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Indirect Tax Analysis

China — VAT Reform: Shanghai pilot

Detailed implementation rules released for China's VAT reform pilot program in Shanghai

Your roadmap to understanding the guidelines

Following the State Council's 26 October 2011 decision to launch the VAT reform pilot program in Shanghai, China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued guidance on 16 November 2011 to provide detailed implementation rules for the program. Although the guidance does not address all issues, it does clarify many questions.

The MOF/SAT guidance on the pilot program is in the form of two Circulars:

- Notice for the Introduction of the Pilot Scheme to Convert Business Tax to VAT (Circular 110)); and
- Notice for Converting from Business Tax to VAT in the Transportation Industry and Certain Modern Service Sectors in Shanghai (Circular 111). Circular 111 is accompanied by three appendices:
 - Appendix 1: Measures for Implementation of Converting Business Tax to VAT in the Transportation Industry and Certain Modern Service Sectors (Implementation Measures);
 - Appendix 2: Regulations on Relevant Issues for Converting Business Tax to VAT in the Transportation Industry and Certain Modern Service Sectors (Relevant Issues); and
 - Appendix 3: Regulations for the Transitional Policy for Converting Business Tax to VAT in the Transportation Industry and Certain Modern Service Sectors (Transition Rules).

Under China's current indirect tax system, VAT is levied on the supply of goods, the provision of repair, processing and replacement services, and on imports at the standard rates of 13% or 17%, while Business Tax (BT) is levied on the provision of other services and the transfer of intangibles and real property at rates of 3% or 5% (with a maximum 20% rate applying to the entertainment industry). The co-existence of the VAT and BT systems has led to a number of issues, such as double (or multiple) taxation because of the availability of an input tax credit for VAT payers with no such mechanism available under the BT system. The pilot program aims to resolve the double taxation issues under the prevailing system and to foster the development of specified modern service industries by gradually transitioning these industries from liability to BT to liability to VAT. The pilot program is considered a milestone for Chinese VAT reform and will have a significant impact on affected industries and companies in China.

Highlights of Circular 110

Circular 110 outlines the general principles for the overall VAT reform pilot program in China (although no date for the full reform pilot program is mentioned). The Circular clarifies that the VAT reform pilot program will be carried out in two phases:

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

Once the two pilot programs are completed, the VAT reform is expected to be rolled out nationwide for all service sectors – the third and final phase of the reform.

Circular 110 states the general principles of the overall reform pilot program, which include:

- Confirmation that the pilot program will commence on 1 January 2012 and, when conditions permit, it is expected that the VAT reform will be expanded nationwide. Applicable VAT rates:
 - Leasing of moveable and tangible goods: 17%;
 - Provision of transportation and construction services: 11%; and
 - Provision of other specified modern services: 6%.
- Financial and insurance services, as well as services provided to consumers for their daily needs, generally will be taxed using the simplified taxing method, while other service sectors will be taxed using the ordinary taxing method. (Under the simplified taxing method, tax due is calculated by multiplying the sales amount by the VAT levying rate (3%), but input VAT is not recoverable. By contrast, under the ordinary taxing method, the standard VAT rate will apply and input VAT is creditable against output VAT.)
- Services provided from overseas and received in China will be subject to VAT at the above rates. The provision of services from China to overseas customers will be exempt or zero rated for VAT purposes.
- With respect to cross-region taxation, taxpayers covered by the pilot program must pay VAT at the location where their organization is situated. BT paid in other regions can be deducted when calculating the VAT due. Taxpayers that do not fall within the scope of the pilot program will continue to pay BT even if they are operating in the pilot regions.

Highlights of Circular 111

Circular 111 sets out detailed implementation rules for the initial pilot in Shanghai and these rules generally follow the principles set out in Circular 110. Some of the principles in Circular 110 (such as the taxing method for construction, telecommunication, financial and insurance services) will not be implemented in the initial pilot in Shanghai, but may be implemented at a later stage.

Circular 111 addresses the Shanghai pilot – specifically, the application of VAT in the transport and certain modern services sectors. The appendices primarily provide details on three main topics: the scope/ application of VAT, the right to deduct input VAT and preservation of the current BT incentives. Circular 111 is drafted to follow the current VAT rules, so the mechanisms for an input VAT credit or simplified taxing method, the point of

taxation, classification of taxpayers and administrative measures, remain unchanged. The following focuses on the main features of the appendices.

Appendix 1 — Implementation measures

This Appendix aims to clarify the scope of the charge to VAT. The Implementation Measures are applicable to entities and individuals located in the pilot region (i.e. Shanghai) and foreign entities and individuals that provide taxable services to entities and individuals located in the pilot region. The Implementation Measures address the relevant issues within eight chapters, including the definition of taxpayers and withholding agents, the definition of VAT taxable services, applicable tax rates, calculation of VAT liabilities, the point of tax and location of the tax payment, tax reduction and exemption, tax collection and administration and supplementary articles.

Scope of service sectors selected for the pilot program.

- Transportation services involving cargo or passengers, including transportation by land (excluding railway transportation), water, air and pipeline;
- R&D and technology services, such as transfers of technology and technology consulting;
- Information and technology services, including software related services, circuit design and testing services, IT system services and process and procedure management services;
- Creative cultural services, including design, transfers of copyrights and trademarks, services related to intellectual property rights, advertising, and conference and exhibition services;
- Logistics and ancillary services;
- Leasing (including operating and finance leasing) of moveable and tangible goods; and
- Attestation and consulting services.

An attachment to Appendix 1, referred to as “Annotations to the VAT Items,” provides detailed explanations of the scope of each service category.

Treatment of provision and receipt of services within and outside China

If either the service provider or the service recipient is located in China, the provision of the relevant services will be considered to be provided in China and, thus, subject to VAT. The following services, however, will not be deemed to be provided in China, so no VAT will be due:

- The provision of the relevant services by overseas companies or individuals to Chinese companies or individuals and the services are used entirely outside China;
- The leasing of moveable and tangible goods by overseas companies or individuals to Chinese companies or individuals and the goods are used entirely outside China; and
- Other situations as stipulated by the MOF and the SAT.

Input VAT

The input VAT that can be recovered is as follows:

- Input VAT amount stated on the special VAT invoice;
- Import VAT amount stated on the Import VAT Payment Certificate issued by Customs;
- 13% on the purchase voucher for agricultural products;
- The recipient of transportation services can deduct input VAT based on the special VAT invoice obtained for transportation services purchased. In cases where no VAT special invoice is obtained, the recipient of the services can claim an input VAT deduction at the deduction rate of 7% based on the transportation fee specified in the transportation fee receipt;
- Where services are provided by overseas entities or individuals and received in China, the VAT withheld by the recipient in Shanghai will be eligible for recovery if supported by a tax payment clearance certificate. Written contracts, payment certificates and debit notes, or invoices issued by the overseas entities must be provided to support the claim.

Appendix 2 — Relevant issues

Appendix 2 aims to clarify certain issues with regard to pilot taxpayers, withholding agents and current VAT payers.

Right to deduct payments to non-pilot companies

- For industries that are allowed to be taxed on a net income basis under the current BT rules, if the taxpayer under the pilot program makes a payment to a non-pilot company that qualified for deduction under current BT rules, in calculating the VAT output for the taxpayer, the payment still could be deducted from the income for VAT purpose to achieve consistent treatment.

Clarification of right to deduct for current general VAT payers

- Input VAT incurred for VAT taxable services provided by taxpayers in the pilot program is creditable. The creditable amount is the input VAT amount shown on the special VAT invoice.
- Input VAT incurred for transportation services provided by small-scale taxpayers in the pilot program is creditable (7% on the invoice amount).
- Input VAT incurred for VAT taxable services provided by overseas suppliers is recoverable by current VAT payers participating in the pilot region. The creditable amount is the input VAT amount shown on the tax payment certificate.
- Input VAT that is not eligible for deduction includes the receipt of passenger transportation services, transportation services related to purchase goods, works-in-progress and finished goods that are in an abnormal loss situation.

- Transportation fee settlement receipts issued in Shanghai on and after 1 January 2012 cannot be used to claim an input VAT credit because a special VAT invoice must be issued for the provision of transportation services in Shanghai.
- Input VAT incurred through 31 December 2011 that is associated with the original VAT taxable activities cannot be credited against the output VAT associated with new taxable services after 1 January 2012.

VAT registration threshold for the pilot

- The annual service revenue threshold for general VAT payers is CNY 5 million (inclusive).
- Small-scale VAT payers that have sound accounting systems and are able to provide accurate documentation for tax filing purposes can apply for general VAT payer status even if their sales revenue does not reach CNY 5 million; this is consistent with current VAT rules.
- It will not be necessary to reapply for recognition of general VAT payer status if a current general VAT payer also engages in VAT taxable services and meets the CNY 5 million thresholds.
- General VAT payers may not convert to small-scale taxpayer status unless so stipulated by the SAT.

Appendix 3 — Transitional rules

Appendix 3 mainly aims to provide VAT incentives, by introducing a VAT exemption or VAT collection with an immediate refund mechanism, to preserve the BT incentives currently enjoyed on certain services.

Exemption from VAT

- Technology transfers, technology development and related technology consulting and technical services provided by taxpayers in the pilot program;
- Qualified offshore outsourcing services provided by companies established in Shanghai during the period 1 January 2012 to 31 December 2013; and
- Ship inspection services provided by the Shipping Classification Society, direct flights between Taiwan and the Mainland and other miscellaneous items

VAT collection with an immediate refund

- Domestic cargo transportation services, warehousing services and loading and unloading services provided by taxpayers in the pilot program and registered in the Yangshan Free Trade Port Area;
- Taxpayers that hire a specified number of handicapped persons and provide VAT taxable services;
- Pilot general VAT payers that provide pipeline transportation services (eligible for a VAT refund in excess of 3% of their actual VAT burden); and
- Authorized finance leasing companies included in the pilot program (eligible for a VAT refund in excess of 3% of their actual tax burden for the provision of finance leasing services of moveable and tangible goods).

Comments

An analysis of Circulars 110 and 111 and the appendices reveals issues that need to be examined further to fully understand their impact.

Services covered

Although Circular 111 clarifies the scope of particular modern service sectors in the Shanghai pilot that will be carried out as from 1 January 2012 and provides detailed information on these taxable items within the Annotations, taking into account the diversity and complexity of typical business arrangements, it is possible that the rules will not cover all situations. Affected companies should begin immediately to take a proactive approach and seek clarification from the competent tax authorities.

Service sectors that are not covered in Circular 111, such as construction, telecommunication and financial and insurance services, may be included in the pilot at a later stage. As such, companies in these sectors should closely monitor developments.

Threshold for VAT registration

The mandatory VAT registration requirement for general VAT payers is set at CNY 5 million of annual sales revenue, as compared to the existing CNY 800,000 or CNY 500,000 for manufacturing or trading companies, respectively. The higher threshold is welcomed because more taxpayers will be classified as small-scale taxpayers subject to the lower rate of 3% without suffering an additional compliance burden.

Place of supply rules for services

Both circulars address the place of supply of services. Circular 110 provides the general principle for services supplied in various regions throughout China and for services supplied from, and received in, China. Circular 111 provides certain detailed implementation rules.

Cross-region supplies

1. Taxable services supplied by a pilot taxpayer in Shanghai to an entity located outside of Shanghai
 - VAT will be due and the pilot taxpayer in Shanghai will be able to issue a special VAT invoice to the service recipient provided the recipient is a general VAT payer;
 - A service recipient that is a general VAT payer will be able to recover the input VAT charged by the pilot taxpayer;
 - According to Circular 110, where services are provided by a pilot taxpayer outside Shanghai, if the taxpayer has paid BT for the service in the location in which the services are provided, the amount of BT paid may be deducted when calculating VAT due for the pilot taxpayer. However, it is still unclear how the deduction mechanism would work in practice and this may require further clarification.

2. Taxable services supplied by an entity outside of Shanghai to a pilot taxpayer located in Shanghai
 - BT will apply on the services provided by the entity located outside of Shanghai;
 - Such BT will not be recoverable by the pilot taxpayer located in Shanghai.

On a related issue, since taxpayers are determined based on the place in which their organization is located and given that a head office and its branch offices are different taxpayers, it is reasonable to conclude that branches located in other places will not be affected by the pilot program in Shanghai even if the head office located in Shanghai is affected, and vice versa. This will give rise to managerial complications for companies operating nationwide, but also may create some tax planning opportunities to shift affected businesses between an affected entity and an unaffected entity.

Supplies from and received in Shanghai from overseas

1. Taxable services supplied from overseas

The general rule is, if either the service provider or the service recipient is located in China, the provision of services under the pilot will be considered to be provided in China and, thus, subject to VAT. Thus, all services supplied from overseas to Shanghai are taxable in Shanghai. This is consistent with the current BT rules. Nevertheless, the pilot program aims to address a long-standing debate on the taxation of services provided and enjoyed overseas, i.e. whether some form of zero rating should apply when services are provided and enjoyed outside China. The new exceptions are for:

- Services provided by overseas suppliers and used entirely outside China by China entities or individuals; and
- The leasing of moveable and tangible assets provided by overseas suppliers and used entirely outside of China by China entities or individuals.

Circular 111 also provides a withholding mechanism for charging VAT on services provided by overseas suppliers in Shanghai where a VAT charge applies but there is no VAT-registered organization in Shanghai. In these circumstances, the pilot taxpayer will have to withhold the VAT payable on behalf of the overseas supplier at the applicable rate. Such VAT can be recovered by service recipients that have general VAT payer status. For taxpayers that are unable to recover VAT at all, the burden in these circumstances likely will increase where the applicable VAT rate is higher than the current BT rate (e.g. 6% VAT as opposed to the current 5% BT).

2. Taxable services supplied from Shanghai to overseas

Circular 110 confirms an important change that services supplied to an overseas recipient are without VAT. However, it is unclear whether such supplies will be exempt or zero rated. Understanding the correct VAT treatment is critical as it will have an immediate impact on whether the input VAT associated with the services is recoverable (as costs attributable to a zero rated supply) or not (as costs attributable to an exempt supply). Neither Circular 110 nor Circular 111 answers this question.

BT incentives

A welcomed confirmation is that, as promised in the State Council's initial announcement of the pilot program, the current BT incentives (e.g. R&D and technology-related activities and qualified offshore outsourcing services) will remain intact during the pilot. The survival of the BT incentives has been implemented through a VAT exemption mechanism that effectively achieves the same result as a BT exemption. Moreover, the tax collection with an immediate refund method will be used to achieve the effect of tax-exempt treatment for certain industries.

Compliance

The VAT compliance requirements generally follow the current VAT rules. However, enterprises that are new to VAT and unfamiliar with VAT compliance obligations will need more practical guidance and information, but will still need to ensure they are prepared for the following:

- The actions required to be compliant, such as registration procedures (forms and documents needed to support the application). Based on past experience, it is likely that the Shanghai tax bureau will assist with the practicalities by holding training sessions and issuing communications with affected taxpayers;
- Timeline for approval of applications;
- Unless there are simplifications, VAT returns generally must be submitted on a monthly basis with a submission date of the 15th of the following month. Therefore, companies will need to ensure that data is available to comply with the first return due on 15 February 2012;
- The special VAT invoice will continue to be required to claim an input VAT credit. However, this rule indicates that affected services provided by non-taxpayers covered by the pilot program will not be recoverable by taxpayers in the program because the non-taxpayers are unable to issue a special VAT invoice for the provision of such services. Such non-recoverable taxes would become a cost to taxpayers in the pilot program.

Planning

Some of the rules announced in the two circulars could provide immediate planning opportunities and it is important to take action now as there is a small window of opportunity. Where commercially possible, companies should consider the following:

- Current BT payers: deferring the purchase of assets to 1 January 2012 when they fall within the scope of the VAT scheme to allow a deduction of the 17% VAT;
- Current BT payers that will become VAT payers: take into account customers within and outside of China:
 - For services within China – consider billing before 1 January 2012 to avoid the additional tax now because the contract price is fixed (5% BT vs. 6% VAT). This also will help to reduce the local surcharges that are calculated based on the VAT or BT due.
 - For services supplied outside China — consider deferring billing to after 1 January 2012 to mitigate the charge to VAT. This will be especially effective for inter-company transactions, as it will reduce the existing BT burden paid by the overseas party.
 - For services payable by China — advance the point of taxation if the company cannot recover VAT at all so the tax payable remains a 5% BT rather than a 6% VAT.

- For companies charging service fees (especially for affected services) to affiliate companies within China — consider aligning the charge scheme with the pilot program to maximum VAT taxable service revenue.
- For companies actively engaged in service activities in Shanghai without an establishment – consider the establishment of an organization in Shanghai to take advantage of opportunities.
- For companies in the process of centralizing service function (especially for affected services) into Shanghai — consider accelerating the reorganization process to take advantage of opportunities.
- For companies in the pilot program that are subject to different VAT rates or that provide both BT and VAT taxable services — consider restructuring internal and external operating arrangements to maximize benefits under the pilot program, i.e. clearly identify assets to be used for VAT-related activities.

Conclusion

Taxpayers that are able to recover VAT under the current system will reap an immediate benefit under the pilot program, but taxpayers that will be subject to a high VAT rate as compared to the current BT rate without much VAT input may benefit less from the pilot program.

With only a very short time before the pilot commences in Shanghai, affected taxpayers should begin to act now to prepare for the pilot, particularly for compliance purposes (e.g. register for VAT, apply for general VAT payer status, etc.). A strategic and methodological approach is essential for companies to make a successful transition from BT payer status to VAT payer status.

Authors/ Contacts

Shanghai

Sarah Chin

Partner
Indirect Tax
Tel: +86 21 6141 1218
Email: sachin@deloitte.com.cn

Gao Li Qun

Partner
Indirect Tax
Tel: +86 21 6141 1053
Email: ligao@deloitte.com.cn

Candy Tang

Senior Manager
Indirect Tax
Tel: +86 21 6141 1081
Email: catang@deloitte.com.cn

For more information on the subject, please contact:

Zurich

Manuela Blochwitz

Chinese Services Group
Senior Manager Indirect Tax
Tel.: +41 44 421 6975
Email: mablochwitz@deloitte.ch

Kerstin Heidrich

Chinese Services Group
Senior Manager International Tax
Tel.: +41 44 421 6301
Email: kheidrich@deloitte.ch

Ralf Schläpfer

Chinese Services Group
Managing Partner
Tel.: +41 44 421 6686
Email: rschlaepfer@deloitte.ch

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General Guisan-Quai 38
P.O. Box 2232
8022 Zurich

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