



Part 1: VAT for transportation and logistics sector – key impacts

Background

The Value Added Tax (VAT) reforms are now operational in Shanghai, and it is expected they will be expanded to Beijing, Tianjin and Chongqing from 1 July 2012, followed by several other provinces in early 2013. Many businesses in Shanghai have now lodged their first few VAT returns, and with this comes the practical realisation of the challenges in implementing these reforms. For transportation and logistics businesses, the challenges are immense, covering the full spectrum of VAT complexity, including different VAT rates for various service categories; a mixture of input VAT credits, deemed input VAT credits and denied input VAT credits; services which may be zero rated, exempt or taxable; withholding obligations, and difficult accounting and invoicing processes.

The complexities for the transport and logistics sector arise due to a combination of factors.

There has been a significant change in the tax rate for transportation services, from a three percent Business Tax (BT) to 11 percent for VAT, coupled with a more modest change for logistics from a five percent BT to six percent VAT.

By their very nature, transport and logistics involve the movement of goods (or people) between places, whereas the VAT reforms currently only apply in one place.

These industries often generate small profit margins, which can be impacted if VAT cannot be passed on in full to the customer.

These sectors may be described as fragmented, meaning that a single delivery can involve multiple handling by different suppliers, and therefore multiple points of VAT compliance.

Businesses in the transportation and logistics sector switching to VAT will pay output VAT on their services straight away, but may not generate significant input VAT credits until such time as they replace their vehicles or fixed assets.

It must certainly be acknowledged that the Shanghai tax authorities are actively assisting businesses to resolve these issues. In fact, the tax authorities have recently announced the availability of subsidies (discussed below) to assist affected businesses whose tax liabilities may have increased as a result of the reforms.

The purpose of this KPMG China alert is to examine some of the impacts of the pilot program on transportation and logistics businesses in Shanghai, as well as identifying many of the relevant issues that have arisen and suggesting possible solutions. Part 1 (featured in this particular issue) looks at the scope of the pilot program for transportation and logistics services; Part 2 (to be published next month) looks at some of the specific impacts for various types of service providers in these industries. This is intended as a summary only.

Scope of the pilot program

Transportation vs Logistics services

The starting point for any business is to consider the scope of the pilot program, and in particular, whether they will be categorised as a transportation or logistics business, or potentially a mix of both. That is because transportation is subject to an 11 percent VAT rate, whereas logistics services are subject to a six percent VAT rate.

According to Circular Caishui [2011] 111, transportation services refers to the business activities of dispatching cargo or passengers to a destination by means of transportation vehicles, including by land, water, air and pipeline. Rail transportation has been specifically excluded from the pilot program at this stage. The types of transportation services covered by the pilot program comprise:

Types of transportation services	Areas specifically included in the pilot program (not an exhaustive list)
Land transportation	Includes the transportation of cargo or people by land (above or underground), including highway, cable car or cableway.
Water transportation	Includes the dispatching of cargo or people by rivers, lakes, streams and other natural and artificial water courses, as well as voyage charter (being a leasing arrangement whereby an ocean freight company provides dispatching services for a particular voyage to a charterer in exchange for a rental fee), and time charter (being a leasing arrangement whereby the ocean freight company provides a vessel with crew to the lessee for a fixed period of time in exchange for a daily rental fee).
Air transportation	The business of dispatching cargo or passengers by air, as well as wet leasing of air transportation services.
Pipeline transportation	The business of delivering gas, liquid and solid materials through pipeline facilities.

The concept of a logistics service is broadly defined under the rules of the pilot program, and specifically includes the following types:

Types of logistics services	Areas specifically included in the pilot program (not an exhaustive list)
Ground and general aviation services	Safety inspection, airport management services, cleaning, take-off and landing, flight communications, ground signal services, security, traffic control, air photography and surveys.
Port services	Communications, channel management, dredging, lighthouse management, pilotage services, cargo handling, clean-up and water transportation management.
Freight and passenger station services	Goods loading services, transportation management, transit services, fleet services, ticketing, parking services.
Salvation rescue services	Providing crew salvation, vessel property salvation, water rescue and shipwreck salvation.
Freight forwarding services	Providing intermediary transportation organisation services as authorised by the consignee and consignor without actually dispatching the goods.
Customs clearance services	Performing customs clearance procedures upon the commission of the consignee and consignor.
Warehousing services	Providing cargo custody services in a warehouse, yard or other storage place.
Loading and unloading services	Dispatching services between transportation vehicles and/or handling sites using material handling tools, manual labour, and animal power.

Sometimes there can be difficulties in differentiating between transportation services and logistics services. Under the old BT regime, the rules specified that a transportation service was supplied where the branch providing the service owned or leased the means of transport (see Circular Guoshuifa [2003] No.121). This same concept also underlies the way that the pilot program operates. Therefore, a good 'rule of thumb' is that if the business previously paid BT at a rate of three percent, then it is likely to be categorised as a transportation service, while if it previously paid BT at five percent, then it is likely to be categorised as a logistics service.

Where a business provides both transportation and logistics services, it needs to ensure that it can separately account for each – otherwise, the higher VAT rate of 11 percent would apply to all services.

Net basis of VAT

Under the old BT regime, the transportation sector paid BT at three percent, while the logistics sector paid BT at five percent. Importantly though, both industries paid BT on a 'net' basis. That is, BT was not levied on the gross revenue from these activities, but was instead imposed on the net revenue they derived. In effect, businesses in these industries were entitled to deduct certain expenses from their revenue in calculating their BT liability. The types of expenses which qualified for deductions were set out by the Shanghai tax authorities in Circulars Hudishuiyi [1995] No.60, Hudishuiyi [1999] No.86 and Hudishuihuo [2010] No.28, and by the State Administration of Taxation (SAT) in Guoshuifa [2003] No.121. Please note that different provinces may have applied different criteria.

Importantly, these principles are relevant now because the pilot program rules effectively provide for a continuation of this approach, albeit modified slightly to fit a VAT environment. In basic terms, the principle is that if the expense is subject to VAT, then potentially an input VAT credit can be claimed. However, if the expense is subject to BT, then a deemed input VAT credit may also be claimed, but only if the amount was previously deductible for BT purposes.

Clearly once the VAT reforms apply nationally to all sectors, then these complexities should be reduced significantly.

Cross-border service flows

The VAT pilot program rules, together with Circular Caishui [2011] 131, introduce a number of concessionary measures for cross-border transactions. These rules are deceptively simple in wording, but very complex to apply in practice. In summary form, they are:

Service	Criteria	Treatment
Services performed wholly outside of mainland China	Not specified	
Supply of international transportation services – licensed services	Licensed services refer to situations where the provider holds an international transportation operation licence.	Zero rated
Export of transportation services – unlicensed services	Unlicensed services refer to the situation where the provider does not hold an international transportation operation licence.	Exempt
Export of logistics services	<ul style="list-style-type: none"> For warehousing services, an exemption only applies if the warehouse is located outside of China. For other logistics and ancillary services, an exemption applies if the service is provided to an overseas entity. 	Exempt
Import of services	Services provided by a foreign entity without a business establishment in China to a customer in Shanghai.	Withholding obligation falls on agent in Shanghai, or if no agent, the customer. Customer can claim input VAT credit if they are a general VAT taxpayer and certain documentary requirements are met.

Some of the issues arising in the application of these rules in practice are:

- What if part of the service is performed in mainland China? Does the whole service cease to be outside the scope of VAT? For example, if a ship enters a port in Shanghai to pick up or deliver goods, is part of the service then performed in China? What if a separate charge is imposed for the Chinese component of the overall service – can the remainder be treated as being outside the scope of VAT?
- If transportation or logistics services are provided by a foreign entity to a customer in Shanghai, is it necessary for the customer to withhold VAT if the customer is a BT taxpayer? What if the customer is a small-scale taxpayer? What is the correct rate of withholding? What documentation is needed for the customer to claim an input VAT credit?
- What are the documentary requirements needed to prove eligibility for these concessions on the export of services? Is it necessary to seek approval in advance?

Transferring out input VAT

There are many situations where transportation and logistics providers may be required to transfer out their input VAT credits. Where this is required, often

difficult apportionment issues can arise in practice. Examples of situations where this may be necessary include:

- providing transportation to the employees of the transportation provider
- receiving passenger transportation services generally
- providing transportation or logistics services which are exempt from VAT (for example, certain exports)
- providing transportation or logistics services which are fully consumed outside of China
- providing services which are involved in abnormal losses
- self-use of transportation vehicles.

Subsidies for increased indirect tax liabilities

The tax authorities in Shanghai have recently announced in Circular Hucaishui [2012] No.5 that taxpayers whose VAT liabilities have increased under the pilot program (compared with BT) are entitled to apply for financial subsidies. While the scope of entities eligible to apply for these subsidies is unrestricted, we anticipate that many of the successful applicants will be businesses in the transport and logistics sector. Anecdotal evidence suggests that many taxpayers in the transportation and logistics sector have incurred additional indirect tax liabilities. KPMG is aware that some transportation businesses have been successful in obtaining these subsidies.

Next month, Part 2 will examine the specific impacts of the pilot program for various types of service providers in the transport and logistics sector.

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