

CHINA'S NATIONWIDE VAT REFORM - IMPLEMENTATION RULES ISSUED

Following the Premier's earlier announcement of the nationwide pilot value added tax (VAT) reform program, under which service sectors historically subject to business tax (BT) would be subject to VAT effective from May 1, 2016, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) of China jointly issued the detailed implementation rules on the pilot program, namely *Circular on Comprehensively Promoting the Pilot Program of the Collection of Value-added Tax in Lieu of Business Tax (Circular 36)* on March 23, 2016.

Circular 36 provides a set of detailed guidance rules on implementation of the pilot VAT reform program, at the same time, it also will supersede the previous rules and regulations in respect of levying of VAT in service sectors¹.

BT v.s. VAT

Since the China tax reform in 1994, China has established a dual indirect tax system under which two sets of tax regimes, i.e., BT and VAT co-exist but apply on different taxable income. Specifically, VAT is levied on income derived from sales and importation of tangible and movable goods and provision of processing, repair and replacement services, whereas BT is levied on income derived from provision of other services and transfer of intangibles and real properties. The standard VAT rate is 17% which would be reduced to 13% for certain goods. BT rate varies from 3% to 20% depending on the service nature.

Since BT is generally described as a "cascading" tax and the co-existence of VAT and BT may result in double taxation in different stages in a sales/service cycle, the Chinese government has launched the VAT reform and gradually rolled out a pilot program to replace BT with VAT starting from January 1, 2012.

With the promulgation of Circular 36, the VAT reform chapter has been officially closed with BT being fully replaced by VAT in all industries in China. It is estimated that this reform will save relevant companies in tax payments of about RMB500 billion in a year.

Nevertheless, please note that after the promulgation of Circular 36, there are still two sets of VAT regulations, namely (i) the current VAT regulations which govern the traditional VAT taxable transactions (including sales and importation of goods and provision of processing,

¹ Please however note that the current VAT regulations governing the traditional transactions subject to VAT (including sales and importation of goods and provision of processing, repair and replacement services) still apply.

repair and replacement services); (ii) Circular 36 which governs sectors/industries that are under the new VAT reform. It is expected that the MOF and SAT will formulate a unified set of VAT regulations applying for all business activities in future.

What's New?

Scope of tax and applicable tax rates

Circular 36 sets out the taxable scope of activities under the VAT reform as below:-

- Provision of various types of services (**VAT Services**), which are further divided into several sub-sectors as depicted in the **Appendix**, subject VAT at 6% or 17%;
- Transfer of intangibles, subject to VAT at 6%;
- Transfer of real properties, subject to VAT at 11% but transitional rules may be issued to provide for a reduced rate which will be discussed below.

Taxpayers

Entities and individuals who provide VAT Services inside China are subject to VAT. For those foreign entities who provide VAT Services but do not maintain an establishment in China, the relevant Chinese service recipients shall have the obligations to withhold the VAT for the foreign entities.

In the following situations, foreign service providers are not considered providing onshore taxable services in China and thus are not subject to VAT:

- VAT Services provided to Chinese recipients are purely for overseas consumption;
- Intangibles transferred to Chinese recipients are completely used outside of China;
- Tangible goods leased to Chinese lessees are located outside of China.

VAT payers are still classified into two categories, namely: (i) general VAT payers and (ii) small-scale VAT payers, depending on their annual sales turnover and abilities of keeping sound accounting system. The annual turnover threshold for the general VAT payer certification remains at RMB five million, regardless of the industry in which the taxpayer engages. Individual taxpayers are however not recognized as general VAT payers even though their annual business turnover is in excess of the aforesaid threshold.

Circular 36 also allows for tax consolidation among different taxpayers (e.g. in a head office and branches situation) and which will be subject to detailed rules to be issued by the MOF and SAT.

VAT calculation and credit mechanism

VAT is essentially a tax collected by businesses, but would eventually be passed on to and borne by the end users.

Unlike other jurisdictions, China uses a VAT invoicing system to monitor VAT payment. For an example, all VAT payers are required to apply for and "purchase" blank VAT invoices from the competent tax authorities and issue invoices to customers for sale of goods and services. The buyer, based on the official VAT invoices obtained from the seller, will then be able to claim VAT credit (i.e. offsetting the output VAT on sales from the input VAT evidenced by the VAT invoices collected from the seller). Specifically, the legitimate documents to enable a VAT payer to claim VAT credit (or VAT offsetting) in relation to the purchases include:

- Special VAT invoices issued by sellers of goods and services;
- Receipts issued by Customs Office for imported goods;
- Purchase invoices or sales invoices for agricultural products;
- Tax payment certificates on VAT withheld from payments made to foreign service providers.

No input VAT credit is available to taxpayers (such as small-scale VAT payers) which are subject to the simplified taxation method, whereby a reduced tax rate or levy rate is applied on sales proceeds with no input VAT credit.

Among others, Circular 36 also provides the following non-creditable input VAT items:

- VAT incurred for purchases that are applied for non-taxable items, collective welfare or personal consumption;
- VAT paid for passengers' transportation services, lending services (i.e., interests, handling charges and related consulting fee paid to lender), catering services, daily services to residents and entertainment services;
- VAT incurred for purchases that suffer abnormal losses;

- VAT incurred in relation to work-in-progress, finished products or construction products that suffer abnormal losses.

Concurrent sales and mixed sales

Where a taxpayer is concurrently engaged in more than one of the items of (a) sales of different types of goods, (b) provision of services, (c) transfer of intangibles, (d) transfer of immovable assets, and (e) tax exemption/reduction activities, it is considered undertaking concurrent sales business. Circular 36 requires such taxpayer to separately account for the sales revenue of each type of the goods/services for tax purposes. Failure to comply with the requirement will cause the total sales revenue to be subject to the highest rate of VAT and will lead to the denial of the application of the VAT exemption/reduction treatment.

If one business transaction involves both the sale of goods and provision of services, it will be treated as a mixed sale transaction and the applicable VAT rate will be determined based on the core business of the taxpayer (i.e. goods or service) and applied on the total income derived.

The above tax treatments for concurrent sales and mixed sale transactions are generally consistent with the past tax regulations under the dual system of indirect taxes.

Deemed sales and transaction price adjustment

Under the old BT regulations, BT on deemed sales is only imposed on the free transfer of real properties and land use rights, as well as provision of the construction services of properties developed and sold by developers. However, the VAT reform policy has expanded the deemed sales scope and provision of any free services, real properties and intangibles would now be subject to VAT based on the deemed sales revenue, except that the activities are rendered for public welfare.

In determining the deemed sales revenue or where the transfer price is abnormally low or high without a justifiable reason or in lack of a reasonable commercial purpose, the competent tax authority will make reference to the following methods (in the order below) to make the relevant price assessment:

- the average price of the taxable services of the same kind provided by the taxpayer at recent time;
- the average price of the taxable services of the same kind provided by other taxpayers at recent time; and

- the cost-plus price which is the actual costs plus a margin calculated based the predetermined cost/profit rate by the SAT.

Circular 36 defines "lacking reasonable commercial purpose" as, for the main purpose of seeking tax benefits, artificial arrangements are made to reduce, exempt, defer the VAT payable or increase the VAT refund amount. For the first time, the "reasonable commercial purpose" are defined and emphasized in the VAT regulations. This also shows the determination of the Chinese tax authorities to combat against aggressive VAT planning in the turnover tax area.

What should be noted by the traditional VAT payers

Traditional VAT payers are those who have been registered as VAT payers during the dual system of indirect taxes. They are essentially engaged in manufacturing and trading activities. With the VAT reform expanded to real properties, construction and entertainment sectors, Circular 36 has made it clear that the traditional VAT payers can claim input credit for the VAT paid for purchasing (a) real properties and construction projects (subject to a two-year deduction schedule) and (b) motorcycles, cars and yachts which are for the self-use of taxpayers and subject to consumption tax. Both of the above items are explicitly prohibited in the existing VAT regulations applicable to the traditional VAT payers.

The traditional VAT payers especially those do not have sufficient input credits or those are eligible for VAT refunds may reconsider their purchase plans to take advantages of the above rules. It is also worth noticing that the traditional VAT payers must separately account for VAT for business income before and after the reform and the input credit balance before May 1, 2016 (which are related to the traditional VAT taxable transaction) can only be recovered by the VAT payable on the same type(s) of income. In other words, the VAT payable on the income from real properties, construction, financial services and consumer services sectors cannot be used to recover the VAT credit brought forward from the previous periods of the traditional VAT payers.

Transitional rules

To ensure that taxpayers can enjoy the same tax benefits and will not significantly increase their tax burden before and after the reform, Circular 36 sets out a detailed list of items which are entitled to preferential treatments during the transitional period for implementing the new VAT reform. Such preferential treatments include VAT exemption, immediate refund of VAT payable levied in excess of the actual rate of 3%, and VAT reduction, which basically follow the previous regulations under the BT regime. Circular 36 also clarifies that for taxpayers

who have been enjoying BT incentives, equivalent VAT incentives will be offered to such taxpayers during the remaining incentive period.

Furthermore, Circular 36 provides another option to general VAT payers of certain sectors (mostly real properties and construction) that they may pay VAT by applying the simplified taxation method, i.e., paying VAT by using the tax rate equivalent to the BT rate under the BT regime, for certain contracts and projects.

Circular 36 preserves most of the existing BT preferential treatments and offers the same to VAT payers. This is one of the key steps to ensure a smooth transition of taxpayers from the past BT regime to the VAT regime.

Preferential treatments for cross-border services

VAT exemption or refund treatments are still available to domestic service providers that export services or intangibles to overseas service recipients.

Circular 36 however introduces a new requirement that the relevant services or intangibles must be used/consumed entirely out of China for domestic taxpayers to enjoy such preferential treatment. In particular, the new requirement requires that the recipient of the export services or intangibles must be physically located outside China and should not be connected with any moveable or immovable assets inside China. It is expected that a large number of taxpayers who were qualified for the preferential treatment under the old pilot VAT reform rules will lose the entitlements under this new restriction.

Going Forward

Financial Impact on Taxpayers

As promised by the MOF and the Chief of the SAT, the VAT reform will not increase the tax burden to taxpayers after its implementation. With BT being replaced by VAT, the double taxation cases should be greatly reduced and accordingly, the overall tax efficiency will be improved. Although the applicable VAT rates for certain industries will be higher than the current BT rates, with the ability to claim the VAT credit for most of the purchases as well as the aforesaid transitional rules, it is anticipated that the tax burden of taxpayers should not be significantly affected.

Nevertheless, it is worth to note that the VAT credit system imposes a higher requirement on taxpayer's bookkeeping and invoicing system - the taxpayers should be able to keep good records and control of VAT invoices and accurately calculate the input and output VAT, etc.

In other words, taxpayers' daily routine maintenance and compliance costs will be inevitably increased as a result of the substitution of BT by VAT.

Immediate Actions

As there is less than one month window to prepare for the VAT reform, taxpayers in the four new sectors have to take immediate actions, including but not limited to:-

- Affected parties in the four industries/sectors need to review the existing contracts, especially the long-term agreements to ascertain whether contracts are to be amended and how; perform financial analysis on the potential impact of such conversion from BT to VAT; prepare several scenarios for adjustments of the buy/sell prices of the concerned goods and services; consider to issue a written notice to each of the vendors/customers on the change of payment/billing process, etc.
- Finance/tax department should check the existing used and unused BT invoices and prepare for filing and cancellation of BT invoices especially those bearing taxpayers' brand names with special tax approval.
- Finance department needs to review the current BT payment status and perform BT reconciliation.
- Taxpayers should attend tax trainings organized by in-charge tax authorities to understand the local implementation practice and action timeline. Taxpayers are also encouraged to consult external tax counsels on any questions and to seek assistance or get resources to cope with the new changes.

We believe the taxpayers in the affected industries/sectors would have a lot to prepare in advance and get used to this new tax reform but, at the same time, they should be excited to see whether and how their tax position will be positively or adversely affected. We will keep close watch on any new development.

Appendix - VAT Reform Taxable Scope and VAT Rates

Taxpayer	Category	Sub-category & Notes	VAT Rate
Small-scale VAT payer		All types of taxable business activities	3% ²
General VAT Payer	Sales of Services	Transportation Service	11%
		Post Service	11%
		Telecommunications Service	
		-- Basic	11%
		-- Value-added	6%
		Construction Service	11%
		Financial Service (including sale-and-leaseback transactions)	6%
		Modern Service	6%
		Including: R&D service, information technology service, culture design service, logistics service, leasing, verification and consulting service, broadcasting and television service, ancillary business service, others	
		Exceptions	
		1) Operating and financing lease of real properties	11%
		2) Operating and financing lease of tangible personal properties	17%
		Consumer Service	6%
Including: culture and sports service, education and medical service, tourism and entertainment service, food, beverage and hotel service, daily service to residents, others			
Transfer of Intangibles	excluding land use rights	6%	
Transfer of Real Properties	including land use rights and lease of real properties	11%	

² No VAT credit is allowed.



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