

Tax Analysis

PRC Tax

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SAT issues guidance on application of zero-rated VAT treatment

China's State Administration of Taxation (SAT) released a bulletin on 28 August 2013 (Bulletin [2013] No. 47), which provides nationwide implementation guidance for the application of zero-rated VAT treatment on qualifying taxable services. Bulletin 47 applies retroactively as from 1 August 2013 and supersedes guidance issued in 2012 on the procedures for claiming zero-rated treatment for taxable services under the VAT pilot program (Bulletin 13).

Bulletin 13 provided that the following services are subject to the zero-rate VAT:

- International transport services (including cross-border and overseas transport of passengers and cargo)¹;
- R&D services provided for overseas entities; and
- Design services provided for overseas entities (except design services provided for domestic immovable property).

Bulletin 13 also clarified how the calculation of the "exempt, credit and refund" method is to be used out and required qualifying service providers to register with the competent tax authorities before applying that method.

Zero-rated VAT treatment provides greater potential refund benefits than a VAT exemption because when a service is zero-rated, no output VAT is payable, but input VAT incurred on costs is fully recoverable; as a result, there is no VAT cost. By contrast, when a service is VAT-exempt, no output VAT is payable, but the input VAT incurred on costs is not recoverable and, therefore, becomes a cost to the business.

Highlights of Bulletin 47

Although Bulletin 47 retains the main provisions of Bulletin 13, it makes the following changes/clarifications:

- Where international transport are provided using vehicles obtained under a voyage charter, time charter or wet lease,² the lessee, rather than the lessor, can apply for zero-rated VAT treatment.

¹ Transportation from/to/in Hong Kong, Macau and Taiwan is also eligible for the zero-rate VAT according to Caishui [2012] No. 86.

² A "wet lease" is a leasing arrangement that includes both the leased aircraft and the crew. During the lease period, the crew will work under the instructions of the lessee. The lessor will charge a leasing fee based on certain standards, while fixed costs incurred will be borne by the lessee.

- The "exempt and refund" method applies to trading companies that provide services eligible for zero-rated VAT treatment. The VAT refund mechanism under this method is generally less complicated than that under the "exempt, credit and refund" method, which requires taxpayers to run additional calculations to determine the amount of refundable VAT but effectively credited against the VAT payable arising from domestic sales.
- The tax base under the exempt, credit and refund method is the total proceeds collected for the provision of qualified services, whereas the tax base under the exempt and refund method is the amount on the VAT special invoice for domestically purchased services or the amount on the VAT withholding certificate for imported services.
- Where a nontrading company that provides zero-rated services also exports goods and provides processing, repair and replacement services to overseas, the VAT refund applicable to these different types of businesses can be calculated together because the applicable calculation method will be the same in all cases (i.e. the exempt, credit and refund method). However, when the tax authorities are examining and approving an export VAT refund, the total amount of the refund must be apportioned based on the relevant percentage of each business (i.e. the proportion of zero-rated services and the goods/processing, repair and replacement services to overseas).
- The "six-month monitoring period" for companies newly engaged in the provision of zero-rated services is abolished.
- Taxpayers can elect to relinquish the right to apply zero-rated treatment and elect for VAT-exempt treatment or pay VAT for the provision of zero-rated services. Once such an election is made, however, it cannot be changed for 36 months.

Comments

Although the concept of zero-rated VAT is understood in China, until the release of Bulletin 47, there were no detailed national implementation guidelines. Bulletin 47 also introduces some positive and welcome clarifications; for example, the bulletin clarifies that trading companies engaged in the provision of zero-rated services to overseas can be taxed by using the VAT exempt and refund method and it provides detailed calculation methods for companies to follow.

The VAT refund method for trading companies is aligned with the method used for the export of goods and the provision of services to overseas, a clarification that is consistent with the new provisions stipulated in Circular Caishui [2013] No. 37. Previously, trading companies had to use the exempt, credit and refund method for zero-rated services, but the exempt and refund method for the export of goods. In practice, a company could not apply for an export VAT refund using both methods simultaneously, so trading companies were required to switch to the exempt, credit and refund method for the export of goods before they could apply for a VAT refund for zero-rated services. This added to the compliance costs of trading companies.

The flexibility allowed under Bulletin 47 permits taxpayers to elect to relinquish zero-rated treatment and instead elect for VAT-exempt treatment or pay VAT on the provision of qualified services to overseas. This benefit of this option arises when a company's input VAT recovery is limited so that electing for an exemption will minimize compliance costs.

The elimination of the six-month monitoring period for companies newly engaged in the provision of zero-rated services is welcome. Under the original rule, a taxpayer in the monitoring period could apply for a VAT refund on a monthly basis, but the refund would not be issued until the expiration of the monitoring period. Now a tax refund can be granted on a regular basis, thus providing a cash flow advantage.

Despite the clarifications provided in Bulletin 47, however, several issues still need to be resolved. For example, the scope of qualified R&D services defined in the prevailing guidance (mainly Circular 37) is very broad, but Bulletin 47 does not provide any further clarification. In practice, there are different views on whether a service (such as a clinic trial) can be classified as R&D services or technical services, and the tax treatment of the two are different (i.e. zero-rating for R&D services and VAT-exempt for technical services).

Another practical issue with regard to the application of zero-rated treatment is the limitation for branch offices. According to Bulletin 13, a Certificate of Technology Contract Export Registration issued by the Ministry of Commerce (MOC) or its local branches is required for the application of zero-rated treatment. Although not stipulated in the rules, in practice, the MOC and its branches will issue such a certificate only to a legal entity, not to a branch office, which effectively means that a branch office cannot apply zero-rated treatment. Bulletin 47 does not address this issue.

Recommendations

Companies providing services to overseas customers that have not enjoyed the preferential zero-rated VAT treatment should take the following steps:

- Review the nature of services provided to overseas and assess whether the services can qualify for zero-rated treatment. Although there continues to be some areas of uncertainty, if a company can demonstrate a good business case, an argument can be made for zero-rating;
- Establish proper internal control processes and track all information required to request zero-rated treatment;
- Collect the necessary information and apply for zero-rated treatment; and
- Explore options, such as business model restructuring, by separating zero-rated services from other services or businesses to maximize the VAT savings, etc.

Deloitte's Indirect Tax Team will continue to monitor the development of the VAT treatment of zero-rated services. We can provide related tax advisory services and assist with communications 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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