China VAT reform
Are you ready for the last run?
January 2016
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The China VAT reform: are you ready for the last run?

China, the world's second-largest economy, is expected to complete the final stage of its comprehensive value-added tax (VAT) reform within the next 6 to 12 months. Chinese tax officials are embarking on major structural changes to lead the nation into a new era, with the goal of aligning the country's indirect tax policies with international practices (worldwide, more than 140 countries have already implemented a full VAT regime).

In recent years, the Chinese Government has indicated that its goal is to transform the nation from a production-based economy into a more service-oriented economy, and it has identified a VAT reform as one of the pathways to a successful transition. Nevertheless, the VAT conversion can be a challenging process as China's VAT system is already considered one of the most complicated in the world. For example, the Government has not implemented a simple VAT rate approach for all sectors of the economy, and some industries will remain exempt from VAT. Even after the reforms are fully implemented in 2016, the level of complexity in China's VAT system is expected to remain the same.

So what can businesses do to adjust to the reforms? That is not an easy question to answer! In this report, we provide a brief background on the history of China's VAT reform; outline some of the highly anticipated upcoming reforms in the lifestyle industries and the financial services, insurance, real estate and construction sectors; and consider how to transition to VAT successfully. We address the challenges that will be posed by the next steps of the VAT reform and offer suggestions for adapting to the new rules and even uncovering potential opportunities in the short and long term.
I. A brief history of China VAT

In 2008, the Chinese National People’s Congress (NPC) formally approved a five-year plan to allow reforms to the VAT Act. In that same year, the Chinese Government pledged to ensure the reforms are duly implemented in line with the country’s overall policy objectives.

In a 2011 press conference, the Chinese Ministry of Finance (MOF) introduced reform projects that would require selected regions and sectors of the domestic economy to shift from paying Business Tax (BT) to paying VAT. Replacing BT with VAT was intended to establish a more reasonable tax system that would encourage more structural economic changes and help develop a modern services industry.

On 26 October 2011, Chinese Premier Wen Jiabao disclosed at the State Council Standing Committee meeting that, effective 1 January 2012, Shanghai would be the first reform city to aggressively implement the BT-to-VAT conversion. Subsequently, VAT reforms have been gradually expanded from reform cities into a nationwide program. The first round of reform affected certain industries such as transportation and certain modern services. Later, the reform was expanded to other sectors of the economy, including postal services.

Policymakers in Beijing have considered further expanding the scope of the VAT reform in China, which is expected to cover many more industries in 2016. More businesses are expected to transition from BT to VAT. The Chinese authorities have forecast that its nationwide VAT reform projects will be completed in 2016, with lawmakers expected to pass a formal and comprehensive VAT Act by the end of 2018.
Announcements in China on the reform are few and far between. It is important for businesses to maintain a dialogue with the relevant authorities to stay on top of the expected developments. It is currently understood that the authorities in Beijing are working on a preliminary draft of VAT regulations for lifestyle services, which include pivotal sectors of the economy, such as restaurants, hotels, education and health care. It is anticipated that the proposal will be formally introduced in 2016. Meanwhile, it is widely anticipated that the financial services and real estate and construction industries will be included in the scope of the VAT reform in the same year.

Challenges

Inevitably, the tax structure (e.g., the tax source, tax base and calculation basis), tax collection and tax administration for lifestyle services, financial services and the real estate and construction sectors are likely to be highly complex and individual, due to the nature of these industries and their respective industry practices, for a number of reasons:

1. These industries play an integral role in the economy and are heavily regulated.
2. VAT reforms will likely have an impact on daily living and a significant influence on the national economy.
3. The nature of the goods and services supplied by these sectors will be very different from those of the traditional manufacturing industries, which were included in the VAT system many years ago.

Are you ready for the reform?

Businesses affected by the VAT reforms need to be prepared for the transition. It is essential for companies in these industries to review their resources to analyze how they will process and manage VAT in China and assess whether changes need to be made to their processes. Common feedback from the new VAT taxpayers involved in the Shanghai Pilot was that they underestimated the financial and operational impact of the change on their companies. We anticipate that the targeted industries that will be subject to the VAT reform will likely experience a difficult transition and face challenges to adjust to an accurate cut-off between BT and VAT practices.

The hotel and restaurant, banking and insurance, real estate and construction, health care, and education industries will soon be drastically impacted by the VAT reform implementation. What exactly will be changed by the China VAT reform, and how should taxpayers in affected industries prepare for this tax transformation? In Part III of this report, we discuss the sector-specific change in more depth and outline step-by-step procedures to undertake when converting from BT to VAT. By following a set of fixed principles and practices, future VAT taxpayers should be able to address the challenges ahead and may even uncover new opportunities.
II. Upcoming China VAT reforms: sector by sector

It is anticipated that more industries will soon be included in the VAT reform policy, which will significantly impact more businesses nationwide. The lifestyle industry is expected to make the switch from BT to VAT in 2016. This sector includes hotels, restaurants, education, health care and a few other areas. In addition, the authorities in Beijing are expected to place the financial services, banking and insurance, real estate and construction industries into the scope of the VAT reform in the same year.

Because each sector could be facing different sets of VAT rules in the near future, we break down the anticipated changes on a sector-by-sector basis in this report. We also asked our EY Indirect Tax team in China to provide some useful suggestions for implementation of the new VAT policies.

The hospitality sector

Hotels

Hotels provide a comprehensive range of services, including those related to accommodation, dining, gym and spa facilities, entertainment and shopping. Under the current BT regime, applying indirect tax to hotels’ activities has been fairly straightforward. Accommodation, dining services and site rental for shopping are currently subject to a simple 5% BT rate, whereas entertainment services (such as karaoke, lounges and billiards) are currently subject to a variety of BT rates ranging from 5% to 20%.
The upcoming VAT requirements for hotels are likely to be much more complicated than the current BT rules. For example, complex VAT rules are likely to apply for determining the VAT liability of activities (with different VAT rates for different types of services), addressing possible “deemed sales” requirements for rooms and gifts exchanged for membership points, and dealing with tax points for prepayment card sales. In addition, hotels must operationalize VAT, including the adoption of onerous VAT invoicing rules and reporting systems to manage VAT. Meanwhile, indirect tax rules applicable to the suppliers and customers involved in the supply chain could affect hotels’ VAT costs and pricing strategy. For instance, what if suppliers, such as real estate owners or construction companies, remain under the BT regime during a certain period and roll into the VAT regime later?

The implementation of VAT will include additional compliance requirements compared with managing BT, which will require additional resources. Hotel operators should closely monitor the changes to come, because having inappropriate levels of VAT management (or none at all) may result in major negative impacts on profitability and on cash flow.

Besides risk, corporate management will need to consider a number of issues, and throughout the enterprise, managers could face a substantial workload in dealing with contract reviews and price negotiations with suppliers and customers, as well as setting up the Golden Tax System (GTS), ERP updates, VAT compliance organization and staff resource management.

EY insights

EY China Indirect Tax Partner Stephane Rinkin, based in Shanghai, shares his views on VAT leading practices for hotels: “VAT will be everywhere in your organization, and it will have an impact on each and every single transaction. Be proactive, consistent, organized and results-oriented when it comes to managing your VAT position. This will allow you to avoid VAT risks, as well as to create VAT opportunities.”

He adds: “At EY, we have worked with many companies in China on their VAT processes, and we understand how these complex steps link together. Leveraging good ideas and best practices learned from previous projects can benefit companies that are just starting to look into their indirect tax functions but do not know where to start or how to proceed with the VAT implementation.”
Restaurants

Restaurant services are less comprehensive than services provided by hotels. Restaurants usually provide dine-in service, takeout orders and delivery services to customers. Currently, dine-in service is subject to 5% BT, while takeout orders and delivery services are already subject to VAT either at 3%, based on a simplified method, or at 17%, if the restaurant provides dine-in services exceeding the prescribed annual sales thresholds for VAT and is deemed to be a general VAT payer.

Those in the food and beverage industry should ask themselves:

• Should dine-in service be subject to the simplified VAT calculation method similar to the current VAT treatment for takeout orders and delivery services?
• Should the restaurant's system be enhanced to cater for both the simplified calculation method and the general VAT method?
• Will the Chinese Government abolish the simplified calculation method for such services and maintain a reasonable tax burden with a low VAT rate?

If the answers to these questions are unclear for your business, it may be time to consider their potential impact before your organization encounters any unwanted surprises!

To reduce, if not remove, the pain, your organization should manage the VAT issue proactively and review how it may impact profitability and cash flow.

Similar to hotel operators, food and beverage service providers should carefully address a number of aspects before the VAT changes are implemented. These include conducting contract reviews and price negotiations, considering VAT compliance solutions, preparing for operational system upgrades, reviewing VAT processes, and conducting VAT trainings for key personnel and relevant departments.

In our view, the enhancement of an organization's current operational systems is the most time-consuming task. This is certainly the case if the VAT treatment of dine-in service, takeout orders and delivery services are different, as that would necessitate distinguishing these service types in the company's operational systems and applying different VAT treatments accordingly.

EY insights

EY Greater China Indirect Tax Leader Kenneth Leung, based in Beijing, invites restaurant business owners to think about the possible impact of the reform. He says: "Ask yourself what is actually going to be the VAT impact on your restaurant business. Will it be positive or negative?"

He notes that the tax authorities have not revealed definitive answers to a number of important questions yet, and he adds: "There are likely to be some winners and some losers in the VAT reform. The winners would see their cost impact reduced, but there’s still so much uncertainty."

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Health care and education

The health care sector

Health care services may include several types of services, such as medical examinations; diagnosis; treatment; rehabilitation and preventive health care; family planning services; the provision of drugs, medical materials and equipment, including ambulances; and food or accommodations provided to patients and relatives.

Health care institutions are classified as nonprofit or for-profit institutions under the current BT regime. Nonprofit institutions usually enjoy some tax concessions (e.g., not having to charge BT on certain services), whereas for-profit institutions generally charge 5% BT on the services they provide. We note for completeness that health institutions may be entitled to certain tax subsidies and exemptions or preferential tax treatment.

Given the above disparity of tax burdens between different providers, various changes in the next wave of VAT expansion have been much anticipated in the sector. Nonetheless, important questions remain to be answered, such as:

• Will some key definitions, including “medical services” and “health care institutions” be defined more clearly to foster the upcoming VAT regime?
• Will for-profit health care institutions obtain a wider scope of tax concessions under the VAT regime?
• Will the health care industry, as a key sector closely related to social welfare, enjoy a lower VAT rate than the currently prescribed BT rate of 5%?
• Will retail sales of pharmaceuticals, prescription drugs and traditional Chinese medicines (manufactured by independent pharmaceutical shops) enjoy a lower VAT rate than the currently prescribed BT rate of 5%?

We anticipate that the authorities will expand the VAT reform to the health care sector in 2016, which will have a considerable impact on its financial performance and existing operations. Accordingly, it is essential to consider comprehensive aspects in the upcoming VAT reform to adopt compliant and efficient VAT management processes, which may include systems and invoicing processes and preparation, communications with customers and suppliers, transitional problems for contracts that span the change, and similar issues. However, the tax authorities could go in a completely different direction and opt for a simplified VAT at 3% for health care (which would be very similar to the current BT system). Failure to stay ahead of the VAT reform could adversely impact not only a company's indirect tax position but also its operations.

Greater China Indirect Tax Leader Kenneth Leung comments: “Many hospitals are currently involved in paying for large infrastructure projects. Dealing with health care costs can be very complicated.” He elaborates: “The billing alone can add a great deal of complication for hospitals. When you think about it, there are so many factors involved when a patient pays his or her medical bills. Hospitals are charging for medical services rendered, equipment used, room accommodation and so much more.”

He adds: “When hospitals shift away from BT to VAT, hospitals must understand the different VAT rates. For instance, a medical service could have a different tax rate for the room accommodation charges. Additionally, hospitals should know which goods and services will be VAT-exempt or out of scope and which will not.”
The education sector

The education sector is similar to the health care industry in some respects; both have institutions that can be classified as either for-profit or nonprofit, and tax exemptions or different rates may apply to different education providers and to educational services. Public schools generally enjoy a tax exemption or preferential tax treatment, and they bear a lower tax burden than for-profit schools whose services are subject to 3% BT.

Many for-profit schools in China have been established based on private investments, foreign investments or joint ventures. How each school operates and the likely impact of any VAT reform may generally depend on the size of the school. Small schools, for instance, may be labor-intensive, with a higher share of human capital costs and less input VAT; in addition, they may not have sufficient and professional resources to maintain a sound accounting system and handle complex VAT invoicing issues. From this perspective, it appears that small schools are likely to prefer the simplified accounting method for paying taxes. In contrast, large schools may invest more in equipment purchases where VAT input tax credit recovery would provide some tax benefits for them. Also, large schools are more likely to maintain sound accounting books together with adequate human resources to handle VAT invoicing issues. From this perspective, it appears that larger schools could accept a higher VAT rate with a view that they would be entitled to recover some VAT input tax credit incurred.

Accordingly, when education service providers move into the new VAT regime — expected to happen in 2016 — these institutions should consider various factors in accounting for VAT, including deemed sales requirements for free educational services, tax points for prepayment card sales, systems and invoicing processes, communications with customers and suppliers, transitional problems for contracts that span the change, and similar issues.

Indirect Tax Director Andrea Yue, based in Beijing, offers her tips for education service providers to adjust to the VAT reform project: “Education is considered to be a ‘lifestyle’ service in China, so education-related companies are expected to shift from BT to VAT in the near future. Schools should prepare as soon as possible to be ‘VAT ready.’ Education service providers should perform an impact study now to understand how the VAT expansion arrangements are going to impact their tax positions, as well as their business operations.”
Financial services sector

Insurance and reinsurance

Risk underwriting services can be divided into two main categories: insurance and reinsurance. However, for tax purposes in China, the type of risk coverage forms the key criterion for classification: life insurance or reinsurance policies and casualty (or general) insurance or reinsurance policies. Under the BT system, tax rules apply to insurance based on the product attributes. For instance, life insurance and other insurance products associated with specific industries (such as the agriculture industry or international transportation sector) currently qualify for BT exemptions. However, for reinsurance practices, the reinsurer will withhold BT for the outward reinsurance business on behalf of the insured party.

Additionally, most insurance companies have investment income generated from their financial assets. Under the current BT regime, depending on the types of financial commodities, some investment income is subject to BT. However, some financial assets are exempt from BT, such as government bonds or interest income. Buying or selling transactions of these financial assets are also subject to BT, but on a netting basis (based on the purchase price minus sale price).

Given the various BT treatments of insurance-related products that currently apply, the VAT treatment for insurance products could be diversified. As even the current BT treatments for some insurance products or types of investment income are ambiguous, this fact raises the question: what would the tax treatment under the new VAT regime really be? Answers to important questions remain to be seen; these include:

- How will taxation apply to insurance-related activities? Will it be general taxation, tax exemption or zero rating?
- How should income of investment-linked products, universal products and annuity products be determined?
- Can international insurance businesses qualify for zero-rated (or exempt) VAT treatment?
- What will be the VAT obligation of insurers compared to reinsurers?
- How will the tax base for insurers differ compared to that for reinsurers?

If you operate in the insurance sector, these questions should invite you to think about the complexity of the topic. Other very specific VAT questions will also have to be answered before the reform arrives, including:

- Can special cost items be deemed creditable against output VAT – for instance, claim costs (investment income paid to the beneficiary, dividend paid to insurers and commission expenses)?
- Can claim settlements or compensation without a special VAT invoice be credited against output VAT?
- Can the amortized claim settlement costs or compensation and amortized reinsurance premium be credited against output VAT?

China Indirect Tax Partner Stephane Rinkin, based in Shanghai, comments: “Some insurance policies, such as life insurance, which focus mainly on savings and are currently tax exempt, are also likely to be VAT exempt after the new tax reforms are introduced. However, other general insurance policies are likely to be taxed under the new rules, although there is uncertainty about VAT input recovery for premiums and payouts.”

Kenneth Leung, EY Greater China Indirect Tax Leader, adds: “Insurers and reinsurers are advised to prepare for the new VAT regime by focusing on policy development, training workshops and learning more about the VAT reform. Tax authorities would probably make the new laws effective six months after the announcement date, so insurance companies should begin to anticipate the upcoming regulations to be ‘VAT ready.’”
Real estate and construction

The real estate and construction sector is currently subject to the BT regime. Specifically, BT applies to transfers or leases of land use rights, sales or leases of domestic immovable property, and the provision of construction services. Business activities associated with land use rights and domestic immovable property are currently subject to 5% BT on a gross basis.

In addition, some financial services are also subject to 5% BT on a net or margin basis, including foreign currency trading, futures trading, marketable securities trading (shares, bonds, foreign exchange, etc.) and finance leases.

Some common financial services are exempt from BT (and are expected to remain VAT exempt under the new regime), and they include interest income on loans between financial institutions inside and outside mainland China, interest income on bonds held to maturity, intercompany loans if the interest income is not higher than a loan from a third-party financier, and offshore outsourcing of IT or business processes.

With the BT exemptions in mind, uncertainties remain on a number of issues for VAT, including:

- Which types of financial services will qualify for VAT exemption?
- What costs incurred will be utilized as input VAT?
- Will VAT apply to other banking services subject to specific fees or charges (e.g., credit card usage fees, fees incurred due to late payment, handling fees for opening or closing a bank account, and handling fees for facilitating a foreign-exchange transaction)?

A diversified financial business will likely be subject to different VAT rules and different invoice requirements for its activities. This will increase not only the level of complexity from a tax compliance perspective, but also the preparation required to be “VAT ready” before the VAT effective date. For example, IT system modifications for separating tax and pricing on invoices will be time-consuming, and organizations should plan to undertake systems changes at an early stage to meet the soon-to-be-announced policy developments. Financial services providers should be prepared for the changes before VAT implementation by considering the available MOF circulars on the topic and by collecting relevant VAT information from clients, collating and reviewing contracts and legal papers, and considering whether to modify relevant tax clauses in contracts and engage IT vendors to implement the changes (if required).

China Indirect Tax Partner Stephane Rinkin, based in Shanghai, comments, “Due to the regulatory environment in China, financial services firms could face lower revenues and higher costs after the introduction of the VAT reform project for the industry in 2016. As the tax consequences increase, companies should focus their attention on VAT compliance and take actions on further risk management.”

He adds: “The new VAT regime could be very complex for the financial services industry, since different products and service offerings are likely to be taxed at different rates.”

Banking and asset management

Organizations in the financial services sector offer a wide array of products and services for clients. Banks, asset managers, brokers, wealth management companies and more are playing a pivotal role in shaping China into a more service-oriented economy.

Financial services providers are generally remunerated through interest on loans and fee-related services, including guarantee fees, late-payment fees, penalties, application fees and credit card fees. These core financial services are currently subject to 5% BT on a gross basis.

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Nowadays, it is common for a real estate project to be complex, including various types of properties (such as a mix of residential housing and shopping malls, or a mix of shopping malls, hotels, offices, car parking spaces with residential housing). However, some projects comprise homogenous types of property, such as a shopping mall, office building or residential village. We anticipate VAT will apply differently based on the types of premises in question. For example, VAT could apply on short-term hotel accommodation at 6%, whereas long-term hotel accommodation could be subject to VAT at 11%. Accordingly, projects comprising homogenous types of property will inevitably require additional VAT analysis to ensure VAT compliance.

Typically, a real estate project has a long life span covering many years (from the time of land acquisition to the time of completing the sale of properties or the expiry of the useful lives of commercial properties). The timing of acquisitions will have a significant impact on the recovery of input credits under the VAT regime. For example, if a property was acquired before the VAT effective date, there would not be any recovery allowed for the BT paid. However, if the property is acquired under the VAT regime, it is possible for a general VAT payer to claim input VAT credits (subject to the relevant VAT recovery rules). We note for completeness that China VAT is operating under an offsetting system and that no refund system is currently available if the input VAT is greater than the output VAT payable. Therefore, if the real estate project invested a significant amount of money in the early stage, the input VAT incurred will not be recoverable until output VAT has to be accounted for (e.g., sale of properties).

Input tax credit

One of the key issues is the slow recovery or even the possibility of no recovery of the VAT input tax credit.

- Development for rental: in these projects, the project company generally pays all input VAT when the construction is certified to be completed and the construction fees are paid. However, the return period of a rental project is generally long (it could take a few years or even a few decades) and, correspondingly, the output VAT will be charged and received at a later stage (similar to the rental income). Coupled with an increase in the tax rate (from the current BT rates that range from between 3% and 5% to the anticipated VAT rate of 11%), the real threat of falling into a “cash flow trap” is also a concern for rental project companies.

- Development for sale: these projects involve an additional level of complexity from a VAT perspective. For example, it is typical for residential projects to have pre-sales, which take place before the construction is completed. Currently, pre-sales are subject to BT (when the pre-sales are recognized in the accounts, the corresponding sales are not subject to BT any longer). If VAT also applies on pre-sales, the project companies will have to pay the VAT output tax with no or little VAT input tax credit to offset it. This is because most or part of the VAT input tax credit would become available only when the construction is completed and the construction fee is paid or due to be paid, which would take place after all or part of the pre-sales have been collected. The delay could result in not only an increase in cash flow pressure, but potentially a permanent loss of the VAT input tax credit. This could occur, for example, if output VAT has been invoiced that will not be available to offset input VAT, as input VAT will only be available only at a later stage of the project.

Transitional rules

Another key issue relates to how transitional rules will apply. There may or may not be transitional rules issued for the transition period for the conversion from the BT regime to the VAT regime to mitigate the adverse impacts for the industry. It will be fundamental to understand any transitional rules and to be properly prepared for them. Transitional rules (if any) may be in various forms and may be subject to certain requirements.

Indirect Tax Director Andy Leung, based in Shenzhen, comments: “We should remember that, although the tax rate may increase, at the same time there should be an introduction of input tax credit on construction costs and materials. The combined effect may not be always detrimental to real estate companies, depending on the circumstances of the company and how its management reacts.”

Andy adds: “A capable strategic project team, set up to equip the company with good command of not only the policies and rules from the VAT reform but also their underlying dynamics and the effective options available to respond, will be crucial for management to be in the most advantageous position to capture opportunities and mitigate risks created by the VAT reform.”
Break the implementation into phases and work streams

Businesses can establish an effective work plan processing system to migrate from BT to VAT as part of the VAT implementation project. Based on our experiences of GST/VAT implementation across the world, we have developed an effective four-phase conversion process:

1. Business analysis/VAT impact study
2. Planning and implementation
3. Transition/output testing
4. Post-implementation review

The four-phase conversion approach can help your organization undertake an effective transition program for VAT implementation.

Each of these four phases can be broken further into six relevant disciplines or “work streams”:

1. Indirect tax regulatory
2. Systems (IT)
3. Processes and controls
4. Business transformation
5. VAT compliance
6. Project management

III.
A structured approach to the China VAT challenge
It is essential to review all relevant areas of the business that will be impacted and to identify issues and options for resolution. Since VAT impacts almost every part of an organization, in our view a holistic approach is the only way to make your organization truly “VAT ready” by the date of implementation.

Specific actions

The four-phase approach should be implemented with careful planning and consideration as each of the phases will include a great deal of preparation work. Future VAT payers should consider the following actions:

1. Conduct a VAT reform impact study to identify areas of the business impacted and needs for conversion
2. Review and revise existing business processes to become “VAT-equipped” suitable to the specific needs and constraints of the company
3. Review and revise business contracts from the VAT perspective
4. Carry out pricing analysis with service suppliers and customers
5. Test and revise accounting systems from a VAT perspective and analyze all Golden Tax System (GTS) needs
6. Review your financial forecasts and make necessary adjustments
7. Review your staff profile and make sure that staff resources are adequate in terms of manpower, knowledge and experience throughout the VAT reform process and afterward
8. Provide necessary training workshops for relevant departments
9. Consult with professionals when necessary

While the ultimate aim of the VAT reform is to encourage the growth of China’s service industries, the transition process will inevitably cause difficulties for each sector. Your company should start now to develop a plan to assess your China VAT risks and opportunities. We believe that our recommendations should provide a starting platform for preparing for the upcoming VAT reform.

By fully embracing the implications of the China VAT reform and its impact throughout the enterprise, your company can benefit from reduced risk, improved compliance, decreased costs and greater cash flow efficiency, which can help both the top and bottom line. We invite you to start down the China VAT implementation path, and we are happy to bring our insights to supplement your internal efforts.

The journey may be long, but the key is to start!
Contacts

China Beijing
Kenneth Leung
China Indirect Tax Leader – Beijing
Email: kenneth.leung@cn.ey.com
Tel: +86 10 5815 3808
Shu Tian
China Indirect Tax Partner – Beijing
Email: shu.tian@cn.ey.com
Tel: +86 10 5815 2159
Hongli Wang
Indirect Tax Director – Beijing
Email: hongli.wang@cn.ey.com
Tel: +86 10 5815 2307
Andrea Yue
Indirect Tax Director – Beijing
Email: andrea.yue@cn.ey.com
Tel: +86 10 5815 3814

China Shanghai
Bryan Tang
China Indirect Tax Partner – Shanghai
Email: bryan.tang@cn.ey.com
Tel: +86 21 2228 2294
Kevin Zhou
China Indirect Tax Partner – Shanghai
Email: kevin.zhou@cn.ey.com
Tel: +86 21 2228 2178
Stephane Rinkin
China Indirect Tax Partner – Shanghai
Email: stephane.rinkin@cn.ey.com
Tel: +86 21 2228 5818
Lynette Dong
Indirect Tax Director – Shanghai
Email: lynette.dong@cn.ey.com
Tel: +86 21 2228 4107

China Shenzhen
Michael CS Lin
China Indirect Tax Partner – Shenzhen
Email: michael-cs.lin@cn.ey.com
Tel: +86 755 2238 5780
Andy SY Leung
Indirect Tax Director – Shenzhen
Email: andy-sy.leung@cn.ey.com
Tel: +86 755 2502 8386

Hong Kong
Marc Bunch
China Indirect Tax Partner – Hong Kong
Email: marc.bunch@hk.ey.com
Tel: +85 2 2629 3588

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