

# Final wave of the VAT pilot reform is coming, are you ready?

March 2016

## **Synopsis**

*China has started its journey on reforming its Indirect Tax system from 2012 by introducing a pilot regime to test how transportation and selected services could be converted from Business Tax (BT) to VAT in Shanghai. The VAT pilot reform has successfully expanded over the past few years and there has been reports made in the early part of 2016 that the VAT pilot shall be completed within this year. With the heightened anticipation, Premier Li Keqiang has announced on 5 March 2016 that the final stage of the VAT pilot reform would start from 1 May 2016.*

*It was also mentioned in the announcement that scope of the VAT pilot reform would expand to cover the Construction Industry, Real Estate Industry, Finance Industry and Life Style service Industry.*

*The announcement has also included some details for the VAT pilot reform expansion:*

- ▶ *The input VAT incurred on newly added immovable properties should be creditable for all enterprises*
- ▶ *The tax burden for all the industries should be reduced by this round of VAT pilot reform expansion.*

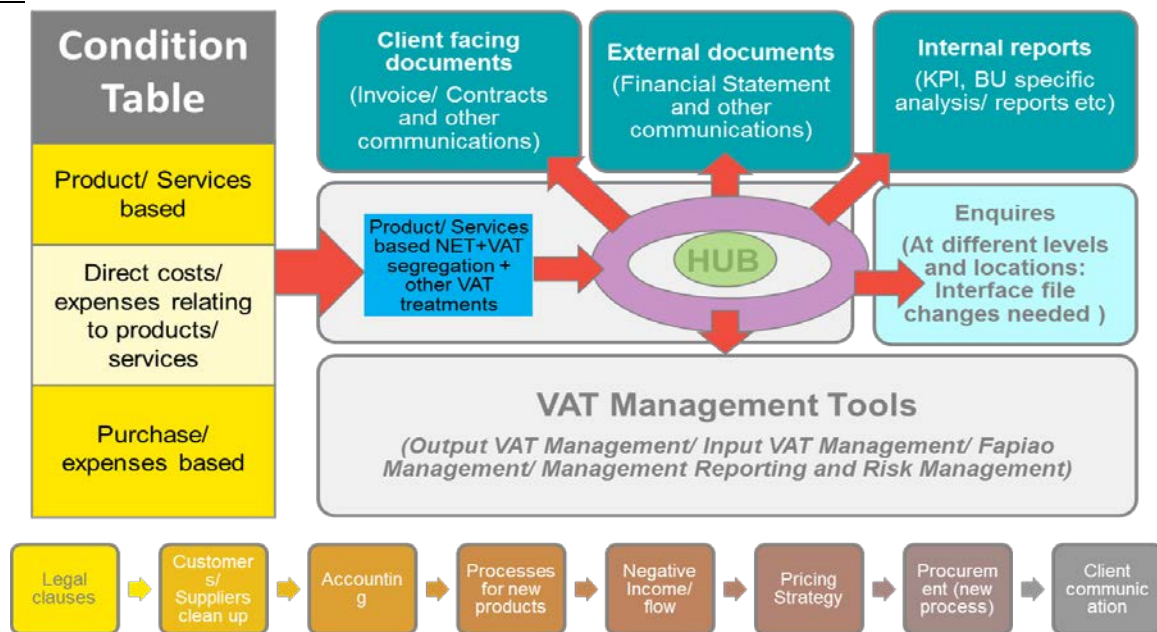
## Our observation

This announcement has confirmed the long waited starting date of the final stage of the VAT pilot. This could help taxpayers to pin down their working plan to get prepared for the VAT reform. We are aware that the policy makers and regulators are in the process of exploring a later start date for the Financial Industry, which is suggested to be 1 July 2016 or 1 October 2016. However, as 1 May 2016 is the only date mentioned in Premier Li's announcement, many are not holding optimistic view on having a deferred start for the Financial Industry.

With respect to the issuance of the detailed rules to over the taxation method applicable to each of the new VAT pilot industries, we understand both the MOF and SAT are working on the detailed implementation rules. It is anticipated that the rules would likely be ready for promulgation within March 2016. EY will continue to provide timely update on the VAT regulatory changes.

The new VAT taxpayers would only have around 50 days to get ready for the VAT world. Based on our experiences in assisting companies to be transited from BT taxpayers to VAT taxpayers, the new VAT taxpayers should consider undertaking the following tasks:

## Overview of VAT reform implementation actions:



## Action plan for the processes:

	Process	Action Plan
1	Condition Table ▶ Product/ Services based	<ul style="list-style-type: none"> <li>▶ Develop the mechanism to sort the existing product/service/revenue types from both business and system perspectives;</li> <li>▶ Develop the template for product/service/revenue information collection for further VAT Pilot analysis;</li> <li>▶ Develop the standardized methodology for Business Unit (BU) to sort and verify VAT related business facts/status;</li> <li>▶ Discuss and confirm the mechanism/template/methodology with the management and relevant BU;</li> <li>▶ Develop the condition table as per the mechanism/template/methodology;</li> <li>▶ Assist the BU in sorting and verifying VAT related business facts/status;</li> <li>▶ Define the VAT treatments based on the facts and status provided;</li> <li>▶ Discuss and confirm the business facts/status against the corresponding VAT treatments with the management and relevant BU;</li> <li>▶ Assist the BU and IT in developing the user requirements for further system set-up.</li> </ul>

	Process	Action Plan
2	Condition Table <ul style="list-style-type: none"> <li>▶ Direct costs/ expenses relating to products/ services</li> <li>▶ Purchase/ expenses based</li> </ul>	<ul style="list-style-type: none"> <li>▶ Develop the mechanism to sort the existing costs/expenses types from both business and system perspectives;</li> <li>▶ Develop the template for costs/expenses information collection for further VAT Pilot analysis;</li> <li>▶ Develop the standardized methodology for BU to sort and verify VAT related costs/expenses facts/status;</li> <li>▶ Discuss and confirm the mechanism/template/methodology with the management and relevant BU;</li> <li>▶ Develop the condition table as per the mechanism/template/methodology;</li> <li>▶ Assist the BU in sorting and verifying VAT related costs/expenses facts/status;</li> <li>▶ Define the VAT treatments based on the facts and status provided;</li> <li>▶ Discuss and confirm the costs/expenses facts/status against the corresponding VAT treatments with the management and relevant BU;</li> <li>▶ Assist the BU and IT in developing the user requirements for further system set-up.</li> </ul>
3	Client facing documents	<ul style="list-style-type: none"> <li>▶ Identify with Legal and relevant BU the client facing documents to be updated pursuant to relevant VAT regulations and internal policies, e.g.:               <ul style="list-style-type: none"> <li>• Invoice;</li> <li>• Contracts;</li> <li>• Other communications.</li> </ul> </li> <li>▶ Review the documents and summarize the key issue/ risk areas to be updated and how to update;</li> <li>▶ Discuss and confirm the key issue/ risk areas as well as the revised content with relevant BU;</li> <li>▶ Develop the client facing document revising guideline;</li> <li>▶ Seek formal opinions from relevant BU and then confirmation of the guideline from Legal;</li> <li>▶ Document the confirmed version for the management's sign-off;</li> <li>▶ Disseminate the guideline and deliver training to relevant BU and IT for their further documents and system update.</li> </ul>
4	External documents	<ul style="list-style-type: none"> <li>▶ Identify with Legal and relevant BU the external documents to be updated pursuant to relevant VAT regulations and internal policies, e.g.:               <ul style="list-style-type: none"> <li>• Financial statement;</li> <li>• Other communications.</li> </ul> </li> <li>▶ Review the documents and summarize the key issue/ risk areas to be updated and how to update;</li> <li>▶ Discuss and confirm the key issue/ risk areas as well as the revised content with relevant BU;</li> <li>▶ Develop the external document revising guideline;</li> <li>▶ Seek formal opinions and then confirmation of the guideline from Legal and other governing departments;</li> <li>▶ Document the confirmed version for the management's sign-off;</li> <li>▶ Disseminate the guideline and deliver training to relevant BU and IT for their further documents and system update.</li> </ul>

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5	Internal reports	<ul style="list-style-type: none"> <li>▶ Identify with relevant BU/ departments the internal reports to be updated pursuant to relevant VAT regulations and internal policies, e.g.: <ul style="list-style-type: none"> <li>▶ Key Performance Indicator (KPI);</li> <li>▶ BU specific analysis/ reports.</li> </ul> </li> <li>▶ Review the documents and summarize the key issue/risk areas to be updated and how to update;</li> <li>▶ Discuss and confirm the key issue/ risk areas as well as the revised content with relevant BU;</li> <li>▶ Develop the external document revising guideline;</li> <li>▶ Seek formal opinions and then confirmation of the guideline from BU and other governing departments;</li> <li>▶ Document the confirmed version for the management's sign-off;</li> <li>▶ Disseminate the guideline and deliver training to relevant BU and IT for their further documents and system update.</li> </ul>
6	Legal clauses review process	<ul style="list-style-type: none"> <li>▶ Collect sample legal documents from relevant BU;</li> <li>▶ Review VAT related clauses and summarize the key issue/ risk areas for future review process;</li> <li>▶ Discuss and confirm the key issue/ risk areas with Legal and relevant BU;</li> <li>▶ Develop standard legal clauses as well as the toolkit to facilitate future legal clause revision and review;</li> <li>▶ Develop legal clauses review process and approval ladders, including revised clauses documentation mechanism;</li> <li>▶ Discuss and confirm the process with Legal and BU;</li> <li>▶ Document the process for the management's sign-off.</li> </ul>
7	Suppliers process	<ul style="list-style-type: none"> <li>▶ Understand the current supplier information collection and management mechanism (including system);</li> <li>▶ Identify the VAT elements to be added on the process and system functions, e.g. <ul style="list-style-type: none"> <li>▶ Supplier Tax Registration No.;</li> <li>▶ Nature of goods/ service supplied;</li> <li>▶ Applicable VAT rates;</li> <li>▶ Whether Special VAT Invoice could be collected;</li> <li>▶ Whether the services are subject to withholding VAT.</li> </ul> </li> <li>▶ Develop solutions to collect and manage the additional information of all existing suppliers ("existing supplier clean-up");</li> <li>▶ Discuss and confirm the existing supplier clean-up solution with relevant BU;</li> <li>▶ Develop the implementing rules and system requirements for future supplier information collection and management process;</li> <li>▶ Discuss and confirm such process and system requirements with relevant BU.</li> <li>▶ Document the process for the management's sign-off.</li> </ul>

	Process	Action Plan
8	Customers process	<ul style="list-style-type: none"> <li>▶ Understand the current customer information collection and management mechanism (including system);</li> <li>▶ Identify the VAT elements (especially the information for VAT invoice issuance) to be added on the process and system functions, e.g.: <ul style="list-style-type: none"> <li>▶ Accurate Chinese name of the customer;</li> <li>▶ Tax Registration No.;</li> <li>▶ Other information required for Special VAT Invoice issuance;</li> <li>▶ Nature of service supplied;</li> <li>▶ Applicable VAT rates;</li> <li>▶ Whether Special VAT Invoice would be issued;</li> <li>▶ Whether the services are subject to VAT exemption/ zero-rated/ preferential treatment.</li> </ul> </li> <li>▶ Develop proper solution to collect and manage the additional information of all existing customers (“existing customer clean-up”) prior to the kick-off of VAT Pilot;</li> <li>▶ Discuss and confirm the existing customer clean-up solution with relevant BU;</li> <li>▶ Develop the implementing rules and system requirements for future customer information collection and management process;</li> <li>▶ Discuss and confirm such process and system requirements with relevant BU.</li> <li>▶ Document the process for the management’s sign-off.</li> </ul>
9	Accounting process	<ul style="list-style-type: none"> <li>▶ Identify the gaps between current accounting rules v.s. VAT regulations/ VAT accounting;</li> <li>▶ Provide sample accounting treatments (debit and credit entries) on specific VAT issues, e.g.: <ul style="list-style-type: none"> <li>▶ Discounts;</li> <li>▶ Deemed sales;</li> <li>▶ Arising time of VAT liabilities;</li> <li>▶ VAT exemption / zero-rated;</li> <li>▶ Preferential VAT treatments;</li> <li>▶ Input VAT transfer-out.</li> </ul> </li> <li>▶ Summarize for the management considerations/ decision-making the business scenarios (e.g. whether input VAT transfer-out would be allocated to specific BU) on which the specific accounting entries would be made;</li> <li>▶ Develop accounting treatment adopted and process as well as the system requirements;</li> <li>▶ Document the accounting treatment adopted and process for the management’s sign-off.</li> <li>▶ Disseminate the accounting treatment adopted and process and deliver training to relevant departments and people.</li> </ul>
10	Process for new products/ services	<ul style="list-style-type: none"> <li>▶ Identify the standard treatments for each product/ service type;</li> <li>▶ Discuss and confirm the standard treatments with relevant BU;</li> <li>▶ Develop proper mechanism to identify the type and corresponding standard treatment of the new product/ service;</li> <li>▶ Develop proper mechanism to identify the difference between the new product/ service and the treatment to be applied;</li> <li>▶ Develop the review process and approval ladders;</li> <li>▶ Discuss and confirm the process with relevant BU;</li> <li>▶ Document the process for the management’s sign-off.</li> </ul>

	Process	Action Plan
11	Negative income/ flow process	<ul style="list-style-type: none"> <li>▶ Identify the standard treatments for each negative income scenario;</li> <li>▶ Discuss and confirm such standard treatments with the management and BU;</li> <li>▶ Develop proper mechanism to identify the type and corresponding standard treatment of the negative income scenario;</li> <li>▶ Develop proper mechanism to identify the difference between the negative income scenario and the treatment to be applied;</li> <li>▶ Develop the review process and approval ladders;</li> <li>▶ Discuss and confirm the abovementioned mechanism with relevant BU;</li> <li>▶ Document the process for the management's sign-off.</li> </ul>
12	Pricing strategy process	<ul style="list-style-type: none"> <li>▶ Analyze the financial impacts based on different pricing strategies;</li> <li>▶ Develop the proper toolkit presenting the impacts of the strategies to facilitate the management's/BU's decision-making. The toolkit should also be a database maintained by relevant BU to collect pricing strategy adopted by other competitors;</li> <li>▶ Develop the review process and approval ladders for the pricing decision-making;</li> <li>▶ Discuss and confirm the abovementioned process with the management and relevant BU;</li> <li>▶ Document the process for the management's sign-off;</li> <li>▶ Disseminate the toolkit and deliver training to relevant departments and people.</li> </ul>
13	Procurement process	<ul style="list-style-type: none"> <li>▶ Identify the major procurement types and perform sample check on the contract and corresponding invoice/ accounting/ tax treatments;</li> <li>▶ Develop the proper toolkit to facilitate the financial position calculation under different supplier and transaction conditions;</li> <li>▶ Develop the monitor and review process and approval ladders for the procurement or supplier selection decision-making;</li> <li>▶ Develop the process and approval ladders for payment request, financial review, invoice verification and payment remittance;</li> <li>▶ Discuss and confirm the abovementioned processes with the management and relevant BU;</li> <li>▶ Document the process for the management's sign-off;</li> <li>▶ Disseminate the toolkit and deliver training to relevant departments and people.</li> </ul>

	Process	Action Plan
14	Client communication and enquiries	<ul style="list-style-type: none"> <li>▶ Identify with relevant BU the key information to be communicated with the client;</li> <li>▶ Develop proper documents to be circulated in public places;</li> <li>▶ Develop proper “script” for day-to-day Q&amp;A in web-based, hotline or front desk channels;</li> <li>▶ Discuss and confirm the abovementioned process with relevant BU;</li> <li>▶ Disseminate the documents and “script” and deliver training to relevant departments and people;</li> <li>▶ Collect feedback for a period of time (e.g. two weeks) and revise the documents and “script” based on such feedback and further discussion;</li> <li>▶ Document the revised version for the management’s sign-off.</li> </ul>

As an observation, many companies have already started their VAT pilot reform preparation well in advance and have already had part of the readiness work completed. However, as the detailed VAT rules are yet to be finalized, we anticipate there could be difficulties in determining what actions should be taken before the issuance of the detailed VAT rules. We would recommend businesses to undertake a detailed review with a view to prioritize tasks based on the MUST HAVE / NICE TO HAVE principle.

## Conclusion

The next two months are going to be challenging for businesses given the tax regulatory and business changes that are going to take place. It is advised that suitable resources be dedicated and actions planned to convert their business operations and prepare for the changes. Consultation with tax professionals is also strongly recommended.

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