

BUSINESS TAX TO VAT PAST, PRESENT, FUTURE

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 **S.J. GRAND**
Financial and Tax Advisory

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I. OVERVIEW



PRC Taxes

RANGE OF PRC TAXES

INCOME TAX

Corporate Income Tax

Individual Income Tax

TURNOVER TAX

Value-Added Tax

Business Tax

Consumption Tax

TAXES ON REAL ESTATES

Land Appreciation Tax

Real Estate Tax

Arable land occupation Tax

Urban and Township Land-
Use Tax

OTHER TAXES

Deed Tax

Stamp Duty

Custom Duties

Motor Vehicle
Acquisition Tax

Vehicle and Vessel
Tax

Resource Tax

Urban Construction
and Maintenance Tax

Vessel Tonnage Tax

Tobacco Tax

Inefficient and Complex: The Dual Tax System

- Historically dual Tax System in China
 - **Business Tax @ 3% - 20%** (services)
 - **VAT @ 0% - 17%** (sold and imported goods)

- **Problem**

Business Tax (BT) as inefficient turnover tax:

- Adding up on each stage of supply chain
- Tax burden at business level
- Bureaucratic and costly

 **Value Added Tax (VAT)**

- Collected by businesses but normally borne by final consumer

Transformation: The VAT Program

January 2012

- Commencement VAT Pilot Program with Shanghai as first pilot city (Circular 110, Appendix of 111, 131)

Key Components

- VAT replaces BT for modern services
- Two new VAT rates @ 6% and 11%
- 0% Tax rate or full exemption for export services

Covered Industries

- Certain Modern Services Industries
- Transportation Industries

August 2013

- Replacement and consolidation of series of pilot program rules in single circular; including production for broadcasting as eligible VAT services “CaiShui (2013) 37”

- Further clarification of services eligible for tax exemption “CaiShui (2013) 52”

June 2014

- Gradual extension of pilot program nationwide finished

Added Sectors

- Telecommunication under “CaiShui (2014) 43”

2014/2015

- Expectation of VAT replacing BT in several other sectors

Such as

- E-Commerce
- Real estate and construction
- Financial services and Insurance
- Hospitality services

II. THE VAT REGIME



TYPE OF VAT TAXPAYERS

General VAT Taxpayer

- General VAT taxpayer are those enterprises whose annual taxable sales value exceeds that of small-scale taxpayers.
- General taxpayer can purchase VAT special invoices from the tax bureau and issue them to buyers.
- Possibility to deduct the VAT paid on purchase from the VAT collected on sales provided a special vat invoice is provided by the vendor.

Small-scale VAT Taxpayer

- Small-scale taxpayers are:
 - The taxpayer engaged in manufacturing with an annual taxable sales amount \leq RMB 0.5m;
 - The taxpayers engaged in trading with an annual taxable sales amount \leq RMB 0.8m;
 - The taxpayers engaged in services with an annual taxable sales amount \leq RMB 5 m.
- NOT entitled to issue VAT special invoices by itself; can only issue ordinary VAT invoices purchased from the tax bureau.
- Subject to a lower VAT tax rate at 3%, without the right to deduct input VAT credit from the VAT output taxable amount.

NOTE: Although the VAT rate for small taxpayer (3%) is lower than that for General taxpayer (6% to 17%), the general taxpayer status may still be beneficial:

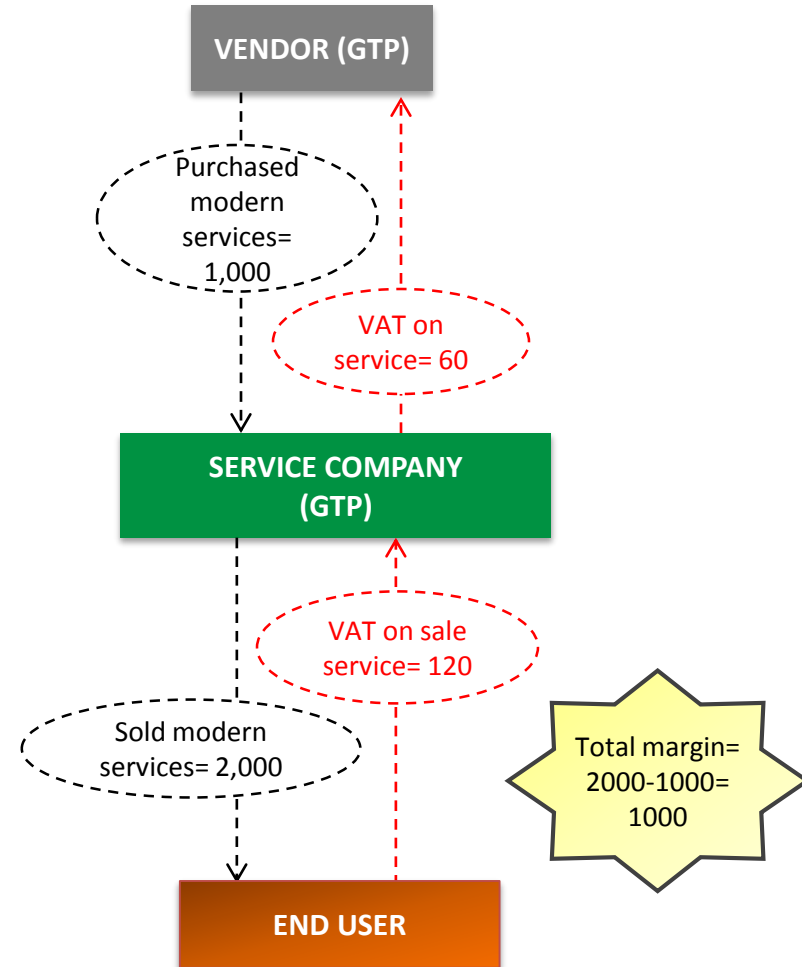
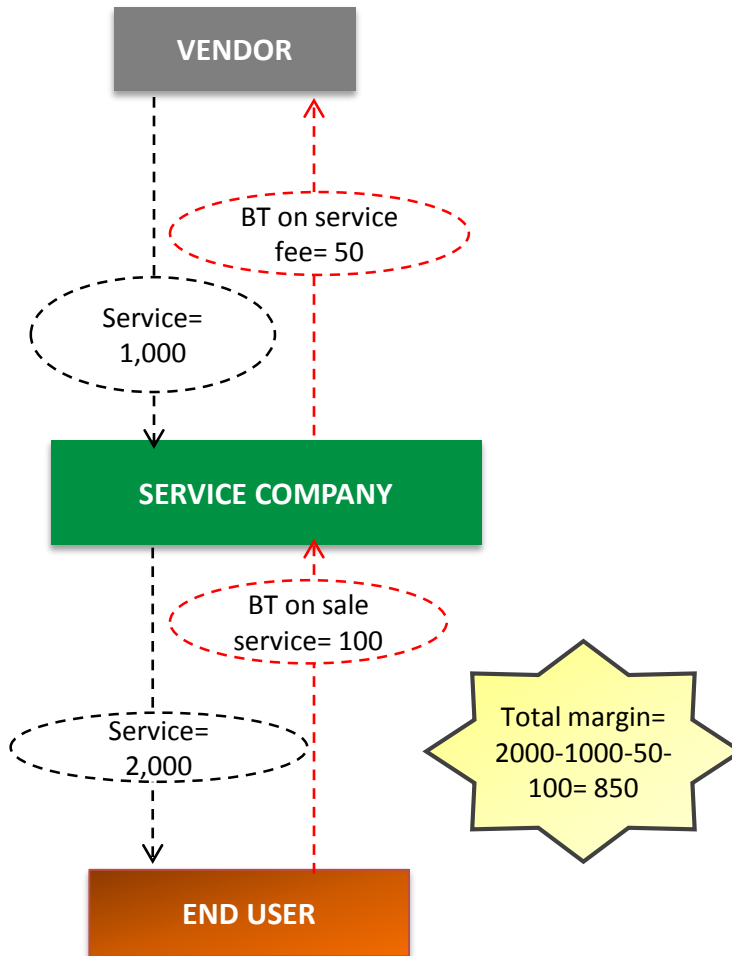
- Allowing companies to deduct the input VAT from output VAT; and
- Increasing companies' range of potential clientele as well as credibility by allowing them to issue VAT receipts (*fapiao*).

BUSINESS TAX (BT) Vs. VALUE-ADDED TAX (VAT)

BEFORE VAT REGIME (BT)

Vs.

AFTER VAT REGIME (BT TO VAT)

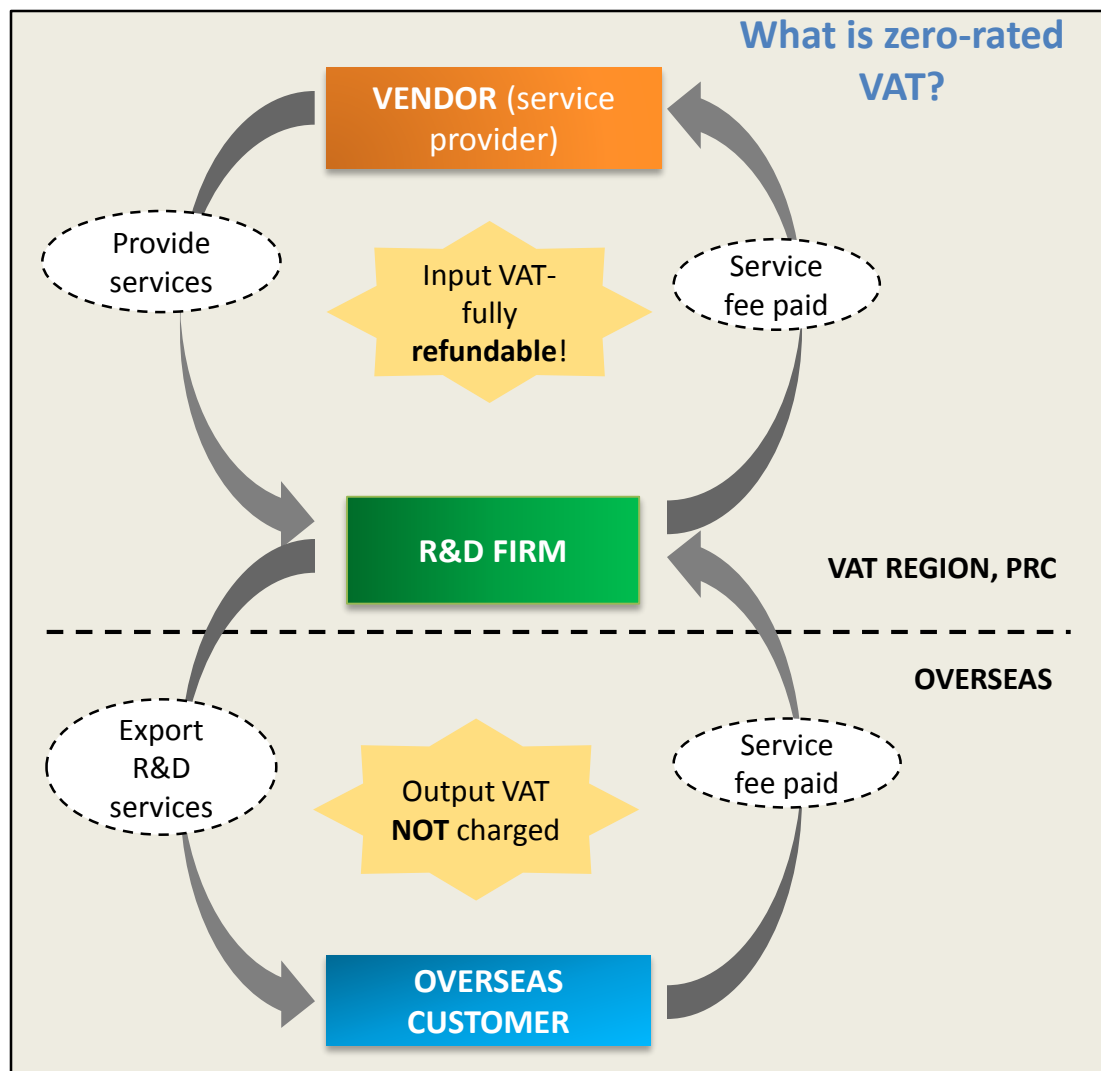


BT as additional cost; Profit reduced

VAT Payable = Output VAT – Input VAT

VAT REGIME: Applicable Treatment for Export Services

VAT ZERO RATING (Input VAT fully refundable)



Subject to qualifications:

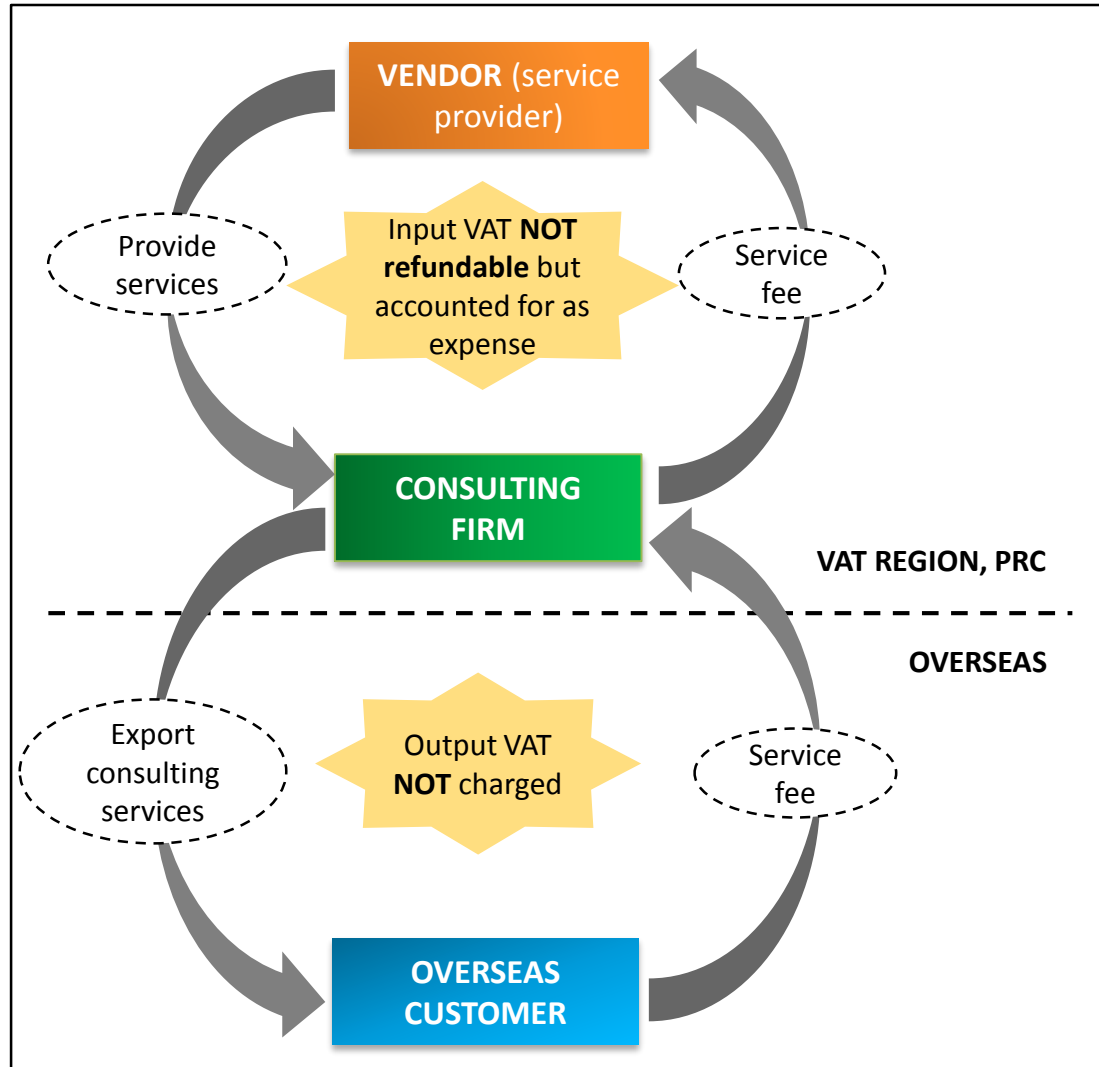
- R&D services
- Design services except the ones related to immovable properties located in China
- International transportation services (with licenses)

Refund procedure: “ECR” (exempt, credit, refund)

- Export sales are exempt from VAT
- Input VAT may be credited against output VAT on domestic sales (depends on services)
- The excess of input VAT over output VAT will be refunded

VAT REGIME: Applicable Treatment for Export Services

VAT EXEMPTION (Input VAT as expense)



Subject to qualifications:

- Technology transfer and consulting
- Transfer of trademarks and copyright
- Intellectual property services
- Certification, authentication, and consulting for assets outside China
- Advertisement and exhibition services
- International transportation services (without licenses)
- Logistics services and warehousing
- Contracted energy management
- Engineering and exploration services

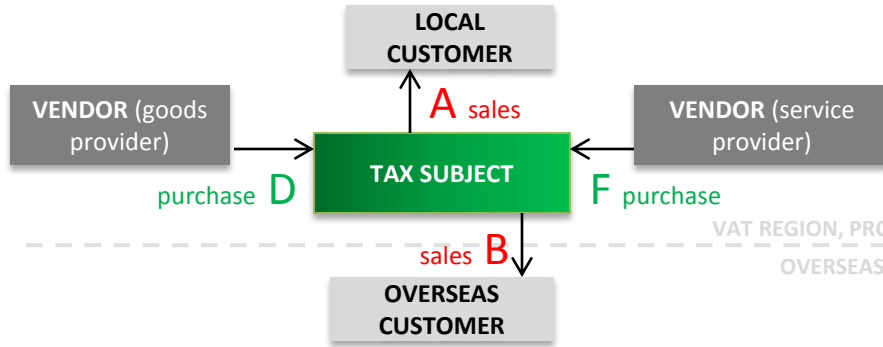
IMPACT OF ZERO RATING AND TAX EXEMPTION

- Zero rated VAT provides greater **potential** refund benefits than a VAT exemption

| ZERO RATED-VAT SERVICES | TAX EXEMPTED SERVICES |
|--|---|
| <ul style="list-style-type: none">• No output VAT is payable• Input VAT recoverable | <ul style="list-style-type: none">• No output VAT is payable• Input VAT NOT recoverable |
| <ul style="list-style-type: none">• Input VAT fully credible against domestic output VAT | <ul style="list-style-type: none">• Input VAT accounted as a CIT deductible expense |

- But application process for Zero-rating more complex

VAT Refund calculation (Zero-Rate)



Output VAT
 $A * 6\%$
 No VAT on B

= C

Input VAT
 $E + G$
 With
 $E = D * 17\%$
 $G = F * 6\%$

= H

Excessive Input VAT
 $C - H$
 = K

- Refundable:
- if $K < 0$ (Input VAT excess)
 - the smaller amount of IKI and J

VAT refund simulation: General Trade Processing

| Description | Item No | General trade Processing |
|---|------------|--------------------------|
| SALE AND OUTPUT VAT | | |
| Sales amount (domestic) | A | 200 |
| Sales amount (export) | B | 70 |
| Output VAT | $A * 6\%$ | 12 |
| DOMESTIC PURCHASE AND INPUT VAT | | |
| Purchase amount (goods) | D | 50 |
| Input VAT (goods) | $D * 17\%$ | 9 |
| Purchase amount (services) | F | 50 |
| Input VAT (services) | $G * 6\%$ | 3 |
| Total input VAT | $E + G$ | 12 |
| CALCULATION OF VAT | | |
| Refunding tax rate | I | 6% |
| Limit of VAT exempt/refund | $B * 6\%$ | 4 |
| Refunding tax (absolute value) IC-HI | K | 1 |

Note: Simplified depiction for illustration
 - other percentages may apply
 - calculation of surcharge not shown

III. TAX IMPLICATIONS



KEY INFLUENCE FACTORS

- VAT reform impact according to:
 - Tax status of supplier/customer (General or small scale-VAT payer, BT)
 - GTP \longrightarrow GTP : Reform reduces tax burden (offset of input & output VAT)
 - GTP \longrightarrow STP & BT : Tax burden for STP increased (prior 5% BT to 6% VAT, no offset)
 - STP \longrightarrow GTP & STP: Tax burden decreased (prior 5% BT to 3% VAT)
 - Breadth of services (international services)
 - Local \longrightarrow Foreign : Exemption or Zero-Tax rating depending on services
 - Foreign \longrightarrow Local : For local GTP and STP tax reduction
 - Scope of services (VAT rate)
 - According to services outlined by the authorities (compare following table)

SERVICES COVERED AND APPLICABLE TAX RATES

| Industry covered under VAT reform | VAT applicability | |
|--|-------------------|---|
| | Domestic sales | Exemption/ Zero rating |
| Leasing of tangible movable properties | VAT @ 17% | Exemption applies |
| TRANSPORTATION SERVICES | | |
| Transportation service industry (including road, water and air and pipeline transportation services) | VAT @ 11% | Zero rating VAT applicable for international transport |
| MODERN SERVICES | | |
| Research & development and technical services | VAT @ 6% | Zero rating VAT |
| IT services | VAT @ 6% | Exemption applies |
| Cultural and creative services | VAT @ 6% | Exemption applies; Zero rating VAT applies to design services |
| Logistics and ancillary services | VAT @ 6% | Exemption applies |
| Certification and consulting services | VAT @ 6% | Exemption applies |
| TELECOMMUNICATION SERVICES | | |
| Basic telecom services | VAT @ 11% | Exemption applies |
| Value-added telecom services | VAT @ 6% | Exemption applies |

With the annual revenue of less than RMB 5 million, an enterprise or individual qualifies as a small VAT taxpayer and accordingly, the tax rate decreases from 5% (“BT”) to 3% (“VAT”) with respect to modern services under the VAT pilot program.

IMPACT OF THE RULES ON BUSINESSES

- Nationwide different application of VAT rules
 - Shanghai requires application for tax exemption on contract base
 - Shenzhen, Guangzhou, etc. require only one time application for qualification certificate
 - Shanghai really strict on service scope (i.e. no tax exemption approval if services related to tangible assets located in PRC)
 - Tax exemption on case by case with yearly review
 - Loss of VAT invoice creates more risk than BT invoice due to its deductibility



Chose business location wisely



Keep all documents organized

IV. OUTLOOK



FURTHER SECTORAL REFORMS I

- E-Commerce (electronically provided services)
 - Had been expected together with telecommunication sector reform
 - Need for modernization of VAT system (currently foreign companies not even able to register for tax purposes)
- Real estate and construction
 - MoF signaled to apply 11% VAT (currently 5% and 3% BT)
 - Questions:
 - Breadth of application, since currently BT also applies on residential property
 - Impact on existing projects/contracts
 - Apply tax on gross revenue or margin of property sales
 - Challenges:
 - Time differences: input VAT credits create output VAT for long period (properties developed for long term leasing) **VS.** permanent excess VAT credit balance due to presale of property (output VAT before input VAT -> tax refund?)
 - Might have significant impact on housing prices

FURTHER SECTORAL REFORMS II

- Hospitality

- Sector has received comparatively little attention to date (5% BT)
- Questions:
 - How to tax mixed and composite supplied services (i.e. accommodation vs. conference and event facilitation)
 - Claim of VAT to which extend (currently i.e. air travel costs not creditable for VAT)
 - Taxation of reward schemes (BT doesn't have deemed sales rule which applies market values to gifts and giveaways)

- Financial Services and Insurance

- Expected to be last sector to move to VAT (mostly 5% BT)
- Questions:
 - China first to apply VAT on interests? Currently taxed at BT; largest revenue for china banks
 - Implementation of financial services VAT system as in New Zealand or South Africa (life insurance VAT exempted)?
- Challenges:
 - With tax on interest Shanghai might lose as financial center to NY, HK and London
 - Chinese and foreign insurers need to change claims management, contracting, pricing

V. RECENT TAX ISSUES



DEDUCTIBLE EXPENSES

| ITEMS | DEDUCTIONS |
|--|---|
| Missing Fapiao | Without legal proof, VAT is not deductible and payment of tax arrears might be imposed |
| Employee welfare (excluding social contribution) | Deductible subject to a limit of 14% of the deductible total payroll of the company |
| Entertainment | Deductible up to 60% of the actually incurred entertainment expense but deduction shall not exceed 0.5% of the sales or business income of that year |
| Charitable donations | Tax deductible up to 12% of the annual accounting profit provided donations are made through public interest social organizations or the People's Government and their departments above county level and used in the activities for public interest stipulated by the "Public Welfare Donation Law". |
| Advertising and business promotion expenses | (1) Deductible up to 15% of the sales income of that year. Any excess amount is allowed to be carried forward and deductible in the following tax years. (2) Enterprises engaged in the manufacturing and sale of cosmetics, manufacturing of pharmaceuticals, and the manufacturing of beverages are eligible to deduct advertising and promotional fee which are less than 30% of the sales incomes of the current year. The excess amount can be carried forward to future years for deduction. |
| Payment to affiliates | Service fees paid for genuine services provided by affiliates in China or overseas and charged at arm's length may be allowed for deduction. Management fee of stewardship nature are not deductible. |
| Interest on loans | Interest on loans from financial institution are deductible. For interest expenses on loan from non financial institution, the portion that does not exceed the commercial rate is deductible |

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CONTACT US



CHRISTOPHE MARQUIS

Managing Director

E: cmarquis@sjgrand.cn

T: +86 (0) 10 6507 8858

+86 (0) 21 6341 1177



HONG KONG | BEIJING | SHANGHAI | SHENZHEN

W: www.sjgrand.cn | M: info@sjgrand.cn | T: +86 (0) 10 6507 8858