



VAT concessions for exported services announced

Regulation discussed in this issue:

- Notice issued by the Ministry of Finance and the State Administration of Taxation on VAT Zero-rating or VAT Exemption for Taxable Services (Cai Shui [2011] No.131)

Background

On 29 December 2011, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued Cai Shui [2011] No.131 (Circular 131) setting out Value Added Tax (VAT) concessions for exported services provided to overseas entities under the VAT pilot program in Shanghai.

Circulars Cai Shui [2011] No.110 and Cai Shui [2011] No.111, which set out general guidelines and a roadmap for indirect tax reforms in the People's Republic of China (PRC), stated that export services would enjoy either VAT zero-rating or VAT exemption treatment based on rules which are to be later specified by the MOF and SAT. Businesses in Shanghai have been eagerly awaiting the release of these rules, which have been issued at an opportune time since the VAT pilot program in Shanghai commenced on 1 January 2012.

Circular 131 is based upon the guiding principle that services provided to overseas entities may be treated as either zero-rated or exempt from VAT if the subject matter of the services does not relate to goods or immovable property located in the PRC. In this respect, the rules bring China's VAT regime for exported services in line with international best practices.

Interestingly, Circulars 110, 111 and 131 provide for more favourable treatment for exported and imported services under VAT than occurs under Business Tax (BT). Under the current BT regime, which still applies throughout the rest of the PRC, if either the service provider or the service recipient is in the PRC, then BT applies. Typically, this means that BT applies if either the export of services from the PRC, or the import of services to the PRC, is subject to BT.

Zero-rating versus exemption from VAT

There is an important difference between the applicable outcome for zero-rated services and those services exempted from VAT. These differences are shown as follows:

	Output VAT	Creditable input VAT
Zero-rating	No	Yes
Exempt	No	No

Businesses that engage solely or predominantly in making zero-rated supplies or services may need to be able to access refunds of input VAT credits. According to Circular 131, the procedures for claiming such refunds will be specified in the near future. The ability to claim VAT refunds, other than in relation to exports of goods or services, is not otherwise generally available in the PRC.

Businesses that engage in providing exempt services and other services will need to identify and track input VAT credits and apportion any expenses which have a duality of purpose or function. International experience highlights some of the difficulties involved in appropriately apportioning expenses, particularly many general overhead expenses, between different revenue items.

Services qualifying for the VAT zero-rating or VAT exemption

Circular 131 specifies that the following services, which are subject to the pilot program, are eligible for either VAT zero-rating or VAT exemption:

Industry (as per Cai Shui [2011] No.111)	VAT treatment (as per Circular 131)	
	VAT zero-rating	VAT exemption
Leasing of tangible movable property		<ul style="list-style-type: none"> Leasing of tangible movable property with the object of the lease being used outside the PRC
Transportation services	<ul style="list-style-type: none"> Qualified international transportation 	<ul style="list-style-type: none"> Unlicensed international transportation
Research and development (R&D) and technical services	<ul style="list-style-type: none"> R&D and design services provided to overseas entities 	<ul style="list-style-type: none"> Engineering as well as exploration services with the related project or mineral resources located outside the PRC Technology transfer, technology consulting, energy management services (except where the object of the energy management contract is located in the PRC) provided to overseas entities
Information technology (IT) services		<ul style="list-style-type: none"> Software services, circuit design and testing services, business process management services provided to overseas entities
Cultural and creative services	<ul style="list-style-type: none"> Design services provided to overseas entities (except for design services in relation to immovable property located in the PRC) 	<ul style="list-style-type: none"> Convention and exhibition services located outside the PRC Trademark and copyright transfer services, intellectual property services provided to overseas entities Advertising services where the related advertisement is released outside the PRC

Logistics and ancillary service		<ul style="list-style-type: none"> • Warehousing services where the location of the warehouse is outside the PRC • Logistics and ancillary services provided to overseas entities (except warehousing services)
Certification and consulting services		<ul style="list-style-type: none"> • Certification, verification and consulting services provided to overseas entities (except for services in relation to goods or immovable property located in the PRC)

Circular 131 defines international transportation as follows:

- 1) Transportation of passengers or goods out of China
- 2) Transportation of passengers or goods into China
- 3) Transportation of passengers or goods outside China

It is not specified whether the domestic component of an international transportation of a passenger, as part of a broader itinerary involving international travel, qualifies for zero-rating or exemption, for example, when a passenger flies from Shanghai to Beijing in connecting to an international flight. Likewise, a cruise ship visiting multiple ports in China, or where there is a minor land transportation component in Shanghai as part of a broader international voyage, have unclear treatment. Many of the same issues will arise in relation to the international transportation of goods, which can result in significant compliance issues.

Circular 131 specifies that the international transportation service provider needs to fulfil relevant license requirements in order to enjoy zero-rating. International transportation providers failing to fulfil the related licensing requirements will only be able to qualify for VAT exemption.

A related circular, Cai Shui [2011] No. 133, also issued on 29 December 2011, provides that airlines with head offices in Shanghai, for example, China Eastern Airlines and Shanghai Airlines, are subject to the pilot program. International airlines with only a branch in Shanghai are not subject to the pilot program.

It should also be noted that the concept of “international transportation” would seem to be limited to the actual transportation of passengers or goods. As such, services provided by travel agents in arranging transportation, or the loading or unloading of cargo, may not qualify for zero-rating or exemption under this category. Instead, these services would need to be considered under the certification and consulting services and logistics and ancillary services categories, respectively.

Procedures for claiming VAT zero-rating or exemption

Circular 131 is silent on the procedures or documentation requirements for claiming VAT zero-rating or exemption.

In the past, services such as those involving technology transfer and offshore outsourcing have enjoyed exemption from BT. However, the availability of those exemptions has depended on the service provider submitting applications, together with the relevant contracts, to the SAT and other government bodies for approval. It is unclear whether those same procedures will apply to the full range of services now eligible for either zero-rating or exemption from VAT under Circular 131. At the very least, service providers

should be prepared for their contracts to be scrutinised, which may require not only that the service recipient be an overseas party and the object of the service not be goods or immovable property in the PRC, but that payment be provided by that overseas recipient.

KPMG Observations

To build Shanghai into an International Transportation Centre and to promote the development of R&D and design services, the MOF and SAT are providing zero-rating VAT treatment and export VAT refunds to enterprises engaged in international transportation and exportation of R&D and design services. The fact that the VAT refund rate is the same as the applicable VAT collection rate of the related services means that there is no VAT leakage. This is good news for those companies competing in international markets.

Taxpayers will need to correctly differentiate the zero-rating of services such as **R&D and design services** from other VAT-exempt services such as **technology transfer, technology consulting, software services, circuit design and testing services** to correctly apply the relevant VAT treatment (e.g. zero-rating VAT or VAT exemption).

The MOF and SAT also provide for VAT exemption for a broader range of services. For such services, the related input VAT will be non-creditable and should be transferred out. We suggest that such companies assess how this transferring out of input will impact its profitability and pricing. For many service providers, particularly those providing certification and consulting services, the two primary costs are staff salaries and the rent of its business premises. Neither of these costs is subject to VAT, although conceivably rental of business premises may become subject to VAT at some stage in the future. At present though, the exemption of services (as compared with zero-rating) is unlikely to produce a significant increase in their costs.

Circular 131 emphasises, on a few occasions, the **location** of the services or the related object of the service in terms of being **inside or outside** the PRC in determining the eligibility for zero-rating or VAT exemption. For certification and consulting services, exemption is denied where the services pertain to goods or immovable property in the PRC. For example, if a consulting firm provides services to an overseas entity in relation to exchange controls requirements, business structuring and legal obligations in setting up business in the PRC, then a VAT exemption should be available. By contrast, if a certification firm provides quality testing services for goods to be exported from or imported into the PRC, then no VAT exemption would apply.

One issue which will be worth monitoring is where a service provider contracts with an overseas entity to provide services, but those services are effectively used or enjoyed, at least to some extent, by a related PRC entity of an overseas entity. This occurs quite commonly in large global supply contracts entered into by multinational companies. In the VAT or GST regimes in a number of countries, such as the UK, Australia and New Zealand, these concerns have resulted in specific legislation, rulings or enforcement provisions.

Our suggestions

Businesses in Shanghai should carefully determine the VAT treatment applicable to their service offerings based on an assessment of their essential nature. Businesses should also assess the impact on their profitability of providing exempt services given that the related input VAT cannot be credited.

Overseas entities engaged in purchasing services from the PRC should carefully consider whether it is preferable to engage with Shanghai service providers who may be eligible to supply their services on either a zero-rated or exempt basis. This is particularly true for related party services where there may be the option to choose the Shanghai branch.

VAT compliance is equally important. Service providers will need to fulfil both substantive *and* procedural requirements in order to enjoy the VAT concessional treatment set out in Circular 131. Careful attention is needed in the drafting of contracts to ensure that both the nature and prices of the services is clearly articulated. Similarly, invoicing and payment procedures must align with the terms of any contracts, given the likelihood of close inspection by the tax authorities.

Service providers in Shanghai should also provide adequate training to their staff and institute internal tax control procedures in response to these changes to ensure that tax concessions are claimed only where appropriate. Similarly, monitoring and tracking of input VAT credits will need to be carefully managed, particularly where businesses have a mix of taxable and exempt services.

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