

VAT reform in Shanghai

Background of the reform

In China, there are two major kinds of turnover taxes, i.e. VAT and business tax (“BT”), which cover different scopes of transactions in a mutually exclusive manner. Specifically, importation and sales of movable/tangible goods are covered by the VAT regime, while transfer of intangibles and immovable properties are covered by the BT regime, with the exception that processing, repairing and maintenance services are covered by the VAT regime.

In general, under the Output-Input Credit System, VAT is normally neutral and can be shifted to and recovered by the customer (unless the customer is not a VAT payer). However, no such system is generally available in the BT regime, which means that BT costs are normally not recoverable by either party. Further, double BT payment will often occur in case of subcontracting of services, because the portion of the subcontracted service value will be taxed twice for BT purposes (once at the main-contractor and once at the subcontractor). The simultaneous operation of both VAT and BT systems has also caused various administrative problems for both taxpayers and tax authorities.

Considering the above disadvantages of the BT system, the PRC Government has planned for a long time to gradually replace BT with VAT. Recently, a milestone step has been taken by them to launch a pilot VAT reform in Shanghai starting from 1 January 2012, which will ultimately be extended to all over China in the future.

On 16 November 2011, the PRC State Administration of Taxation (SAT) and the Ministry of Finance (“MoF”) jointly issued a notice to announce their general plan of replacing the BT regime with the VAT regime (“the Plan”). Accompanying the Plan, details of the Shanghai Pilot Program are provided under the Tax Circular Caishui [2011] No.111 (“Circular 111”). Further detailed Tax Circulars have also been issued to address specific issues in this respect.

Main Content of the Shanghai Pilot Reform

1. Affected industries and taxpayers

Starting from 1 January 2011, the following Taxable Services provided by tax payers registered in Shanghai or provided by foreign entities to their Shanghai customers shall be subject to VAT instead of BT:

- Transportation services (including road, water, air and pipeline transportation);
- R&D, technology transfer, technology consulting, energy management contract and reconnaissance and prospecting;
- IT technology services including software services, circuit design and testing, IT system services and business process management ;
- Design services; transfer of trademarks, goodwill and copy rights; IP related services; advertisement; conference and exhibition services.
- Logistics-related services such as warehousing, freight forwarding, customs agency services, etc;
- Lease of movable tangible assets (including financial lease and operation lease);
- Certification services, authentication services (including authentication services in the areas of accounting, tax, asset appraisal, law, real estate evaluation and project cost estimation) and consulting services (including consulting services in the areas of finance, tax, law, internal management, business operation and process management).

In case foreign entities are subject to VAT for the above Taxable Services, the Shanghai service recipients shall withhold such VAT payable from the gross amount and remit it to the competent tax authority in Shanghai.

2. Applicable VAT rates and tax calculation

a) General VAT payers and small-scale VAT payers

VAT payers are either general VAT payers or small-scale VAT payers with different tax rates and calculation methods.

A tax payer is required to apply for the general VAT payer status if its annual turnover from providing the Taxable Services is above RMB 5 million. Small-scale VAT payers with an annual turnover of below the threshold can also become general VAT payer upon application if they keep proper accounting records.

b) Tax rates for general VAT payers

A general VAT payer can issue VAT invoices and credit its input VAT against its output VAT. The applicable VAT rates for calculating output VAT are as follows:

- 17% for lease of movable tangible assets;
- 11% for transportation services;
- 6% for other Taxable Services.

c) Small-scale tax payers

A small-scale VAT payer shall pay VAT at 3% on the gross amount for its Taxable Services and is not able to credit any input VAT. A small-scale VAT payer can not issue VAT invoices by itself but can ask the tax authority to issue VAT invoices for it.

d) Exportation of services

On 29 December 2011, the SAT and MoF jointly issued the Tax Circular Caishui [2011] No. 131 (“Circular 131”) concerning VAT treatments for exportation of Taxable Services in the context of the Pilot Program. Circular 131 clarifies that for international transportation services, R&D services and design services, zero VAT rate applies. For exportation of other Taxation Services, VAT exemption applies.

3. Impacts of the tax reform

The tax reform is in general a tax reduction program. However, the exact impacts are complex and in some cases, the actual tax burden could also increase. To better understand the real changes in the tax burden, it is necessary to take into consideration various factors such as the VAT rate, the tax status of the customers (general VAT payer or not), the amount of input VAT available to the service provider, etc.

a) Taxable Services provided by Shanghai general VAT payers to general VAT payers (whether located in Shanghai or not)

The tax burden for such services will be decreased significantly. The service provider does not need to pay BT any more. It can charge the output VAT to its customers which can be recovered by the latter and is therefore not a real cost. In addition, the service provider can now credit its input VAT against its output VAT.

- b) Taxable Services provided by Shanghai general VAT payers to small-scale VAT payers or BT payers

Since the Chinese customer is not a general VAT payer, it can not credit any input VAT. Therefore, the VAT costs can not be recovered and are real costs of the Chinese customer. On the other hand, the input VAT of the service provider now becomes creditable.

The result could be either positive (increase) or negative (decrease) as the case may be. Therefore, the reform is not necessarily benefiting those companies which mainly provide Taxable Services to non-general VAT payers.

- c) Taxable Services provided by Shanghai general VAT payers to overseas customers

The tax burden for such services is significantly reduced because either VAT exemption or a zero VAT rate applies to exportation of Taxable Services.

- d) Taxable Services provided by a foreign party to a Shanghai general VAT payer

Under the VAT system, the Chinese customer shall withhold the VAT payable by the foreign party and remit it to the Chinese tax authority. However, such VAT can be recovered by the Chinese customer by crediting the same amount as Input VAT against its output VAT. As such, the decrease in the tax burden equals to the Chinese BT amount otherwise payable by the foreign party under the previous BT regime. Considering the above, the foreign party may wish to shift the VAT costs to the Shanghai customer.

- e) Taxable Services provided by a foreign party to a Shanghai small-scale VAT payer or BT payer

The Chinese customer shall also withhold the VAT amount from the gross payment. These are real costs because the customer is unable to make a credit. The change in the tax burden is the difference between the VAT and the BT otherwise payable in the past. This means that the tax burden is slightly higher since the VAT rate is higher than the standard BT rate of 5% (applicable to the vast majority of services).

The above lit a) – e) represents a simplified analysis of the changes in the tax burden. The real world is more complex and the actual results for a specific industry or transaction may differ from the general conclusion of the above analysis.

4. BT exemption

In general, VAT exemption is also granted to transactions which previously enjoyed BT exemption treatment, e.g. technology transfer, technology development and related technical services.

5. Old Contracts

The Plan does not provide any transitional arrangements for old contracts concluded before 1 January 2012. However, as an exception, outstanding contracts for lease of movable tangible assets concluded before 1 January 2012 continue to be covered by the BT system until the termination of such contracts.

6. Circular 111 also covers other details such as mixed sales, consolidated VAT declaration, deemed sales of Taxable Services, conditions for creditable input VAT, non-creditable input VAT, consequence of not applying for the general VAT payer status, exchange rate, timing of VAT liability, tax declaration deadline, tax payment location, value threshold for individuals, issuance of VAT invoices, and a detailed explanation of the scope of Taxable Services, etc.

Suggestions:

1. Tax payers located in Shanghai providing Taxable Services are advised to start applying for the general VAT payer status (where applicable) and prepare themselves to the new VAT regime;
2. Group companies with entities in Shanghai may need to make an in-depth analysis of the changes in the tax burden, adjust their pricing where necessary and restructure business models where possible;
3. Foreign companies providing Taxable Services to customers in Shanghai shall also take the BT/VAT issue into consideration when concluding the relevant contracts.

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