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BACKGROUND

The State Administration of Taxation ("SAT") and the Ministry of Finance ("MOF") issued *Caishui* [2011]110 ("Circular 110") titled "The Notification on Issuing the Pilot Program for the Transformation from Business Tax to Value Added Tax" on November 16, 2011. On the same date, SAT and MOF issued *Caishui* [2011] 111 ("Circular 111") titled "The Notification Regarding the Pilot Program for the Transformation of Transportation and Certain Modern Service Industries in Shanghai from Business Tax to Value Added Tax".

SAT also issued SAT Public Notification Nos. 65 and 66 to explain points in Circular 111. The Shanghai MOF and the Shanghai tax authority also issued explanations on Circular 111.

These two circulars, together with the following regulations, implement the long awaited transformation from business tax ("BT") to value added tax ("VAT") and are likely to have a dramatic impact on the Chinese indirect tax system.

The pilot program will only apply to Shanghai, from January 1, 2012. However, it is expected that this new system will expand nation-wide once the conditions have been developed.

This document summarizes the key points of these Circulars and the regulations issued by SAT, the Shanghai MOF and the tax authorities.

VAT PILOT PROGRAM – KEY POINTS

Taxpayer

Under Circular 111, companies and individuals working in the transportation industry and part of the modern service industry ("Taxable Services") within the territory of Shanghai will be subject to VAT instead of BT, from January 1, 2012, onwards.

The modern services that Circular 111 refers to include:

- Research, development and technological services
- Information technology services
- Cultural innovation services
- Logistics support
- Lease of corporeal movables
- Attestation and consulting services



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Construction, the telecommunications industry, and the sale of real estate, as well as the catering and entertainment industry, are not included in the pilot program for the time being, and companies or individuals engaging in these industries are still subject to BT.

For companies or individuals that are outside of China ("Overseas Entities") and provide Taxable Services to companies or individuals inside Shanghai, the agents of the Overseas Entities must withhold the VAT or the recipient of the service shall withhold the VAT if there is no agent.

In the following situations, no Taxable Services are considered to take place in Shanghai, and therefore no VAT applies:

1. Overseas Entities that provide services to companies or individuals in Shanghai, but the services are totally consumed overseas.
2. Overseas Entities that lease to any entity or individual in Shanghai tangible assets that are entirely used overseas.

Appendix I of Circular 111 provides a more detailed explanation of Taxable Services, and it can serve as a guideline to assess whether a company would be included in the pilot program. In practice, the in-charge tax bureau would notify the company in writing of whether the company is involved in the pilot program.

Export of services

Under Circular 110, export of Taxable Services must be VAT exempt or zero VAT rated (which has not been defined yet). Consequently, Taxable Services that a taxpayer established in Shanghai but provides to a client overseas will not be subject to VAT if these Taxable Services were entirely used or consumed overseas.

Whether this is a zero VAT rated or a VAT exemption is relevant for the deductibility of the input VAT borne on acquisition of goods or services connected to the export of the Taxable Services: under the zero VAT rated regime, that input VAT would be creditable or refundable, while under the VAT exemption, it would not.

Tax rate as a general VAT payer and as a small scale VAT payer

The applicable VAT rate would vary depending on the type of service and whether the taxpayer is a general VAT payer or a small scale VAT payer.

Under Circular 111, if the annual revenue from Taxable Services is equal to or higher than RMB 5 million, then the company is a general VAT payer. If the annual revenue is lower than RMB 5 million, then the company is a small scale VAT payer, but could apply to be treated as a general VAT payer if it (i) has a fixed place of business, and (ii) has a sound and reliable accounting book that can provide accurate data for tax calculation.

Circular 111 states that any person recognized as a general taxpayer may not change its identity to a small scale VAT taxpayer subsequently, unless otherwise authorized by the SAT.

It is unclear whether the tax bureau will use the 2011 annual revenue to assess the RMB 5 million threshold. Additionally, the detailed assessment measure for general VAT payers is pending the regulation stipulated by the Shanghai SAT.

The main implications of being considered a general VAT payer or a small scale VAT payer are the following.

General VAT payer:

- The applicable VAT tax rate is calculated based on the type of services rendered:
 - 17%: Lease of tangible assets
 - 11%: Transportation services
 - 6%: Modern services (excluding lease of tangible assets)
 - 0%: Services stipulated by MOF and SAT
- Input VAT is generally creditable against output VAT with some exceptions
- The general VAT taxpayer must issue special invoices for which the proper equipment must be acquired

Small scale VAT payer:

- The applicable VAT rate is 3% for any kind of services rendered
- Input VAT is not creditable against output VAT
- The small scale VAT taxpayer may request that the competent taxation authority issues invoices on its behalf

Compliance requirement

When the taxpayer provides Taxable Services, the VAT tax obligation arises when the payment is received, or on the date the invoice is issued, whichever is earlier.

The VAT must be filed per day, month or quarter and the in-charge tax bureau will assess the filing period depending on the taxable amount.

If the taxpayer receives the tax benefits under the original BT scheme, these tax benefits can still be received in the form of VAT exemptions or VAT rebates.

Final remarks

For existing VAT taxpayers, this transformation means these companies may be able to deduct the input VAT incurred from January 1, 2012, on the acquisition of Taxable Services provided by companies or individuals in Shanghai, as long as they receive qualified VAT special invoices for those services.

The BT taxpayers included in this pilot program must register with the in-charge tax bureau either as a general VAT payer or a small scale taxpayer. As a general VAT payer, certain input VAT on the acquisition of Taxable Services or fixed assets could also be credited. Those qualifying as small scale VAT payers should consult both an accountant and tax advisor on the convenience of being registered as a general VAT payer.

It is expected that the national or local authorities issue more detailed explanations of the pilot program in Shanghai.