

Tax Analysis

PRC Tax

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MOF and SAT issue new VAT reform rules

China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) issued guidance on 13 December 2013 (Caishui [2013] No. 106 (Circular 106)) that contains a new set of rules that will apply to the VAT reform. This guidance follows on the heels of the 4 December announcement by the State Council that the VAT reform will be expanded to include railway transportation and postal services as from 1 January 2014. Circular 106 also will apply as from 1 January 2014, except for a few provisions that apply retroactively.

Notably, Circular 106 will supersede Circular 37, the circular that formalizes the nationwide implementation of the VAT reform and provides detailed rules on the national rollout.¹ Circular 37 will be abolished as from 1 January 2014, although many provisions from Circular 37 will remain intact in Circular 106, except for the provisions discussed in this analysis.

Circular 106 specifies that railway transportation and postal services - the two new sectors brought within the scope of the VAT reform - will be subject to the 11% VAT rate and that pick-up and delivery services will be subject to the 6% rate. Circular 106 also contains rules and clarifications that will affect sectors other than the railway transportation and postal services sectors, in particular, finance leasing companies, international freight forwarders and shipping agencies.

Highlights of Circular 106

Finance leasing

For finance leasing of tangible and movable property provided by qualified taxpayers,² the service revenue, which is the basis for the VAT calculation, is the total proceeds net of certain items. As indicated in the following table, Circular 106 makes certain adjustments to this calculation, which apply retroactively from 1 August 2013:

¹ See Deloitte Tax Analysis issued on 3 June 2013:

[http://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Tax/Tax_analysis_2013/cn\(zh-cn\)_tax_tap1832013eng_030613_new.pdf](http://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Tax/Tax_analysis_2013/cn(zh-cn)_tax_tap1832013eng_030613_new.pdf)

² "Qualified taxpayers" are finance leasing companies approved by the People's Bank of China, China Banking Regulatory Commission or Ministry of Commerce, and finance leasing companies that have a minimum registered capital of RMB 170 million and that are approved by the provincial commerce authorities or equivalent authorities in a national economic development zone.

Items excluded from total proceeds		
Circular 106 ³		Circular 37
Leaseback ⁴	Non-leaseback	
<ul style="list-style-type: none"> • Cost of leased object (i.e. the principal) collected from the lessee, as supported by invoices issued by the lessee • Loan interest payments (including foreign exchange loans and RMB loans) • Bond interest payments 	<ul style="list-style-type: none"> • Loan interest payments (including foreign exchange loans and RMB loans) • Bond interest payments • Insurance expense • Installation expense • Vehicle purchase tax 	<ul style="list-style-type: none"> • Loan interest borne by the lessor (including foreign exchange loans and RMB loans) • Customs duty • Import consumption tax • Insurance expense • Installation expense

Circular 106 provides that a VAT special invoice may not be issued by the lessor to collect principal from the lessee in a leaseback, although a general invoice may be issued.⁵

Qualified general VAT payers engaged in finance leasing activities still may be able to claim a VAT refund if the VAT burden percentage (i.e. the VAT paid by the taxpayer expressed as a percentage of the total lease payments received) exceeds 3%. However, Circular 106 provides that this policy will expire on 31 December 2015.

Deloitte observation

According to guidance issued by the SAT in 2010 (Bulletin [2010] No. 13), an asset sale by a lessee to a lessor in a leaseback arrangement is not a VAT-able transaction, so a VAT special invoice cannot be issued.

Therefore, a general VAT payer engaged in finance leasing will be subject to 17% VAT on all lease payments (i.e. principal and interest) received from the lessee, but will not be able to credit input VAT corresponding to the purchase price of the leased object (i.e. principal) in a leaseback according to existing VAT regulations.

This rule gave rise to considerable concern by the finance leasing industry which believes that, as a financing arrangement in substance, the principal itself should not be taxed; otherwise, the tax burden for finance leasing would be increased significantly. Circular 106 resolves this issue by adding principal to the list of deductible items for VAT calculation purposes, which should be welcomed by the finance leasing industry.

However, Circular 106 eliminates several expenses (e.g. customs duty, import consumption tax) from the list of deductible items.

Practical guidance is needed for the issuance of an invoice in a leaseback transaction.

International freight forwarding / shipping agency

Circular 106 grants net basis treatment to general VAT payers engaged in international freight forwarding or in a shipping agency business. Under this treatment, the taxpayer is allowed to deduct international transport fees paid to transport service suppliers from the total proceeds in order to calculate the output VAT; that is, output VAT will not be levied on the gross revenue, but instead on the net revenue from the activities after the VAT payer deducts certain expenses.

Circular 106 also allows all international freight forwarding or shipping agency companies to enjoy a VAT-exempt treatment. To apply for the exemption, *all* of the taxpayer's service proceeds received from customers, as well as international transport fees paid to transport service suppliers, must be settled through a financial institution ("settling requirement"). After the exemption is granted, VAT general invoices showing the full amount of the service proceeds should be issued if the customer requested an invoice. The exemption treatment is applicable retroactively from 1 August 2013; if any VAT special invoices have been issued, the exemption cannot be granted until the invoices have been withdrawn.

³ For a finance leasing company approved by the provincial commerce authorities or equivalent authorities in a national economic development zone, this provision is applicable retroactively from 1 August 2013 if its registered capital reached RMB 170 million before 31 December 2013; otherwise, the provision will apply after the company's registered capital reaches that amount.

⁴ A "leaseback arrangement" is a financing arrangement under which a company (i.e. the lessee) sells an asset to a finance leasing company (i.e. the lessor) and then leases the asset back.

⁵ A VAT special invoice is an invoice with which the buyer may be able to claim a credit for the VAT shown on the invoice. A general invoice cannot be used to support the VAT credit.

Deloitte observation

International transport services usually are zero-rated or VAT-exempt. As a result, general VAT payers engaged in international freight forwarding and shipping agency business will not have input VAT from international transport services they purchased and their VAT burden largely will be determined by the output VAT. The net basis treatment, which is considered preferential, applied to international freight forwarders and shipping agencies before 1 August 2013, when it was removed by Circular 37. This removal resulted in a much higher output VAT for affected enterprises, which has to be calculated on the gross amount of the proceeds, leading to many service charge increases. The welcome re-introduction of the net basis rule by Circular 106 should help to eliminate the adverse impact on the industry and market.

International freight forwarders and shipping agencies also may choose to apply for a VAT exemption. However, it is not uncommon for multinational freight forwarders to provide service reciprocally among the group and offset the relevant receivables and payables. It is unclear whether such an offset will disqualify the settling requirement so that the exemption may not be granted.

Postal / express delivery services

A. Postal services

As a new industry brought within the scope of VAT, postal services will be subject to the 11% VAT rate. Circular 106 defines postal services as basic postal services (e.g. the delivery of post, postal remittances, etc.) provided by the China Post Group (CPG) and its group companies.

B. Pick-up and delivery services

A new sub-category of "pick-up and delivery services" is introduced under the tax category of "certain modern services - logistics ancillary services," which will be subject to the 6% VAT rate. These services are broken down into the following:

- Picking up post and parcels from a customer and couriering them to distribution centres in the same city in which the service supplier is located;
- Sorting post and parcels by the service supplier within the distribution centre; and
- Delivering the post and parcels to a recipient within the same city.

Deloitte observation

Express delivery services are considered postal services under the current Business Tax (BT) rules and are subject to a 3% BT. However, there has been inconsistent tax treatment of these services, because it is often difficult to distinguish express delivery services from similar activities that are subject to different tax treatment (e.g. transportation). As a result, some companies continue to pay 3% BT after the VAT reform, while others pay 11% (transportation) or 6% (logistics ancillary) VAT.

With the updated definition of postal services in Circular 106, express delivery services provided by non-CPG entities clearly will be excluded from the scope of postal services under the VAT reform. However, it seems that such services (in particular, express delivery between different cities) may not squarely fit in the new category of pick-up and delivery services. It seems possible that an express delivery between different cities could be considered a combination of transportation services (11%) and pick-up and delivery services (6%), which may increase the complexity of the tax treatment. Future clarification and guidance is needed.

Offshore service outsourcing

According to Circular 106, the VAT exemption treatment applicable to offshore service outsourcing will be rolled out to the entire country from 1 January 2014 and VAT-exempt treatment extended from 31 December 2013 to 31 December 2018. Circular 106 provides a detailed list of VAT-exempt offshore service outsourcing items, which seems to be a response to issues encountered in interpreting the scope of offshore service outsourcing.

Voyage / time charter and wet leases in international transportation

Under a voyage/time charter or wet lease arrangement where the lessor is a domestic entity or an individual, zero-rated treatment may be granted if the transportation vehicle is used for international transportation and the applicant (with general VAT payer status) has the relevant international transportation license. Circular 106 changes the determination of an applicant who is able to enjoy the zero-rated treatment, with retroactive application from 1 August 2013:

	Circular 106 Applicant	Circular 37 Applicant
Voyage charter	Lessor	Lessee
Time charter / wet lease - domestic lessee	Lessee (if providing international transportation services to others)	Lessee
Time charter / wet lease - foreign lessee	Lessor	Lessee

Miscellaneous

A. New VAT-able items

In addition to the new industries, Circular 106 clarifies several other items to be covered under the VAT reform. Newly added VAT-able items are as follows:

Category (VAT rate)		Newly added items
Transportation	Land transportation (11%)	Railway transportation
	Air transportation (11%)	Outer space transportation (i.e. launch of spacecraft)
Postal service	General postal services (11%)	Delivery of post and parcels, issuance of postal stamps, distribution of newspapers, postal remittances, sales of postal articles, etc.
	Special postal services (11%)	
	Other postal services (11%)	
Certain modern service	R&D and technology services (6%)	Technical consulting - technical testing; technical training
	Information technology services (6%)	Business process management services - audit management; tax management; digging, management or use of internal data
	Cultural and innovation services (6%)	Design services - design of web games
	Logistics ancillary services (6%)	<ul style="list-style-type: none"> • Aviation services - aviation training; • Transportation stop or station services - cargo packaging, railway-related items • Pick-up and delivery services
	Certification, attestation and consulting services (6%)	Consulting - language translation or interpretation services

B. Net basis treatment

i. Supporting documents

With the introduction of the net basis treatment for certain industries (e.g. international freight forwarding, passenger transportation station services) under which specified payments are deductible or excluded from the sales proceeds for VAT calculation, Circular 106 set out the general documentation requirements to support a claim for net basis treatment:

- Where the payments are made to domestic parties, valid invoices (i.e. Fapiao) must be provided;
- Where the payments are made to foreign parties, signed receipts by the recipients must be provided, although the tax authorities may require the taxpayer to provide certifications issued by foreign notary agencies, if necessary;
- Where the payments are made for tax or government charges, tax payment certificates or relevant finance documents must be provided.

ii. Transitional rules for net basis treatment applicable before 1 August 2013

With respect to net basis treatment (excluding finance leasing) that was applicable in pilot areas⁶ before 1 August 2013, but discontinued after the date, deductible items incurred before 1 August 2013 (supported by valid invoices or other documents issued before 1 August 2013) still may be deducted from the sales proceeds for VAT calculation purposes through 30 June 2014.

C. Simplified tax method

Circular 106 introduced following new items for which a general VAT payer may elect to apply a simplified tax method (i.e. under which the VAT payable is calculated as 3% of VAT-exclusive sales without any input VAT credit):

- Movie broadcasting services;
- Warehousing services;
- Loading, unloading and moving services;
- Pick-up and delivery services; and
- Animation production and relevant services (e.g. design, painting, dubbing, domestic copyright transfer, etc.) by recognized animation companies through 31 December 2017.

D. Filing

If a company's head office and branches are located in the same province, subject to the approval from the provincial finance authorities and the SAT, the company may ask to file its VAT return on a consolidated basis with the tax authorities in the place where its head office is located.

Comments

Circular 106 is an important and significant circular due to the range of issues covered and welcomed clarifications. Given the short time before most of the new rules in Circular 106 apply, affected businesses should take the following steps:

- Review operations and supply chains and assess the impact of the new rules, especially where changes are made to the existing/previous rules;
- Understand the new rules and proactively apply for beneficial treatment to obtain the benefits of the reform;
- Seek clarification from the tax authorities regarding the unclear points in the new rules;
- Monitor further developments and consult with experts if necessary.

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

⁶ Pilot areas include Anhui, Beijing, Fujian, Guangdong, Hubei, Jiangsu, Shanghai, Tianjin and Zhejiang.

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