

# Tax Analysis

## VAT Reform - SAT clarifies disputed VAT issues

China's State Administration of Taxation (SAT) issued a tax bulletin (i.e. SAT Bulletin [2016] No. 53) on 18 August 2016 that clarifies certain VAT issues that have been subject to dispute due to the absence of clear guidance. Bulletin No. 53 provides some clarifications of the VAT treatment of the sale of prepaid cards, the supply of certain services within China and the sale of restricted shares.

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### *Sale of prepaid cards*

A prepaid card generally refers to an instrument that gives the holder the right to receive a supply of goods or services in the future (i.e. "redemption"). The price paid for the right is a prepaid expense for the buyer. While the instrument often is in a form of a physical card ("prepaid card"), it also may be in another physical format (e.g. paper voucher) or in electronic format for VAT purposes. There are two types of prepaid cards:

- **Single-purpose cards (SPCs)<sup>1</sup>:** An SPC is a prepaid card whose holder is entitled to receive a supply of goods or services only from the party that issues the card (i.e. issuer), or parties that are affiliated with the issuer (e.g. parties within the same franchising business group). SPCs are widely used in industries, such as retailing, hospitality, catering, etc., and are aimed at instilling loyalty in customers for a specific brand.
- **Multi-purpose cards (MPCs)<sup>2</sup>:** An MPC is a prepaid card whose holder may receive a supply of goods or services from a broad scope of suppliers other than the card issuer or its affiliates. Unlike an SPC, MPCs normally are used to facilitate the payment process and, therefore, legally they can be issued only by companies that have obtained a payment service license from the People's Bank of China.

It has long been disputed whether VAT (or business tax (BT) before the recent VAT reform) should be charged when a prepaid card is issued or redeemed, and how the tax should be charged. Bulletin No. 53 provides the following guidance on the VAT treatment of prepaid cards:

<sup>1</sup> The issuance of single-purpose cards is governed by the commerce departments (see Decree of the Ministry of Commerce [2012] No. 9).

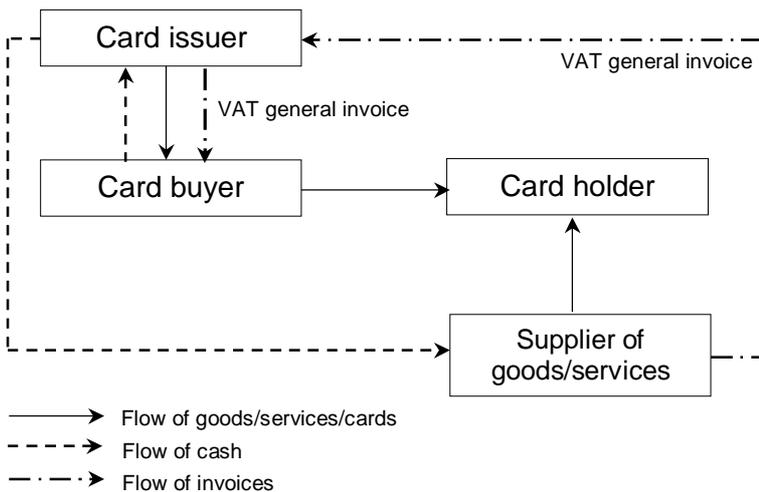
<sup>2</sup> The issuance of multi-purpose cards is governed by the People's Bank of China (see Bulletin of the People's Bank of China [2012] No. 12).

- 1) **Issuance of cards:** When the prepaid card is issued, no VAT will be charged on the price paid by the buyer for the card where the price generally represents the value of the goods or services the card holder will be entitled to receive. A VAT general invoice<sup>3</sup> may be issued by the card issuer to the buyer, but a VAT special invoice may not be issued.

When a prepaid card is issued, any service fee charged by the card issuer for handling the payment will be subject to VAT under the normal rules.

- 2) **Redemption of cards:** When a prepaid card is redeemed, the supplier of the goods or services will be subject to VAT. However, a VAT invoice may not be issued to the card holder.
- 3) **Settlement between card issuers and suppliers (if applicable):** When the prepaid card issuer pays the price of the goods or services to the supplier, a VAT general invoice must be issued by the supplier to the card issuer, and a VAT special invoice may not be issued.

The flow of cash, goods or services and invoices can be depicted in the following diagram:



Note: The card buyer and card holder may be the same party; the card issuer and the supplier of the goods/services may be the same party (where no settlement is required).

Although local guidance has been issued by the tax authorities in some cities and provinces (e.g. Beijing, Dalian, Fujian, Hebei, Sichuan and Zhejiang), Bulletin No. 53 is the first nationwide guidance issued by the SAT on the VAT treatment of prepaid cards. The guidance should be welcomed by affected businesses because it provides certainty of the tax treatment. However, it should be noted that only VAT general invoices can be issued for the issuance of prepaid cards; therefore, a card buyer will be unable to claim an input VAT credit for the underlying acquisition of goods or services.

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<sup>3</sup> Unlike VAT special invoices, VAT general invoices cannot be used to support an input VAT credit.

One possible exception to the above invoice rules concerns gasoline cards issued by oil/gas sellers and whose VAT treatment is governed by another SAT decree (Decree No. 2). Decree No. 2 provides that a gasoline buyer may request the seller to issue a VAT special invoice if the buyer purchases gasoline using the card, provided there is a redemption record. Since Decree No. 2 remains unaffected by Bulletin No. 53, it may override the general rules in Bulletin No. 53. There also may be situations where MPCs are issued without a payment service license — Bulletin No. 53 will not be applied in these cases where the legality of the card is questionable.

Affected businesses should be aware of the requirements relating to the issuance of VAT invoices; in particular, any discrepancies between the items shown on the VAT invoice (e.g. names and categories of the goods/services) and information relating to the actual transaction may result in penalties and even the disallowance of the deduction for the relevant cost or expenses for income tax purposes. To facilitate the issuance of VAT invoices for the sale of prepaid cards, Bulletin No. 53 adds a new sub-category (i.e. "601 - Sales of prepaid cards") under the category of "Non-VATable activities" in the coding system for VAT invoices. However, when the card issuer remits the fund to the supplier and requests the issuance of a VAT invoice, Bulletin No. 53 is not entirely clear on whether the supplier must specify all of the underlying goods and services in the invoices, a requirement that could be cumbersome if there are multiple supplies.

### *Services supplied within China*

Bulletin No. 53 clarifies that the following services provided by foreign parties are not "services supplied within China" and, therefore, fall outside the scope of Chinese VAT:

- Postal and delivery services provided outside China for letters and packages sent overseas;
- Construction and project supervision services provided to domestic entities or individuals, where the relevant project is located overseas;
- Engineering prospecting services provided to domestic entities or individuals, where the relevant project or natural resources are located overseas; and
- Meeting and exhibition services provided to domestic entities or individuals, where the relevant meeting or exhibition is located overseas.

According to article 12 of the Implementation Measures of the Pilot VAT Reform, if the service provider or purchaser is a domestic party, the service generally will be considered as "service supplied within China" and, therefore, subject to Chinese VAT. This general rule may lead to a much wider scope of taxation and result in certain transactions being subject to indirect tax both in China and in a foreign jurisdiction. Therefore, article 13 of the measures restricts the scope by excluding services provided by foreign parties to domestic recipients and that are "wholly incurred outside China." With the vast expansion of the digital economy, many services can be provided remotely, which creates additional challenges in determining whether a service is "wholly incurred outside China." The SAT likely will issue more guidance or specific examples in this area.

### *Sale of restricted shares*

Restricted shares are shares that may not be sold for a certain period of time. A Chinese entity generally may acquire restricted shares of a Chinese joint stock company in the following situations:

- 1) **Nontradable shares reform:**<sup>4</sup> Where the nontradable shares will become tradable after the reform, but are subject to a sale restriction for a period of time;
- 2) **Initial public offerings (IPOs):** Where both the shares acquired by shareholders before the IPO (pre-IPO shares) and those newly subscribed by shareholders in an offline IPO will be subject to a sale restriction for a period of time;
- 3) **Private placement:** Where restricted shares will be issued in a private placement to the relevant investors;

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<sup>4</sup> Historically, a large portion of the shares of Chinese listed companies were not allowed to be traded on the Shanghai and Shenzhen stock exchanges. The government launched a reform in 2005 to gradually convert nontradable shares to tradable on the stock exchanges.

- 4) **Significant reorganizations**: Where restricted shares will be issued in a significant reorganization to the relevant investors; and
- 5) **Stock dividends**:<sup>5</sup> Where the restriction also will be imposed on certain stock dividends in relation to the restricted shares acquired in the above situations.

Questions have arisen as to whether the sale of restricted shares (pre-IPO shares, in particular) after a restriction is lifted should be subject to BT under the taxable item "purchase and sales of financial products." Some have argued that, when the pre-IPO shares were acquired, the shares were not yet listed and could not be considered "financial products," so no BT should be levied when the shares are subsequently sold. The Chinese tax authorities seem somewhat divided on this issue; some local tax authorities (e.g. Beijing, Guangxi, Hainan, Jiangsu, Tianjin and Zhejiang) have acknowledged the taxability, while others have remained silent, resulting in varied local practices. With the taxable item being moved from the scope of BT to VAT after 1 May 2016, this dispute has been ongoing until the issuance of Bulletin No. 53.

Bulletin No. 53 indicates that the sale of restricted shares (after the restriction is lifted) should be subject to BT or VAT. Since the indirect tax is calculated on the margin (i.e. the selling price net of the purchase cost), Bulletin No. 53 provides that the purchase cost of restricted shares is determined as follows:

- **Nontradable shares reform**: For restricted shares arising from the nontradable shares reform and the corresponding stock dividends, the purchase cost is determined according to the opening price of the stock on the first trading day after the reform is completed.
- **IPOs**: For restricted shares arising from an IPO and the corresponding stock dividends, the purchase cost is determined according to the IPO offering price.
- **Significant reorganizations**: For restricted shares arising from significant reorganizations and the corresponding stock dividends, the purchase cost is determined according to the closing price of the stock on the last trading day before the stock trading is suspended due to the reorganization.

Although Bulletin No. 53 is silent on the determination of the purchase cost of restricted shares acquired through a private placement, it does not appear that the guidance intends for sales of such restricted shares not to be subject to BT or VAT; presumably, it is because the determination of the purchase cost of such shares is relatively straightforward. Nevertheless, guidance still may be needed for the determination of the purchase cost of stock dividends in relation to restricted shares acquired through private placement.

It is worth noting that Bulletin No. 53 has retroactive effect so that the tax authorities are empowered to pursue BT on sales of restricted shares that took place before 1 May 2016.

Deloitte's indirect tax team will continue to monitor the VAT reform developments and provide updates and insights in due course.

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<sup>5</sup> Stock dividends refer to stock arising from the recapitalization of retained earnings or capital surplus (e.g. share premium).

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