



VAT and the digital economy in China



Contents

Introduction	2
.....	
e-Commerce	5
.....	
Payment services and virtual currencies	16
.....	
Crowdfunding	17
.....	
The rise of the agent/intermediary	18
.....	
Electronic invoicing	18
.....	
How KPMG can help	19
.....	
KPMG contacts	20
.....	



In this special publication, we examine the short- and long-term changes that we anticipate may occur in China's indirect tax system as a result of the digital economy. These changes will likely arise as a result of technological developments, in the ways in which goods and services are delivered and consumed, and in the modernisation of China's indirect tax system which was conceived in a pre-internet era.

In our view, the growth and expansion of the digital economy will have profound changes on how indirect taxes are managed, administered, collected and enforced. The issues which must be grappled with affect the most fundamental aspects of how China's indirect tax system currently operates.



Introduction

A number of factors are coming together which may drive significant change:

1. The digital economy in China is booming. Chinese consumers have shown themselves to be both early adopters of new technologies, and voracious consumers of e-commerce products and services. Some of the statistics are simply breath-taking – for example, the recent Singles Day in China where major online provider Alibaba recorded sales of USD 14.3 billion in just one day.¹ To put that into perspective, the sales volume in a single day in China through one company was equivalent to the entire gross domestic product (GDP) of many Caribbean countries for an entire year.
2. China is increasingly shifting from a cash-based society towards an economy dependent on very large traditional payment providers such as China UnionPay, as well as newer payment mechanisms offered by Alipay, WeChat, Sina Weibo and Tencent's Tenpay. In addition, there is an array of other virtual currencies, not to mention substantial growth in credit card usage.
3. Governments all over the world are focusing on the tax challenges of the digital economy. In 2015, the Organisation for Economic Co-operation and Development (OECD) and the G20 released their final report entitled *Addressing the Tax Challenges of the Digital Economy* (the "OECD Digital Economy Report").² While the main focus has been on addressing Base Erosion and Profit Shifting (BEPS) through the lens of corporate taxes and transfer pricing, the report also highlighted concerns from a Value Added Tax (VAT) perspective, and made recommendations to address these. In our view, those concerns are actually significantly understated in a China context, and moreover, the recommendations may be more difficult to implement in China.

¹ 'Alibaba Singles' Day sales reach \$14.3 billion, smashing record', Bloomberg News, 10 November 2015, <http://www.bloomberg.com/news/articles/2015-11-10/why-alibaba-is-having-singles-day-in-beijing-for-first-time>

² 'Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project', OECD, 2015, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264241046-en>



4. China's VAT system is based on a few fundamental features – its VAT registration system generally requires a business establishment in China, and in practice, that means a physical presence; its VAT registration system also currently excludes foreign entities; and its highly regulated invoicing system is paper-based. None of these features can survive the impact of the digital economy.
5. There is a significant gap between the taxes which the government should collect from the digital economy, and what it is actually collecting. This is commonly referred to as the VAT gap. While estimates regarding the proliferation of the VAT gap are by their very nature imprecise, in *Tax Policy and Tax Reform in the People's Republic of China*, the OECD estimates that approximately 55 percent of all VAT revenue is not properly accounted for in China.³ As growth in China slows, tax authorities will be keen to reduce this gap.
6. China is already undergoing significant VAT reforms, with VAT replacing Business Tax (BT) across the service industry. Those reforms are expected to be completed in 2016. In addition, the government has also proposed Consumption Tax (CT) reforms during 2016. This will, amongst other things, change the rates and types of products subject to CT, as well as alter the imposition of CT from producers and importers to wholesalers and retailers.

It is our firmly held view that not only will these factors lead to significant change in China's VAT system, but that any such changes will also fundamentally alter the way that VAT is managed, administered and collected in China.

In this special publication, we examine the changes that we foresee over the coming years in China's indirect tax system as a result of the digital economy.

³ 'Tax Policy and Tax Reform in the People's Republic of China', OECD Taxation Working Papers, No. 18, Brys, B. et al., 2013, OECD Publishing, Paris, <http://dx.doi.org/10.1787/5k40l4dlmnmzw-en>

What do we mean by the 'digital economy'?

In the recently released *OECD Digital Economy Report* which examines the tax challenges of the 'digital economy', the term 'digital economy' is used, as opposed to 'electronic commerce', 'internet commerce' or 'digital services' which were used a few years ago. This shift in terminology is significant.

The report describes the digital economy as being "the result of a transformative process brought by information and communication technology (ICT)"⁴ and as having the following features:

- Mobility, with respect to (i) *the intangibles* on which the digital economy relies heavily, (ii) *users*, and (iii) *business functions* as a consequence of the decreased need for local personnel to perform certain functions, as well as the flexibility in many cases to choose the location of servers and other resources
- Reliance on data, particularly the use of so-called 'big data'
- Network effects, understood with reference to user participation, integration and synergies
- Use of multi-sided business models in which the two sides of the market may be in different jurisdictions
- Tendency towards monopoly or oligopoly in certain business models relying heavily on network effects
- Volatility due to low barriers to entry and rapidly evolving technology.

It is important to recognise though that the digital economy is more and more indistinguishable from the real economy. The ability to differentiate transactions taking place in a digital world compared to those in bricks-and-mortar retailers is increasingly difficult, as seen in the example below.

In this example, the consumer may purchase through a traditional bricks-and-mortar retail store, but the digital economy was responsible for alerting them to the potential purchase and served as a means of conducting research. The same can happen in reverse.

The digital economy is said to comprise a number of new business models, including e-commerce, payment services, app stores, online advertising, cloud computing, high-frequency trading, and participative network platforms. We examine several of these new business models on the following pages. We also examine electronic invoicing, given that invoicing is such a prominent feature of China's VAT system.

The consumer online-to-offline journey



Source: 'China's Connected Consumers: When 10,000 Chinese shop ... Insights from a 2015 survey', KPMG China, 2015, p. 27, <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/China-Connected-Consumers-201510.pdf>

⁴ 'Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project', OECD, 2015, OECD Publishing, Paris, p. 11, <http://dx.doi.org/10.1787/9789264241046-en>

e-Commerce

According to Reuters, the Chinese Government estimates that the total value of cross-border e-commerce in China will be worth USD 1 trillion in 2016.⁵

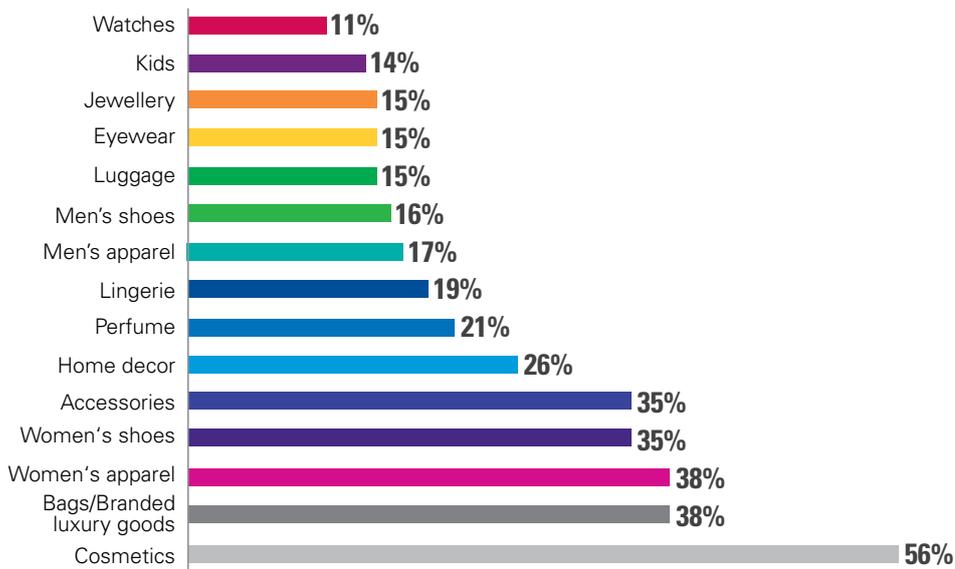
The significance of how VAT and CT are imposed, collected and administered is therefore critical from the perspective of overall government revenue.

Goods

Chinese consumers have been enormous users of e-commerce platforms, using smartphones and other devices to purchase goods online. The largest provider is Alibaba, which is reported to have a market share of around 80 percent of China's online market.⁶ In many cases, Alibaba is not the supplier, but is instead the platform through which sales are made by manufacturers, wholesalers or retailers, utilising either Taobao (which is predominantly a consumer-to-consumer (C2C) market) or T-Mall (which is predominantly business-to-consumer (B2C)). The experience in China is consistent with OECD trends, which highlight the tendency towards monopolies or oligopolies in the markets in which these business models operate.

In terms of the types of products which Chinese consumers purchase online, the following chart summarises the results of a 2015 survey conducted by KPMG and published in *China's Connected Consumers*:

Top categories purchased online



Source: 'China's Connected Consumers: When 10,000 Chinese shop ... Insights from a 2015 survey', KPMG China, 2015, p. 17, <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/China-Connected-Consumers-201510.pdf>

⁵ 'UPDATE 1-Chinese rivals snap at Alibaba's heels in cross-border e-commerce race', Brenda Goh, Reuters, 25 February 2015, <http://www.reuters.com/article/2015/02/26/china-retail-internet-idUSL4N0W01B120150226>

⁶ 'China's Alibaba breaks Singles Day record as sales surge', BBC News, 11 November 2015, <http://www.bbc.com/news/business-34773940>



VAT

From the perspective of VAT systems internationally, the use of e-commerce platforms for the sale of goods does not ordinarily raise new or unique issues. Goods which pass through China's borders are generally easier to administer from a tax collection perspective. Rules are in place to ensure the efficient collection and payment of customs duty and VAT on the importation of goods by businesses; and similarly, there are simplified calculation methods applicable to goods sold to domestic individual customers and which are imported into China by foreign suppliers. VAT liabilities payable to tax authorities are not avoided or evaded simply because an order is placed online. However, the practical experience in China has been a bit different, especially with domestic sales.

The Chinese VAT system requires VAT registration at the branch level. The location of the branch is important because the provincial tax authority in that location shares in at least 25 percent of the revenue, with the remaining 75 percent going to the central government. Unlike the position in many other countries, this can lead to multiple registration and filing locations for a single company with multiple branches; transactions between head office and branches, or even between branches can attract VAT; and competition to collect revenues can exist between tax authorities in different locations.

The usual location at which payment must be made is the tax authority where the taxpayer is registered in respect of its fixed establishment. However, in an online world, a taxpayer may not have a fixed establishment, and there is no clear guidance in these situations. In practice, the determination of the business location for registration purposes may make reference to where the sales activities take place, where the physical office is located (if there is an office), or where the taxpayer is physically located (in cases involving entrepreneurs).

In the context of online sales, the tax authorities still face particular difficulties with enforcement. Some major online platforms allow unregistered entrepreneurs to set up virtual stores to sell goods, which is one avenue through which VAT may be evaded. Nevertheless, it must be acknowledged that many of the platform providers are taking positive steps to improve compliance amongst those entrepreneurs. Even registered entrepreneurs may fail to declare sales; and with relatively unsophisticated tools at their disposal to obtain the data from platform providers or to otherwise detect such sales, the tax authorities' task is daunting.





Unlike in many other countries, China's VAT system does not seek to draw distinctions between B2C sales (which attract VAT) and C2C sales (which other countries do not tax). Instead, the distinction between B2C and C2C in China is often blurred. The question of whether there is a liability to pay 17 percent VAT tends, in practice, to be based more on whether the relevant supplier reaches the turnover threshold for registration as a general VAT taxpayer, compared with its status as a business or entrepreneur. There is also no distinct turnover threshold for e-commerce activities, so the applicable threshold is generally determined by the underlying business activity engaged in – for example, the provision of services and the sale of goods.

China's VAT law is clear though – VAT obligations do arise for online sales in the same way as any sale of goods through a bricks-and-mortar business. Although the problem is lack of enforcement, there are simplified rules applicable to purchases from overseas e-commerce businesses for personal consumption products, as discussed further below. Anecdotal and media reporting suggests that in practice, there is a virtual army of small online retailers selling products for which no (or very little) VAT is actually being paid.

As noted in the introduction, the VAT gap in China has been estimated to represent around 55 percent of all VAT revenue, and those statistics were put together prior to e-commerce really taking hold. There is also talk of lax enforcement by some tax authorities.

With a tax collection and enforcement system which is highly desegregated along provincial lines, the task of ensuring those with an online presence are paying the requisite amount of indirect taxes appears to be slipping between the cracks. However, the tax environment in China is changing – an experienced colleague recently described the three most significant developments in China's tax expected over the coming few years to be "enforcement, enforcement and more enforcement". Not only is greater enforcement likely to be driven by a desire to maintain government revenues, but in the context of VAT, it will also be driven by a need to ensure that bricks-and-mortar retailers are not unduly disadvantaged commercially compared with online sellers.



To be fair though, China's problems with the enforcement of VAT collection from e-commerce retailers are not totally unique. Recent press coverage has highlighted concerns in other jurisdictions, with smaller retailers selling through platforms such as eBay and Amazon also allegedly evading their tax obligations.⁷ However, the response of tax authorities in countries such as the UK has been swift. Rather than seeking to enforce proper tax compliance from a vast array of smaller retailers, collection and penalty provisions are being considered to avoid platform providers unwittingly being used to facilitate tax evasion by the retailers who use their services.

The logic here is very clear – it is far easier for a tax authority to collect taxes and/or impose penalties (or at least the threat of penalties) on a few large platform providers operating in their jurisdiction to bring about higher levels of compliance by smaller retailers, than it is for the tax authorities to apply audit, collection and enforcement techniques to the smaller retailers themselves. Likewise, in a cross-border context, countries such as Australia are in the process of changing their Goods and Services Tax (GST) laws to enable the collection of taxes from the large platform providers directly.

More recently, there has been a change to the simplified rules under which import duties and VAT are imposed on purchases from overseas e-commerce retailers for personal consumption (sometimes referred to as the 'parcel tax'). Under the new rules, which take effect in April 2016, purchases of products from foreign e-commerce providers will be subject to a flat tax rate of 11.9 percent for purchases of up to RMB 2,000 at a time, with a RMB 20,000 yearly limit per person. Purchases in excess of these thresholds are subject to normal customs and VAT liabilities. These concessions effectively provide at least a 30 percent reduction on the taxes which would otherwise be payable on importation.

The UK example should serve as an early warning to China's e-commerce industry of the changes which may inevitably come. Put simply, it is easier for the tax authority to try and achieve significantly improved outcomes by taking strong action against a few large providers rather than going through the painstaking process of chasing relatively miniscule amounts from an overwhelming number of small retailers. It is also easier for the tax authorities to get the platform providers to apply their superior commercial bargaining position to improve the compliance of smaller retailers.

⁷ 'Amazon and eBay face crackdown over VAT fraud by overseas sellers', Simon Bowers, The Guardian, 22 December 2015, <http://www.theguardian.com/politics/2015/dec/22/tax-officials-investigate-amazon-ebay-vat-fraud-overseas-sellers>



Looking further ahead, it would not be surprising if point-of-sale tax collection systems were introduced in China (and elsewhere), to ensure that when customers buy goods online, the requisite VAT is diverted directly to the tax authority.⁸ When it was first introduced, China's Golden Tax System was a highly advanced (near real-time) tax data transmission system. Therefore, it is possible that it will also transform into a real-time tax collection system in the near future.

So, in the short term, the major area of change predicted for sales of goods through e-commerce platforms is the imposition of VAT on the platform providers themselves rather than on small retailers, coupled with substantially greater enforcement. In the longer term, real-time tax collection will become the norm.

Consumption Tax

As noted in the introduction, China is expected to undergo CT reforms in 2016. At present, CT applies to 14 different categories of goods, and is typically collected upon production or importation of those goods. The rationale for goods being subject to CT has either been because they are regarded as luxury items, goods which are highly pollutant, or goods which are typically excisable such as alcohol and tobacco.

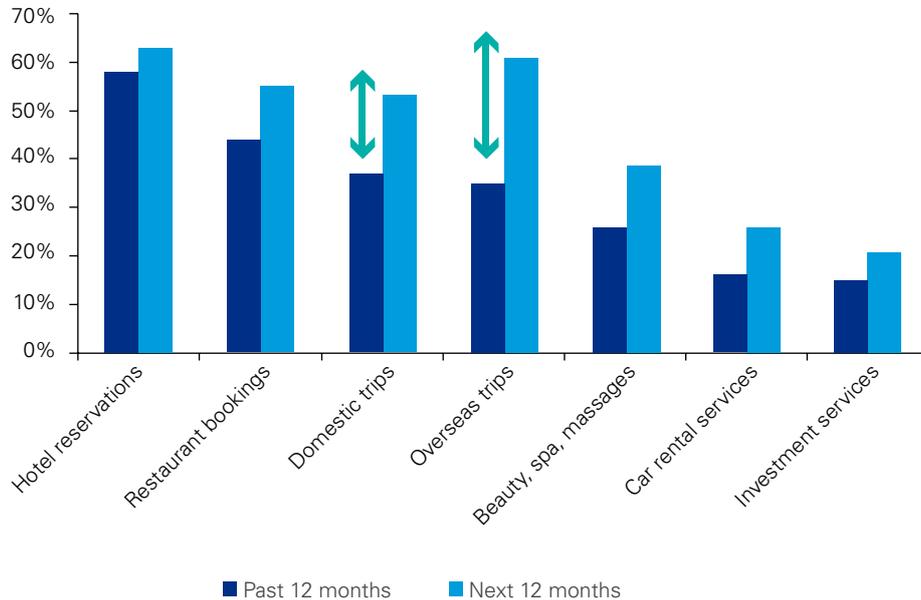
The CT reforms are expected to have three main facets:

1. The categories of goods which are subject to CT are likely to be modernised: For example, women's cosmetics are currently subject to CT. This was introduced at a time when cosmetics may have been regarded as luxury items, however, few would agree with that characterisation in a modern Chinese economy.
2. The rates of CT are likely to be adjusted to ensure that highly pollutant goods attract much higher rates of tax, whereas the tax rates for more environmentally sensitive products will be reduced: The primary example is in the motor vehicles sector, where incentives for the production of more fuel-efficient vehicles are being introduced. This aligns with the government's objective of significantly reducing emissions.
3. The imposition of CT will change from producers or importers, to wholesalers or retailers: This will necessarily lead to a significant increase in the number of businesses paying consumption tax. Accompanying this is a proposed shift from tax collection by the central government to local governments.

Interestingly, this proposed shift in CT collection to wholesalers or retailers will likely exacerbate the tax collection problem currently being experienced in the e-commerce sector in China. Yet again, this may create a perfect storm under which enforcement is dramatically increased.

⁸ 'Reforming the VAT System for the 21st Century', Herbain & Lamensch, August 2015, Bloomberg BNA

The extent of services purchased online by luxury consumers



Source: 'China's Connected Consumers: When 10,000 Chinese shop ... Insights from a 2015 survey', KPMG China, 2015, p. 19, <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/China-Connected-Consumers-201510.pdf>

Services

The challenges facing China's VAT system with respect to the service sector are potentially much more complex. If you consider that services can more readily be provided cross-border than ever before, the advances being made in 3D digital printing which will result in more goods being delivered as services, the growth of the sharing economy, the proliferation of peer-to-peer services, and the general shift towards more of a services-based economy, it is not difficult to foresee the challenges that lie ahead.

The types of services which Chinese consumers purchased online in 2015 are highlighted in the chart above.

While this chart provides a snapshot from 2015, let us examine the likely changes both from a technical perspective, as well as from a product and technology perspective.

Domestic

The major change foreshadowed in the service sector is the transition from BT to VAT, which is expected to be completed by the end of 2016. As at March 2016, there are three main sectors which are still subject to BT – real estate and construction, financial services and insurance, and lifestyle and other services. This last category is a general catch-all category which captures any other services which are still within the scope of BT. It is also worth noting that in China, services effectively encapsulate intangible rights generally, though electricity, heat and gas, as well as the processing of goods, and repair and replacement of goods, are categorised in the same way as supplies of goods.⁹

The government's objective is to ensure that by the end of 2016, all suppliers, whether of goods or services, will be within the scope of VAT.

⁹ 'See 'Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Value-Added Tax', Article 2, http://www.gov.cn/gongbao/content/2012/content_2121706.htm

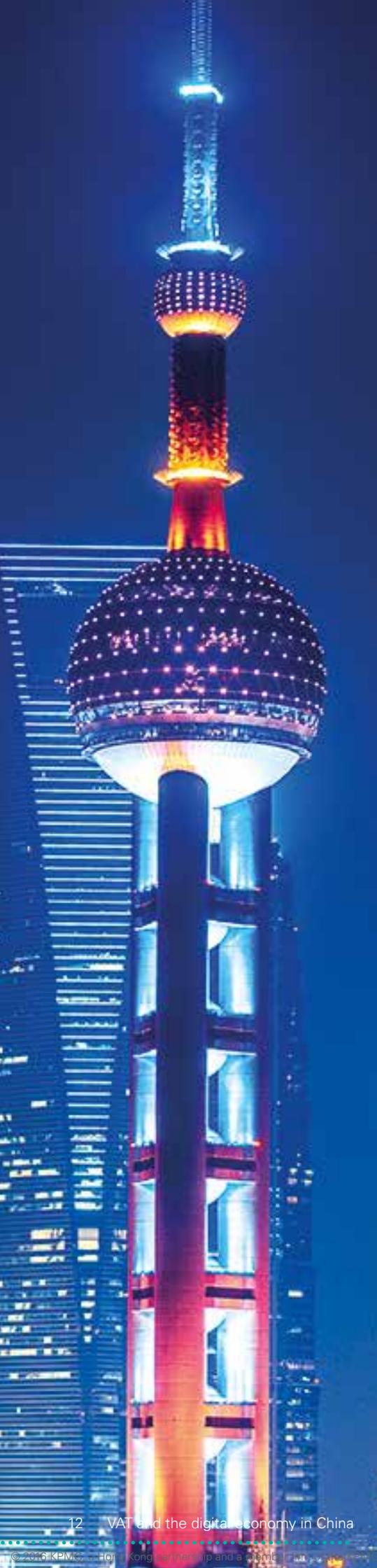
An interesting by-product of this change is that this is likely to lead to significantly greater levels of voluntary tax compliance. The reason is that under the current bifurcated system, there are gaps in the invoicing chain. For instance, where a VAT supplier supplies to another business which is within the BT system, there is no practical need for the recipient business to obtain a special VAT invoice because no input VAT credit is available to them. However, once all businesses are under the VAT system, the process becomes more self-enforcing. The recipient business will demand a special VAT invoice at the time of payment to ensure they can claim an input VAT credit. Once a special VAT invoice is issued by the supplier business, the transaction will therefore have been recorded and a readily enforceable document trail established.

Notwithstanding this, there are still significant challenges around enforcement and compliance, especially at the B2C level. Specifically, the nature of the service sector is such that there is no cost of goods sold, and the use of capital-intensive equipment may be limited. Put simply, the major component of the supplier's cost structure may be the labour of its workers, and this means that the 'value added' for VAT purposes is significant. Given that it is more difficult for tax authorities to track the movement of services, and there is still no incentive for end-consumers to demand an invoice, it is not difficult to see how an environment of non-compliance can emerge. However, as Chinese society moves away from being predominantly cash-based, this is where increasingly sophisticated audit and detection techniques will emerge. The tax authorities in China have historically been very process-oriented, with inspections and audits primarily being paper-driven. The presence of a digital footprint between the parties enables the use of data analytics, and even predictive analytics, to better compel the payment of VAT.

The tax enforcement environment may allow tax authorities to improve their VAT collection on services supplied domestically. However, if left unchecked, other technological developments may reduce overall VAT revenues as more and more products are sold as a service (which is subject to 6 percent VAT) rather than as a good (which is typically subject to 17 percent VAT).

Consider the following:

- Only a few years ago, most software products were sold to consumers as the sale of a good. Many businesses used extensive IT infrastructure to meet their IT needs. In each case, what was involved was the sale of a good, attracting 17 percent VAT. However, few consumers nowadays purchase software products, and the development of software as a service (SAAS) and cloud computing both result in the delivery of services. They typically attract 6 percent VAT, though it is not uncommon for the tax authorities to treat a software licence as a sale, and seek to apply 17 percent VAT. This also highlights the difficulties which can arise in distinguishing software which is sold as a good, as a licence or as a service.
 - A similar example arises in relation to the sale of e-books. Many tax authorities consider that these should be subject to VAT at 13 percent (as the sale of a good), while e-book businesses tend to treat it as a service which is subject to 6 percent VAT.
 - Certain goods, such as motor vehicles, also attract CT. However, what happens when 3D digital printing takes hold? Will this still be a supply of a good at 17 percent VAT, or the supply of a service at 6 percent VAT?
 - The sharing economy and peer-to-peer services have also exposed major gaps in the VAT systems of most countries. If you consider that a hotel stay currently attracts 5 percent BT (and will likely attract 6 percent VAT in the near future), but a homestay advertised through Airbnb or other similar providers will, in all likelihood, not result in any VAT being paid, then it is easy to see where gaps emerge. Similarly, a loan with a bank currently attracts 5 percent BT (and will likely attract 6 percent VAT in the near future) – but what about peer-to-peer lending? Already, there are major enforcement issues associated with China's 'shadow banking' industry, and that has emerged before the C2C services have matured as a market in China.
- All of this strongly suggests that over the next few years, change is inevitable to counter these developments. We predict that:
- China will move towards a single-rate VAT system (or perhaps a VAT system with fewer rates) rather than the present multi-rate system. However, until such time as the VAT rates for goods are merged with those of services, problems will continue. A single merged VAT rate would likely be at around 13 percent or even 15 percent.
 - Governments around the world, including in China, will move towards applying VAT on certain C2C transactions, though with effective turnover thresholds which exclude most one-off, or occasional business-like activities.



Cross-border services – Inbound into China

China's VAT system was devised in a pre-internet age. Unlike most other countries, registration for VAT purposes occurs at the branch level, the rules generally assume the establishment of a physical presence, and they preclude foreign entities from registering for VAT purposes. Plainly, it is ill-suited to an environment where services may be delivered cross-border at the click of a button.

Again though, this issue is not unique to China. The OECD/G20 recently grappled with this issue in the context of their *Digital Economy Report*. They examined mechanisms to ensure the efficient collection of indirect taxes on business-to-business (B2B) supplies of services, and on B2C supplies of services. They concluded broadly as follows:

B2C purchase of digitised services from offshore without VAT

1. Requiring end-consumers to self-assess VAT has proven to be largely ineffective.
2. Non-resident suppliers will be required to register for VAT, and collect and remit VAT according to the jurisdiction in which the customer is located. This approach has been described as being 'largely effective', even though it is, in effect, a form of voluntary compliance since enforcement is difficult for individual countries.
3. Improved international cooperation between countries will be needed to enforce this approach, through enhanced information exchanges, assistance in recovery and simultaneous audits.

VAT-exempt businesses able to save VAT by acquiring services and intangibles from offshore without VAT

1. Opportunities for tax planning can be addressed by encouraging the implementation of the OECD's guidelines on the place of taxation for B2B supplies of services and intangibles. These guidelines recommend the implementation of the 'destination principle' which would ordinarily result in VAT being collected on a 'reverse charge' basis in the country in which the services are consumed.

Source: *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project*, OECD, 2015, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264241046-en>

Let us examine how this compares with the current position in China. In a cross-border context, China's VAT system currently operates on the basis of two key principles:

- VAT applies if either the service provider or the service recipient is in China. This effectively means that both imports and exports of services are prima facie subject to VAT. In practice though, most exports of services are exempted or zero-rated.
- Where the service provider is located outside of China, VAT shall be collected and paid on a withholding basis by either an agent in China or by the service recipient in China.

China's VAT system implements the destination principle of taxation. That is, VAT is paid based on the place where the service is consumed, rather than the place of origin of the supplier. In that regard, China's VAT system already aligns with the OECD/G20 recommendations.

In a B2C context, there is no technical rule (of which we are aware) which specifically excludes an individual in China from the requirement to withhold and account for VAT to the tax authorities, in circumstances where the supplier is based outside of China and does not appoint a local agent. Theoretically, this would mean that a consumer in Beijing would be required to withhold VAT when they purchase an app online from a supplier based in the US, for example. As the *OECD Digital Economy Report* notes, imposing requirements to withhold and pay VAT on end-consumers has "proven to be largely ineffective".¹⁰

That being the case, the *OECD Digital Economy Report* recommends that foreign service providers should be able to register for VAT and account for it. They propose simplified registration processes to ensure the efficient collection and payment of VAT. The European Union (EU) member states, as well as countries such as Iceland, Norway, Switzerland, South Africa, Japan, South Korea, Australia and New Zealand have all either implemented these changes already, or are in the process of doing so.

While evasion may still occur given the fact that governments will find it very difficult to enforce and actually collect unpaid taxes from foreign companies without a physical presence in that country (even with exchange of information agreements in place), the OECD/G20's recommendation is plainly based on the 80/20 rule of thumb. That is, they anticipate around 80 percent of the tax will be collected from 20 percent of taxpayers, and in that regard, the very large platform providers will invariably voluntarily comply.

More specifically though, the problems with applying the OECD/G20 recommendations in a Chinese context are that:

- At present, the Chinese VAT system does not allow foreign companies to register for VAT purposes. They are also unable to operate under the Golden Tax System.
- The Chinese VAT system is based on linkages with its business licensing and registration systems.
- The Chinese currency is, to a large extent, still a controlled currency.

Notwithstanding these observations, our very simple proposition is that this will need to change. Put simply, unless the Chinese Government makes the necessary changes to enable foreign suppliers of services to register and account for VAT in respect of digital services-provided B2C, government tax collection revenues will be detrimentally affected. It is in the government's best interests to make it easy to comply and collect the tax.

We therefore anticipate a simplified process being introduced whereby foreign suppliers of digitised services will be allowed to register for VAT purposes and account for VAT in respect of their sales. We believe this will be done in such a way that would still exclude them from claiming input VAT credits, and similarly exclude them from issuing or receiving special VAT invoices. An interesting question will be whether the simplified process will allow them to settle the taxes in the currency in which they earned the revenue, but ultimately this issue should diminish over time as the renminbi (RMB) becomes more readily convertible.

A further interesting question is the precise place of registration for those foreign suppliers within China, given that a part of the VAT revenue which is collected goes to local governments, and they will be competing for their share of the revenue.

In a B2B context, China currently collects VAT on cross-border supplies of services into China on a withholding basis. By contrast, the more generally accepted method internationally is a reverse charge basis. It is our experience that a withholding system is not as efficient as a reverse charge for dealing with VAT, for the following reasons:

- VAT withholding affects the price as between the parties. That is, the supplier is ordinarily short paid unless they know about it and take steps to gross up the price for VAT purposes. By contrast, a reverse charge imposes the liability on the recipient and therefore does not affect the price.
- VAT withholding causes difficulties from an accounting perspective, given that the invoice issued by the supplier is ordinarily short paid. The debt then needs to effectively be written off in the accounts of the supplier.

¹⁰ 'Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project', OECD, 2015, OECD Publishing, Paris, p. 121, <http://dx.doi.org/10.1787/9789264241046-en>

Historically, it is understood that a VAT withholding system has been applied because it links in with China's currency controls. That is, the recipient may be required to provide a tax clearance certificate confirming their payment of the tax on a withholding basis as a prerequisite to funds being released to the supplier. As China loosens its currency controls, the need to utilise a withholding system rather than a reverse charge diminishes.

In conclusion, we anticipate that China will likely introduce simplified processes to enable foreign suppliers to account for VAT on B2C cross-border supplies of services. The longer the delay in introducing such measures, the greater the gap in tax revenues will grow. In a B2B context, we anticipate that China may ultimately move towards the adoption of a reverse charge system. Having said that, it must be acknowledged that a withholding system generally operates to the advantage of Chinese customers and the relative detriment of foreign suppliers, and therefore any such change may not be seen as being in China's best interests.

Cross-border services – Outbound from China

As noted above, China's VAT system operates on the basis of the destination principle of taxation. This means that when services are provided by Chinese suppliers to overseas consumers (or businesses), then VAT does not ordinarily apply in China. However, this is only a relatively recent development that resulted from the VAT pilot programme which commenced in 2012.

For those industries which are still subject to BT, there is no comparable concession for the export of services. In other words, *prima facie* exports of services are subject to BT.

The shift to applying more favourable treatment for exports of services in a VAT context is consistent with the Chinese Government's broader objective of promoting the growth and development of the service sector. However, it is noteworthy that as at 2016, most exported services are exempt from VAT, and not zero-rated. According to the OECD's *International VAT/GST Guidelines*,¹¹ exports of services should in fact be zero-rated.

In a crucial development in late 2015, the Ministry of Finance and State Administration of Taxation introduced zero-rating for exports of the following to accompany the existing categories of research and development (R&D) and design services, and certain international transportation services which have been zero-rated for some time now:

- Offshore outsourcing services, such as information technology outsourcing (ITO), business process outsourcing (BPO) and knowledge process outsourcing (KPO) services
- Certain radio, television, film production services and publishing services¹²
- Certain technology transfers and software services.

In our view, the change which was recently introduced for this small category of services is indicative of a longer-term trend. We expect that over the next few years, most exported services will be zero-rated, rather than exempt, in China.

A related issue is that at present, the process for claiming either exemptions from VAT or zero-rating can be time-consuming and cumbersome. This is likely to follow the same path as many of China's other tax concessions – they are initially introduced with difficult approval processes, but over time, they are relaxed in favour of self-assessment. We anticipate the same thing happening here.

Services consumed entirely outside of China

The VAT rules in China currently provide that VAT shall not apply where the service is consumed entirely outside of China.¹³ The application of this regulation can be difficult in practice. Take the example of a Chinese consumer who holds a professional qualification issued by a reputable overseas organisation. To maintain their professional qualifications, they subscribe to an e-learning programme which is offered through a 'virtual classroom' format. The issue in this case is whether the service can be regarded as being 'wholly consumed outside of China', where the Chinese consumer enjoys the benefit of the e-learning programme from their home in China. Increasingly, the challenge will be to determine the place of consumption of services.

¹¹ 'International VAT/GST Guidelines', OECD, November 2015, <http://www.oecd.org/tax/consumption/international-vat-gst-guidelines.pdf>

¹² See Circular Caishui [2015] 118. See also 'China Tax Alert: VAT zero rating concession for exported service scope expanded', KPMG China, November 2015, <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/ChinaAlerts/Documents/China-tax-alert-1511-30-VAT-zero-rating-concession-for-exported-service-scope-expanded.pdf>

¹³ See Article 10, Appendix 1 of Circular Caishui [2013] 106

Customs duties on services

If you consider that customs duties currently apply to the importation of goods but not to services, and that things which were being supplied as goods will in the future increasingly be supplied as services, then it is not difficult to foresee that the customs duty base may be under threat in the long term. There are already murmurings internationally of the need to apply customs duties to services in the future. While this is likely to be some way off, the possibility cannot be discounted.

Interaction between CIT and VAT

While this publication is dedicated to considering the VAT issues associated with the digital economy, it is important to recognise that any developments in the VAT rules will likely have knock-on consequences for Corporate Income Tax (CIT) purposes, and vice versa. For example:

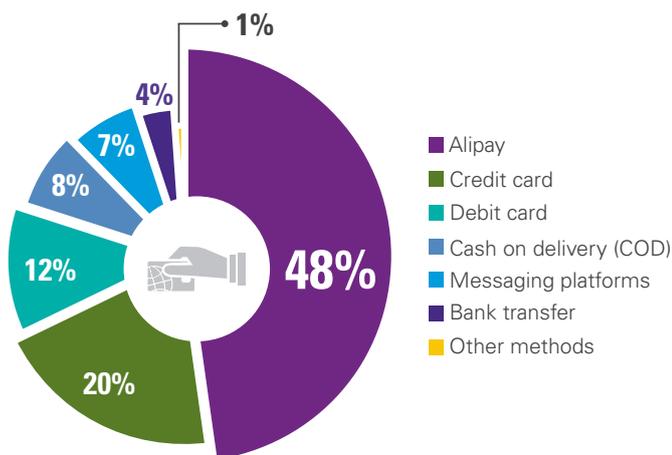
- If the rules regarding permanent establishments are expanded as a result of the BEPS recommendations, will it follow that those foreign businesses will then be required, or even allowed to register for VAT purposes? An example is where a foreign supplier has a digital presence through the active management of a server in China.
- Does the characterisation of a transaction for CIT purposes determine the applicable VAT rate? For example, where a payment is characterised as a royalty for CIT purposes, does it necessarily mean that for VAT purposes, 6 percent VAT should apply on the basis that there is a licence or other intellectual property right which is granted?



Payment services and virtual currencies

One area of Chinese business which has experienced monumental growth is payment services. Until recently, cash was the most common method of payment for goods and services; the large operator China UnionPay had a virtual monopoly of debit card payment services; and credit card usage was relatively limited. However, the following chart highlights the significant changes which have already taken place in the establishment of more diverse payment services:

Breakdown of purchases by payment types



Source: 'China's Connected Consumers: When 10,000 Chinese shop ... Insights from a 2015 survey', KPMG China, 2015, p. 56, <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/China-Connected-Consumers-201510.pdf>

From a regulatory perspective, China has not allowed foreign companies to clear electronic payments in its domestic market until recently. This effectively made it impossible for companies like Visa, MasterCard and American Express to process domestic transactions in China. More recently though, the government has announced it will allow foreign companies into the payments market, a market that was valued at USD 6.84 trillion in 2014. From 1 June 2015, foreign companies are able to apply for licences for bank card clearing businesses. We can expect to see more competition in credit card payments in the future, as overseas entrants will likely attempt to convince consumers to use their cards rather than the UnionPay cards for spending.¹⁴

Many commentators had expected a boom in traditional banking products, only to see China effectively overtaking many other developed countries in its use of an array of payment service providers such as Alipay and virtual currencies. The growth of messaging platforms such as WeChat, Sina Weibo and Tencent's Tenpay providing payment options is also a clear trend.

The interesting issue faced by each of these payment service operators is that they currently pay BT at the rate of 5 percent, and will soon transition to VAT. Many countries, including the EU member states, exempt payment services from VAT. However, in China, it is expected that these payment services will be subject to VAT at the rate of 6 percent. Already, a number of practical issues have emerged in the transition to VAT for the payment service operators, including:

- Whether VAT will apply to their services when consumers purchase goods or services overseas
- How to manage the VAT and related invoicing through the supply chain which sits behind these payment operators, such as banks and other financial institutions, clearing houses and other intermediaries, as well as the merchants and other retailers which enable these payments to be made.

¹⁴ 'China's Connected Consumers: When 10,000 Chinese shop ... Insights from a 2015 survey', KPMG China, 2015, p. 55, <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/China-Connected-Consumers-201510.pdf>



One issue which does not appear to have been raised thus far in a Chinese VAT context is the status of virtual currencies, such as bitcoin. With the People's Bank of China recently announcing that it may create its own virtual currency, this issue may become relevant in the near future.¹⁵ Specifically, in Australia, the tax authorities have ruled that bitcoin does not fall within the definition of 'money', and therefore when used to exchange for goods or services, there is effectively a barter transaction in which GST (equivalent to VAT) is payable on both sides of the transaction.¹⁶ By contrast, the European Court of Justice has recently ruled the opposite, finding that bitcoin is a form of currency and therefore VAT is only payable one way when exchanged for goods and services.¹⁷

Crowdfunding

A relatively recent phenomenon is the growth of crowdfunding, which essentially involves the raising of funds for specific projects via open calls on the internet. Certain companies have designed platforms which facilitate peer-to-peer interaction between entrepreneurs seeking to raise funds, and contributors willing to provide funds. One of the largest crowdfunding sites internationally is Kickstarter, while in China it is Zhongchou.

Although a range of crowdfunding models are used, they essentially come down to this:

- Donation-based funding models – that is, the contributor donates funds for a specific purpose: There are typically no VAT consequences involved, though in practice, the issues can become clouded when the entrepreneur provides some form of benefit to the contributor.

- Reward-based funding: In this model, the contributor provides funds, and in return they may receive payments from the promoter. Ordinarily, VAT would be payable by the promoter on the goods or services it provides by way of reward. Difficult issues can arise where the value of the reward is considerably lower than the payments provided by the contributor. For example, a contributor may provide funds of RMB 1,000 towards a project which will see their favourite musician record an album, and in return, they receive a CD worth RMB 50.
- Equity-based funding: Here the contributor provides funding, and in return receives shares or some other form of equity interest from the entrepreneur. In most jurisdictions, the issuance of shares will be exempt from VAT. The same outcome would likely arise in China.
- Debt-based funding: In this model, the contributor lends funds to the entrepreneur, and is provided with interest in return. Again, in most jurisdictions this would be exempt from VAT, but in China, it is expected that VAT will apply to interest income. Having said that, the contributor who is receiving interest income would not ordinarily be expected to be registered as a general VAT taxpayer.

These issues have recently been explored by the EU Commission in its Working Paper No. 836¹⁸ and by the Australian Taxation Office.¹⁹ In a Chinese context, the added complexity is that different VAT rates apply depending on how the goods or services provided by the entrepreneur are characterised, and depending on the VAT registration status of the entrepreneur. In addition, the crowdfunding platform, which ordinarily receives a share of revenue raised, would be expected to pay VAT, though the precise VAT rate will similarly depend on how its services should be characterised.

¹⁵ 'China's central bank plans to launch its own digital currencies', Reuters, 20 January 2016, <http://www.reuters.com/article/us-china-currency-digital-idUSKCN0UY1JT>

¹⁶ 'Goods and services tax: the GST implications of transactions involving bitcoin, Goods and Services Tax Ruling, GSTR 2014/3', Australian Government: Australian Taxation Office, <http://law.ato.gov.au/atolaw/view.htm?DocID=GST/GSTR20143/NAT/ATO/00001>

¹⁷ 'Judgment of the Court (Fifth Chamber) of 22 October 2015 (request for a preliminary ruling from the Högsta förvaltningsdomstolen – Sweden) – Skatteverket v David Hedqvist (Case C-264/14)', 27 November 2015, <http://curia.europa.eu/juris/document/document.jsf?text=&docid=172954&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=212745>

¹⁸ 'Value Added Tax Committee: VAT treatment of crowdfunding', Article 398 of Directive 2006/112/EC, Working Paper No 836, European Commission, 6 February 2015, <https://circabc.europa.eu/sd/a/c9b4bb6f-3313-4c5d-8b4c-c8bbaf0c175a/836%20-%20VAT%20treatment%20of%20Crowd%20funding.pdf>

¹⁹ 'GST and Crowdfunding', Australian Government: Australian Taxation Office, modified on 24 June 2015, <https://www.ato.gov.au/Business/GST/In-detail/Rules-for-specific-transactions/GST-crowdfunding/>

The rise of the agent/intermediary

The internet has provided us with borderless and timeless communication with people all over the world, and it has significantly changed our modes of communication and lifestyle. As both internet coverage and doing business over the internet increases exponentially, there has been a rise of online platforms, or agents/intermediaries which facilitate the purchase and sale of goods and services, covering B2B, B2C and C2C transactions. These platforms usually take a percentage of profits as commission and to facilitate payment between buyers and sellers.

From an indirect tax perspective, transactions involving agents or intermediaries have always been difficult to administer, and in China, the legal recognition of agency concepts is perhaps less developed than in some other countries. For example, the tendency has sometimes been to require agents or intermediaries to account for VAT on the gross proceeds of the transaction using a 'follow the money' style of approach, even though only a small fraction of those proceeds may be retained by the agent or intermediary. Moreover, the requirement to account for VAT on the gross proceeds can be difficult to reconcile with the accounting treatment, where the agent or intermediary may only record its commission income as its revenue for accounting purposes.

Recent case law in other jurisdictions highlights the uncertainties which can exist in determining whether an intermediary is acting as an agent in the transaction, or as a principal. The travel industry is a classic example of this.²⁰

The VAT issues associated with the use of agents or intermediaries are further complicated considerably where there are cross-border elements involved. An example is if the agent is located overseas, but is collecting revenue from a local Chinese customer in respect of a transaction with a local principal, such as where an international booking engine is used to book hotel accommodation in China. While these issues were once more confined to industries such as the travel industry, the rise of businesses such as Uber in the ride sharing industry, or Airbnb in the accommodation sector, highlight the likelihood that these challenges will only grow over time.

Electronic invoicing

Many countries have already introduced the option of using electronic invoicing for GST/VAT purposes. Electronic invoicing is not only consistent with the mode in which business is conducted these days, but it also allows rapid access and retrieval of VAT data, and reduces reliance on paper storage and handling costs for paper-based invoicing. Given the developments in the digital economy, the use of electronic invoicing around the world for GST/VAT purposes is inevitable.

China first launched its Golden Tax System in 1994, in a pre-internet era. In recent years though, the Chinese tax authorities have embarked on a process of switching from paper-based to electronic invoicing, with some trial programmes currently taking place throughout China (for specific taxpayers). With new high transaction volume industries such as financial services expected to become subject to VAT in 2016, the use of electronic invoicing will be broadened significantly in the near future.

²⁰ See for example, 'Judgment: The Commissioners for Her Majesty's Revenue and Customs (Respondent) v Secret Hotels2 Limited (formerly Med Hotels Limited) (Appellant)', Hilary Term, [2014] UKSC 16, 5 March 2014, https://www.supremecourt.uk/decided-cases/docs/uksc_2013_0036_judgment.pdf

How KPMG can help

This article has highlighted not only challenges with the existing VAT system in China in terms of how it applies to the digital economy, but also the raft of changes which lie ahead.

KPMG has a team of tax professionals with a deep understanding of the practical and commercial implications for businesses operating in the digital economy. The team can assist in a number of areas, including helping you:

- Understand how the current rules apply to business models in the digital economy
- Prepare and manage tax risk in this rapidly changing compliance environment, especially as the tax authorities move towards an approach of “enforcement, enforcement and more enforcement”
- Structure your supply chains to optimise indirect tax outcomes, as well as Corporate Tax and transfer pricing outcomes in a new post-BEPS world.

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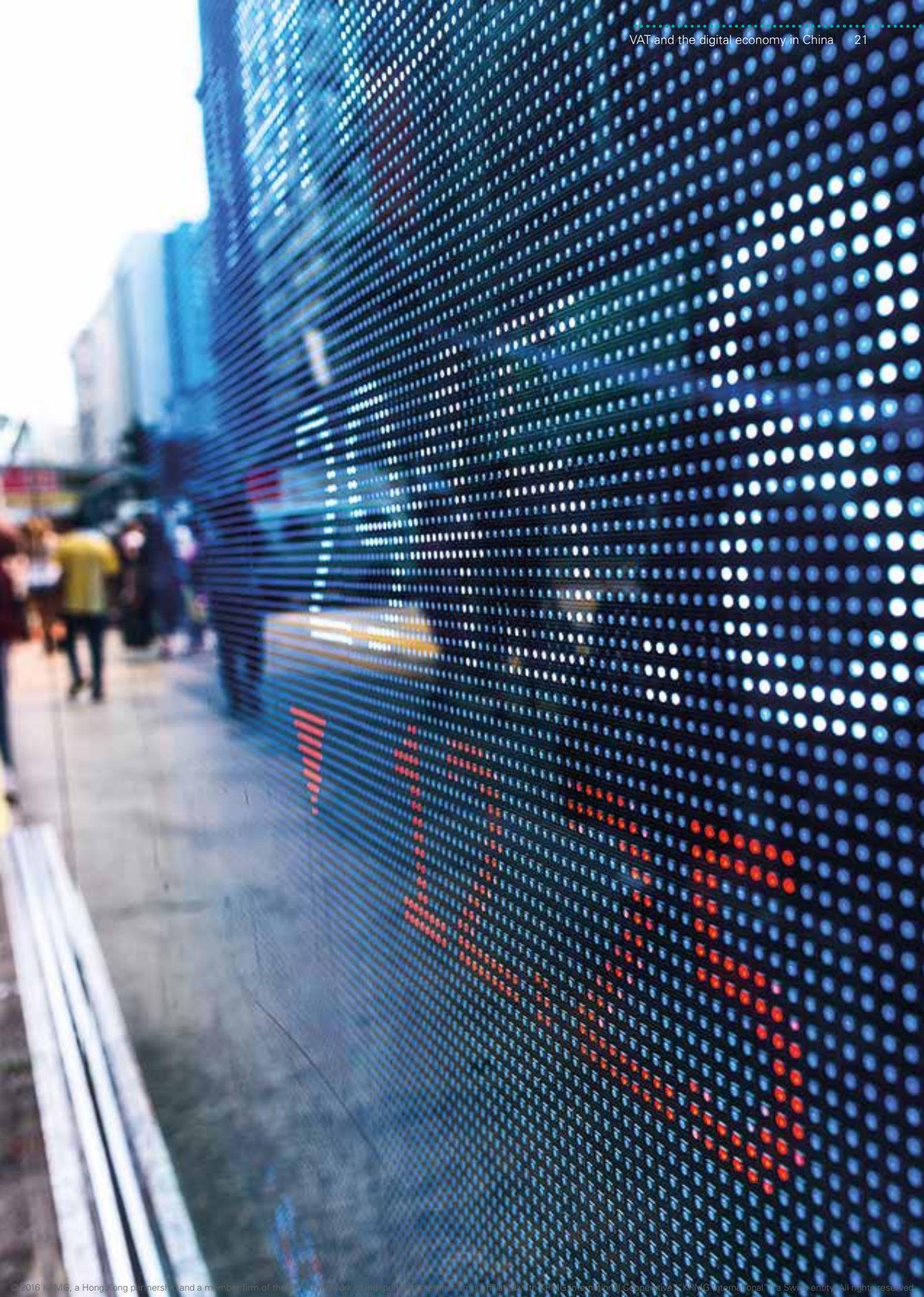
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