



LEGAL UPDATE | SHANGHAI OFFICE

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NEW VAT PROGRAM IN CHINA

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The Value Added Tax (“VAT”) pilot program, effective in Shanghai since January 1, 2012, has gradually expanded on a national scale, as announced by the Chinese government.

The program has been approved in eight other locations, based on Caishui [2012] 71:

- Beijing, effective since September 1, 2012.
- Jiangsu and Anhui, effective since October 1, 2012.
- Fujian and Guangdong, effective since November 1, 2012.
- Tianjin, Zhejiang and Hubei, effective since December 1, 2012.

This pilot program aims to implement the long-awaited transformation from business tax (“BT”) to VAT in relation to certain services.

## BACKGROUND

The most relevant regulations of the VAT pilot program are Caishui [2011] 110 (“Circular 110”) of November 16, 2011, and Caishui [2011] 111 (“Circular 111”) of the same date. Both circulars were issued by the State Administration of Taxation (“SAT”) and the Ministry of Finance (“MOF”).

The local authorities of the pilot districts have helped complete these regulations with circulars that follow the same lines as those applied in Shanghai. This document summarizes the key points of the VAT pilot program as implemented in Shanghai and how the program will be implemented in these eight provinces in a similar –if not identical– way.

## VAT PILOT PROGRAM – KEY POINTS FOR TAXPAYERS

VAT (instead of BT) will be applied to companies and individuals that work in the transportation industry and are part of the modern service industry (“Taxable Services”) within the pilot districts.

The **modern services**, as defined in Circular 111, include:

- Services related to research & development and technology.
- Services related to information and communication technology.
- Cultural and creative services.
- Logistics support.
- Attestation and consulting services.

The lease of movable tangible assets (including financial leasing) and transportation services also fall under the scope of the VAT pilot program.

Construction, the telecommunications industry, the lease of real estate, and the catering and entertainment industry are not currently included in the pilot program. Therefore, entrepreneurs working in these industries are still subject to BT.

Taxable Services are subject to VAT in China if they are rendered by entrepreneurs not established in China ("Overseas Entrepreneurs") to entrepreneurs or individuals established or living in the pilot districts. In these cases, the appointed agent or the service payer must withhold VAT on behalf of the Overseas Entrepreneur. Nonetheless, VAT is not applied in any of the following situations even when services are rendered in the pilot district:

- If the modern services or transportation services are entirely consumed overseas.
- If the lease of movable tangible assets are entirely used overseas.

Appendix I of Circular 111 describes Taxable Services in greater detail and can be used as a guideline to assess whether a company would be included in the pilot program. The corresponding tax bureau would send a written notification informing the company if it is involved in the pilot program.

## **EXPORT OF SERVICES**

According to Caishui [2011] 131 ("Circular 131") of December 29, the VAT zero-rating policy will apply when entities and individuals located within the pilot district provide international transportation services, research & development services and design services to outside entities by entities and individuals located within the pilot region..

The VAT exemption policy will apply to the following Taxable Services provided by entities located within the pilot region, unless the SAT and the MOF apply the VAT zero-rating policy:

- Mineral resources, engineering reconnaissance and exploration services provided abroad.
- Conference and exhibition services located abroad.
- Warehousing services with storage sites located abroad.
- Leasing services for tangible movable property in which the subject matters are used abroad.
- International transportation services that meet specific standards.
- Specific taxable services provided to outside entities, as defined in Circular 131.

Although these exemptions are described in the regulation, a more detailed definition of how they will be applied has not yet been published. At this stage, companies should prepare the relevant documents (formula invoices, contracts, etc.) to request a refund once the implementation rules are announced.

Regarding the deductibility of the input VAT borne on the acquisition of goods or services connected to the export of the Taxable Services, it is important to decide whether the VAT zero-rating policy or the VAT exemption is applicable. Under the VAT zero-rating policy, this input VAT would be creditable or refundable; 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 at least 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 be treated as a general VAT payer if it has (i) a fixed place of business, and (ii) a sound and reliable accounting book that can provide accurate data for tax calculation. This application should be made the year the service activities begin or the year the VAT pilot program becomes effective, whichever occurs first.

Circular 111 states that any person recognized as a general taxpayer cannot subsequently become a small-scale VAT taxpayer unless authorized by the SAT.

Additionally, the detailed assessment measure for general VAT payers will be subject to the regulation stipulated by the Shanghai SAT.

The main implications for general VAT payers or small-scale VAT payers are the following.

General VAT payers:

- 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.
  - 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 using the correct equipment.

Small-scale VAT payers:

- The applicable VAT rate is 3% for all services rendered.
- Input VAT is not creditable against output VAT.
- In general, the recipient of a service cannot deduct VAT charged by small-scale taxpayers unless they ask the competent tax authority to issue qualified VAT special invoices on their behalf.

### COMPLIANCE REQUIREMENT

The VAT tax obligation begins when payment is received or on the date the invoice is issued, whichever is earlier.

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

If the taxpayer benefited from a special treatment under the original BT scheme, the same treatment would still apply in the form of VAT exemptions or VAT rebates.

### FINAL REMARKS

For existing VAT taxpayers, they may still be able to deduct the input VAT incurred from the date the VAT pilot program becomes effective, depending on their location, as long as they receive qualified VAT special invoices for those services.

The BT taxpayers included in this pilot program must register with the corresponding tax bureau as general VAT payers or small-scale taxpayers. General VAT payers could be credited with some input VAT if they acquire Taxable Services or fixed assets. Small-scale VAT payers should consult an accountant and a tax advisor on the benefits of being registered as a general VAT payer.

All companies in the pilot districts are advised to read the detailed explanations of the pilot program issued nationally or locally and keep on contacting the local tax authority for information on policies and local practices.

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