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Indirect Taxation of Cross-Border Services in China: (Partial) Switch to Destination-Based Taxation

Wei Cui*

I. Introduction

In early November 2008, China's State Council approved a major overhaul of the country's VAT: starting in 2009, registered VAT payers are allowed to claim input credit for VAT paid on purchases of equipment and other non-real-property fixed assets.[1] The change marks a decisive abandonment of China's previous esoteric "production-type" VAT (which disallowed input tax credit for fixed asset purchases) in favour of the conventional consumption-type VAT, and a giant step in the rationalization of the country's tax structure. It also promises to accelerate the pace of VAT reform, the next major stage of which is widely regarded as expanding the VAT into services and other sectors currently subject to the business tax (BT). The BT, which generally applies to services and the transfer of real and intangible properties, covers a tax base that is normally covered by the VAT in other countries, but is a cascading tax imposed at lower rates than the regular VAT rates. Its eventual unification with the VAT had been anticipated ever since the two taxes were given their current shape during the 1994 tax reform.[2] A major task facing tax policymakers, scholars, and practitioners in China today, therefore, is how to introduce VAT norms and rule design into the operation of the BT.

An important example of these novel issues of tax policy design is the choice between destination- and origin-based taxation for a range of transactions currently covered by the BT: the cross-border provision of services. The issue recently attracted much notice in China as the VAT reform also prompted revisions to the BT regulations.[3] In draft versions of the

* I am grateful to Huang Zheng, Li Kaigeng, and Tong Yingying for research assistance related to this paper. Email: wei.cui@aya.yale.edu.

1. See Provisional Regulations on the Value Added Tax, State Council Order No. 538, 10 November 2008 ("VAT Provisional Regulations"); Detailed Rules Implementing the Provisional Regulations on the Value Added Tax, Ministry of Finance and State Administration of Taxation Order No. 50, 15 December 2008.
2. See Xu Shanda, "A New Tax System Free from Old Defects", *Caijing Magazine*, 24 August 2008.
3. Provisional Regulations on the Business Tax, State Council Order No. 540, 10 November 2008 ("BT Provisional Regulations", revising regulations with the same

BT Implementation Rules circulated in November 2008, the Ministry of Finance (MOF) and State Administration of Taxation (SAT) appeared willing to reverse the BT treatment of import and export of services. Under the previous regime, imports of services were generally not subject to the BT, whereas exports of services were generally BT-able. If one thought of the BT as a quasi-VAT, this was an origin-based system. In November, the MOF and SAT considered making a 180-degree turn, taxing imports but exempting exports. This would render the BT treatment of cross-border services analogous to the Chinese VAT, which practices destination taxation with respect to the cross-border flow of goods.

The government did not ultimately adopt this proposed change (the "November Proposal"). The finalized BT Implementation Rules contain, instead, a provision that subject *both* the import and export of services to the BT. Not surprisingly, this has caused widespread consternation on the part of foreign suppliers and Chinese importers of services.[4] However, there has been little discussion of how cross-border services *should* be taxed, or of what the economic consequences are of the recently imposed tax on imports of services, largely because it is still unclear to many what standards should be applied to analyzing and evaluating BT design.

I have argued elsewhere[5] that, even before the BT is integrated with the VAT, it is both natural and imperative to apply VAT norms to the design of BT rules. In this paper, I follow this approach to evaluate China's taxation of cross-border services. Section I below sketches how the destination and origin principles have been implemented under the Chinese VAT and BT, respectively, until the recent changes. Section II analyses the economic implications both of the BT treatment of cross-border services that was in place until recently, and of the November Proposal, had it been adopted. The analysis takes into account the fact that the BT is currently a cascading, turnover tax, and not a conventional invoice-credit VAT. In Section III, I discuss the finally-adopted rules, effective in 2009, which

title issued as State Council Order No. 136 on 13 December 1993; the prior regulations hereinafter referred to as "BTPR"); Detailed Rules Implementing the Provisional Regulations on the Business Tax, Ministry of Finance and State Administration of Taxation Order No. 52 ("BT Implementation Rules", revising regulations with the same title issued as Caifa [1993] 40 on 25 December 1993, the prior regulations hereinafter referred to as "BTIR").

4. See, e.g. Peter Stein, "China's Airlines Face Risk of New Costs," *Wall Street Journal*, 15 January 2009.

5. See Wei Cui, "Business Tax: China's Quasi-VAT", *International VAT Monitor* 2009, pp. 291–295.

dramatically alter the taxation of imported services. The change, I argue, may have unfortunate economic consequences, even if it may raise revenue. Fortunately, there are signs that China will gradually broaden the BT exemption for export of services, and thus follow the destination principle in a more consistent manner.

II. Origin v. destination under the existing VAT and prior BT rules

1. Existing VAT rules

Because the focus of this paper is on the cross-border provision of services, we limit ourselves to two comments about the practice of the origin and destination principles under the Chinese VAT.

First, because China is a large country with many sub-national-level governments, it is worth noting that at the sub-national levels, VAT administration in one sense follows the origin principle. Since the VAT, like all taxes in China, is nationally legislated, VAT rates are uniform across the country. But the choice between the destination and origin principles affects not only tax rates but also which jurisdictions collect the VAT revenue.[6] The general rule determining this issue of revenue allocation is that registered traders pay VAT where their establishments are located.[7] If a business has multiple establishments in different jurisdictions, either it has to pay VAT separately in each of these jurisdictions, or it may seek the government's approval to pay VAT only in the jurisdiction where the headquarters is located. Generally, any VAT revenue collected is split 25/75 between the local government and the national (central) government.[8] What the allocation by reference to establishments accomplishes, therefore, is determining which local government gets to take the 25% cut at the VAT revenue collected.

Second, with respect to imports and exports across national borders, China nominally practices the destination principle by taxing imports at normal

6. Ebrill, Keen, Bodin, and Summers, *The Modern VAT* (2001) p. 179.
7. VAT Provisional Regulations, Art. 22. Suppliers without a fixed place of business are required to pay tax where sale is made.
8. This is subject to a further "revenue returned" mechanism, treated as part of the transfer payment system, where some VAT revenue belonging to the central government is returned to the local government. See Ahmad, Lockwood, and Singh, "Taxation Reforms and Changes in Revenue Assignments in China." IMF Working Paper WP/04/125, International Monetary Fund, Washington, DC (2004), Section IV.

VAT rates and zero rating exports. However, zero rating on exports has become a merely aspirational objective, the realization of which is relegated to the indefinite future. Instead, the government frequently adjusts the rates at which input taxes are credited or rebated on exports, making the VAT on exports intentionally non-neutral and an instrument of trade policy. Interestingly, the initial reasons for the government's inability to implement full zero rating in the mid-1990s were the same that explain the failure of zero rating in many other countries newly adopting the VAT[9]: the government was fiscally unprepared to return the large amount of revenue to taxpayers, and there was concern about VAT fraud in the claim for rebates. However, improved budgeting and combat against VAT fraud appear no longer determinative of whether full zero rating would come to fruition. Instead, whether exports should receive a full VAT rebate has become deeply entangled with hugely controversial issues relating to China's exchange rate and trade policy.

Without wading into the treacherous waters of these debates, it suffices to say that one could not apply the standard welfare analysis supporting the destination principle (or an analysis demonstrating the theoretical equivalence of the destination and origin principles) to China's current situation without modifications.[10] China does not have a flexible exchange rate and whether the Chinese currency (renminbi or RMB) is undervalued is subject to intense debate. China has also been running huge trade surpluses against the rest of the world during the last few years, the reversal of which is believed to require extraordinary adjustments. Finally, not only are VAT rates non-uniform, the VAT also does not cover the full range of transactions in goods and services but instead operates alongside the BT. To ignore these complex real-world circumstances and extol the virtues of the ideal VAT alone risks undermining one's credibility.

Indeed, some noted economists have suggested that to the extent the RMB is undervalued and distorts trade, an export tax is a preferable policy instrument to an exchange rate adjustment for China.[11] The suggestion seems to have been made without awareness that China's failure to zero rate export already amounts to an export tax. Others have questioned whether the classic critique of the failure in zero rating for the distortions it generates is cogent, given that China has an inefficiently high level of reserve

9. See Ebrill et al., *The Modern VAT*, Chapter 15.
10. For such analyses, see Ebrill et al., *The Modern VAT*, Chapter 17.
11. Lawrence Lau and Joseph Stiglitz, "China's alternative to revaluation", *Financial Times*, 25 April 2005.

accumulation.[12] While uncertainties relating to China's foreign exchange and trade policy perhaps render a definitive welfare analysis of China's failure to zero rate impossible, it seems prudent, at least in the near future, to refrain from any purist, classic critique of the imperfect implementation of the destination principle.

2. Prior BT rules

Turning now to the BT and the taxation of services, we also first observe that, within China, cross-jurisdictional transactions have not, until recently, been subject to a uniform rule for determining who exercises taxing authority, in contrast to the origin-based system for the VAT. Specifically, for the supply of services,[13] BT regulations generally adopt an approach under which, for any instance of supply of service, there is deemed to be a component of performance of labour service. Service is then considered supplied and taxable where the labour service is performed.[14] This, in itself, implemented neither the origin nor destination principle. Moreover, the conception that any supply of service necessarily involves a labour component can be difficult to sustain, for example when equipment or real estate is leased.

The newly adopted BT Provisional Regulations take a step towards introducing greater uniformity in this regard. For domestic transactions, services are generally taxed where the place of establishment or residence of the supplier is located.[15] This conforms to the domestic allocation of taxing jurisdiction under the VAT, although there is no option, as under the VAT, of consolidating tax payment at headquarters. And since local governments are entitled to BT revenue without having to share it with the central government, the allocation completely determines where BT revenue ends up.

12. John Whalley and Li Wang, "Evaluating the Impure Chinese VAT Relative to a Pure Form in a Simple Monetary Trade Model with an Endogenous Trade Surplus," NBER Working Paper 13581 (http://www.nber.org/papers/w13581).

13. Domestic transfers of intangible and real property were subject to separate rules. Any transfer of intangibles other than land use rights is taxed at the place of establishment of the transferor. Transfers of land use rights and real property are taxed at the location of the land or property. BTPR, Art. 12. These rules are basically preserved under the newly adopted BT Provisional Regulations (Art. 14).

14. Id. An exception was made for transportation services, where the provider pays BT at its place of establishment.

15. BT Provisional Regulations, Art. 14. The old rule, under which tax is payable where labour services are performed, is preserved for construction services and other services to be identified by the MOF and SAT.

For supplies of service across borders, the BT regulations, prior to their recent revision, roughly implemented the origin principle. That is, foreigners with no establishment inside China would generally not be subject to the BT for services provided to Chinese customers, and domestic providers are generally subject to the BT for services rendered to customers outside China. This is achieved, however, through the unusual conception, mentioned above, that rendering a service is necessarily a matter of performing a labour service: the place of supply is deemed to be where the labour service involved in each instance of service supply is performed. This conception has generated some odd results in connection with both imports and exports.

For example, based on the principle that only services performed within China are taxable, central and local tax authorities have ruled that:

- design services for construction or engineering projects provided by foreigners to Chinese customers are non-taxable if conducted outside, even if inspection and information gathering take place inside China before the design process begins;[16]
- offshore provision of IT support to Chinese customers through email, telephone or fax are non-taxable;[17]
- a foreign entity providing advertising services for Chinese clients, with design, production, printing and publishing of ads all outside China, is nontaxable on such services, even if the provider has representative or liaison offices in different Chinese provinces and cities, soliciting clients and handling receipt of advertising fees;[18] and
- legal and other consulting services provided by foreigners to Chinese clients are nontaxable, as long as the services are not performed jointly with a Chinese establishment and no personnel is present in China to perform such services.[19]

These "place-of-performance" rules function to exempt or partially exempt the import of services. The same principle has also occasionally exempted the export of services; for example:

16. SAT, *Guoshuifa* [1994] 214; Beijing Local Tax Bureau *Jingdishuiying* [2001] 518.
17. Shanghai Local Tax Bureau, *Hushuiliu* [2001] 35, *Hushuiliu* [2001] 379.
18. SAT, *Guoshuihan* [2003] 433.
19. SAT, *Guoshuifa* [2000] 82. If there is joint performance of services with an onshore establishment or if personnel are present in China to perform services, then a certain percentage of total revenue is deemed to be paid for services rendered within China by such establishment or personnel visits, regardless of the actual proportion of onshore services to total services.

- Chinese entities sending employees to perform services outside China are not charged BT on fees received for the services.[20]

When it comes to other types of services, such as financial and leasing services, the exemption of import and the taxation of exports have stood on seemingly less certain ground:

- foreigners lending funds to Chinese parties are deemed to provide a service from outside China, if they have no establishments in China or if the interest received is not effectively connected with the establishment; interest payments on such loans are exempt from BT, even though BT generally applies to gross interest. The status of this rule, however, has been uncertain since 2006;[21]
- similarly, foreigners leasing movable property to Chinese parties are deemed to provide a service from outside China if they have no establishments in China or if the rent received is not effectively connected with establishment. Rental income from such leases is exempt from BT. The status of this rule has also been uncertain since 2006;[22]
- Chinese parties renting ships to foreigners to be used outside China are treated as providing rental services where "labour" is provided inside China, and therefore taxable;[23] and
- foreigners providing credit guarantees to foreigners in favour of Chinese entities or individuals are treated as rendering a service outside China.[24]

The taxation of certain rental and insurance services, however, does not seem to depend on where the labour is performed:

- foreigners renting immovable property located inside China are subject to the BT on rental income received regardless of whether ownership of the property gives rise to an establishment under income tax rules;[25]
- insurance provided by foreign insurers where physical items within China are the objects of insurance is taxable;[26] and

20. SAT, *Guoshuihan* [1999] 830.
21. SAT, *Guoshuifa* [1997] 35; SAT *Guoshuiwaihan* [1997] 068. *Guoshuifa* [1997] 35 was made obsolete by SAT *Guoshuifa* [2006] 62 in April 2006. Since then it has been unclear whether interest or rent received that is not effectively connected with a Chinese establishment is subject to the business tax.
22. SAT, *Guoshuifa* [1997] 35; *Guoshuiwaihan* [1997] 068. See the preceding footnote.
23. SAT, *Guoshuifa* [1996] 126.
24. Dalian Local Tax Bureau, *Dadishuifa* [1998] 47.
25. SAT, *Guoshuifa* [1996] 212.
26. BTIR, Art. 8(2). This provision has been removed in the revised BT Implementation Rules.

- domestic insurers' provision of insurance services in relation to exported goods, indcluding credit insurance and credit guarantee, is not taxable, apparently even if the insurance is offered in favour of foreign customers.[27] This is generally understood as a piece of tax preference, not derived from basic principles about how services should be taxed.

In summary, the result of the pre-2009 set of BT rules governing cross-border services is largely the same as would be achieved under origin-based taxation, with some notable exceptions (particularly in connection with exports).[28] We now turn to what the economic consequences of this prior system might have been, and how the system has been changed by the new BT regulations that have taken effect at the beginning of 2009.

III. Change to BT rules (effective 2009): Partial switch to destination-based taxation

1. Likely economic effects of prior BT treatment of cross-border services

In the absence of actual empirical investigation, one could still conjecture as to the economic effects of the pre-2009 BT treatment of cross-border services. First, theoretically speaking, if a service received from a foreign supplier is not subject to tax when imported,[29] but the same service is subject to the non-recoverable, cascading BT when received from a domestic supplier, the domestic supplier is clearly at a disadvantage. What is unclear is in which sectors of the Chinese economy domestic and imported services are substitutable. For example, where labour is an important part of the service supplied, the generally lower labour cost in China implies that substitutable services would already have been supplied domestically. Actually imported services, such as foreign-provided design, legal, advertising, and consulting services, are likely to be non-substitutable.

27. BTIR Art. 8(1); MOF/SAT, *Caishuizi* [1994] 015, *Caishuizi* [1996] 002, *Caishui* [2002] 157, *Caishui* [2003] 16. This rule has been adopted by the new BT regulations; see BT Provisional Regulations Art. 8(7), BT Implementation Rules, Art. 22(5).

28. This is in contrast with the other two parts of the BT tax base. The transfer (including license) of intangible property is taxed where the intangible is used; the transfer of real property is taxed where the property is located. BTIR Art. 7. Both rules are consistent with the destination principle.

29. We assume that the imported supply does not bear an unrecovered tax imposed at its country of origin.

In certain other sectors such as financial services, where the cost of labour is not the chief factor determining price, domestically- and foreign-provided services are also unlikely to be substitutable, for numerous reasons. Foreign loans, for example, may be made in foreign currency and are subject to different and potentially more flexible lending criteria than those adopted by domestic banks. On the downside, foreign loans are subject to capital control and regulated as to loan amount, and charge international market interest rates, which are generally higher than the suppressed lending rates in China's domestic banking system. It seems likely that domestic and foreign loans cater to different types of borrowers, and therefore domestic banks are unlikely to be disadvantaged by the exemption from BT on foreign loans.

This is not to say that substitutable classes of onshore and offshore services are non-existent. In the field of legal services, for example, the same service may be provided by either an international law firm's offshore (e.g. Hong Kong) offices or by the same firm's representative office in China. Since transactions entered into by the latter are generally subject to the BT whereas those entered into by the former can be structured to avoid the BT, there may have been a BT-induced bias against the onshore provision of services in this sector.

What about the export of services? Again, certain services provided from China are unique, e.g. legal and accounting services based on Chinese legal and accounting rules. While subjecting such services to the BT generates deadweight loss either by raising the price of services or reducing suppliers' profits, there need not be distortions to the choice between services provided by Chinese suppliers and those provided by others. In other sectors, however, e.g. tourism and outsourcing, China could conceivable be in competition with low-cost suppliers of such services in other countries, and the BT could work to the Chinese suppliers' disadvantage.

Finally, since the Chinese VAT and certain other parts of the BT operate according to the destination and not the origin principle, taxpayers can be expected to allocate prices in composite transactions in tax-favourable ways. For example, since the transfer of intangibles to be used inside China is generally subject to the BT, taxpayers may try to re-characterize at least a part of such transfers as the provision of services. (The VAT on imported goods, to the extent recoverable, should not cause importers to re-characterize the import of goods as the import of services.) On the other hand, since the export of goods is at least partially zero-rated,

whereas the export of services is taxable, taxpayers exporting a package of goods and services should allocate the price to the goods portion as much as possible.

2. The November proposal

In November 2008, in unpublished drafts of the BT Implementation Rules informally circulated to tax practitioners for comment, MOF/SAT modified the basic rules for taxing cross-border services. According to the November Proposal, services would be subject to the BT if they are provided to entities and individuals within China. By implication, services rendered to entities and individuals outside China would be exempt from the BT. This rule would supersede the "place of performance" rule previously determining the taxability of services. MOF/SAT noted that that proposed change was made in light of the considerations of "ensuring fair competition between domestic and foreign enterprises" and "encouraging the export of labour services".

If one thinks of the BT as a quasi-VAT, the proposed change is immediately recognizable as a switch from origin-based to destination-based taxation. Such switch has occurred elsewhere before, for example, in 1997 in the EU with respect to telecommunication services supplied by non-EU providers.[30] Even though the BT is a cascading, turnover tax, its adoption of the destination principle invites comparisons with a similar switch under the VAT. Such a comparison highlights two principal differences between a transition under the BT and a transition under the VAT; they are: (1) different methods by which the destination principle is implemented with respect to foreign suppliers, and (2) the different economic impacts of the switch to the destination principle.

2.1. Administration of destination principle for foreign suppliers of services

When a foreign supplier without an establishment or other business presence in country X is taxed on services provided to customers in country X,

30. See Rainer and Claeys, "European Commission Proposes VAT Regime for Telecommunication Services", *Tax Notes International* 1997, pp. 547–50; Ogley, "VAT and Telecommunications Services in the European Union", *Tax Notes International* 1997, pp. 1155–62.

how should such tax be collected? Under a conventional VAT system, the typical approach is to require recipients of services that are registered traders to reverse charge. If the customer is unregistered, however, as in the case of a final consumer, implementation of the destination principle could require suppliers to register in the jurisdiction of destination. This is what the EU required of non-EU telecom suppliers to private consumers in EU Member States, and it is perceived as a difficult requirement to enforce, as foreign suppliers may have no other reason to create a business presence in country X.[31]

There is currently no practice of reverse charging under China's VAT system. In addition, since services are subject to the BT and not the VAT, they are generally not a type of input the tax on which can be recovered; reverse charging therefore would also not make sense. Instead, China has traditionally required foreigners subject to destination-based BT taxation to remit tax in one of two ways. First, if the foreigner has a Chinese agent, the agent may remit the BT. Second, in the absence of an agent, BT would simply be withheld by the purchaser or transferee making payments to the foreigner.[32] These methods have been practiced, for example, with respect to BT-taxable transfers of intangibles by foreigners,[33] and with respect to real estate rental activities.[34] If imported services are generally taxed on a destination basis, one can simply expect the scope of the traditional withholding mechanism to expand.

Moreover, it is still rare for Chinese consumers to directly purchase imported services, even electronically.[35] Therefore, the worry that final consumers would fail to withhold on imported services seems to lie far enough in the future.

31. See Ebrill et al., *The Modern VAT*, pp. 187–8 for discussion.
32. BTIR Art. 29(1); this rule has been codified in the new BT Provisional Regulations (Art. 11). The jurisdiction where the withholding party – agent or purchaser/transferee – has its establishment located then claims the BT revenue. BT Provisional Regulations, Art. 14.
33. Under the BTIR (Art. 7), transfers of intangibles to be used in China are subject to the BT.
34. See note 37 supra.
35. Even internet transactions would require the Chinese purchaser to have a foreign currency account from which payments can made, and most Chinese consumers do not have such accounts.

2.2. Economic impact of proposed switch

Under a VAT system, origin-based taxation of cross-border services is perceived to disadvantage domestic suppliers in two ways, both of which assume that the competing, foreign supplier is not subject to an un-recovered VAT or similar tax in the country of production.[36] First, some domestic customers, including final consumers and exempt businesses, could prefer imported services over domestically supplied services of the same kind: neither could recover the VAT charged on purchases from domestic suppliers, and imports unburdened by the VAT would have a price advantage. Second, the export of services, being taxable, may be disadvantaged in comparison to services provided to customers in countries without a VAT by suppliers located in such countries.[37] A switch to destination taxation, on the import side, puts domestic and foreign suppliers on an equal footing, while effectively raising prices faced by final consumers and exempt entities. On the export side, if zero rating is practiced, domestic suppliers' position may also improve.

Under China's BT system, however, the switch to destination-based taxation should have different consequences. If the importers of services in China are mostly businesses themselves, then subjecting their services input to the non-recoverable, cascading BT will not only raise the price of imported services, but also the prices of outputs generated by such businesses. Deadweight loss seems to be a given. This is very significant, especially if, as we discussed earlier, the previous differential treatment of domestically-supplied and imported services may not have caused significant distortion, due to the general lack of substitutability between foreign and domestic suppliers. In other words, the BT on imported services may be accused of introducing a real tax distortion in an attempt to correct (or under the pretension of correcting) an imagined one.

Another potential negative effect of taxing imported services is that for any package of imported goods and services, the parties may not longer be indifferent to the price allocation between goods and services. Amounts allocated to services would be subject to the non-recoverable BT whereas amounts allocated to goods would be subject to the recoverable VAT. Taxpayers and tax authorities can thus be expected to engage in socially

36. Ogley, *Tax Notes International* 1997, p. 1156.
37. "Although a business customer based outside the European Union can recover VAT paid under the 13th Directive, the compliance costs and cash-flow disadvantages associated with this procedure are likely to be a deterrent to recovering the VAT paid." Id.

unproductive disputes about price allocation. At the same time, it should be conceded that the motivation to allocate prices for taxable transfers of intangibles to services may lessen.

A sector that could suffer especially from the import tax is financial services, particularly loans. China imposes the BT on the gross interest paid on loans. Even though the tax rate is currently 5%, compared to the exemption for financial services practiced by other countries, the rate is still high – it would represent a tax increase by one half relative to the baseline of income tax withholding of 10% on interest payments to offshore lenders.

On the export side, the November Proposal would have exempted the export of services. Had this aspect of the proposal been adopted – and if indeed less tax was collected from supplies of services to foreigners as a result[38] (more on this assumption below) – two things could have happened: one is that the prices for exported services would drop, inducing greater demand for Chinese services by foreign customers; the other is that some Chinese service providers would retain greater profit. Of course, exemption is not as good as zero rating, but since Chinese service providers are generally not VAT payers, zero rating is not yet an option. Taxpayers exporting a package of goods and services would still try to allocate price to the goods portion – insofar as it is zero-rated – as much as possible. Nonetheless, exporters of services would have benefited from the exemption.

IV. The finally-adopted hybrid rule and directions of future development

The BT Implementation Rules, as finally issued, did not incorporate the November Proposal. It did away with the "place of performance" rule for determining whether a particular instance of services is taxable in China.

38. The reason why the exemption of exported services may not actually reduce tax paid for all service providers is that some service providers in China are subject to presumptive taxation. That is, firms may be taxed on a fixed amount of revenue without regard to actual operational results. Alternatively, some firms must report actual revenue received, but the BT is collected from such revenue along with income and other taxes, and the total tax as a percentage of revenue is fixed by prior agreement. This is how, for example, law firms are taxed in many jurisdictions in China. See Beijing Local Tax Bureau, *Jingdishuige* [2005] 69 (personal income tax liabilities of individual partners of law firms are determined on the basis of revenue, not profits.) Given such arrangements, firms may not be in a position to negotiate a tax reduction simply because the BT on the export portion of their revenue is reduced. Such firms would be indifferent, at least in the short term, to any exemption for exported services.

But the new rule that replaces it provides that services are taxable if either the provider or the recipient of the service is within China: *both* import and export of services are generally taxable. Import of services is subject to the destination principle, export of services to the origin principle.[39]

At least at a first glance, this seems to be a very bad result, both for taxpayers affected and from the perspective of policy.[40] The decision to tax the import of services is likely to have all the negative effects discussed above: increased prices for imported services *and* for the output of businesses that use such services; increased attempt by taxpayers to avoid the cascading tax, including by re-characterizing the import of services as the import of goods; and possibly a significant impact on offshore financial services offered to Chinese customers. On the export side, not only do previously taxable services remain taxable, other services that had once escaped taxation due to the quirks of the "place of performance" rule may also now be subject to tax. For example, an SAT circular issued in early March 2009 explicitly repealed a number of previous BT circulars, including one that had exempted labour services performed by employees sent to work overseas by Chinese companies.[41]

In addition to the problems inherent in implementing a destination-based BT, the new regime has caused no small amount of chaos also because the destination principle is itself is unfamiliar to many Chinese tax officials and practitioners. It has been reported that some officials have interpreted the taxation of service imports as implying that even training of Chinese personnel at foreign locations is subject to the Chinese BT.[42] Not only is this an implausible reading of the provision that services are taxable if received by Chinese entities and individuals "located within China"[43], it is also inconsistent with the destination principle, which requires that

39. BT Implementation Rules, Art. 4(1). The new BT Implementation Rules also states explicitly that the rental of real property is taxable if the property is located in China. It is no longer necessary to derive this result by pretending the performance of rental services takes place in China. Moreover, transfers of intangibles to Chinese parties will now be BT-able, regardless of whether the intangibles are used in China. BT Implementation Rules, Art. 4(2)–(4).

40. The revenue agent of course gains from this change. As a revenue raiser that directly benefits local governments – local governments claim the entire BT revenue – the change may be particularly welcome, since it has been suggested that local governments lose more from the VAT transition.

41. See note 20 supra. Also repealed were the BT-related provisions in the SAT circulars cited in notes 16, 18, 19, 23, and 25 supra.

42. Conversation with SAT official, Beijing, March 2009.

43. BT Implementation Rules, Art. 4(1).

consumption be taxed only in the country in which it occurs. If Chinese persons receive training in Europe, that is not an instance of import, and therefore should not be subject to Chinese BT if the destination principle is followed.[44]

On the part of practitioners, confusion has manifested itself in the description of the policy of taxing import of services as "sourcing" the supply of services to China (even when the services are performed abroad).[45] "Source", however, is an income tax concept, and has no useful function in the consumption tax context. If China decided to "source" income earned on the import of goods and services by foreigners to itself, this would raise serious concern about double taxation. However, in the VAT context, the practice of destination taxation is the norm, and what China has done is merely to take a step towards greater conformity with this practice.

Despite all the unintended consequences and confusion that follow from subjecting service imports to the BT, there is indication that China is moving towards fully implementing the destination principle for cross-border services. Although the revised BT regulations did not generally exempt service exports (as had been contemplated in the November Proposal), such exemptions are gradually being granted in the guise of tax preferences. On 15 January 2009, the State Council promulgated certain measures aimed at promotion of the service-outsourcing industry.[46] One key measure adopted was the exemption from BT for services supplied to offshore clients by "technologically advanced service enterprises." "Technologically advanced service enterprises," in similar contexts, have been defined as enterprises engaged in software and products design and services, information technology, and data processing.[47] This exemption is permitted in 20 cities for a five-year duration ending on 31 December 2013.

44. Indeed, taxation of foreign consumption by one's nationals is also inconsistent with the origin principle. In "Residence v. Source, Origin v. Destination: The Relationship between the Two Dichotomies" (manuscript available upon request), I explain in detail why "worldwide" consumption taxation of either individual consumption or enterprise output under a VAT is inconsistent with both the destination and origin principles.
45. See, e.g. PriceWaterhouseCoopers, China Tax/Business Advisory News Flash, December 2008, Issue 19, p. 2 (http://www.pwccn.com/home/eng/chinatax_news_dec2008_19.html).
46. State Council, Reply regarding the Issue of Promoting the Development of the Service Outsourcing Industry, *Guobanhan* [2009] 9.
47. MOF, SAT, et al., Notice On Policy Issues in the Experimental Promotion of Technologically Advanced Service Enterprises in the Suzhou Industrial Park, *Caishui* [2006] 147.

This is of course not the first time that an internationally widely-accepted practice generally associated with economic neutrality is introduced in China as a tax preference. The abandonment of the production-type VAT – the fundamental tax reform that instigated all the BT changes described in this paper – was also first introduced as a preferential tax measure in select regions and sectors. The failure to exempt service exports and fully adopt destination-basis taxation for the BT, therefore, should be understood as the product of concerns to protect revenue. It is likely to constitute only a temporary stage in the movement towards a modern consumption tax for the services sector.