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KPMG TaxWatch Webcast: Navigating through the 2012 China VAT reforms

February 29, 2012

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Agenda

- Background of VAT reforms
- General rules
- Profitability impact
- Cross-border service flows
- How to prepare for VAT reforms

Speakers

- Frank Sangster, Principal, US Indirect Tax, KPMG LLP
- Lachlan Wolfers, Partner, KPMG Centre of Excellence, Indirect Taxes, KPMG in China

Administrative

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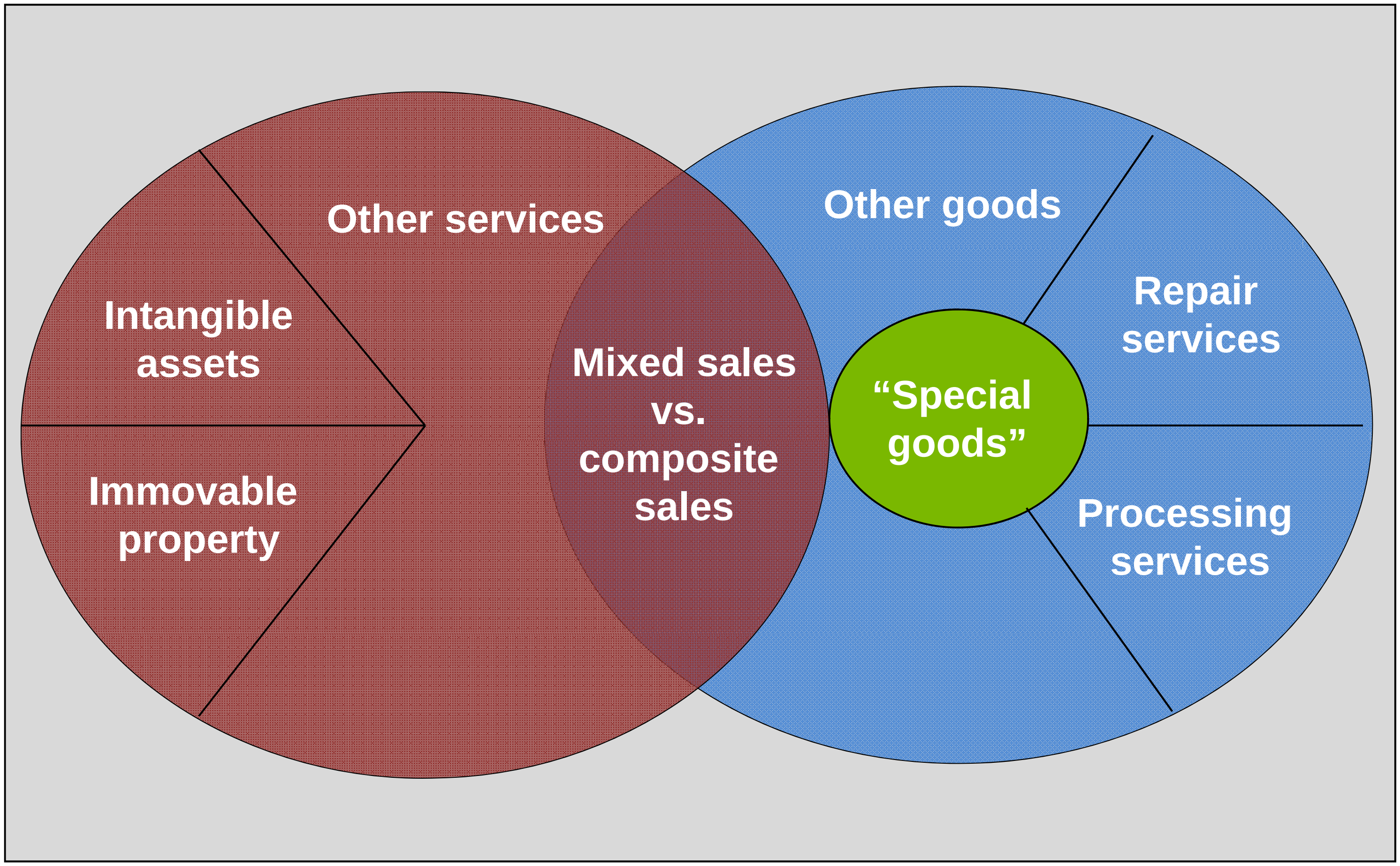
Background of VAT reforms

Pre-reforms, how did indirect taxes in Shanghai look?



Key:

- *VAT*
- *Business Tax (BT)*
- *Consumption Tax & VAT*
- *VAT and/or Business Tax*

Key features of system – pre-reforms

VAT

- Tax collected by business, but embedded in prices charged to end consumers
- Applies to sale and importation of goods, provision of repair and processing services
- General rate of 17 percent, with some food at 13 percent and narrow range of exemptions
- Exports are zero rated, but ≠ full recovery of VAT incurred on cost (input VAT)
- If VAT on sales (output VAT) < VAT incurred on cost (input VAT), generally only carry forward the balance

BT

- Tax on business
- Applies to provision of all other services, including financial services and real estate
- General rates of 3-5 percent, except for entertainment (up to 20 percent)
- Cascading tax – i.e. no entitlement to input credits
- Most industries pay output BT on gross revenue basis, but some instances on net basis
- Very narrow range of exemptions (e.g. offshore outsourcing, sale of a business)
- Applies if either supplier or recipient in China

How indirect taxes in China are different

While China's VAT system exhibits many characteristics of VAT systems throughout the world, there are some important differences:

•System is very document driven, no invoice = no input VAT credit

•Invoices are controlled, and must be issued on Government approved machines

•If input VAT > output VAT, generally no refund

•Transfers between branches of the same legal entity give rise to VAT liabilities

•Convoluted procedures for claiming exemption, generally require pre-approval

•No real case law, and no culture of engaging in litigation with tax authorities

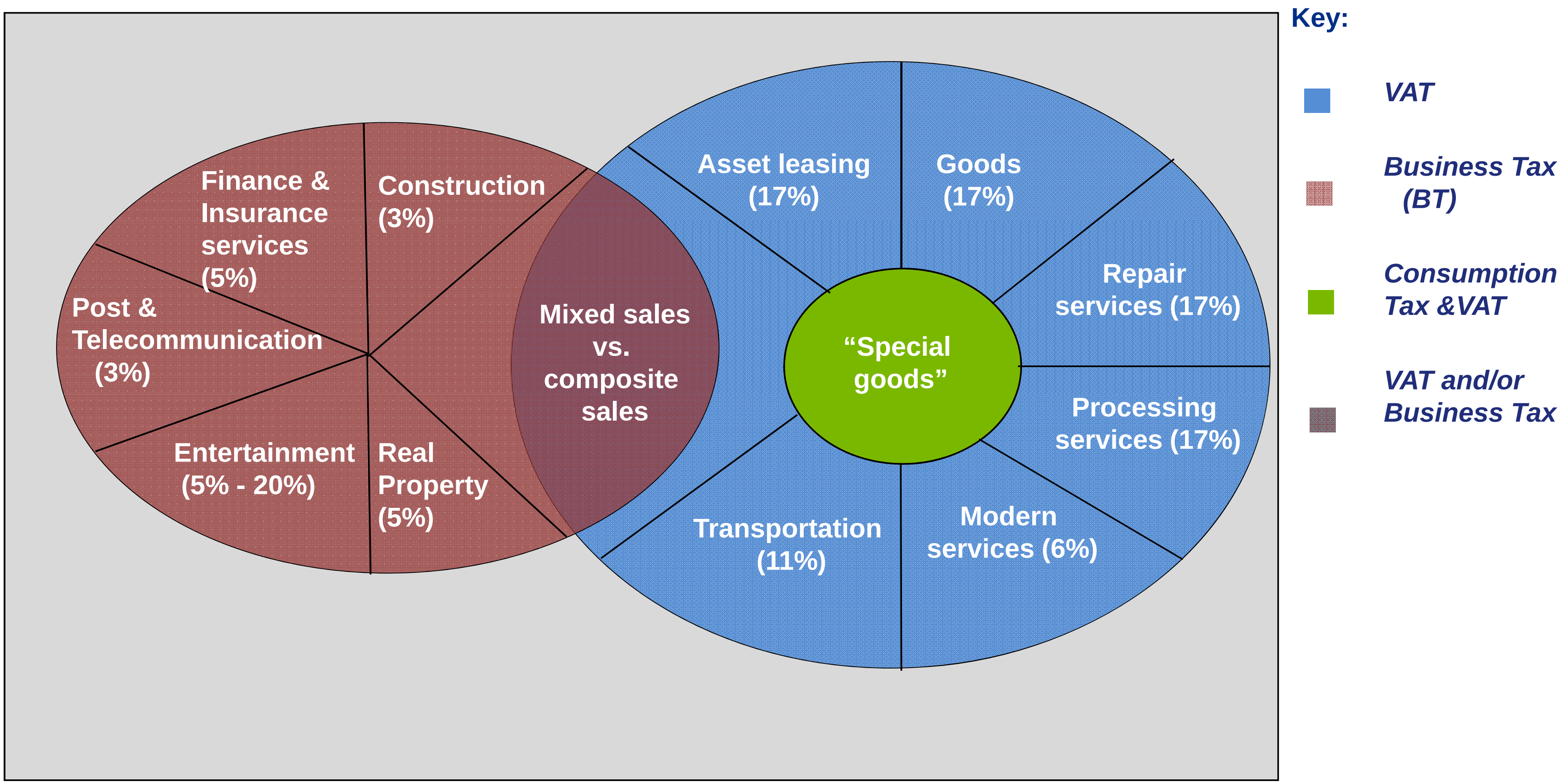
•Administration at provincial level often leads to differing interpretations

•Regulation of tax closely linked to regulation of corporations and currency controls

•Foreign entities cannot register for VAT and claim input VAT credits

•New system introduces hybrid concepts from old BT system, to preserve various concessions

Post-reforms, how do they look now in Shanghai?



CPE Question 1

Which of the following industries falls under the scope of the VAT pilot program?

A. Entertainment

B. Modern Services

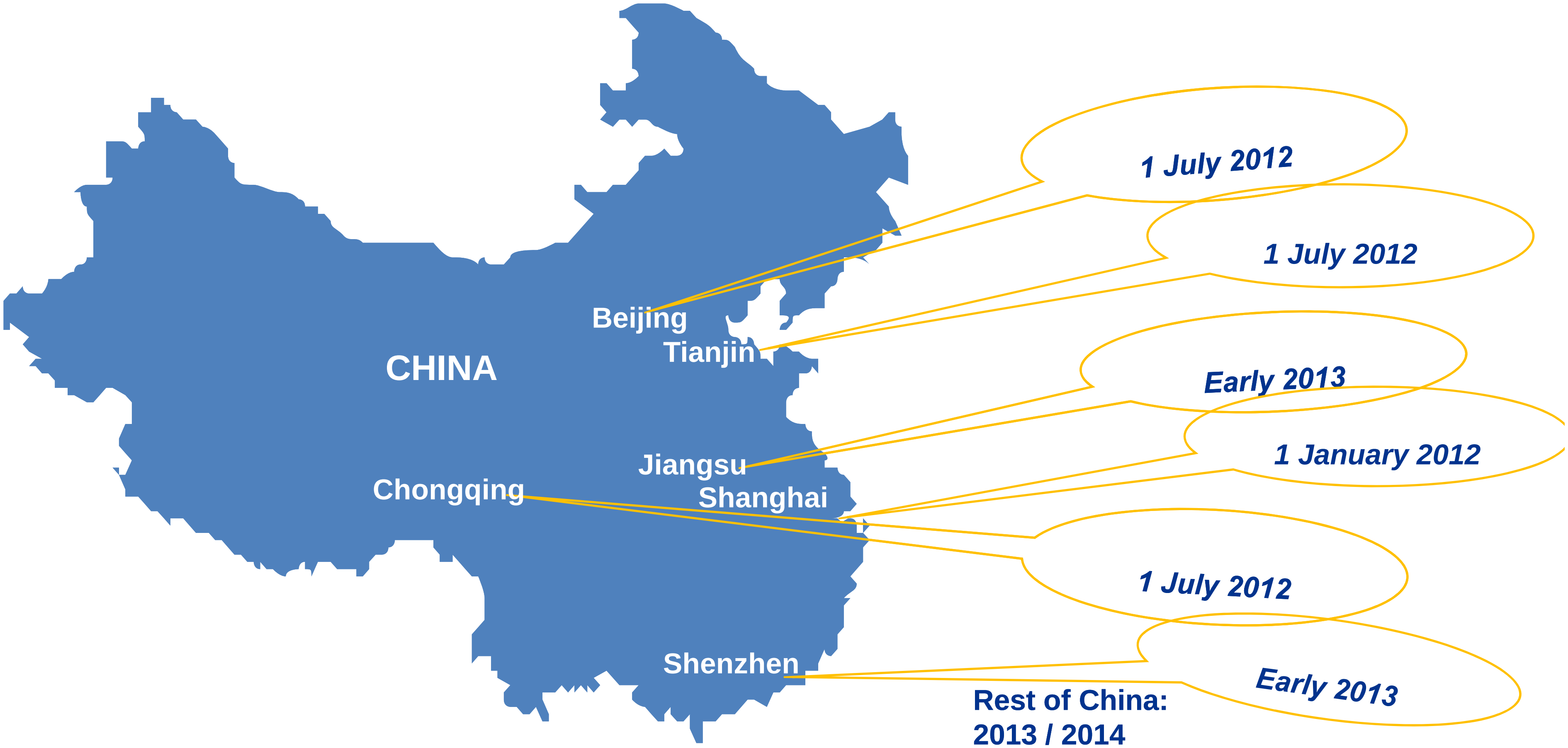
C. Real Estate

D. Finance

Background - merger of VAT & BT – snapshot

Rules	•Detailed implementation rules released on 17 November 2011
Commencement	•Shanghai pilot scheme commenced on 1 January 2012
Scope – what's in	•Applies to transportation sector and 'modern services industry' in Shanghai
Scope – what's out	•Financial services, insurance, real estate, construction and post and telecommunication services excluded from pilot scheme
Rates	•2 new VAT rates – 6% and 11%
Expansion	•Roll out of VAT reforms to progress across China, Beijing has applied to join
Exports	•Exports of services are either zero rated or exempt
Imports	•Imports subject to VAT, but recipient may be able to claim credit

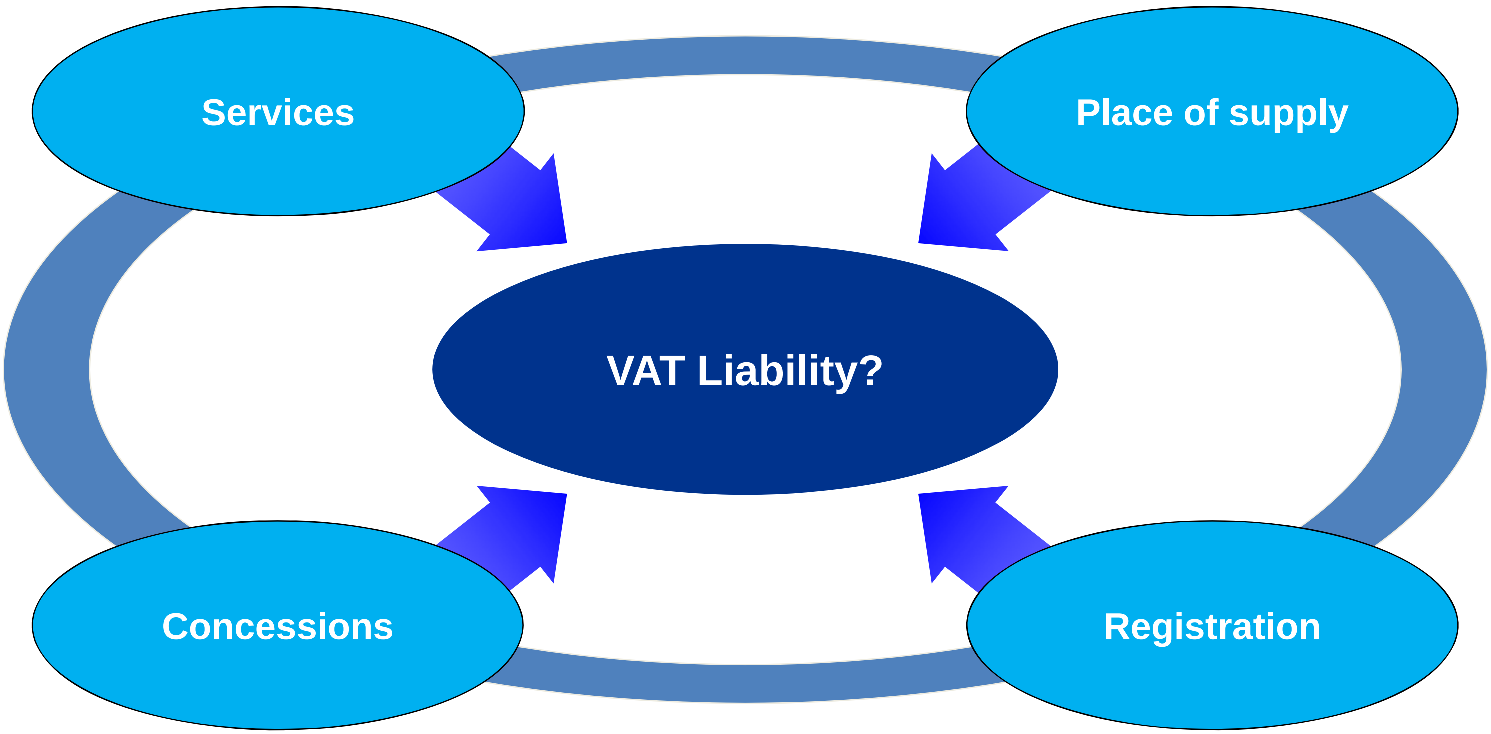
Likely rollout of VAT reforms across China



Expansion by scope: Financial Services → Real Estate and Construction → Entertainment → Post and Telecommunications cutting through complexity

General Rules

VAT reform decision matrix



Merger of BT and VAT – services & rate

Industry	Rate
Leasing of tangible movable property	17%
Transportation services	11%
Research and development (R&D) and technical services	6%
Information technology (IT) services	6%
Cultural and creative services	6%
Logistics and ancillary services	6%
Certification and consulting services	6%
Small scale VAT taxpayers	3%

Rule of thumb: If unsure, look at your approved business scope. Also look at basis upon which you paid BT before.

CPE Question 2

What is the VAT rate applicable to transportation services under the reform?

A. 17%

B. 11%

C. 6%

D. 3%

Merger of BT with VAT – place of supply - domestic

Location of supplier	Location of services	VAT or BT
In Shanghai	In Shanghai	VAT
In Shanghai	Elsewhere in China	BT, but credit allowed against VAT payable (very limited application in practice)
Elsewhere in China	In Shanghai	BT
Elsewhere in China	Elsewhere in China	BT

Rule of thumb: If you paid BT in Shanghai previously, and those same services are now within scope of the pilot program, then you pay VAT in Shanghai. It does not matter where the customer is located in China.

Merger of BT with VAT – place of supply - cross border

Location of supplier	Location of recipient / place of consumption	VAT treatment
In Shanghai	Outside of China	Zero rated or exempt – see Circular 131
Outside of China	In Shanghai	VAT withholding, recipient may claim input VAT credit subject to documentary requirements
Outside of China	Services consumed wholly outside of China	Not subject to VAT
Outside of China	Leased goods used entirely outside of China	Not subject to VAT

Merger of BT with VAT - registration

Annual sales revenue	Registration	Consequence
> RMB 5 million (USD 794k)	Compulsory	VAT at either 6%, 11% or 17%, input VAT credits
< RMB 5 million	Optional registration	VAT at either 6%, 11% or 17%, input VAT credits
< RMB 5 million	Small scale taxpayers	VAT at 3%, no input VAT credits
Transportation providers	Not registered	VAT at 3%, input VAT credit of 7%

CPE Question 3

What is the threshold to register as a general VAT payer under the VAT pilot program?

A. RMB 800,000 (USD 127k)

B. RMB 3 million (USD 476k)

C. RMB 5 million (USD 794k)

D. RMB 40 million (USD 6.3 million)

Merger of BT with VAT – concessions

Concession	VAT treatment	Input VAT credits
Technology transfers by pilot taxpayers	Exempt from VAT	No
Offshore outsourcing services by businesses registered in Shanghai	Exempt from VAT	No
Pipeline transportation services	VAT levy first and refund later for VAT burden in excess of 3%	Yes
Approved finance leases	VAT levy first and refund later for VAT burden in excess of 3%	Yes

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Profitability Impact

Impact of VAT reforms on profitability - example

	BT Regime	VAT Regime
Sales Revenue ($)	100	?
BT payable @ 5%	5	N/A
VAT – output ($)	N/A	?
Costs of Sales($)	80	?
VAT - input($)	N/A	?
Profit($)	**15**	**15**

Seek to pass on VAT to customers

Ensure cost savings of suppliers is passed on

Maximise input VAT credits

CPE Question 4

Is the VAT reform going to impact your P/L?

A. Yes

B. No

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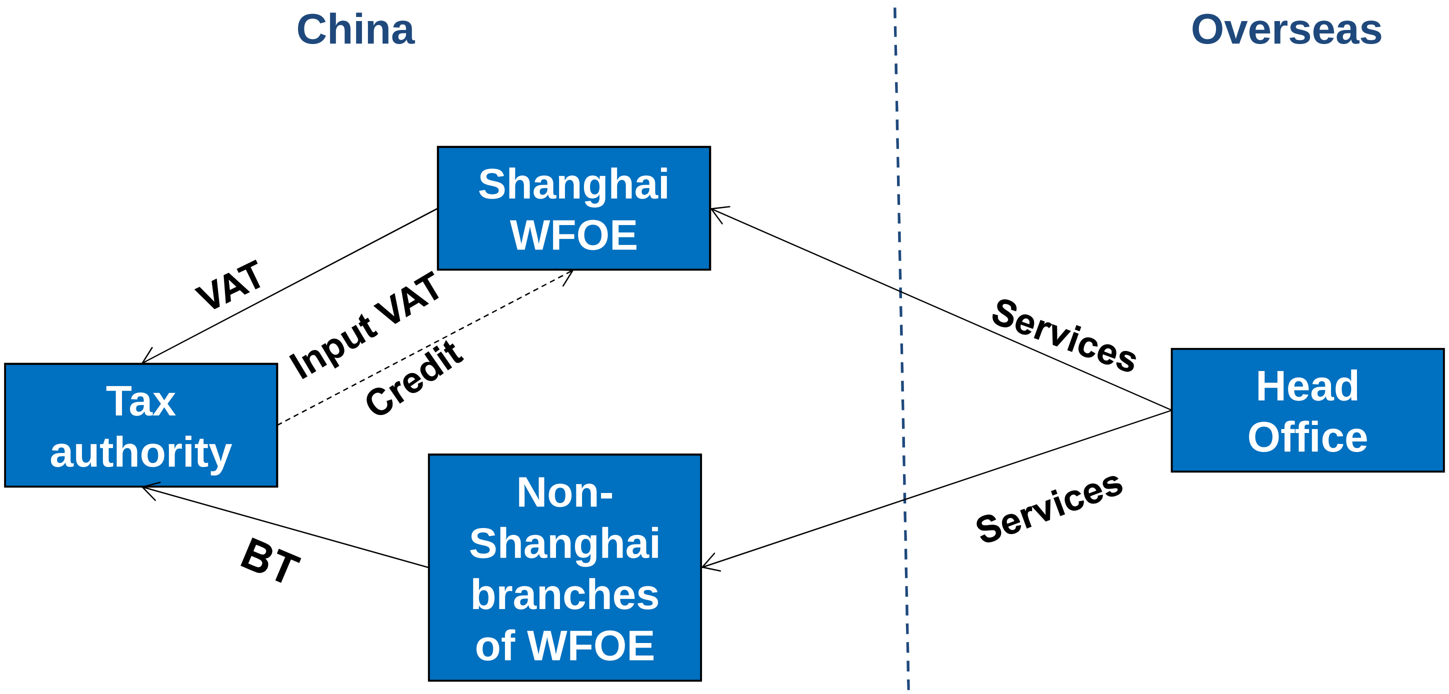
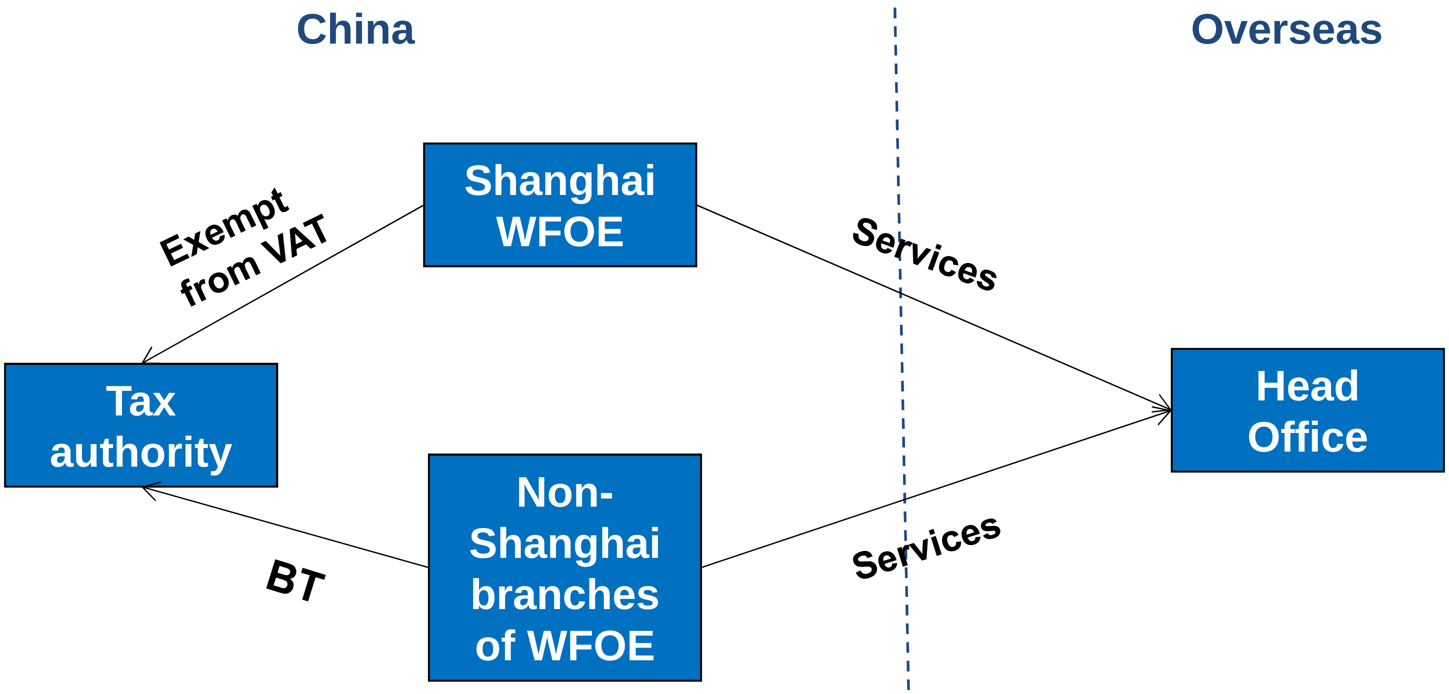
Cross Border Service Flows

Cross border service flow opportunities - imports



Issues: Need to ensure service within scope
Gross up for VAT withholding
Meet documentation requirements for claiming input VAT credit
Interaction with transfer pricing

Cross border service flow opportunities - exports



Issues: Need to ensure services within scope of pilot program
Service must not relate to goods or real estate in China
Comply with procedures for claiming exemption
No credit for VAT on costs
Interaction with transfer pricing

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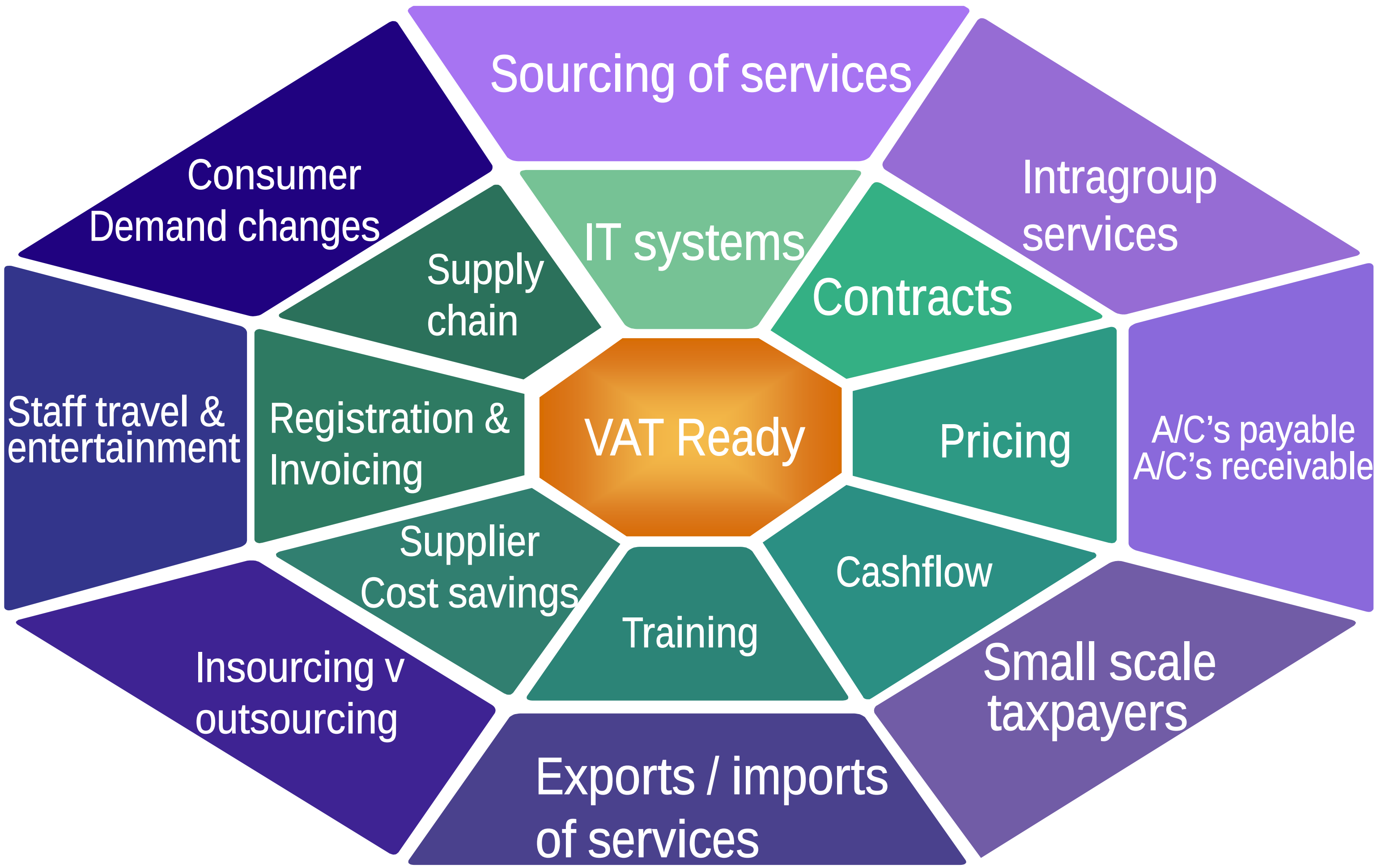
How to Prepare for VAT Reforms

How to get VAT ready



Merger of BT and VAT – contracting and cost saving impacts

Existing contracts:

•If contracts entered into prior to reforms, and price is inclusive of BT, will supplier have to absorb VAT? Or can supplier pass on VAT?

•Leases of tangible movable property entered into prior to 1 January 2012 – remain subject to BT

•If contract allows for entitlement to pass on ‘indirect taxes’ or ‘turnover taxes’, will supplier be able to pass on VAT?

New contracts:

•If you are the **supplier**:

- how do you ensure VAT can be recovered in addition to contract price?

•If you are the **purchaser**:

- how do you ensure supplier does not simply add on VAT to price which already includes BT?
- how do you ensure supplier passes on benefit of cost savings arising from removal of BT and availability of input VAT credits?
- how do you ensure supplier provides you with a special VAT invoice before you pay the VAT?

Merger of BT and VAT – IT systems

Key issues to consider:

•Do my IT and accounting systems recognise VAT?

•What tax codes does my accounting system recognise?

•Output VAT codes - 0% (exempt), 2% (2nd hand goods), 3% (transportation), 6% (new VAT rate), 11% (new VAT rate), 13% (foodstuffs and other items) and 17% (general VAT rate);

•Input VAT rates - 0% (ineligible for VAT credit), 6% (new VAT rate), 7% (transportation), 11% (new VAT rate), 13% (foodstuffs and other items), 17% (general VAT rate), export refund rates

•How do my systems link in with golden tax system?

Merger of BT and VAT – supply chain

Key supply chain issues to consider:

•Consider current legal structure – what aspects of that structure are superfluous? How could things be rationalised or improved?

•Assuming no cascading of BT, what aspects of my supply chain can now be removed?

•Absent BT, is my supply chain most effective from a trade and customs perspective?

•How does my renewed supply chain impact on transfer pricing?

•Does my supply chain model consider the concept of unbundling non-dutiable costs from my customs value such as commissions or service fees paid to buying agents for the sourcing of products?

Merger of BT and VAT – registration & invoicing

Key registration and invoicing issues to consider:

•Is my business registered as a general VAT taxpayer, or does it need to register now?

•If not, is my business turnover sufficient to register?

•Will my business be subject to a monitoring period?

•What equipment does my business need to purchase to issue special VAT invoices? Do my staff know how to use it?

•What is the lead time for registering and obtaining approval and equipment for issuing special VAT invoices? Will my business be ready for 1 January 2012?

•Will my business only deal with other businesses which are registered as general VAT taxpayers?

Merger of BT and VAT – cashflow and training

Key cashflow impacts:

•Can my business fund an increase to 17% in VAT on services (up from 3% or 5%)

•What are my payment terms for accounts receivable? Do I pay VAT before I receive it?

•What terms does my business pay accounts payable? Do I get a special VAT invoice at or before I pay the VAT component?

•Is there are a net cashflow deficiency?

•When borrowing to fund major acquisitions, will I be able to get short-term financing of VAT component?

•How do the VAT reforms impact on internal budgeting – i.e. VAT inclusive or VAT exclusive?

Key training considerations:

•Who in my organisation needs to know about these reforms?

•What about impact on staff in finance function? A/c's receivable and a/c's payable function

•For foreign MNCs, what about head office training?

CPE Question 5

Which of the following will be impacted by the VAT reform?

A. Contracts

B. Supply chain

C. IT system

D. All of the above

VAT reforms – practical tips

Some lessons from other countries:

1. Significant tax reforms like this are a key management issue, not simply a tax issue

2. Need to start preparing now – this includes taxpayers not subject to pilot program - the reforms are inevitable

3. Obtain a budget to prepare for the reforms

4. Put together a key team – project leader + key external advisers

5. Consider impact on IT systems, accounting systems and processes, pricing, contracts, consumer demand, cashflow management

6. Businesses who provide services likely to suffer increased strain on cashflow

7. Financial services and real estate are often problematic under VAT – hence likely to be left until later

8. Transition to new system – always produces winners and losers – the key to being a winner is to be prepared

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Q&A

Please send any questions to:
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Polling Question

- Would you like a KPMG professional to contact you regarding the topics discussed today?
  - Yes
  - No

Q&A (continued)

Today's Presenters

Frank Sangster, Principal	**267-256-1680**	**fbsangster@kpmg.com**
Lachlan Wolfers, Partner	**+86 21 2212 3515**	**Lachlan.wolfers@kpmg.com**

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Thank you for joining us. Please send any questions to us-taxwatch@kpmg.com

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