAT from the price. Whilst similar to a reverse charge, VAT withholding means that the supplier should include a 'gross up' clause in the contract so as to ensure they are not out of pocket, and the parties may need to put through adjustments in their accounting system to write off the withholding amount in their accounts as a 'bad debt'.

Part 2 - Tax burden impact for each industry transitioning to VAT

A key issue for many businesses in China, especially given recent periods of economic uncertainty, is whether the new VAT rates and rules will increase or decrease their tax burden impact. According to a report by China International Capital Corp Ltd, which is China's first joint venture investment bank, the overall tax savings for business from the VAT reforms are expected to reach RMB 900 billion (approximately 0.4% of GDP) by the time all industries have transitioned to VAT.

While in an overall economic sense the government is committed to reducing the tax burden impact on business, this is not to suggest that all businesses will benefit from a reduction – this point was recently acknowledged by Finance Minister Lou Jiwei in a press conference on 7 March 2016. In many cases the question of whether a business benefits from a tax burden reduction, or is subject to an increase, lies within its control, or is subject to commercial negotiations with suppliers or customers.

Furthermore, it must be acknowledged that the essential nature of a VAT is that it is not a tax on business – rather, it is tax which is collected by business, but is imposed on the end consumer. When businesses in China discuss the "tax burden impact", it is a concept which is foreign to many people outside of China given its inherent inconsistency with the normal operation of a VAT. However, this concern around the tax burden impact is more valid in China given the following factors:

- The BT system was a tax on business, and consequently, in shifting to a VAT, there is an appropriate focus on how that changes the tax burden impact, not to mention that the mindset of many businesses and consumers will take time to adapt to the new system;
- The timeframe for implementation of VAT is very short, and businesses can be locked into contracts which do not allow for the VAT to be passed on – this is why discussions around grandfathering relief or transitional measures is so important; and
- China's VAT system is not a "pure" system and examples of business bearing tax as a real cost regularly occur.

In the table below, we summarise our overall impressions of the tax burden impact on each of the 3 affected industries and sub-sectors within those industries. It is important to note that these are generalised or aggregate observations only, based on the results of conducting financial impact modelling for many clients and our own empirical assessments.

The specific circumstances of each situation must always be considered, and moreover, as noted previously, is in many cases subject to the control of the individual business and its commercial negotiations with key suppliers and customers:

Industry	Sub-sector	Expected tax burden impact	Key factors influencing tax burden impact
Real estate & construction	Construction	Neutral in the short-term, and neutral or potential increase in the longer-term, depending on commercial factors	• Generous grandfathering or transitional relief should assist in the short-term • In the longer-term, the higher output tax rate must be weighed against the ability to claim input VAT credits for many construction materials • The extent of those input VAT credits will depend on the nature of the materials and the proportion of subcontractors who are small-scale taxpayers
	Decoration services	Neutral	• Able to continue to apply current BT preferential policies and pay 3% simplified VAT
	Residential property – developers, funds, investors	Neutral in the short-term, and in the longer-term, neutral or potential increase depending on commercial factors	• In the short-term, able to apply 5% simplified VAT method to old projects, so tax burden impact should be comparable to current BT system • New projects where 11% VAT rate applies is likely to produce an increase in tax burden impact in the longer-term, though the result may be cushioned by the ability to claim a deemed input VAT credit on purchase of land use rights. Projects where the labour and profit components are relatively higher will be most affected. • No input VAT credits for financing costs impacts on the tax burden

	Commercial property (e.g. office, industrial, retail) - developers, funds, investors	Potential decrease or neutral	• If VAT can be passed on under the sale or lease contract, and purchaser/tenant is able to claim input VAT credits • If VAT cannot be passed on under the sale or lease contract, then consider applying 5% simplified VAT rate method
	Property related service providers, such as agents, property managers, architects etc	Neutral, or perhaps slight decrease	• These service providers will pay VAT at 6%, rather than 11% for real estate and construction • The tax burden impact may fall slightly, given the ability to claim input VAT credits
Financial services & insurance	Banks	Neutral, or perhaps slight decrease	• The output tax rate is 1% higher than under BT, but the ability to claim input VAT credits should neutralise or even slightly reduce tax burden impact, even assuming the VAT is not passed on • Interbank lending exemption should assist from a compliance perspective
	Finance leasing	Likely to change	• Currently the financing component is subject to 17% VAT (except sale & leaseback, where the loan interest is at 6%). They will be adversely affected from a commercial perspective compared with other forms of financing unless the rate is aligned with that of the FS sector at 6%, which is not addressed in these new rules • The “net basis method” under which interest and insurance expenses are deductible for sales and lease back services is available

	Business borrowers	Neutral	• Borrowers who are registered as general VAT taxpayers will not be eligible to claim input VAT credits for interest expense, or for fees and charges relating to loans. This policy was expected for a "temporary period", but the new rules do not put a timeline on this measure
	Asset managers	Potential decrease	• 6% VAT will apply instead of 5% BT • Where the Fund or Trust receiving these services can claim an input VAT credit, then more likely to be able to pass on the VAT cost
Lifestyle services	Hospitality (e.g. hotels)	Neutral, or perhaps slight decrease	• For those hotels which predominantly serve business customers, the tax burden impact should fall if those customers can claim input VAT credits
	Entertainment	Neutral, or decrease	• For those businesses subject to a BT rate higher in the 5% to 20% range, a decrease in tax burden impact may occur
	Healthcare	Neutral or perhaps slight increase (mainly private operators)	• Previously broad based exemptions for medical services have been replaced by an exemption which only applies to approve providers and up to a threshold limit of the fees they charge. This is likely, in practice, to result in many private operators being subject to VAT, instead of them benefiting from exemption which they currently enjoy under BT

	Education	Neutral or perhaps slight increase (mainly private operators)	• Public based schools and education should generally be exempt from VAT, consistent with the current BT exemption • Same as under BT regime, the exemption only applies to approved providers and up to a threshold limit of the fees they charge.

Part 3 – Key technical or commercial issues arising under the rules

For those businesses which are subject to VAT for the first time by these new rules, the tendency is often to assume that only the VAT rules for that industry must be consulted. However, it is the nature of the service which determines the VAT consequences, not the general nature of the service provider's business. Consequently, a goods trader may be engaged in providing financial services, a hospitality provider may engage in real estate transactions. Similarly, the tendency amongst businesses which are subject to VAT for the first time is to focus only on the specific rules applicable to that industry, yet in reality, many of the general VAT rules which have been in operation since 1994 will apply. For example, the timing for accounting for output VAT is generally resolved by reference to these general rules, whereas only certain unique circumstances require special rules.

With this background in mind, we have set out in Part 3 of this China Tax Alert, many of the key technical issues which new VAT taxpayers need to consider for the first time, mainly because these rules reflect inherent features of the VAT system, but not of the previous BT system. Industry specific rules are set out in the separate China Tax Alerts we have produced for those industries.

Transitional or grandfathering relief

One of the key challenges in implementing a VAT is that it is necessary to manage the change from one form of taxation (BT) to another (VAT), together with a change in rates. Unless some form of transitional or grandfathering relief is introduced, it can produce either favourable or detrimental impacts on existing contracts, projects and other undertakings.

For example, a lease contract may have been signed with a commercial tenant in 2014 which does not allow the landlord to recover VAT in addition to the rent. The general position in China is that VAT is only recoverable under contracts where the contract allows for it. In other words, there is no automatic right to gross up the price for VAT purposes. In the absence of grandfathering or transitional relief, the landlord may be required to pay 11% VAT out of the rent it is collecting, even though that rent had been determined based on an assumption that the landlord would only pay 5% BT.

The tenant may equally say that they need only continue to pay the rent agreed under the lease, and in fact they can benefit in being able to claim an input VAT credit of 11% of the rent, even though they are paying no more rent than previously (where no credit was allowed). In short, transitional or grandfathering rules may be needed to prevent 'winners' and 'losers'.

Circular 36 only provides grandfathering or transitional relief for the real estate and construction sector. The rules applicable to that sector are set out in detail in the China Tax Alert which is specific to them. However, for other industries such as financial services and lifestyle services, there is no grandfathering or transitional relief for any pre-existing contracts, reservations or other commitments, which means that from 1 May 2016 VAT will apply at 6%.

Preferential policies generally retained

Circular 36 generally preserves most of the BT preferential policies which have been in place for some time. That is, most of the exemptions from BT have effectively been continued under VAT, though for healthcare in particular, the exemptions have altered significantly.

A key issue in practice is whether these exemptions will automatically be applied to a VAT or require re-approval, and even then, whether the exemptions will be assessed on a contract-by-contract basis, or will be 'blanket' exemptions which apply given the essential nature of the activities being carried on by the supplier. It is expected that many of these exemptions affecting new VAT industries will be of a blanket nature, though this is a significant issue because the compliance costs involved in contract-by-contract exemptions, which have been the norm under the VAT system for exported services, can be significant.

Impact in other sectors (which are already VAT taxpayers)

Nearly all of the focus of these reforms has been on the taxpayers in these sectors which are primarily impacted. However, every sector is in fact affected, for the simple reason that they all either consume or utilise real estate, financial services, and lifestyle services in the conduct of their businesses.

This effectively means:

- Businesses which are already VAT taxpayers will now generally be able to claim input VAT credits for the services they consume from those sectors now becoming VAT taxpayers; and
- Businesses which are now becoming general VAT taxpayers are generally eligible to claim input VAT credits for the goods and services they purchase or consume.

The general position is that most of these other sectors should be a net beneficiary of these reforms. This means that businesses in the traditional manufacturing, wholesaling and retail sectors will now be eligible for a broader range of input VAT credits than previously, simply when they consume these services.

Small scale v general VAT taxpayers

Earlier in this alert we referred to the tax burden impact for small scale VAT taxpayers, who typically pay VAT at the rate of 3%. To understand this impact, it is necessary to briefly describe what this means.

Under the VAT reforms, taxpayers in the services sector are only required to register as a "general VAT taxpayer" if their annual turnover exceeds RMB 5 million. Businesses with a turnover less than RMB 5 million may still elect to be taxed as a general VAT taxpayer where they have been approved to do so by the tax authority and they have sound accounting records.

Where a taxpayer is registered as a "general VAT taxpayer", it means:

- They pay output VAT at the rates prescribed for those services, typically either 6%, 11% or 17%;
- They may claim input VAT credits for the expenses they incur generally where they hold a special VAT invoice;
- They may issue special VAT invoices to businesses who consume their services, provided those consumers are themselves general VAT taxpayers.

By contrast, "small scale VAT taxpayers" are businesses with an annual turnover less than RMB 5 million and have not chosen to be registered as a general VAT taxpayer. Where a taxpayer is registered as a "small scale VAT taxpayer" it means:

- They pay output VAT at a rate of 3% of their gross revenue;
- They are not entitled to claim input VAT credits for the expenses they incur; and
- They may not issue or receive special VAT invoices.

Cross border services

China's current BT system effectively taxes both the importation and exportation of services. It does this by requiring BT to be paid where either the supplier or the recipient is in China. This has historically resulted in inefficiencies and disadvantaged Chinese service providers from exporting their services, given that BT is not a creditable tax. However, the transition from BT to VAT results in a much more efficient and internationally competitive approach to taxing cross-border services.

Exports

The general position in China is that exports of services may qualify for exemption from VAT, though certain exported services may be zero rated (such as R&D and design services, certain international transportation services, and certain offshore outsourcing services). While exemption from VAT is the dominant approach for exported services now, it is still not as favourable as the zero rating approach suggested by the OECD VAT/GST guidelines.

Furthermore, as noted in our China Tax Alert on financial services, the categories of exported services have not been expanded (except in limited respects) so as to include exported financial services, which is likely to mean that these services will remain taxed in the short term. This is an area where change is necessary, so as to ensure that Chinese financial services businesses can remain internationally competitive.

The categories of exported services were expanded in two respects as a result of the new industries becoming subject to VAT. Those two changes are:

- Exemption may apply to construction services and construction supervision services for construction projects located outside of China; and
- Exemption from VAT may apply to cultural services, education and healthcare, and travel services provided outside of China.

One feature of the exported services provisions in China is that they are typically assessed on a contract-by-contract basis and may require significant substantiation to take place before the concessions can be accessed.

Imports

As noted earlier, one feature of China's VAT system which is quite different from many other countries is that foreign companies are generally ineligible to register for VAT purposes (and similarly ineligible to claim input VAT credits). Instead, what happens is that the VAT associated with the importation of services is typically collected on a withholding basis. The requirement to withhold is imposed on the foreign company's agent in China, or in the absence of such an agent, by the service recipient. The VAT rate which applies to the importation of the service is determined based on the nature of the service which is provided by the offshore supplier, rather than the nature of the recipient's general business.

The withholding VAT is effectively accounted for in a separate VAT return from the agent's or the recipient's own VAT return. The amount of the withholding is calculated on the basis of the payment made by the domestic purchaser / (1 + VAT) x VAT rate.

Internationally, most countries collect VAT on B2B supplies of imported services by using a reverse charge. However, while similar to a reverse charge, China's VAT withholding system differs in two key respects:

- The withholding affects the price, such that if the foreign supplier does not know about it, then they may be effectively short paid. Consequently, the foreign supplier may wish to negotiate to gross up for withholding purposes so as to mitigate the impact; and

- From an accounting perspective, the foreign supplier will often be asked to issue an invoice showing Chinese VAT, even though they are not paid it, and then the outstanding VAT component which is not received then needs to be written off. This can create accounting and administrative complexities.

While the withholding VAT system may not be optimal, importantly it does allow the service recipient to claim an input VAT credit where they are registered as a general VAT taxpayer. Consequently, for many B2B supplies of imported services, the VAT should no longer be a real cost. The service recipient is eligible to claim an input VAT credit without a special VAT invoice – instead, the service recipient is eligible to claim an input VAT credit provided it has the taxpayer payment certificate issued by the tax authorities which indicates the VAT paid, the contract, evidence of payment, and a commercial invoice from the offshore service provider.

Deemed sales

A major issue which all businesses transitioning to VAT for the first time need to consider is the potential impact of the "deemed sales" rules. In effect, they are rules which require output VAT to be paid (usually based on the average selling price of goods or services) where goods or services are provided free of charge, or for less than their market value. In practice, deemed sales raise significant compliance difficulties given that:

- For accounting and financial systems purposes, no price or other consideration is received, so there may not be an automatic 'trigger' point in the system for recognizing the transaction for VAT purposes;
- There are no comparable 'deemed sales' rules for BT purposes, so this is a new compliance issue which needs to be considered.

A further challenge is that the 'deemed sales' rules in China have a potentially very wide impact. In the context of the new industries transitioning to VAT, deemed sales are a common feature of their business models. For example, the hospitality sector commonly uses marketing incentives or benefits to attract or retain customers, such as loyalty rewards programs, 'free' benefits such as internet, breakfast, or upgrades or even free nights. The difficulties from a compliance perspective are not only about whether to account for VAT, but also how much. Consider the situation where a hotel provides a 'free' upgrade to a customer – that benefit may not cost the hotel anything, the hotel may have excess capacity that night, or the hotel may in fact be providing the upgrade to suit its own purposes (e.g. it has oversold rooms in that category). The question is whether to account for VAT, and if so, how much. These issues are likely to take some time to resolve with tax authorities on a case-by-case basis, given the absence of any general guidance contained in the rules themselves.

In the context of real estate, issues can similarly arise about whether 'rent-free' periods are liable for VAT as a deemed sale, or similarly 'free parking'. While the technical risks are real and genuine, the underlying policy of requiring output VAT to be paid on the provision of such benefits to arm's length parties makes very little economic sense. That is because these benefits are not in fact 'free' – rather, economically they are compensated for by the higher fees and charges which are obtained for the actual goods and services which are sold.

For example, if a tenant signing a 1 year lease gets a rent-free period of 1 month, it is effectively compensated for by the landlord charging a higher rent over the remaining 11 months of the lease. To require VAT to be paid on the value of both the rent-free period and the actual rent paid over the remaining 11 months of the lease involves double taxation of the same compensation. Consequently, a reasonable policy argument can be made that the 'deemed sales' rules should in fact be repealed for transactions involving arm's length parties. Notwithstanding this, they remain very much a part of the VAT system in China and therefore must be complied with.

Mixed and composite sales

As noted earlier, China's VAT system uses multiple VAT rates, the most common of which are 6%, 11% and 17%. One issue which arises when multiple VAT rates are used is how to determine the applicable rate where a mixed or composite sale occurs – that is, when a good and/or service is supplied with different components potentially subject to different VAT rates, or when a good and/or service is supplied with a principal and an ancillary component. The problem of how to treat mixed or composite sales has been a source of considerable disputes in VAT/GST systems around the world. Some simple facts situations which have arisen in those cases highlight the difficulties:

- Whether a patient visiting a doctor is supplied with a single medical service, or a separate supply of goods (e.g. medicines) which are administered during the consultation from the medical service itself;
- Whether an airline is supplying a single international transportation service, or a separate meal service when it supplies meals on board its flights.

China's VAT rules contain some guidance in this area. In particular where a composite sale occurs, the applicable VAT rate should be determined based on the main business activities of the taxpayer. However, where a mixed sale occurs, the highest VAT rate applies to the entire supply, unless the price has been separately allocated. This provides a powerful incentive for suppliers to allocate prices for mixed supplies.

When does BT end and when does VAT start?

The implementation rules do not contain any guidance about when BT ends and when VAT starts – while the date is 1 May 2016, the question is whether the rules apply based on the time of supply of the service, or the time when the relevant BT/VAT must be accounted for.

The position which was generally applied in practice for earlier stages of the VAT reforms was to apply the rules based on when the relevant BT/VAT must be accounted for. This should ordinarily mean that where the service is provided before 1 May 2016, but a right to receive payment or actual payment is made on or after 1 May 2016, then the service would be subject to VAT, not BT. While this may give some commercial flexibility, great care should be taken before engaging in delayed invoicing or other manipulation, especially where contracts are already in place, where the right to receive payment under the contract is stated.

Also, the tax officials collecting BT will generally differ from those collecting VAT, and the payment of one tax may not preclude the other tax authority from requiring payment.

Net basis method is not dead…yet

Previously when both BT and VAT operated, there was often a need for a supplier paying VAT to be able to deduct certain expenses (which were typically subject to BT) from their gross revenue in calculating their VAT liability. Otherwise, they would end up paying VAT on higher than the "value added" amount. With VAT now fully replacing BT, it had been anticipated that the use of these 'net basis' methods would end. However, the new VAT rules continue with 'net basis' methods in certain instances, such as for travel agents and others, where they may otherwise be required to account for VAT on an amount higher than the "value added". In a practical sense, the use of 'net basis' methods often give effect to the general principle of agency that the revenue collected on behalf of the principal belongs to the principal, not the agent.

Change of use provisions

Many VAT systems around the world have detailed 'change of use' provisions which are designed to ensure that when substantial assets are acquired, the use of the asset at the time of purchase does not necessarily govern the input VAT credit entitlement for the entire duration of the asset.

China's new VAT rules now contain 'change of use' provisions which, in effect, provide for an adjustment to input VAT credit entitlements based on the use of fixed assets, intangibles, and immovable property changing. The time limit to which the change of use must be tracked is not set out, which may suggest that the rules can apply for the useful life of the asset.

Filing periods and deadlines

For most taxpayers which are registered as general VAT taxpayers, the default filing period is monthly. That is, taxpayers are generally required to file VAT returns each month, and the usual deadline is by the 15th day of the following month. However, as a transitional measure the government has already announced that the VAT return filing deadline for all new VAT taxpayers entering the VAT system will be extended until 25 June 2016 for the first VAT return – in effect, a 10 day deferral.

As noted in the China Tax Alert on the financial services sector, the new VAT rules also contain a special concession for banks, financial companies and trusts (but notably not insurers), which are required to file VAT returns on a quarterly basis. This should give those businesses an extra few months to prepare their systems for the filing of VAT returns.

What to do to prepare for implementation?

The timeframe for implementation of around 5-6 weeks from the release date of the new rules will prove very challenging for business. It is expected that many businesses which are not already well advanced in their preparations will adopt a progressive process for implementation. Managing priorities will be a key task, and those priorities and their deadlines are:

Managing your obligations to external stakeholders

- *From now until 1 May 2016* – assess the impact of the implementation rules (when released) upon the issues which have previously been identified, finalise pricing decisions, and in so doing, understand the financial burden impact on your business; ensure that all existing contracts are reviewed to understand whether VAT can be passed on or not; update new contract templates to deal with VAT implications; register for VAT purposes with the tax authority and attend the compulsory training to be able to purchase invoice machines; purchase the invoice machines and negotiate the number and value of special VAT invoices which may be issued; ensure that the VAT registration details of your customers have been obtained (to enable VAT invoices to be issued), and that your VAT registration details have been conveyed to your suppliers;

Managing your internal systems and processes

- *From now until 25 June 2016 (at latest)* – put in place controls over VAT invoicing, implement internal processes for managing VAT risks; conduct training for staff in (at least) finance, operations, tax, legal and IT; prepare a VAT manual which records the positions being taken and be prepared to update them; implement either an automated interface solution between your Enterprise Resource Planning ("ERP") system and the Golden Tax System, or a temporary manual compliance solution;

Meeting your compliance obligations

- *25 June 2016* – the government recently announced an extension from 15 to 25 June 2016 of the due date for the filing of the first VAT return. Compliance with this date is a necessity;

Managing risk and change

- *Post 25 June 2016* – the rules will be new for many of the tax officials, so be prepared for "the unexpected"; anticipate several rounds of refinement or amendment to the rules and ensure your VAT manual and processes are updated to reflect them; expect that claims for VAT exemption for exported services may not be ready to implement until after 25 June 2016.

Contact Us

Khoonming Ho
Head of Tax,
KPMG China
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang
David Ling
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Tianjin
Eric Zhou
Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

Qingdao
Vincent Pang
Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing
Lewis Lu
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Chengdu
Anthony Chau
Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Hangzhou
John Wang
Tel. +86 (571) 2803 8088
john.wang@kpmg.com

Guangzhou
Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen
Maria Mei
Tel. +86 (592) 2150 807
maria.mei@kpmg.com

Shenzhen
Eileen Sun
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong
Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

Northern China

David Ling
Head of Tax,
Northern Region
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Vaughn Barber
Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

Andy Chen
Tel. +86 (10) 8508 7025
andy.m.chen@kpmg.com

Yali Chen
Tel. +86 (10) 8508 7571
yali.chen@kpmg.com

Milano Fang
Tel. +86 (532) 8907 1724
milano.fang@kpmg.com

Tony Feng
Tel. +86 (10) 8508 7531
tony.feng@kpmg.com

John Gu
Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Helen Han
Tel. +86 (10) 8508 7627
h.han@kpmg.com

Naoko Hirasawa
Tel. +86 (10) 8508 7054
naoko.hirasawa@kpmg.com

Josephine Jiang
Tel. +86 (10) 8508 7511
josephine.jiang@kpmg.com

Henry Kim
Tel. +86 (10) 8508 5000
henry.kim@kpmg.com

Li
Tel. +86 (10) 8508 7537
li.li@kpmg.com

Lisa Li
Tel. +86 (10) 8508 7638
lisa.h.li@kpmg.com

Thomas Li
Tel. +86 (10) 8508 7574
thomas.li@kpmg.com

Simon Liu
Tel. +86 (10) 8508 7565
simon.liu@kpmg.com

Paul Ma
Tel. +86 (10) 8508 7076
paul.ma@kpmg.com

Alan O'Connor
Tel. +86 (10) 8508 7521
alan.oconnor@kpmg.com

Vincent Pang
Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Shirley Shen
Tel. +86 (10) 8508 7586
yinghua.shen@kpmg.com

State Shi
Tel. +86 (10) 8508 7090
state.shi@kpmg.com

Joseph Tam
Tel. +86 (10) 8508 7605
laiyiu.tam@kpmg.com

Michael Wong
Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Jessica Xie
Tel. +86 (10) 8508 7540
jessica.xie@kpmg.com

Irene Yan
Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Jessie Zhang
Tel. +86 (10) 8508 7625
jessie.j.zhang@kpmg.com

Sheila Zhang
Tel: +86 (10) 8508 7507
sheila.zhang@kpmg.com

Tiansheng Zhang
Tel. +86 (10) 8508 7526
tiansheng.zhang@kpmg.com

Tracy Zhang
Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

Eric Zhou
Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

Central China

Lewis Lu
Head of Tax,
Eastern & Western Region
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Anthony Chau
Tel. +86 (21) 2212 3206
anthony.chau@kpmg.com

Cheng Chi
Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Cheng Dong
Tel. +86 (21) 2212 3410
cheng.dong@kpmg.com

Marianne Dong
Tel. +86 (21) 2212 3436
marianne.dong@kpmg.com

Alan Garcia
Tel. +86 (21) 2212 3509
alan.garcia@kpmg.com

Chris Ge
Tel. +86 (21) 2212 3083
chris.ge@kpmg.com

Chris Ho
Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Dylan Jeng
Tel. +86 (21) 2212 3080
dylan.jeng@kpmg.com

Jason Jiang
Tel. +86 (21) 2212 3527
jason.jt.jiang@kpmg.com

Flame Jin
Tel. +86 (21) 2212 3420
flame.jin@kpmg.com

Sunny Leung
Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Michael Li
Tel. +86 (21) 2212 3463
michael.y.li@kpmg.com

Christopher Mak
Tel. +86 (21) 2212 3409
christopher.mak@kpmg.com

Henry Ngai
Tel. +86 (21) 2212 3411
henry.ngai@kpmg.com

Yasuhiko Otani
Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

Ruqiang Pan
Tel. +86 (21) 2212 3118
ruqiang.pan@kpmg.com

Amy Rao
Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Wayne Tan
Tel. +86 (28) 8673 3915
wayne.tan@kpmg.com

Rachel Tao
Tel. +86 (21) 2212 3473
rachel.tao@kpmg.com

Janet Wang
Tel. +86 (21) 2212 3302
janet.z.wang@kpmg.com

John Wang
Tel. +86 (21) 2212 3438
john.wang@kpmg.com

Mimi Wang
Tel. +86 (21) 2212 3250
mimi.wang@kpmg.com

Jennifer Weng
Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

Henry Wong
Tel. +86 (21) 2212 3380
henry.wong@kpmg.com

Grace Xie
Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Bruce Xu
Tel. +86 (21) 2212 3396
bruce.xu@kpmg.com

Jie Xu
Tel. +86 (21) 2212 3678
jie.xu@kpmg.com

Robert Xu
Tel. +86 (21) 2212 3124
robert.xu@kpmg.com

William Zhang
Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

Hanson Zhou
Tel. +86 (21) 2212 3318
hanson.zhou@kpmg.com

Michelle Zhou
Tel. +86 (21) 2212 3458
michelle.b.zhou@kpmg.com

Southern China
Lilly Li
Head of Tax,
Southern Region
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Penny Chen
Tel. +1 (408) 367 6086
penny.chen@kpmg.com

Vivian Chen
Tel. +86 (755) 2547 1198
vivian.w.chen@kpmg.com

Sam Fan
Tel. +86 (755) 2547 1071
sam.kh.fan@kpmg.com

Joe Fu
Tel. +86 (755) 2547 1138
joe.fu@kpmg.com

Ricky Gu
Tel. +86 (20) 3813 8620
ricky.gu@kpmg.com

Fiona He
Tel. +86 (20) 3813 8623
fiona.he@kpmg.com

Angie Ho
Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Ryan Huang
Tel. +86 (20) 3813 8621
ryan.huang@kpmg.com

Cloris Li
Tel. +86 (20) 3813 8829
cloris.li@kpmg.com

Jean Li
Tel. +86 (755) 2547 1128
jean.j.li@kpmg.com

Kelly Liao
Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Grace Luo
Tel. +86 (20) 3813 8609
grace.luo@kpmg.com

Maria Mei
Tel. +86 (592) 2150 807
maria.mei@kpmg.com

Eileen Sun
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Michelle Sun
Tel. +86 (20) 3813 8615
michelle.sun@kpmg.com

Bin Yang
Tel. +86 (20) 3813 8605
bin.yang@kpmg.com

Lixin Zeng
Tel. +86 (20) 3813 8812
lixin.zeng@kpmg.com

Hong Kong

Ayesha M. Lau
Head of Tax, Hong Kong
Tel. +852 2826 7165

Chris Abbiss
Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern
Tel. +852 2826 7166
darren.bowdern@kpmg.com

Yvette Chan
Tel. +852 2847 5108
yvette.chan@kpmg.com

Lu Chen
Tel. +852 2143 8777
lu.l.chen@kpmg.com

Rebecca Chin
Tel. +852 2978 8987
rebecca.chin@kpmg.com

Matthew Fenwick
Tel. +852 2143 8761
matthew.fenwick@kpmg.com
ayesha.lau@kpmg.com

Barbara Forrest
Tel. +852 2978 8941
barbara.forrest@kpmg.com

Sandy Fung
Tel. +852 2143 8821
sandy.fung@kpmg.com

Stanley Ho
Tel. +852 2826 7296
stanley.ho@kpmg.com

Daniel Hui
Tel. +852 2685 7815
daniel.hui@kpmg.com

Charles Kinsley
Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos
Tel. +852 2685 7457
john.kondos@kpmg.com

Kate Lai
Tel. +852 2978 8942
kate.lai@kpmg.com

Jocelyn Lam
Tel. +852 2685 7605
jocelyn.lam@kpmg.com

Alice Leung
Tel. +852 2143 8711
alice.leung@kpmg.com

Steve Man
Tel. +852 2978 8976
steve.man@kpmg.com

Ivor Morris
Tel. +852 2847 5092
ivor.morris@kpmg.com

Curtis Ng
Tel. +852 2143 8709
curtis.ng@kpmg.com

Benjamin Pong
Tel. +852 2143 8525
benjamin.pong@kpmg.com

Malcolm Prebble
Tel. +852 2684 7472
malcolm.j.prebble@kpmg.com

Nicholas Rykers
Tel. +852 2143 8595
nicholas.rykers@kpmg.com

Murray Sarelius
Tel. +852 3927 5671
murray.sarelius@kpmg.com

David Siew
Tel. +852 2143 8785
david.siew@kpmg.com

John Timpany
Tel. +852 2143 8790
john.timpany@kpmg.com

Wade Wagatsuma
Tel. +852 2685 7806
wade.wagatsuma@kpmg.com

Lachlan Wolfers
Tel. +852 2685 7791
lachlan.wolfers@kpmg.com

Christopher Xing
Tel. +852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

Adam Zhong
Tel. +852 2685 7559
adam.zhong@kpmg.com

kpmg.com/cn