Are you ready for Chinese Value Added Tax?

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Leading today's discussion

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Today's agenda

- **Overview of the VAT Pilot Program**
- **General VAT Policies under the Pilot Program**
- **VAT implications on Cross-region/border Services**
- **Special Tax Incentives under the Pilot Program**
- **Common Questions and Answers**

Three phases

On Oct. 26, 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 Jan. 1, 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.

Phase 1

- Shanghai has been selected as the VAT pilot location and the VAT Pilot rules will take effect on Jan. 1, 2012.
- In this webcast, we aim to provide you with the salient points on Phase 1 of the Pilot Program.

Key conceptual terms

- BT is a tax which applies to each transaction in a supply chain. By contrast, VAT is a tax which, although applying to each transaction in a supply chain, effectively only taxes the final price paid by the end-consumer. As such, a comparison of the rate of BT with the rate of VAT is a false comparison.
- Businesses that have been paying VAT have effectively had BT embedded in the price of services they acquire. Businesses that have been paying BT have effectively had both VAT and BT embedded in the price of goods and services they acquire. By merging the two systems, these embedded taxes largely disappear.

Key conceptual terms

- BT is a tax collected and administered by local tax bureaus. VAT is a tax collected and administered by State tax bureaus. While these bureaus are one and the same in Shanghai, the merger of the two taxes should significantly simplify administration for businesses when the reforms are implemented in other regions.
- BT is a tax which applies to both the import and export of services. By contrast, VAT regimes globally do not generally tax the export of services by businesses. In relation to the import of services, offsetting VAT credits can ordinarily be claimed by business.
- These reforms are initially being implemented by way of a pilot program. The use of a pilot program enables the government to identify the effects of these reforms, and to make changes where necessary.

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Key conceptual terms

- During the period in which the pilot program operates (that is, until such time as these reforms are implemented nationally), there is likely to be short-term impacts across certain industries, competitive tensions between suppliers subject to the pilot program (and those outside it), and even some confusion and uncertainty. However, international experience has shown that these short-term impacts dissipate and that businesses generally benefit long-term.

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General VAT Policies under the Pilot Program

- Under the prevailing 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 Business Tax ("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.

Pilot Program

- To resolve these issues and to encourage the development of service industries, Pilot Program is introduced by the State Council.

  Main updates from Circular 110 and 111:
  - VAT instead of BT will be levied on Shanghai enterprises engaged in Pilot Industries ("Pilot Enterprises") effective Jan. 1, 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
  - Current BT incentives applicable to the Pilot Enterprises will still be adopted.

Pilot Program

- Under Phase 1 of the Program, Pilot Enterprises will be transformed from BT Payers to VAT Payers. The process has already been started in Jan. 2012.

- 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.

VAT Payers

- The prevailing VAT policies are largely adopted and applicable to Pilot Enterprises under the Pilot Program.
- Two classes of VAT Payers:
  1. **General VAT Payers** – Shanghai Enterprises engaged in the Pilot Industries with annual turnover of RMB 5 million or above; and
  2. **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 RMB5 million of annual sales revenue under the Pilot Program.

Applicable VAT Rates

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 • Information technology services • Cultural and creative services • Logistics auxiliary services • Authentication and consulting services	6%
Small Scale VAT Payers	• All services included in the pilot program	3%

Types of Services

- **Leasing of tangible movable property** – this includes both finance leasing as well as operating leasing of tangible movable property.
- **Transportation services** – this includes land, sea, air and pipeline transportation. It includes road transportation, passenger and cargo transportation as well as time charter services and wet-lease operations.
- **R&D and technical services** – this includes R&D services, as well as technology transfer services and technical consulting services (such as feasibility studies, contract energy management services and engineering exploration services).
- **IT services** – the processing of information using computers, communication networks and other technologies, including software services, circuit design and testing services, information system services, business process management services.

VAT Zero-rating

- 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)

VAT-exempted services

- 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)

Specific overseas recipients exempted

- Technology transfer or consulting 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 and 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 and consulting services (not applicable to those goods/immovable property located in China)

Calculating VAT for general payers

The VAT calculation method under the Pilot Program remains unchanged:

- 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.

"VAT payable = Output VAT – Input VAT"

whereas

"Output VAT = Sales revenue x Applicable VAT rate"

Deductible input VAT

- 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).

Sample VAT calculation for General VAT payers

A PRC Entity (General VAT payer) is charging a fee of RMB100,000 for a consultation service with a client in Shanghai. For the derive of such service income, the entity has received proper VAT receipts worth of RMB1,980 (use of third party for other services required for the engagement in the amount of RMB33,000)

Output VAT = RMB100,000 x 6% = RMB6,000

VAT Payable = RMB6,000 – RMB1,980 = **RMB4,120**

Calculating VAT for small scale payers

VAT Payable =
Sales revenue (VAT inclusive) /
(1 + Applicable VAT rate) x 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.

Sample VAT calculation for Small Scale VAT payers

A PRC Entity (Small Scale VAT payer) is charging a fee of RMB100,000 for a consultation service with a client in Shanghai. For the derive of such service income, the entity has received proper VAT receipts worth of RMB1,980 (use of third party for other services required for the engagement in the amount of RMB33,000)

Revenue (VAT exclusive) =
RMB100,000 / (1 + 3%) = RMB97,088

VAT Payable = RMB97,088 x 3% = **RMB2,913**

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VAT implications on 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.

Cross-region Services
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:
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.

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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:
  1. Services provided by an overseas enterprise/individual and entirely consumed outside China;
  2. 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.

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Cross-border Services

Crucially, the rules provide that the export of services will be subject to either zero rating or VAT exemption, however, the criteria to apply still varies from one tax bureau to another within Shanghai. Indeed, one of the key inefficiencies of the BT system is that it effectively taxes the export of services. To the extent that the export of services is not subject to output VAT, this represents a significant cost saving for business.

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Cross-border Services

One effect of these reforms is that many businesses should now seek to revisit transfer pricing policies, given that cross-border service flows covered by the pilot program may no longer generate BT liabilities, or irrecoverable VAT liabilities. However, to achieve this result, they will need to ensure the services being provided fall within the specific description of services covered by the pilot program, and the documentation requirements for input VAT credits are closely followed.

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Cross-border Services
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.

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Special tax exemptions

- 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 Jan. 1, 2012 to Dec. 31, 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).

BT incentives

- 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.

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We will now answer your questions.
Please submit any additional questions you may have at this time.

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