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**TAX FLASH**  
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### **THE PILOT PROGRAM OF VAT REFORM**

*In January 2011 of our Tax Flash, we have reported that one of the major PRC tax policies changes under the State's 12th Five-year Plan relates to indirect tax reform. On 26 October 2011, the Chinese State Council officially announced the launching of a pilot Value Added Tax ("VAT") reform program ("Pilot Program") which will be carried out in three phases as follows:-*

*Phase 1: The initial trial (effective 1<sup>st</sup> January 2012) is applicable to transportation industry and certain modern services industries ("Pilot Industries") in Shanghai.*

*Phase 2: The Pilot Program will be rolled out to other regions (or nationwide) for the Pilot Industries. If Phase 1 runs smoothly during the first half year of 2012, it is expected the implementation rules of Phase 2 will come out within year 2012.*

*Phase 3: The full VAT reform will be rolled out nationwide for all service industries. No timeline for the full reform program is mentioned in the announcement.*

*Further to the State Council announcement, the Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT") jointly issued guidance and detailed implementation rules on 16 November and 29 December 2011 for the Pilot Program, in particular:*

- *Notice for the Introduction of the Pilot Scheme to Convert Business Tax ("BT") to VAT (Caishui [2011] No. 110 (Circular 110));*
- *Notice for Converting from BT to VAT in the Transportation Industry and Certain Modern Service Sectors in Shanghai (Caishui [2011] No. 111 (Circular 111))<sup>(Note)</sup>; and*
- *Notice for Taxable Services that are eligible for VAT Zero-rating and VAT Exemption (Caishui [2011] No. 131 (Circular 131))*

*In this Tax Flash, we aim to provide you with the salient points on Phase 1 of the Pilot Program.*

#### **I. The Pilot Program**

Under the prevailing People's Republic of China ("PRC") turnover tax system, the general VAT rates levied on the income generated from selling goods, provision of processing, repair or replacement services and imports are 13% or 17% while the general BT rates levied on income generated from provision of other services and transfer of intangibles or real properties are 3% or 5% (with a maximum 20% rate applying to the entertainment industry). Since input tax credit is only available for VAT payers and no such mechanism exists under the BT system, the co-existence of the VAT and BT systems have led to a number of issues, including double taxation and other tax administrative matters. To resolve these issues and to encourage the development of service industries, Pilot Program is introduced by the State Council. Circular 110 and 111 highlight the main updates of the Pilot Program as follows:

- VAT instead of BT will be levied on Shanghai enterprises engaged in Pilot Industries (“Pilot Enterprises”) effective 1<sup>st</sup> January 2012;
- Two new VAT rates of 11% and 6% are introduced, which will apply in conjunction with the current VAT rates of 17% and 13%;
- Export of services from China may be eligible for VAT zero-rating or VAT exempted;
- The threshold of the annual revenue for General VAT Payer under the Pilot Program has been raised to RMB 5 million; and
- Current BT incentives applicable to the Pilot Enterprises will still be adopted.

Under Phase 1 of the Program, Pilot Enterprises will be transformed from BT Payers to VAT Payers. The replacement of BT (a tax on business) with a VAT (a tax collected by business and effectively borne by the end-customer) will generally reduce taxpayer’s turnover tax liabilities (as the input VAT incurred will now be creditable against their output VAT) and should be a welcome change for most of the Pilot Enterprises.

## II. VAT Policies under the Pilot Program

The prevailing VAT policies are largely adopted and applicable to Pilot Enterprises under the Pilot Program.

### Classes of VAT Payers

There are two classes of VAT Payers:

- “General VAT Payers” – Shanghai Enterprises engaged in the Pilot Industries with annual turnover of RMB 5 million or above; and
- “Small Scale VAT Payers” – Shanghai enterprises engaged in the Pilot Industries with annual turnover of less than RMB 5 million. Small Scale VAT Payers may voluntarily apply for General VAT Payer status if certain conditions are met.

As compared to RMB800,000/RMB500,000 for manufacturing/trading companies under the prevailing VAT regimes, the General VAT Payer registration threshold is raised to RMB 5 million of annual sales revenue under the Pilot Program.

### Applicable VAT Rates

The applicable VAT rates for different classes of VAT Payers under the Pilot Program have been set out below:

| Classes of Taxpayers   | Type of Services   | VAT Rate |
|------------------------|--|----------|
| General VAT Payers     | - Leasing of movable property  | 17%      |
|                        | - Transportation services  | 11%      |
|                        | - Research & Development (“R&D”) and technology services;<br>- Information technology services;<br>- Cultural and creative services;<br>- Logistics auxiliary services<br>- Authentication & consulting services | 6%       |
| Small Scale VAT Payers | - All services included in the Pilot Program   | 3%       |

Pursuant to Circular 131, the provision of following services will be eligible for VAT zero-rating:

- Qualified international transportation services (provided that the related operating permit is obtained)
- Provision of R&D services to overseas service recipient(s)
- Provision of design services to overseas service recipient(s) (except for design services in relation to immovable properties located in China)

If the captioned Pilot Enterprise is a General VAT Payer, “Exempt, Credit and Refund Method” should be applied. Otherwise, the related services will be VAT exempted.

Circular 131 also stipulates that the provision of the following services will be VAT exempted:

- Engineering and exploration services with the related project or mineral resources located outside China
- Overseas conferencing and exhibition services
- Overseas storage services
- Movable property leasing services for which the object of leasing is located outside China
- Unlicensed international transportation services which do not qualify for VAT zero-rating
- Overseas advertising services
- Provision to overseas service recipient(s) the following services:
  - Technology transfer services
  - Technology consulting services
  - Contract energy management services (except where the project is located in China)
  - Software services
  - Circuit design and testing services
  - Information system services
  - Operation process management services
  - Trademark and copyright transfer services
  - Intellectual property services
  - Logistics auxiliary services (except storage services)
  - Verification services (not applicable to those goods/immovable property located in China)
  - Authentication services (not applicable to those goods/immovable property located in China)
  - Consulting services (not applicable to those goods/immovable property located in China)

However, Circular 131 currently does not provide the procedures and documentation requirements for claiming VAT zero-rating or VAT exemption.

### VAT calculation

The VAT calculation method under the Pilot Program remains unchanged:-

#### *(i) General VAT Payers*

Output VAT would be charged based on the service income at the relevant VAT rates, whilst input VAT paid for the purchases of goods and services would be creditable.

$$\text{“VAT payable} = \text{Output VAT} - \text{Input VAT”}$$

whereas

$$\text{“Output VAT} = \text{Sales revenue} \times \text{Applicable VAT rate”}$$

Deductible input VAT includes:

- The input VAT amount shown on the **special** VAT invoice;
- The import VAT amount shown on the Import VAT Payment Certificate issued by PRC Customs;
- 13% of the purchase amount shown on the “agricultural products sales invoice”;
- The recipient of transportation services can deduct input VAT based on the **special** VAT invoice obtained for transportation services providers. In cases where no VAT special invoice is obtained, the recipient of the services can claim an input VAT deduction at 7% based on the transportation service fee shown on the “transportation invoice”;
- Where services are provided by entities or individuals overseas and received in China, the VAT withheld by the recipient in Shanghai can be deducted if Tax Clearance Certificates are obtained from the tax bureau (written contracts, payment certificates and debit notes, or invoices issued by the overseas entities must be provided to support the claim).

Besides, certain Pilot Enterprises which were allowed to file BT on a net margin basis under the BT regulations are allowed to deduct payments made to non-Pilot Enterprises in or outside Shanghai in computing their VAT liabilities.

*(ii) Small Scale VAT Payers*

Output VAT = Sales revenue (VAT inclusive) / (1 + Applicable VAT rate)

- Similar to small scale VAT Payers under the prevailing VAT regime, no input credit is allowed for small scale VAT Payers under the Pilot Program.

### **III. Cross-region/border Services**

Under Phase 1 of the Pilot Program, the main uncertainties come from the cross-border and cross-region services provided. Although the guidance clarifies some important tax issues, there are a few issues that still remain unclear.

#### ***Cross-region Services***

##### Taxable Services provided by a Pilot Enterprise to a non-Shanghai Enterprise

- Pilot Enterprise shall be subject to VAT, and special VAT invoices should be issued to the service recipient (i.e. the non-Shanghai Enterprise);
- If the service recipient (i.e. the non-Shanghai Enterprise) is a General VAT Payer, the input VAT can be deducted;
- If the service recipient is a BT payer, it would suffer from additional VAT cost charged by the Pilot Enterprise as it has to treat the VAT paid as part of its purchase cost;
- Where services are provided outside Shanghai by a Pilot Enterprise, the BT paid in other regions in which the services are provided can be deducted from Pilot Enterprise’s VAT liability.

##### Taxable Services provided by a non-Shanghai Enterprise to a Pilot Enterprise

- The revenue from the services provided by the non-Shanghai Enterprise shall be subject to BT;
- The above BT paid cannot be deducted by the Pilot Enterprise.

Please note that if the head office of a group and its branch offices are registered in different locations, whether they shall pay BT or VAT will be depended on their registered location.

### ***Cross-border Services***

Please note that the provision of following services would be considered as outside China and the revenue is not subject to VAT:

- Services provided by an overseas enterprise/individual and entirely consumed outside China;
- Movable property leased by an overseas enterprise/individual and this movable property is entirely used in overseas area.

Except for the above situations, all other revenues generated from provision of cross-border services under the Pilot Program will be considered to be generated from China and thus subject to VAT.

### **Withholding Mechanism**

Circular 111 provides a withholding mechanism for collecting VAT on the revenue generated by overseas suppliers through the provision of taxable services to Pilot Enterprise under the Pilot Program. If the service provider does not set up an entity in Shanghai, the service recipient (i.e. the Pilot Enterprise) shall withhold the VAT on behalf of the overseas service supplier. Provided that the Pilot Enterprise is a General VAT Payer, the VAT paid can be claimed as input VAT.

## **IV. Special Tax Incentive under the Pilot Program**

Tax exemption is granted on the following services:

- Technology transfers, technology development and relevant technology consulting and technical services provided by taxpayers in Shanghai;
- Qualified offshore outsourcing services provided by taxpayers in Shanghai during the period from 1<sup>st</sup> January 2012 to 31<sup>st</sup> December 2013; and
- Ship inspection services provided by the Shipping Classification Society as well as direct flights between Taiwan and the Mainland.

VAT collection with an immediate refund will apply to the provision of the following services or taxpayers:

- Domestic cargo transportation services, warehousing services and loading and unloading services provided by taxpayers within the Pilot Program and registered in the Yangshan Free Trade Zone;
- Taxpayers that hire a certain number of handicapped staff and provide VAT taxable services;
- General VAT Payers that provide pipeline transportation services (eligible for a VAT refund in excess of 3% of their effective VAT liability); and
- Authorized finance leasing companies included in the Pilot Program (eligible for a VAT refund in excess of 3% of their effective tax liability for the provision of finance leasing services of moveable and tangible goods).

## **V. Suggested Actions**

For many years, double taxation has been a serious problem in China. In order to move forward to mitigate the multiple taxation issue associated with goods and services, the VAT reform program has been introduced. It will likely bring dramatic changes to the landscape of Chinese indirect tax system and a profound impact on not only those within the Pilot Program but also on most businesses. As the Pilot Program will be launched from 1<sup>st</sup> January 2012, enterprises should now begin to prepare for new rules and requirements, as well as changes to their internal systems that may be necessary such as:-

- Closely monitoring the development and issuance of the detailed rules and seeking clarification and confirmation from the authorities, where possible;
- Estimating the possible impact of the Pilot Program on the actual tax burden, especially in cases where the new VAT rates are higher than the current BT rates;
- Evaluating the cash flow effects; providing sufficient flexibility when drafting tax clauses in commercial contracts and seeking modifications to existing clauses where necessary and feasible;
- Checking and confirming whether existing IT and accounting systems are appropriate and flexible enough for the tax conversion and making any necessary adjustments thereto;
- Ensuring that responsible personnel are knowledgeable about the Pilot Program;
- Communicating with customers and overseas headquarters; and
- Consulting with tax professionals, where necessary.

Enterprises that are not included in the Pilot Program should also keep current on the Program and estimate the potential impact on their business.

**Notes:**

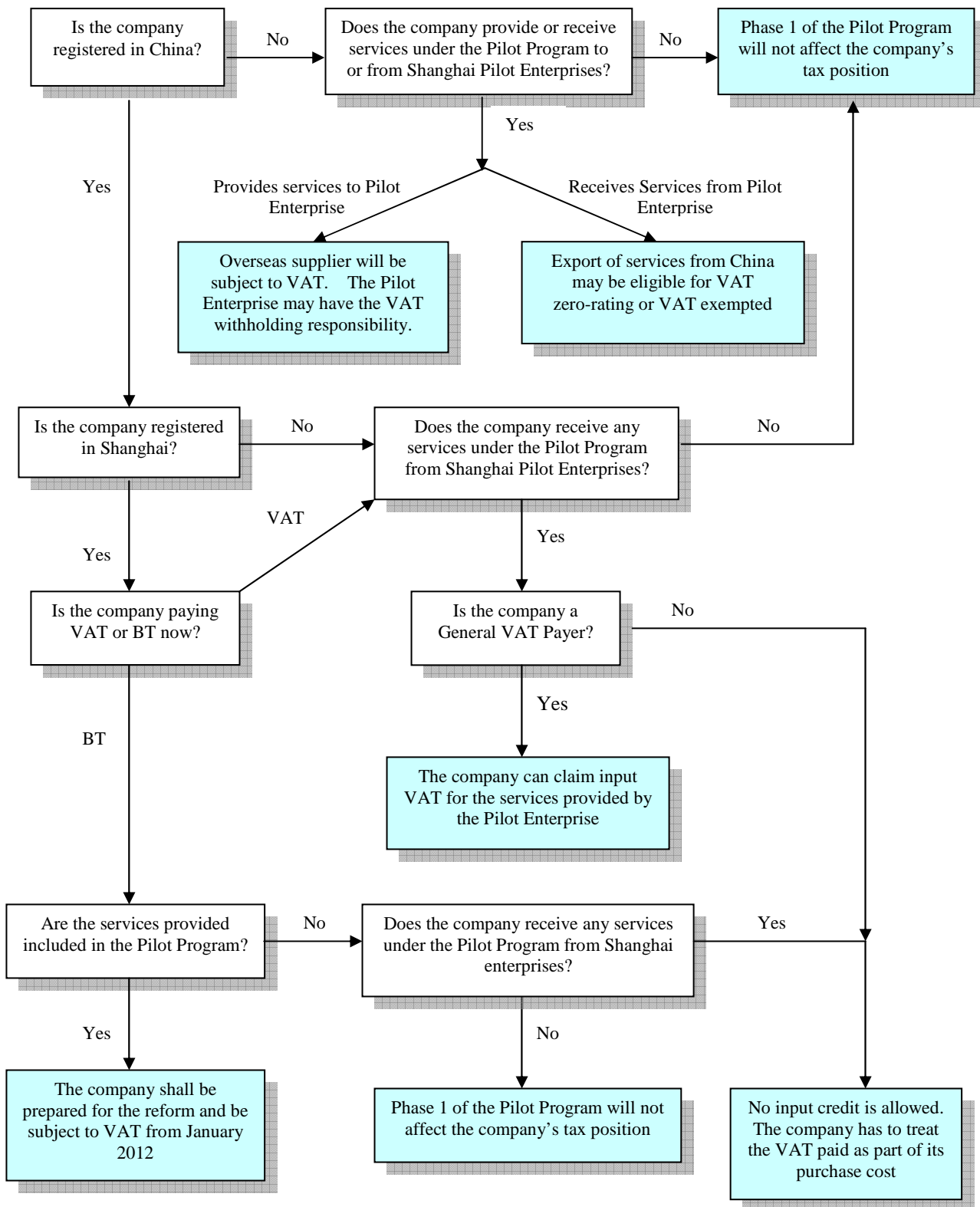
*Circular 111 is accompanied by three appendices:*

*Appendix 1: Measures for Implementation of Converting BT to VAT in the Transportation Industry and Certain Modern Service Sectors;*

*Appendix 2: Regulations on Relevant Issues for Converting BT to VAT in the Transportation Industry and Certain Modern Service Sectors; and*

*Appendix 3: Regulations for the Transitional Policy for Converting BT to VAT in the Transportation Industry and Certain Modern Service Sectors.*

Diagram 1: The management or finance personnel of an enterprise can consider the Pilot Program's challenges using the following diagrammatic guidance:



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- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
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