

# Tax Analysis

PRC Tax

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## Timetable for expanded VAT reform pilot announced

China's State Council announced on 25 July 2012 that the VAT reform pilot program in Shanghai will be expanded to eight provinces/cities. The Ministry of Finance and the State Administration of Taxation jointly issued a circular on 31 July 2012 (Circular 71 (Caishui (2012) No. 71)) that formally sets out the timetable for, and scope of, the expanded program.

The VAT reform pilot commenced on 1 January 2012 in Shanghai and applies to the transportation and certain modern service industries, with the intention that the reform program eventually would be expanded nationwide. The pilot aims to resolve the double or multiple taxation issues that arise under China's current indirect tax system, which includes both a VAT levied on the supply of goods, the provision of repair, processing and replacement services, and on imports, and a Business Tax (BT), levied on the provision of other services and the transfer of intangibles and real property. Different rates are imposed under the VAT and BT regimes, and unlike VAT, an input tax credit is not available under the BT regime. The reform will gradually replace the dual tax system with a single system applying to the supply of both goods and services.

According to Circular 71, the expanded program will be phased in between September and December 2012, as follows:

- Beijing – 1 September;
- Jiangsu and Anhui – 1 October;
- Fujian (including Xiamen) and Guangdong (including Shenzhen) – 1 November; and
- Tianjin, Zhejiang (including Ningbo) and Hubei – 1 December.

The applicable industry sectors and policies in the eight provinces/cities will be the same as those of the Shanghai pilot; the transportation and specified modern service industries are currently participating. However, the finance and construction sectors, which were expected to be included during the expansion of the pilot to other locations, are still not included in the pilot scope.

The circular also mandates that the local tax authorities immediately begin to prepare affected industries for the pilot to ensure a smooth transition and, once the program starts, to monitor its progress. Some local authorities already have been proactive in this regard, by conducting taxpayer training sessions, initiating verification of taxpayer status, and testing systems and equipment for tax filing/administration purposes and for the issuance of invoices.

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## Comments

When the Shanghai pilot was first announced on 26 October 2011, it was envisaged that Shanghai was just the first step in a gradual transition from BT to VAT. The State Council's announcement on 25 July included a potential start date of 1 August for the new locations, but there were concerns that the one-week lead time was insufficient for taxpayers to be adequately prepared for the rollout. Circular 71 is welcome as it confirms the timetable for the eight provinces/cities and clarifies that 1 August is the start date to do the preparation work for the reform in those locations. Nevertheless, with less than four weeks before the first of the expanded pilots, businesses in the affected areas need to ensure that they understand the overall impact of the VAT reform pilot, as well as the technical and practical issues that have surfaced during the Shanghai pilot.

## Technical issues

### Ø Application for exemption for services provided to overseas

Since development of the services sector is one of China's primary objectives, it is imperative for the pilot program to focus on improving China's competitiveness as regards the provision of services, especially services provided overseas. Previously issued guidance clearly laid out the possibility for services invoiced overseas to be exempt or zero rated (services eligible for zero rating and VAT exemption were initially provided in Caishui [2011] No. 131 and SAT Bulletin [2012] No. 13, along with the conditions needed to qualify for zero rating). However, given that most services provided overseas should be VAT exempt, it is important that the Chinese authorities issue guidance so that taxpayers clearly understand what is required to qualify for the exemption. According to a recent survey carried out by Deloitte, more than 50% of businesses stated that it has not been possible to apply the VAT exemption, with the result that many qualifying services are subject to VAT at 6%, which may actually increase the tax burden for the overseas recipient. Seven months have passed since the launch of the Shanghai pilot, and this remains one of the most critical issues where guidance is needed to clarify the conditions that must be satisfied to obtain the VAT exemption.

### Ø Supplies between the same legal entity

The tax treatment of supplies between the same legal entity (e.g. branch to branch, head office to branch, hereafter referred to as "establishment") is another area where clarification is needed. Under the VAT rules, a branch and its head office are considered different VAT payers. Prevailing VAT rules contain a deemed supply rule for the supply of goods between establishments within the same legal entity; VAT charged by one establishment is generally creditable by another, so the net impact is nil from the legal entity's perspective. However, it is unclear whether there is a deemed supply rule for the supply of pilot services between different establishments within the same legal entity. Particularly during the period in which the VAT pilot is limited to specific locations, VAT charged by one establishment may not be recoverable by an establishment in a location outside the pilot which remains a BT payer and consequently, it becomes an absolute cost to the business. It is therefore important for affected businesses to know whether the SAT will issue clarifications on this issue.

### Ø Representative offices of foreign law firms

It also is unclear whether the pilot program applies to representative offices (ROs). Various approaches have been taken in Shanghai, especially in the case of foreign-invested law firms established in the form of an RO. Such firms are able -- and required -- to file taxes based on an "actual income" basis and their

services should fall under the “consulting service” category according to the rules governing the pilot program. Some local tax authorities allow these law firms to participate in the VAT reform, while others do not due to the RO status. Thus, it is in the interest of law firms to know whether they will be covered by the pilot program.

#### Ø VAT deduction

The expansion of the VAT pilot program should allow more companies to recover input VAT. Therefore, it is possible that the tax authorities will more closely scrutinize input VAT claimed by taxpayers. Taxpayers should carefully review existing internal control procedures to determine whether they have sufficient controls in place to ensure the full recovery of input VAT and make improvements if necessary.

#### Ø Arguing for inclusion in the pilot

While the pilot rules attempt to define the covered services, some of the definitions are broad and not sufficiently detailed, making it difficult to match services provided by a company with the services covered by the VAT pilot rules in some cases. Taxpayers need to assess whether their services will fall within the scope of a specific covered category and the potential impact on their business. If it is beneficial to join the pilot, the business must present convincing arguments to the in-charge tax bureau. We have worked with several companies to carry out financial modeling to assess the impact of the pilot, formulate appropriate strategies and help taxpayers convince the tax authorities in Shanghai that the company should participate in the pilot.

### Practical issues and recommendations

As a result of the workshops and training that Deloitte has held in recent months, especially for companies registered for VAT in Shanghai, the technical issues are well understood. The most formidable challenge remains communication, especially with customers, on the impact of the VAT charge to pricing; although this is a commercial issue, internal understanding and agreement are needed to manage the discussion. To ensure there is an ability to charge VAT, thus preserving a company’s top line revenue, it is critical to understand how to address the discussion with customers and to have an internal execution strategy. Deloitte has designed an internal and external communication package and we will be happy to assist and advise on the optimal strategy for a business.

Tax clauses in legal agreements also need to be examined to determine whether VAT can be charged (given that BT is a tax-inclusive charge, service contracts probably quote all sales fees as tax-inclusive). Contracts need to be examined now so they can be renegotiated as soon as possible; otherwise, there will be no legal basis to allow the charge to VAT, which means the company likely will have to bear any additional tax cost. Our indirect tax team understands the wide range of tax clauses and we can assist businesses determine the implications of such clauses and how they should be revised.

VAT functions differently to BT. Thus, to ensure compliance requirements are met, it will be crucial for businesses to automate the issuance of the special VAT invoices, VAT ledgers and VAT returns. Many ERP systems have functionalities to automate compliance requirements, but this needs to be planned for and implemented. Deloitte is experienced with various ERP systems and adapting systems for the VAT reform, and we will bring our specialist implementation team to assist you.

Finally, the VAT reform is a positive development for many businesses *provided* it can be applied in a methodical manner. However, the success of transitioning from a BT system to a VAT system also requires a comprehensive and analytical approach of the kind that Deloitte has worked to develop. For more information or advice on the above tax issues, please contact our Deloitte indirect tax service team.

Please also click below to view the archive of our Tax Analysis and Dbriefs on the VAT reform and stay tuned for more:

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