

China Tax & Investment News

China starts second wave of the country's tax reform amidst a global economic slowdown

New provisional regulations and implementation rules on Value-Added Tax, Business Tax and Consumption Tax released

Background

Ever since the successful unification of the domestic and foreign corporate income tax laws into a new law effective 1 January 2008, mainland China has been announcing publicly that a second wave of tax reform, i.e., an overhaul of the turnover tax system, is underway. Turnover tax, as its name suggests, is a tax on business revenue. In other countries, the tax may be called sales tax, value-added tax or goods and services tax.

Mainland China has hitherto practiced three different types of turnover taxes, i.e.,:

- ▶ Value-Added Tax (VAT) - mainly levied on the sales of tangible goods
- ▶ Business Tax (BT) - mainly levied on service income
- ▶ Consumption Tax (CT) - mainly levied on a selected list of luxurious and polluting products

The overhaul aims at ultimately unifying the current VAT and the BT regulations into one as it is widely alleged among the business community, and heeded by the Chinese Government, that the interplay of these two turnover tax regulations does create unintended discriminatory tax consequences on some businesses.

Recently, the State Council revamped and reissued the Provisional Regulations of the People's Republic of China on Value-Added Tax, Business Tax and Consumption Tax on 11 November 2008. The three revised turnover tax provisional regulations came into force on 1 January 2009.

Subsequently on 15 December 2008, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) revised and reissued the implementation rules of the turnover tax provisional regulations. The revised implementation rules also became effective from 1 January 2009.

Further guidance on some miscellaneous issues arising from the new turnover tax regulations and implementation rules was jointly issued by the same two authorities on 19 December 2008 via the latest circulars Caishui [2008] No. 170 and 171.

Please note however that the summation of all these recently announced changes still falls short of a major overhaul of the turnover tax system in China. At the best, they can only be viewed as some quick fixes to improve the reigning system pending the overhaul. It appears that these patches are precipitated by the financial turmoil that currently rages globally.

As overseas demand for Chinese export wanes, it is becoming increasingly apparent that mainland China cannot be immune from the worldwide economic slowdown. The revision of the aforesaid three turnover tax provisional regulations mainly aims at easing the tax burden of Chinese companies through eliminating the previous disallowance of input VAT credit on fixed assets and lowering the VAT rate for small-scale taxpayers to a unified rate of 3% so that they remain competitive in the price battle with other players in the difficult times ahead.

What surprises everyone though is a radical change in the chargeability of service fees to BT. Mainland China traditionally practices a territorial concept of charge and only brings service fees earned from the performance of services on mainland Chinese soil into the BT tax net. The new BT provisional rules however expand the BT taxing right on service income to include services where either the provider or the recipient of service is located in mainland China. This change potentially may have huge impact on the tax burden of overseas service providers who provide services outside of Chinese territories to Chinese clients.

This issue of China Tax & Investment News summarizes the major changes brought about by the new VAT, BT and CT provisional regulations, and highlights some important areas where, we believe, company executives should pay attention to in view of the changing business environment of mainland China.

What has been changed

Value Added Tax (VAT)

Perhaps the most eye catching change brought about by the new VAT provisional regulations is, in terms frequently used by Chinese government officials, the country wide switch from a production based VAT system to a consumption based system.

In a nutshell, the old production based VAT system does not permit the recognition of VAT input credit for the purchase of fixed assets, resulting in the VAT burden for taxpayers in mainland China being relatively higher than their counterparts in other countries that allow such credit. The old system may well be effective in ensuring adequate fiscal revenue for the country, but does undermine the price competitiveness of Chinese companies and does not encourage capital investment. The Chinese government has long been aware of the issue and applied various quick fixes including the exemption of VAT on qualified imported equipment, the refund of VAT paid on purchase of qualified Chinese made equipment, and allowing input VAT credit on purchase of fixed assets in designated North-eastern region, Central region, Eastern Inner Mongolia and the earthquake-stricken Sichuan Province.

Subject to certain transitional arrangements, all of these quick fixes has come to an end by 31 December 2008. Starting 1 January 2009, the new VAT provisional regulations permits a country-wide input VAT credit on purchased or self-constructed fixed assets except motorcycles, motor vehicles and pleasure boats held for own use. The creditable input VAT includes a deemed VAT at 7% of transportation costs incurred in acquiring eligible fixed assets.

We wish to call your attention to the following cut off issues when the full-fledged consumption based VAT system starts to kick in:

- ▶ Only VAT paid on the purchase or self-construction of qualified fixed assets on or after 1 January 2009 (as shown on VAT invoices bearing such a date) are creditable
- ▶ For input VAT credit on purchase of fixed assets in designated North-eastern region, Central region, and Eastern Inner Mongolia which was implemented through a periodic refund mechanism, the amount not yet refunded at 31 December 2008 shall be transferred on 1 January 2009 to become an input VAT pending set off, and no further refund will be made
- ▶ For sales of used fixed assets acquired or self-constructed before 1 January 2009, VAT at 2% will apply
- ▶ VAT at the normal VAT rate will apply to sales of used fixed assets acquired or self-constructed after 1 January 2009, and the same will apply to fixed assets that have been given VAT credits in designated Northeastern region, Central region, Eastern Inner Mongolia and the earthquake-stricken Sichuan Province.

The VAT rate for all small-scale taxpayers is reduced to 3%. This lowering of the tax rate comes with a tightening of the criteria for eligibility as a small-scale taxpayer. To qualify, the annual turnover volume should not be more than RMB500,000 for goods producers and service providers; and not more than RMB800,000 for other businesses (including wholesalers and retailers).

As part of a concerted effort to improve the competitiveness of Chinese companies, the MOF and the SAT jointly issued a circular, Caishui [2008] No. 144 on 17 November 2008, to increase the export VAT refund rates for certain labor intensive commodities. The raise is the second time in two months and became effective from 1 December 2008. Please refer to Appendix 1 for more details on the export VAT refund rates increased. It is expected that further raises of export VAT refund rates for other products may be announced.

Apart from the above described changes aiming at easing the tax burden of Chinese companies, the Chinese government also took the opportunity of the revision to improve quite a number of provisions in the old turnover tax provisional regulations.

One of these changes is the extension of the VAT reporting and payment deadline from 10 days to 15 days after the month end, and is now in line with that for corporate income tax filing. The same extension has also been written into the revised BT and CT provisional regulations, thus achieving uniformity and easing the way for combination of all turnover taxes into one in the long run.

Another more important technical change to the VAT rules involves the treatment of "concurrent businesses (兼营行为)". A VAT taxpayer is considered as carrying on concurrent businesses if it also carries on business as a service provider. Such a taxpayer is required to separately book and account for the revenues subject to VAT and BT respectively. Under the old rules, a failure to separately account for the different revenues will result in the total revenue being subject to VAT. This has led to disagreements between the State Tax Bureaus who collect VAT and the Local Tax Bureaus who collect BT, and in extreme cases, resulted in higher tax paid or double taxation with both VAT and BT being levied on the same revenue. The new VAT provisional rules have been rewritten to require an allocation of the total revenue into sales of goods and service income by the supervising State Tax Bureau and Local Tax Bureau. Whether the change will be successful in alleviating the misery of double taxation by taxpayers carrying on concurrent businesses remains to be seen, but the revision surely provides a most welcomed way out.

You can access a copy of the revised VAT provisional regulations and implementation rules (in Chinese) by clicking the following URLs.

VAT provisional regulations:

<http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/8527018.html>

VAT implementation rules:

<http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/8729815.html>

Business Tax (BT)

The new BT provisional regulations and implementation rules made changes corresponding to the extension of reporting deadline to 15 days and allocation of total revenue in the case of taxpayers carrying on concurrent businesses as described in more details in the VAT section above.

There are two more radical changes in addition to technical improvements to the rules and regulations.

The first has to do with the location where BT is payable for the provision of taxable services. Under the old provisional regulations, BT on services is payable at the location where the services are rendered. On the assumption that in most cases a taxpayer normally provides the majority of their services at where it is located, the new BT provisional regulations now stipulate that BT on services, unless specifically provided for otherwise, will be reportable and payable at where the taxpayer is located. One specific exception to the above new requirement applies to construction service which remains to be taxed at the location where the construction service is performed. For most taxpayers, this change would mean an easing in BT compliance burden and should be most welcomed.

The second, and the most radical, change again has to do with the provision of services. Article 1 of the new BT provisional regulations maintains the old language that provision of services within the mainland China territories is subject to BT. However, Article 4 of the new BT provisional implementation rules defines "provision of services within the mainland China territories" to mean services where either the provider or the recipient of the service is in mainland China. Thus a literal application of the new BT rules will result in a Chinese service provider being subject to BT on all service income regardless of where the services are performed. Similarly, an overseas service provider performing services for a Chinese client outside mainland China will be subject to BT. In some countries, the imposition of a turnover tax liability on foreign service providers is referred to as a "reverse charge", but frequently accompanied by provisions where the taxes can be refunded under certain circumstances. Our recent inquiries with the Chinese authorities showed that there is no plan in issuing any exceptions to this reverse charge, or providing any refund mechanism. Readers who find themselves caught by the above change should immediately quantify the BT impact on future operations and be prepared to deal with the additional BT costs. It is uncertain at this stage whether there will be any grandfathering arrangement for services provided before 1 January 2009 but payments made after this date.

We wish to take this opportunity to call your attention to an area of uncertainty under the new BT system. Like the old BT regulations, the new one comes with a table showing the heads of charge and the corresponding BT rates. The heads of charge remains nine, viz., transportation, construction, financial and insurance, postal and communications, cultural and sports, entertainment, services, transfer of intangibles, and transfer of immovables, and the applicable rates also remain unchanged. However, the new table of charging heads had done away with a listing of the subheads which were clearly listed in the past. The subheads and the detailed scope of charge are now to be further announced jointly by the MOF and the SAT. What is certain in the past has now become uncertain and we will have to wait for further announcement by the authorities to find out more exactly who may come under the BT net.

For a copy of the revised BT provisional regulations and implementation rules (in Chinese), please click the following URLs.

BT provisional regulations:

<http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/8527032.html>

BT implementation rules:

<http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/8729458.html>

Consumption Tax (CT)

The new CT provisional regulations and implementation rules made changes corresponding to the extension of reporting deadline to 15 days, as well as technical improvements on some language used and minor tax rate changes. There are no radical changes.

For a copy of the revised CT provisional regulations and implementation rules (in Chinese), please click the following URLs.

CT provisional regulations:

<http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/8527133.html>

CT implementation rules:

<http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/8729527.html>

Readers should be aware that shortly after the announcement of the new CT provisional rules and regulations, the MOF and the SAT jointly issued a circular, Caishui [2008] No. 167, on 19 December 2008 to further increase the CT rates on leaded and unleaded gasoline, diesel, lubricant, and aviation fuel starting 1 January 2009. After the increase in these CT rates, all other fees, surcharges and levies currently imposed by local governments on the users of roads and waterways will be abolished. According to the authorities, the net effect after these changes, together with the recent drop in crude oil prices, will be a reduction in burden to users of all transportation means.

Appendix 1

Increase in export VAT refund rates

Circular 144 adjusted the export VAT refund rates for 3,770 commodities constituting approximately 27.9% of the total commodities listed in the Directory of Customs Import and Export Tariff of the People's Republic of China¹.

Circular 144 basically increased export VAT refund rates on labor intensive, mechanical and electrical products on 1 December 2008 and which included the following items:

1. Certain rubber products, forest products: 9%
2. Certain moulds and glassware: 11%
3. Certain aquatic products: 13%
4. Suitcases, bags, shoes, hats, umbrellas, furniture, bedding and similar furnishing, light fixture, clocks and watches: 13%
5. Certain chemical products, stone materials, non-ferrous metal processing materials: 11% or 13%
6. Certain electrical products (such as farming pumps, motorcycles, bikes, electric appliance): 11%, 13% or 14%

[1] Xinhua Net: Article title "The export VAT refund rates of 3,770 products will be increased next month", 18 November 2008.



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