

Tax Analysis

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Authorities issue further guidance on VAT reform pilot program

China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued a circular on 4 December 2012, which provides further clarification of, and guidance on, certain aspects of the VAT reform pilot program ("*Supplementary Notice on Several Tax Policies in Relation to the Scope of VAT-able and Other Matters in the Transportation and Selected Modern Service Sectors under the VAT Reform Pilot Program*", Caishui [2012] No. 86 (Circular 86)). Similar guidance was issued on 21 June 2012 (Circular Caishui [2012] No. 53, "*Supplementary Notice on Several Tax Policies under the VAT Reform Pilot Program in Transportation and Selected Modern Service Sectors*"). The new guidance comes after the pilot reform project has been operating for almost a full year.

Circular 86 applies retroactively as from 1 December 2012, except for the transition rule applicable to Pingtan, which applies as from 1 November 2012.

Highlights of Circular 86

Circular 86 provides four groups of clarifications: (1) how certain services are to be taxed under the pilot program; (2) provide transition rules for certain taxpayers; (3) the VAT treatment of transportation services; and (4) other matters.

- *Clarification of services within the scope of the pilot program*
 - Review and verification of architectural drawings, environmental assessment and investigation of medical negligence are taxed as "Attestation Services";
 - Book-keeping services are taxed as "Consulting Services", whilst blueprinting and copying services are taxed as "Design Services";
 - The organization and arrangement of conferences and exhibitions are taxed as "Conference and Exhibition Services";
 - Port facilities security fees collected by the operator of port facilities are taxed as "Port Services";
 - Website operation services provided by website owners for non-self-owned online games are taxed as "Information System Services"; and
 - Management fees collected by a cab company from taxi drivers are subject to VAT as "Land Transportation Services" if the taxi is owned by the cab company; if the taxi is owned by the driver, the fees are not subject to VAT.

- *Transition rules for certain pilot taxpayers*
 - VAT collection with an immediate refund will apply to domestic cargo transportation services, warehousing services, loading, unloading and moving services provided by pilot taxpayers registered in the Tianjing Dongjiang Free Trade Port Area;
 - As from 1 November 2012, a VAT exemption applies to offshore outsourcing services (if falling within the scope of the pilot program) provided by pilot taxpayers registered in Pingtan, Fujian province; and
 - For pilot taxpayers approved by the Broadcast, Movie and TV administration authorities to engage in the business of film production, distribution and/or screening, transfer of film copyrights is exempt from VAT until 31 December 2013.
- *VAT treatment of transportation services*
 - The provision of transportation services from/to/in Taiwan, Hong Kong and Macao¹ by pilot taxpayers is eligible for zero-rating; and
 - Long-distance passenger transportation services, shuttle bus services (with fixed schedules / routes / stops), metro services and urban light railway services are considered "Public Transportation Services" in the pilot rules where general VAT payers participating in the pilot can opt for the simplified taxing method² when paying VAT.
- *Other clarifications*
 - (International) shipping agency services are reclassified from "port services" to "(international) freight forwarding services"; and
 - The "actual VAT tax burden" under the pilot rules refers to the proportion of VAT payable in the total consideration and any additional fees received from the provision of taxable services.

Comments

- Clarification of certain services

One of the most formidable challenges for taxpayers operating under the VAT reform pilot is understanding the scope and/or definition of services that are listed as pilot services. Circular 86 clarifies some issues and states that the review and verification of architectural drawings, environmental assessment, appraisal of medical negligence and blueprinting services are considered pilot services (these are newly added). The circular also confirms that book-keeping services fall within the scope of VAT as "Consulting Services"; it has been unclear how book-keeping services were to be taxed and, in fact, they have been taxed differently in different locations (e.g. taxed under Business Tax in Shanghai, but under VAT in Beijing).

Despite the clarifications in Circular 86, there still are many types of services where the VAT or Business Tax implications remain uncertain. Such services mainly include back-office support provided by management companies, sourcing services, after-sales services, etc., all of which have been taxed differently for VAT or Business Tax purposes, depending on how the case is presented. Taxpayers should review the nature of their services and assess whether the current VAT or Business Tax treatment is appropriate; supporting documentation should be prepared to support the taxpayer's assessment and mitigate any possible future tax exposure.

- Transition rules for existing preferential Business Tax treatment post-VAT reform

One of the key features of the VAT reform pilot is that it will allow existing Business Tax preferential treatment to remain intact after the reform. Circular 86 confirms the VAT preferential treatment for specified services provided by pilot taxpayers registered in the Tianjing Dongjiang Free Trade Port Area and Pingtan. VAT collection with an immediate refund in the Tianjing Dongjiang Free Trade Port Area is the same as that in the Shanghai Yangshan Free Trade Port Area.

¹ Taiwan, Hong Kong and Macao are part of China from a political perspective.

² Under the simplified taxing method, VAT due is calculated based on the gross sales amount multiplied by the VAT levying rate (3%); the input VAT, however, is not recoverable.

Circular 86 also confirms that the transfer of film copyrights would be exempt from VAT before 31 December 2013. This stipulation follows the provision in Circular 31³ that the transfer of film copyrights by qualified film companies is exempt from Business Tax.

- Clarification affecting transportation industries

Circular 86 provides two major clarifications relating to the transportation industry:

1. The provision of transportation services from/to/in Taiwan, Hong Kong and Macao can be VAT zero-rated, meaning that such services are treated as international transportation services. A specific transportation operation license is required, however, to support a claim for zero-rating treatment. Circular 86 (and prior circulars) do not provide clear guidance (such as is found in the EU VAT directive) on how to apportion trips between China and other countries for VAT purposes. Taxpayers normally need to self-assess the international transportation portion and provide adequate documentation to support their claims.
2. Long-distance passenger transportation services, shuttle bus services (with fixed schedule / route / stops), metro services and urban light railway services are treated as "Public Transportation Services" in the pilot rules where general VAT payers participating in the pilot can opt for the simplified taxing method when paying VAT. VAT due under the simplified taxing method is calculated based on the gross sales amount multiplied by the VAT levying rate (3%) and input VAT is not recoverable. This treatment is comparable to the Business Tax treatment on transportation services, whereby the 3% Business Tax applies with no input VAT credit.

Recommendations

In view of the rapidly evolving VAT reform pilot and the frequency of clarifications and guidance coming from the authorities, affected taxpayers should take the following actions:

- Review the nature of the services they provide and assess the possible VAT or Business Tax implications by referring to the pilot rules (including relevant clarifications);
- Prepare substantiating documentation and ensure the existence of a justifiable business case to apply for the favorable and appropriate VAT or Business Tax treatment in cases where the rules are not clear enough;
- Apply for preferential indirect tax treatment where possible since this can result immediate tax savings; and
- Closely monitor the development of the pilot rules and seek assistance from consultants where necessary.

For more information or advice on the VAT reform pilot program, please contact our Deloitte Indirect Tax Team.

Note: Contents discussed in this Tax Analysis pertains to Deloitte Indirect Tax Services.

³ Circular Caishui [2009] No. 31, "Notice on Several Tax Policies to Support the Development of Cultural Industries"

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