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## China Alert

## The Pilot Program of VAT Reform in Shanghai

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On 16 November 2011, the Ministry of Finance ('MOF') and the State Administration of Taxation ('SAT') jointly issued two circulars to provide important guidance on the pilot program of VAT reform in Shanghai with effect from 1 January 2012:

- CaiShui [2011] No.110 – Notice of the Pilot Scheme for Transforming Business Tax ('BT') to Value Added Tax ('VAT') ("Circular 110")
- CaiShui [2011] No.111 – Notice regarding the Pilot Program for the Transformation of BT to VAT in the Transportation Industry and Certain Modern Service Sectors in Shanghai (Pilot location) ("Circular 111"); Circular 111 contains 3 appendices which set out the implementation and transitional measures.

The release of Circulars 110 and 111 marked the official rollout of the pilot program for the transformation of BT to VAT for service industries. The launch of the pilot program represents an important milestone in the history of turnover tax reform in China.

On 29 December 2011, the MOF and the SAT issued two additional circulars to clarify the relevant issues and address the transitional and implementation requirements under the pilot program:

- CaiShui [2011] No. 131 – Notice of VAT Policies regarding Zero Tax Rate and Tax Exemption for Taxable Services ("Circular 131"); and
- CaiShui [2011] No. 133 – Notice of Certain Tax Policies regarding the Transformation of BT to VAT in the Transportation Industry and Certain Modern Service Sectors

The pilot program has commenced from 1 January 2012 in Shanghai and is expected to be rolled out nationwide.

This article summarizes the salient points of the above circulars.



### Applicable VAT rate

The table below sets out the applicable VAT rates for pilot taxable services (“Taxable Services”):

Taxable Services	Applicable VAT Rate
Leasing of tangible and movable assets	17%
Transportation services by land (excluding railway), water, air and pipeline (e.g. for liquid and gas)	11%
<ul style="list-style-type: none"> <li>■ Research / development and technology services (Note 1)</li> <li>■ Information technology services (Note 2)</li> <li>■ Creative culture services (Note 3)</li> <li>■ Logistics ancillary services</li> <li>■ Attestation and consulting services (Note 4)</li> </ul>	6%
Other taxable services stipulated by the MOF and the SAT	0%
Simplified taxing method	3%

Note 1: include technology transfer services, technical consultation services, contract energy management services and services of engineering and exploring

Note 2: include software services, circuit design and testing services, information system services and business process management services

Note 3: include design services, trademark and copyright transfer services, intellectual property services, advertising services as well as conference and exhibition services

Note 4: include certification, attestation and consulting services

### Mechanics of the pilot program in Shanghai

Basically, the pilot program can be analysed from two transactional perspectives, i.e. 1) Cross-region transactions within China, and 2) Cross-border transactions between China and overseas.

#### Cross-region transactions within China

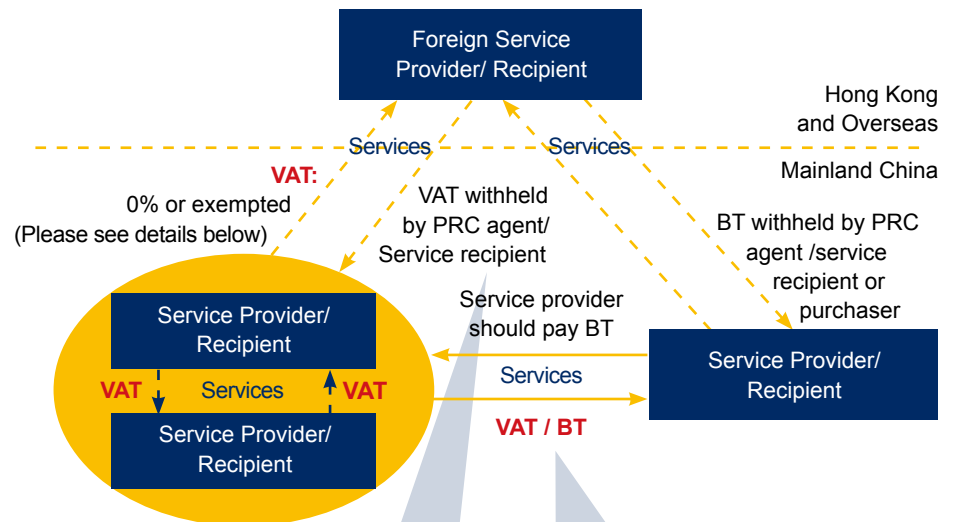
- 1) Taxable Services rendered by a pilot taxpayer in Shanghai region to a company outside Shanghai region
  - A pilot VAT payer in Shanghai can issue special VAT invoice to the service recipient provided that the service recipient is not an individual consumer and the services are not VAT-exempted.
  - If the service recipient is a general VAT payer, it can deduct the input VAT paid.
  - VAT should be settled at the place where the establishment of the pilot taxpayer is located. When services are rendered by a pilot taxpayer outside Shanghai and BT was paid to the tax authority where the services were rendered, the amount of BT paid could be deducted from the VAT payable of the pilot taxpayer.
- 2) Taxable Services rendered by a service provider outside Shanghai region to a pilot taxpayer in Shanghai
  - The company outside Shanghai region should file and pay BT in accordance with the current BT law.

### VAT taxpayer and the withholding agent

A VAT taxpayer is defined as a unit or an individual providing services in transportation or certain modern service sectors within China. The taxpayer is subject to VAT instead of BT when it provides pilot taxable services in China.

For a foreign company or an individual (“Foreign Service Provider”) providing taxable services in China, the withholding agent is defined as:

- 1) The agent of the Foreign Service Provider if the Foreign Service provider does not have an operating establishment in China; or
- 2) The service recipient if the Foreign Service Provider does not have any agent in China.



### Cross-border transactions

- Taxable services rendered from overseas to China

Under the pilot program, the company or the individual that provides Taxable Services in China is subject to VAT instead of BT. According to Circular 111, such Taxable Services will be considered as provided in China and be subject to VAT if either the service provider or the service recipient is located in China, except for following situations:

- 1) Taxable Services provided by foreign companies or individuals to Chinese companies or individuals are entirely consumed outside China;
- 2) Leasing of tangible and movable assets by foreign companies or individuals to Chinese companies or individuals and the assets are entirely used outside China; or
- 3) Other circumstances as stipulated by the MOF and the SAT.

- Taxable Services rendered from China to overseas

Taxable Services rendered by a pilot taxpayer in Shanghai to overseas are free of VAT. Such services are either subject to VAT at zero rate or VAT-exempted.

The following diagram summarizes the mechanics of the VAT pilot program for illustration purpose:

A general VAT payer that receives Taxable Services from overseas should obtain Tax Payment General Certificate and thus the VAT amount thereon can be deducted from the output VAT

If the service provider neither has an establishment nor an agent in China, the service recipient in Shanghai region can be the withholding agent provided that it is a general VAT payer and thus the VAT amount paid can be deducted from the output VAT

A service provider should pay VAT if the services are provided in Shanghai region

A service provider should pay BT if the services are provided outside Shanghai region

Circular 131 sets out details in relation to Taxable Services that are subject to either zero rate or exemption treatment as follows:

### Zero VAT Treatment

The following Taxable Services are subject to zero VAT treatment:

- International transportation services with relevant permits (whereas international transportation services cover transportation of passengers or goods out of China, transportation of passengers or goods into China and transportation of passengers or goods outside China)
- Research and development services provided to overseas entities
- Design services provided to overseas entities (however, design services provided to overseas entities in relation to immovable properties situated in China are not eligible for zero VAT treatment)

### VAT Exemption Treatment

VAT exemption applies to the following Taxable Services:

- International transportation services without relevant permits
- Engineering and exploration services whereby the relevant projects or mineral resources are located overseas
- Convention and exhibition services with venues located overseas
- Warehousing services provided through warehouses located overseas
- Leasing of movable properties situated overseas

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VAT exemption is only applicable to services provided to foreign recipients excluding foreign individuals:

- Technology transfer and technology consulting services provided to overseas recipients
- Energy management services provided to overseas recipients (however, energy management services with contracted objects located in China are specifically excluded)
- Software services, circuit design and testing services, information system services and business process management services provided to overseas recipients
- Trademark and copyright transfer services, intellectual property services provided to overseas recipients
- Logistics ancillary services (which do not fall into the category of warehousing services) provided to overseas recipients
- Certification, verification and consulting services provided to overseas recipients (except for services in relation to goods or immovable properties situated in China)
- Advertising services with advertisements released outside China

According to Article 10 of the PRC VAT Law, input VAT incurred on purchased goods or taxable services used for tax exempt items cannot be credited against output VAT. In this connection, input VAT incurred for the provision of VAT exempted services cannot be credited. Instead, such input VAT should be transferred out and be treated as the cost of the taxpayer. On the contrary, a general VAT payer may claim input VAT credit incurred for provision of taxable services subject to zero VAT rate.

### Our observation and comments

1. Overseas service providers who provide Taxable Services to pilot taxpayers in Shanghai will likely suffer an increase in tax burden where the applicable VAT rates are higher than the BT rates (e.g. VAT at 6% v.s. BT at 5% for consulting services) before the pilot program. To the overseas service providers, the increase in withholding VAT paid will become part of the costs of providing services.
2. The pilot program enhances the competitiveness of Shanghai service providers, as they may now attract service recipients who have a general VAT payer status and would like to replace non-creditable BT purchases from non-Shanghai providers with creditable VAT purchases from Shanghai providers.
3. It is worth noting that the pilot program affects not only the Shanghai service providers but also other domestic or foreign enterprises or individuals who provide services to Shanghai recipients. All affected enterprises should fully understand the tax implications and compliance requirements under the VAT reform.
4. It is possible that the program could be rolled out to other cities or regions in the near future. Foreign investors and enterprises in China should keep track of the latest development.
5. The above circulars also contain detailed compliance procedures, registration requirements and measures in relation to small-scale VAT payers, cross-year transactions and disposal of used fixed assets. For more information or advice on the pilot program, please contact our PRC tax team.

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