

Tax Analysis

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MOF and SAT issue new regulations on nationwide implementation of VAT reform on transportation and modern services sectors

China's Ministry of Finance (MOF) and State Administration of Taxation (SAT) issued a circular (Caishui [2013] No. 37, "Circular 37") on 24 May 2013 announcing that the VAT reform pilot program for transportation and modern services sectors will be rolled out nationwide as from 1 August 2013. Circular 37 formalizes the national implementation of the VAT reform from a legislative perspective and also provides detailed implementation rules on the national rollout.

Background

The VAT reform pilot program for the transportation and modern services sectors started in Shanghai on 1 January 2012 and was later rolled out to eight other cities/provinces during 2012. The nationwide rollout has been anticipated because of the distortion in competition created by the pilot program in certain areas. During an Executive Meeting of the State Council on 10 April 2013, it was decided that the VAT reform pilot will be expanded throughout the country and that new service industries will be included within the scope of the reform.

Highlights of Circular 37

Circular 37 provides that the current pilot program, as applied to the transportation and modern service sector, will be implemented nationwide starting on 1 August. Although Circular 37 does not clearly state whether the reform will be implemented immediately in *all cities and provinces*, this seems likely to be the case. Some local tax authorities (e.g. Shandong) already have issued local circulars to confirm that they will join the pilot on 1 August.

Circular 37 also abolishes seven sets of measures that have guided the VAT reform pilot to date. The following will be abolished as from 1 August:

- Circular Caishui [2011] No. 111
- Circular Caishui [2011] No. 131
- Circular Caishui [2011] No. 133
- Circular Caishui [2012] No. 53
- Circular Caishui [2012] No. 71
- Circular Caishui [2012] No. 86
- Items 16 and 18 of Article 3 of Circular Caishui [2003] No. 16

The four appendices to Circular 37 provide detailed implementation guidelines regarding the national implementation of the VAT reform. These guidelines also apply as from 1 August.

The detailed implementation rules generally follow the principles stated in Circular Caishui [2011] No. 110, but make some welcome clarifications:

- Radio, film and TV production, distribution and broadcasting will be covered by the VAT reform and will be subject to 6% VAT rate. Broadcasting and the distribution of TV and radio programs and films outside of China and the production of TV and radio programs and films for overseas entities will be exempt from VAT.
- If a pilot service is eligible for both VAT exempt and zero-rated treatment, the zero-rated treatment should take precedence. (If a service is zero-rated, no output VAT is payable, but the business can recover input VAT for expenses incurred in supplying the services).
- A domestic entity or individual that provides services eligible for zero-rating can opt to waive such treatment and instead apply the VAT exemption, or treat the transaction as a taxable supply and pay VAT. Once zero-rated treatment is waived, the taxpayer cannot elect for zero-rating for the subsequent 36 months.
- Trading companies should apply the "exempt and refund" method for the provision of zero-rated services. According to Circular Caishui [2011] No. 131, the "exempt, credit and refund" method should be applied to zero-rated services. However, trading companies usually apply the exempt and refund method for export goods. In practice, a company could not adopt both methods, so Circular 37 clarifies that trading companies should apply the exempt and refund method for the provision of zero-rated services, since that is the method used for the export of goods.
- An input VAT credit is allowed for the self-use of automobiles, motorcycles and yachts that are subject to consumption tax. Under the old rules, the input VAT on such vehicles for self-use could not be used as a credit against output VAT.
- For finance leasing of tangible and movable property provided by pilot taxpayers approved by the People's Bank of China, the Ministry of Commerce or the China Banking Regulatory Commission to engage in such activities, the service revenue as the basis for an output VAT calculation should be the total proceeds net of the loan interest (including foreign exchange loans and RMB loans), customs duty, import consumption tax, installation expenses and insurance expenses related to the property and borne by the lessor. The provisions in Circular 111 allowing pilot taxpayers to deduct payments to non-pilot taxpayers from sales revenue are eliminated in Circular 37.

Comments

Circular 37 formalizes the national implementation of the VAT reform, which signifies a very important milestone in the development of the VAT reform in China. The MOF and SAT have taken into consideration experience gained from the current pilot program and introduced some positive changes in Circular 37, which should be welcomed by businesses. These changes also signal that the authorities are taking a more flexible approach to the implementation of a VAT exemption and zero-rating of services provided to overseas. In practice, there have been cases in which it was unclear whether a transaction should be exempt or zero-rated and which would take precedence. The case of software development and design services under offshore outsourcing is illustrative: although R&D and design services provided to overseas are zero-rated, qualified offshore outsourcing services may be exempt. With the clarification of Circular 37 that zero-rating should prevail in such cases, businesses can recover the input VAT incurred, which is the most beneficial outcome.

In some cases, taxpayers may prefer an exemption to zero-rating, for example, if the taxpayer has minimal input VAT and wants to reduce the VAT compliance burden. Circular 37 allows taxpayers eligible for zero-rating to opt to pay VAT or apply the exemption. This offers flexibility to choose the most desirable treatment according to the needs of the taxpayer.

The clarification regarding the VAT refund calculation method for trading companies is good news for businesses that also provide pilot services. Under current practice, the tax authorities have required some trading companies to switch from the "exempt and refund" method to the "exempt, credit and refund" method to be able to obtain a VAT refund for zero-rated pilot services. This increased the compliance burden for the companies and may increase the irrecoverable VAT cost. Circular 37 resolves this problem.

Circular 37 allows an input VAT credit for the self-use of automobiles, motorcycles and yachts, which provides more input VAT credit for taxpayers. This is a surprising development because, in many countries, VAT incurred on such costs are blocked to prevent abuse. A possible reason for allowing an input credit is to reduce the administrative burden of the tax authorities when they have to determine the type of use of such means of transportation, which may change from year to year. It also reduces the practical compliance difficulties in differentiating automobiles, motorcycles and yachts for self-use from those for business use.

With the national implementation of the VAT reform, it is expected that pilot taxpayers should be able to obtain VAT special invoices from suppliers across the country. Therefore, Circular 37 updates the rules to delete the redundant provision of allowing pilot taxpayers to deduct payment to non-pilot taxpayers from sales revenue. However, if small-scale taxpayers who were allowed to calculate VATable income net of deductible payments apply the same rule, they likely will have an increased tax burden because they cannot deduct input VAT. Circular 37 does not specify the treatment for small-scale taxpayers, so this will need to be clarified. The measure in Circular 37 specifically allowing deductible expenses for finance leasing businesses is likely to provide some relief to such businesses that claim they have suffered from an increased VAT burden as a result of the pilot program.

Suggestions

With the national implementation of the reform within two months and the new implementation rules introduced in Circular 37, businesses should take the following steps:

1. Review operations and supply chains and assess the impact of the national rollout, especially in smaller cities, to ensure that the local tax bureaus can address new VAT needs, such as an increased demand for VAT invoices;
2. Understand the new rules and proactively apply for beneficial treatment to obtain the benefits of the reform;
3. Prepare for the VAT compliance work in affected operations; and
4. Monitor the development of the reform and consult with experts if necessary.

Deloitte's Indirect Tax Team will continue to monitor the development of VAT reform. We can provide related tax advisory services and assist with communication with the tax authorities. If you have any questions, please feel free to contact us.

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

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