



An Introduction to China's VAT Reform

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Effective May 1, 2016, the People's Republic of China has fully implemented its VAT reforms¹ by replacing its business tax (BT) with a value-added tax (VAT) system following the inclusion of four remaining business sectors: construction, real estate, finance and the lifestyle services sector (hotels, catering services, healthcare, education, and cultural/entertainment services).

Businesses affected by the recent tax changes need to prepare for this transition and become aware of the challenges in the move from BT to VAT practices. Many issues remain to be settled and clarified. It is essential for companies in the above-mentioned industries to review their resources to analyze how they will process and manage VAT in China and assess what changes need to be made to their business operations. This is especially important as a formal VAT act is expected to be passed at the end of 2018.

What is the impact of the latest VAT reform on foreign companies doing business with China? What VAT rules are applicable to foreign companies?

¹ *Circular Caishui 2016 No. 36* jointly issued by the Ministry of Finance and State Administration of Taxation, March 24, 2016



The government's VAT reform will bring significant benefits to enterprises. Businesses selling goods as well as importers can claim input VAT credits received from the purchase of services which were previously subject to BT. All service providers in China who register as general VAT taxpayers are now entitled to claim input VAT credits obtained from the purchase of goods, fixed assets and services used in their businesses.

Under the previous regime, BT was paid on the whole cost of a service at every point in the supply chain. By only taxing "value added" parts throughout the supply chain, instead of taxing the entire business turnover, the VAT reform has the potential to reduce the overall level of tax burdens. This does not mean, however, the tax

burdens for all enterprises will be reduced. In order to ensure the benefits of the VAT reform to the greatest extent, businesses affected by the new tax reform will need to pay more attention to their VAT management.

Foreign companies with Chinese operations should:

- Understand the PRC VAT rules applicable to foreign companies and understand the VAT withholding mechanism;
- Assess the potential tax impact on PRC-related transactions and negotiate with their Chinese business counterparties regarding price adjustments (including reviewing the status of their current projects and contracts, not only from a tax perspective, but also from a cash-flow management perspective);
- Review and amend cross-border contracts to clarify the party responsible for VAT and VAT filing.

What to be aware of when issuing bills with a China connection under the new law (an example)

If a foreign company sends an invoice for services performed outside of the PRC to a

Chinese customer, the invoice will be subject to the foreign country's VAT.

When the Chinese company pays the invoice, the Chinese tax authorities will deduct the new applicable VAT rate of six percent. For example, if the gross price of an item is USD 100 (including Chinese VAT), six percent VAT will be deducted and thus the foreign company only receives USD 94. But if the net price excludes Chinese VAT then the Chinese company shall pay USD 106 with USD 6 deducted by the tax authorities, with the foreign company receiving USD 100. It is thus important that the parties are aware of the relevant tax issues and regulate the pricing structure, including who shall bear the taxes in the contract.

Zero-rated VAT and VAT Exemption Policies

With the launch of *Circular Caishui 2016 No. 36*, the regulation on which the VAT reform is based upon, the list of zero-rated VAT items and VAT-exempt items categorized by sectors is being modified and updated. Regarding VAT exemptions on cross-border services, certain activities related to construction, finance and lifestyle services have been included in the scope of cross-border taxable activities eligible for VAT exemption.

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