CHINA VAT REFORM: ACHIEVING A SUCCESSFUL TRANSITION TO VAT
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A significant milestone in the reform of China’s indirect tax system was reached on 1 January 2012 with the launch of a VAT reform pilot program in Shanghai. Following the initial announcement, the pilot program has been implemented extremely quickly and if the rollout continues at the current pace, affected companies must take smart actions now in response to assess the impact to their business and start planning to ensure readiness for the new rules.

This whitepaper addresses the practical implications of the VAT reform, the challenges and opportunities it presents, and reflects on lessons learned from the Shanghai pilot. A suggested course of actions is presented to help companies consider the steps they need to take to ensure they are adequately prepared for the full transition from Business Tax (BT) to VAT. It also explores common types of technology solutions that assist companies in maximizing their VAT compliance and efficiency through automation.

As the VAT reform evolves, we will issue regular updates on the latest developments and keep you up to date.

INSIGHT REGARDING PHASE 1 TO DATE

How well have companies adapted?

Due to the nature of the reform, which is a transformation of BT into VAT, we see different impacts to different taxpayers. The traditional VAT payers (i.e. those who trade in goods), where the reform only impacts their service elements, have generally managed the reform well, as they are already familiar with the tax and the associated compliance requirements. Whilst questions remain regarding the taxation of certain services provided, especially those to recipients outside of China and the ability for a zero rating or exemption, most have developed a strategy to implement the VAT reform.

For the traditional BT payers (i.e. the service sector), the reform has been a challenge. Due to the obligatory launch date of 1 January 2012, the service sector has had to implement VAT, but this required significant efforts to understand the resulting impact, so it was an extensive exercise. Despite some inevitable teething problems, these traditional BT payers have been compliant with the new regulations. It is, however, interesting to note that the major consequence of the reform is the resulting commercial impact. This is an issue which remains ongoing. Compared to the general BT rate of 5% versus the VAT rate of 6% (in most cases), many recipients have considered this to be an additional tax burden.

SCOPE AND TIMELINE

Though the scope of the VAT pilot program in Shanghai is limited to transportation and modern service industries, through Circular 110, the State Administration of Taxation (SAT) and Ministry of Finance (MOF) jointly announced intentions to roll the pilot out to other regions and other service sectors. This would be carried out in two phases:

- Phase 1: The initial pilot applicable to specific sectors in Shanghai.
- Phase 2: Rollout of the pilot to other regions, or nationwide, for specified sectors when conditions permit.

If successful, the VAT reform is expected to be rolled out nationwide for all service sectors.
Looking forward – how should companies prepare for the national rollout of the reform?

From the initial announcement of the VAT reform on 26 October 2011, it was clear that although Shanghai is acting as a pilot, the ultimate goal will be a national rollout. Within a few weeks following the announcement of the pilot in Shanghai, there was a flurry of speculation from other cities who wished to join the pilot. Hence, the pilot has created some competition between Shanghai and the rest of China. It is safe to assume that additional cities will join the pilot — the question is how soon this will take place. Therefore, it is necessary for enterprises outside Shanghai to learn from the implementation of Shanghai pilot, and identify actions that they should take prior to the pilot’s go-live date.

As the Shanghai pilot was announced relatively quickly, it is expected that there will be a short lead time for companies located in other places to join the pilot soon. Based on our experiences from the Shanghai VAT pilot, the following summarizes the four cornerstone issues to be considered:

**FINANCIAL IMPACT** – Understand now how the VAT reform can affect your business. There are two main issues at play, which is how the charge of VAT may increase the burden of the customer and how the ability to recover VAT may affect who your suppliers will be in the future.

**LEGAL IMPACT** – Understand now whether your contracts are structured in a way to allow you to charge VAT or not. This point is especially important for those traditional service providers who typically have written their contracts to be tax inclusive in the past due to the nature of BT.

**COMMERCIAL IMPACT** – Understand how recipients will react to the need to pay 6% VAT, which is often regarded as creating a tax burden. For suppliers who are unable to charge the VAT for commercial reasons, the reform is costly as the tax is borne as a cost which decreases the top-line profit.

**SYSTEMS IMPACT** – The issuance of the special VAT invoice, the resulting VAT reporting obligations, should be automated. The ERP will need to be adapted to cater for the requirements of VAT.

**PRACTICAL IMPLICATIONS**

**Pricing & financial analysis**

With Shanghai being a pilot, it has created some distortions in the market (and this is a fundamental reason why there has been increasing speculation of several other cities wanting to join the pilot). Given that certain service providers will now be general VAT taxpayers and they will be able to recover VAT incurred on costs, it is financially more beneficial for them to contract with other providers who are also VAT payers.

Contracting with a party who will charge VAT, which is now deductible, is clearly more advantageous than contracting with a BT payer where the 5% BT is not deductible. On the other hand, when receiving service, a general VAT payer will be able to deduct the VAT charge from the service provider. Therefore, for service recipients, contracting with a service provider subject to VAT will also be more advantageous than contracting with a service provider subject to BT. Taxpayers need to revisit their pricing policies for identification of potential benefits. However, to achieve a positive result, they will need to understand whether the services provided fall within the specific
thus creating a queue. Therefore, even if there is by-batch approach has been taken for certain sectors, in the administration to register companies, a batch-consequence of the pilot, and the significant increase that the onus to comply rests with the taxpayer. As a VAT is a self-assessed tax, meaning amount over RMB 5 million, there is an obligation to register for VAT. VAT is a self-assessed tax but no further guidance has been issued until now. The regulations state that if a taxpayer is providing services fall within the scope of the VATable services. A technical confirmation is especially important supporting documentation needed when applying for the zero rating of services — this is a welcomed clarification as the initial comments on supporting documentation was first announced at the end of 2011, but no further guidance has been issued until now.

Supporting evidence to enjoy the zero rating
The regulations provided clarity of the services covered by the reform, but in reality it is not always easy to understand whether some of the non-standard services fall within the scope of the VATable services. A technical confirmation is especially important where the services are issued to recipients overseas to take advantage of the zero rating/exemption. The recent release of Bulletin 13 clarified the nature of the supporting documentation needed when applying for the zero rating of services — this is a welcomed clarification as the initial comments on supporting documentation was first announced at the end of 2011, but no further guidance has been issued until now.

VAT is a self-assessed tax
The regulations state that if a taxpayer is providing services covered by the reform, with an annual amount over RMB 5 million, there is an obligation to register for VAT. VAT is a self-assessed tax, meaning that the onus to comply rests with the taxpayer. As a consequence of the pilot, and the significant increase in the administration to register companies, a batch-by-batch approach has been taken for certain sectors, thus creating a queue. Therefore, even if there is an obligation to register for VAT, some may not be able to register immediately. It is important to note that the taxpayer should continue a dialogue with their local tax bureau to ensure that they remain compliant. It is also important to note that the need to register for VAT is a matter of fact and not one of choice. Hence, a more proactive approach is needed whereby the company examines whether the VAT reform is beneficial and take steps to ensure that it is included into the reform program as soon as possible.

Technology in automation of the compliance
Businesses affected by the VAT reform will need to update their IT systems in accordance with new rules. Companies levying only BT on their goods and services will need to be able to raise VAT invoices. Therefore, any information not captured for issuing or processing a VAT invoice will need to be captured, such as new tax rates and tax classification codes. These changes will in turn need to be reflected in any interfaces used by accounts clerks to ensure that invoices raised or received are given the appropriate tax treatment and the relevant information is saved into the accounting system. To the extent these processes are not currently automated, staff training may be required.

The impact of the VAT reform is exacerbated by the fact that the rollout is gradual, so businesses that operate out of a number of regions may need to implement changes on a piecemeal basis. Even companies already involved in the Shanghai pilot may need to implement additional changes down the line when the scope of the VAT reform is extended to other service sectors.

Companies will also need to embed appropriate steps in the reporting process to be able to produce VAT returns on a monthly basis. Questions they may wish to consider include: what are the information requirements? how can the information be extracted from the system? and how can the information be processed to generate the requisite figures for the return?

OPPORTUNITIES
As is clear from the implications described above, affected companies will need to invest in preparing for the VAT reform. Although not all companies may necessarily look forward to an overall reduction in their liability, the new measures are being implemented to help ease administration and stimulate the economy. Furthermore, the changes give rise to potential immediate and longer-term tax planning opportunities.

Progressive companies will not just react to the VAT reform, but embrace it as an opportunity to review their existing systems, processes, and controls and consider whether further improvements can be made, through means of automation or otherwise. Performance improvement in planning, implementation, and operations of VAT processes can result in direct cost
savings for the tax function. An effective tax strategy supported by a well-designed technology infrastructure fosters synergy between processes and people. As companies transit from BT to VAT payer status, the key questions tax functions must ask and address include:

- Are tax professionals spending time wisely on strategy and planning, and not on manual preparation work for compliance?
- Are processes integrated and automated to ensure compliance with VAT filing requirements and deadlines?
- Are the existing tax systems dynamic and flexible in making updated adjustments in accordance to changing VAT rates and rules?

ENSURING READINESS

Careful planning can help minimize the impact of the VAT reform and ensure identified opportunities are realized. Conversely, a failure to appropriately plan for any changes may result in an overpayment of tax, VAT reclaim opportunities being missed, or penalties imposed by the tax authorities arising from incorrect disclosures.

There are a number of aspects that companies need to consider in ensuring readiness for VAT reform. Though the change has been brought about by changes in tax, the impacts extend far beyond the boundaries of the tax department.
**USING TECHNOLOGY TO AUTOMATE VAT DETERMINATION AND COMPLIANCE PROCESSES**

Since its invention in France in the 1950s, VAT has been implemented in many countries. A harmonized VAT system has existed in the EU for a number of years. Global trends indicate that countries are moving away from corporate taxes and towards indirect taxes as a more reliable means of raising revenue. In countries where established VAT systems have evolved, technology tools have been developed to help companies achieve greater levels of efficiency and accuracy in their tax compliance by introducing automation.

Businesses with VAT obligations have successfully deployed software tools to benefit their compliance process. The efficiency brought about by these solutions has led to direct cost savings. Furthermore, the use of software tools has helped safeguard companies against future tax changes, such as changes in tax rates and rules. One example would be the changes in VAT rates in Europe in 2008.

Two areas where technology is commonly used to automate VAT compliance processes are:

1. Automated determination, calculation and recording of transactional taxes (determination processes).

These are explained in further detail in the following sections.

**Automated determination, calculation and recording of transactional taxes**

Although large companies rely on ERP systems to manage their business processes, multiple departments supporting those ERPs can spend hours updating and administering tax codes within the systems. This work is not only labor intensive and expensive, but does not catch every scenario, thus problems can arise at a later stage in the process. This work is further complicated by frequently changing rules and regulations, and by increasing global economic pressures which lead governments to apply greater scrutiny on taxpayers.

Using software to automate the VAT determination relieves some of these internal pressures on company resources without disrupting existing ERP processes. It offers additional advantages by improving the accuracy of the tax department’s work, automatically keeping pace with changing tax systems worldwide and installing needed controls.

Tax determination solutions — often called tax engines or bolt-ons — work alongside ERP systems and connect in real time directly to the ERP. Tax engines add highly accurate tax decisions to the standard ERP purchase, sales, and post-purchase processes. The tax determination solution is continually updated for global changes in tax logic, rates, rules, and messaging.

Complementing an existing ERP system with this single addition can free up significant company resources. With a tax determination solution in-house, tax departments no longer need to track VAT determination rules across the globe. IT departments are saved from having to build, rebuild, test, and implement new tax requirements alongside the ERP.

Because manual configuration is no longer necessary, the data feeding the compliance process doesn’t need to be checked and analyzed for errors. ERP users with complex trading requirements benefit greatly, as these companies can fully automate their decision processes by removing the manual tax code selection processes and replacing them with automatic tax decisions.

All of this translates into a more cost-effective, automated, and streamlined compliance process which enables indirect tax staff to spend less time fixing and manipulating data, and focusing more on higher value activities such as tax planning.

**Automated production of VAT returns**

Some ERP systems can offer advanced reporting and even generate tax return figures. However, the data may not be in the format required by the indirect tax return preparer, or may require certain adjustments. Therefore, staff can often spend significant amounts of time importing or rekeying ERP tax data into spreadsheets for further consolidation, analysis, correction, manipulation, and preparation of returns.

This approach poses a number of challenges:

- **Expensive** – The work associated with getting the data into the worksheets can be manual and therefore costly.
- **Lack of control** – Users can deliberately or inadvertently change formulae within spreadsheets that are not appropriately locked down.
- **Lack of audit controls** – There is no audit trail between the ERP reports and the spreadsheets, which themselves can be difficult to audit.
- **Inconsistency** - Large businesses, especially those with international operations, may be running multiple ERP systems. Accordingly, return preparation staff may be dealing with various data formats, following different processes, and using different customized calculation spreadsheets for each reporting entity. Such inconsistencies can create inefficiencies and increase risk.
- **Ownership** – Sometimes the spreadsheets are only fully understood by those who created them, leading to difficulties when staff changes.
- **Maintenance** – Constantly changing rules mean that the spreadsheets need to be kept up to date.
Historically, particularly in Asia, it has been possible to commit additional staff resources to manage compliance as the business grows. However, the increasing cost of labor and increased scrutiny on taxpayers means this is not sustainable. Companies need to turn to a more robust and cost-effective model.

Many companies have been able to reduce their compliance cost by automating their processes. Tax determination and compliance software takes standard data extracts from ERP systems or the tax determination engines described above, and consolidates them into a warehouse. Once in the data warehouse, predefined exception reports can be run to identify anomalies in the data or give the preparer comfort that it is free of error. Trend analyses can help identify items which may be out of sync with historical reporting periods. Once validated, the data can then be uploaded into pre-formatted, country-specific working papers where further analysis is possible and manual adjustments can be entered, with full audit functionality. From these working papers, the necessary return figures are produced and in some cases can even be electronically submitted directly from the software.

The above diagram illustrates the integrated tax determination and tax compliance approach that can give companies an end-to-end automated solution for indirect tax compliance.

CONCLUSION

China’s VAT reform is major and although not all businesses may be in favor of it, it presents potential tax savings and other opportunities. Businesses not currently affected by the Shanghai pilot may soon be affected if the scope of industries to which the rules apply is widened, or as pilots take place in other regions, which is almost a certainty. As the changes can have wide-ranging implications, companies should act now to assess the impact on their business. A methodological approach can help ensure readiness, minimize the risk of non-compliance, and ensure any benefits that have been identified are realized.

Updating systems and compliance processes represents a key part of the readiness exercise. Lessons can be learned from best-practice companies in Europe and beyond that have successfully implemented automated VAT systems to achieve higher levels of compliance, reduce compliance costs, and protect against future changes to rates and regulations. Tax advisors can also assist companies in undertaking readiness reviews and advise on technology solutions that are available.
FOR MORE INFORMATION OR ADVICE ON THE ABOVE SUBJECT, PLEASE CONTACT:

**Charlotte Rushton**  
Managing Director  
EMEA and Asia Pacific  
Thomson Reuters  
Tel: +65 6870 3529  
Email: charlotte.rushton@thomsonreuters.com

**Sam Reeves**  
Director, Client Services  
Tax & Accounting  
Thomson Reuters  
Tel: +65 6318 4895  
Email: sam.reeves@thomsonreuters.com

**Sarah Chin**  
Partner, Indirect Tax  
Deloitte Touche Tohmatsu CPA Ltd  
Tel: +852 2852 6440  
Email: sachin@deloitte.com.hk

**Robert Tsang**  
Asia Pacific Indirect Tax Leader  
Deloitte & Touche LLP  
Tel: +65 6530 5523  
Email: robtsang@deloitte.com
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Corporate Headquarters
2395 Midway Road
Carrollton, TX 75006

China
7/F, China Central Place, Unit 03-06
No 81 Jianguo Lu, Chaoyang District
Beijing 100025

+86 13910571713 | onesource.asia@thomsonreuters.com