

## China Indirect Tax Alert



# The start of a new era in Chinese VAT: the Shanghai VAT Pilot

### Synopsis

On 16 November 2011, the Chinese Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued Caishui [2011] No. 110 (Circular 110) and Caishui [2011] No. 111 (Circular 111) which set out the details of the Shanghai VAT pilot arrangements (VAT Pilot rules). Circular 110 contains the general framework of the VAT pilot while Circular 111 details the implementation rules that are specifically applicable to Shanghai.

The VAT pilot arrangement is a significant step towards the planned wider structural VAT reform and has ushered in a new era in Chinese VAT history. We describe some of the key features of the VAT pilot arrangements below:

#### VAT pilot location and start date

Shanghai has been selected as the VAT pilot location and the VAT Pilot rules will take effect on 1 January 2012.

#### Scope of the VAT pilot arrangements

The following services that are currently subject to Business Tax (BT) will be subject to VAT:



<b>Transportation industry</b>	Land transportation Water transportation Air transportation Pipeline transportation	
<b>Certain modern services industry</b>	R&D and technology services	R&D services Technology transfer services Technology consulting services Contract energy management services Project survey and exploration services
	Information technology services	Software services Circuit design and testing services Information system services Operation process management services
	Cultural and creative services	Design services Trademark and copyright transfer services Intellectual property services Advertising services Conferencing & exhibition services
	Logistics auxiliary services	Aviation services Port services Transport terminal services Salvage assistance services Cargo transport agent services Customs brokerage services Storage services Load-unloading services
	Movable property leasing	Operating lease Finance lease
	Authentication & consulting services	Verification services Authentication services Consulting services

Please note that detailed definition of each of the above services has been set out in Circular 111.



## Two classes of VAT taxpayers and applicable VAT rates

There are two classes of VAT taxpayers under the VAT pilot arrangements:

- ▶ VAT general taxpayers providing VAT pilot services with annual turnover of over RMB 5 million
- ▶ VAT small-scale taxpayers providing VAT pilot services with annual turnover of RMB 5 million or less (please note that it is possible for VAT small-scale taxpayers to voluntarily apply to become VAT general taxpayers)

The applicable VAT rates for the different classes of VAT taxpayers for the different types of the VAT pilot services have been set out below:

VAT general taxpayers	Movable property leasing	17%
	Transportation services	11%
	R&D and technology services, Information technology services, Cultural and creative services, Logistics auxiliary services and Authentication & consulting services	6%
VAT small-scale taxpayers	All VAT pilot services	3%

Please note that there is a zero rating provision in the VAT pilot rules and the scope of this zero rating will be determined by the MOF and the SAT.

## Place of supply of VAT pilot services

The place of supply of VAT pilot services would be in China if either the service supplier or the service recipient is located in China.

Please note that the following provision of services would be considered as outside of China:

- ▶ VAT pilot services are provided by an overseas supplier and entirely consumed outside of China;
- ▶ Leasing of movable property is provided by an overseas supplier and this movable property is entirely used outside of China

## Output VAT and new VAT computation method

Output VAT will be computed by:

$$\text{Output VAT} = \text{Sales amount} \times \text{Applicable VAT rate}$$

If the consideration received by the VAT pilot service provider is VAT-inclusive, output VAT should then be computed by:

$$\text{Output VAT} = \text{VAT-inclusive sales amount} \div (1 + \text{Applicable VAT rate})$$

A new computation method has been introduced to the VAT pilot arrangements. The new method has incorporated the “netting” mechanism that is currently applicable to certain BTable supply of services. The following items could be deducted from the total considerations received for the provision of VAT pilot services when the BT netting mechanism is already applicable to the supply of VAT pilot services. For instance:



- ▶ Amounts paid to Shanghai based taxpayers that are excluded from the VAT pilot arrangements
- ▶ Amounts paid to taxpayers located outside of Shanghai

Please note that if a Shanghai VAT taxpayer concurrently sells goods and provides processing and maintenance services as well as VAT pilot services, it should separately account for the different supplies that are subject to different VAT rates. In the case that the taxpayer cannot separately account for the VATable sales amount, it would be required to compute its output VAT based on the higher VAT rate.

The concept of deemed supply of services has been included in the VAT pilot rules. Please note that special valuation method would apply if there is deemed supply of services or the sales amount of VAT pilot services is found to be too high or too low without reasonable commercial justification.

#### **Input VAT and new creditable item**

VAT general taxpayers who incur VAT on the purchase of goods, receiving processing, repair and maintenance services as well as VAT pilot services for the purposes of providing VAT pilot services could treat the VAT incurred as input VAT. The following input VAT amount could be credited from output VAT:

- ▶ VAT amount indicated on special VAT invoices issued by the sellers or service providers
- ▶ VAT amount indicated on the Import VAT Payment Certificates
- ▶ 13% of the purchase value of agricultural products indicated on invoices unless the special VAT invoice or import VAT payment certificate is obtained
- ▶ 7% of the transportation expenses incurred in delivering taxable goods for domestic sales, if the expenses are supported by proper transportation invoices issued by a transportation company or individual unless the special VAT invoice is obtained
- ▶ VAT amount indicated on the Tax Clearance Certificate (withholding VAT) obtained from the tax bureau when a payment is made to the overseas VAT pilot service provider

Please note that the VAT pilot rules contain specific provisions which disallow input VAT recovery.

#### **VAT administration matters**

Suppliers of VAT pilot services with annual revenue above RMB 5 million should be registered as VAT general taxpayers. Once registered, the suppliers should purchase the anti-counterfeit tax control equipment and issue special VAT invoices in accordance with the VAT pilot rules.



Please note that the Chinese VAT tax periods vary in length. A VAT tax period may be 1 day, 3 days, 5 days, 10 days, 15 days, 1 month or 1 quarter. The length of the tax period is determined by the local tax authorities, based on the amount of VAT payable by the taxpayer. Taxpayers who have a VAT tax period of 1 month must submit VAT returns and pay the VAT due on a monthly or quarterly basis within 15 days after the end of the period.

#### **Transitional VAT exemption and VAT refund policies**

There are thirteen specific VAT exemptions set out in Appendix 3 of Circular 111 and four types of transactions that would be subject to special VAT refund measures.

For taxpayers included in the VAT pilot who have obtained BT incentives before 31 December 2011, the taxpayers should enjoy VAT incentives in accordance with the VAT pilot rules until the expiry of the BT incentive.

#### **Our observation**

The business community has been waiting for the issuance of the VAT pilot rules since the State Council announcement of the VAT pilot on 26 October 2011. There are a number of ground breaking changes which would impact businesses:

- ▶ Technology transfer services and transfer of trademark and copyright are included in the scope of the VAT pilot. Based on the detailed description set out in the VAT pilot rules, technology transfer services include transfer of the ownership and the use right of patented and non-patented technology while the transfer of trademark and copyright encompasses transfer of trademark, copyright and goodwill. We understand some businesses are paying significant amounts of withholding BT upon the remittance of royalty/licensing fees payment from China and the withholding BT represents considerable costs. The VAT pilot rules bring improvements to the above situation as the overseas remittance will be subject to withholding VAT and this withholding VAT could be used as input VAT by the payment remitting party (subject to conditions).
- ▶ The concept of VAT zero rating and corresponding VAT refund mechanism are introduced for the supply of services. Although the scope of zero rating has not been set out in Circular 111, the introduction of VAT zero rating and VAT refund mechanism should be welcomed. We look forward to the detailed scope of the VAT zero rating which would cover certain services and we understand this will depend on the decision of the MOF and SAT.



- ▶ The hybrid computation method that combines the current VAT and BT calculation mechanism could be perceived as a creative way of resolving the problems for some taxpayers who are subject to BT netting mechanism (e.g., who would not be able to collect special VAT invoices for some of their purchases). However, as the current practices of BT netting could create practical challenges under the new VAT pilot regime, we anticipate the MOF and the SAT will issue further detailed guidance to taxpayers

To respond to the changes and challenges to be brought by the VAT pilot, we suggest business managers or tax professionals consider undertaking the following actions:

VAT Pilot impact study	Analyze your business relationships with suppliers as well as customers with a view to assessing the impact of the changes that will arise from the Shanghai VAT pilot. The study should focus on the potential changes to the VAT costs and VAT cash flow and highlight potential VAT planning ideas (if any).
VAT training workshop	Bring your management/ tax/ finance/ operation teams up to speed and confirm understanding of the new VAT rules and their practical implications.
VAT sensitive contract reviews	Analyze the contractual terms agreed or to be agreed with your suppliers and/or customers. We would specifically review 1) whether VAT could be charged to customers 2) whether the suppliers can charge VAT under the contractual terms and impact from the Pilot.
VAT specific ERP system/ Finance & Accounting software review	Analyze your ERP system / Finance & Accounting software (“systems”) with a view to understanding the changes that would be required for the systems to produce the necessary data for VAT invoicing and VAT reporting purposes.
VAT process design	Understand your business operations to develop VAT processes (e.g., VAT invoicing handling processes and VAT reporting processes, etc.) that ensure compliance



## Conclusion

The Shanghai VAT pilot indicates the Chinese authorities' determination to reform its VAT system. It is important to note from the State Council's announcement of 26 October 2011, that if certain conditions are met, selected industries could be trialed under the VAT pilot arrangements on a nationwide basis and this means businesses should be ready for even more VAT changes.

The announcement of the VAT pilot rules has cleared many doubts but there are areas where further details should be issued to address certain VAT treatments. As the VAT pilot will take effect on 1 January 2012, these measures should be issued in time for taxpayers to react and adapt to changes. This means businesses should pay full attention to the further announcements. We also anticipate that many practical issues and challenges will surface after the VAT pilot regime is put into practice. It is advisable that businesses dedicate resources in order to face the changes and be prepared for any challenges. Consultation with tax professionals is also strongly recommended.

You may click this link below to assess the full VAT pilot rules (in Chinese only) and Ernst & Young's previous indirect tax alert on VAT pilot arrangements:

[http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201111/t20111117\\_608456.html](http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201111/t20111117_608456.html)

[http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201111/t20111117\\_608457.html](http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201111/t20111117_608457.html)

[http://www.ey.com/Publication/vwLUAssets/ITA20111027\\_en/\\$FILE/ITA2011001\(ENG\).pdf](http://www.ey.com/Publication/vwLUAssets/ITA20111027_en/$FILE/ITA2011001(ENG).pdf)

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