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Pilot VAT Reform Program Announced for Shanghai

Background

On October 26, 2011, the Chinese State Council announced that it would launch a pilot value-added tax ("VAT") reform program ("Pilot Program") effective on January 1, 2012. The Pilot Program will initially apply to transportation and modern service industries in Shanghai and may extend nationwide if conditions permit.

Following the State Council's announcement, the Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT") jointly released two important circulars on November 16, 2011, to implement the Pilot Program in Shanghai on the announced January 1, 2012, date. The two circulars are:

- The Notice for the Introduction of the Pilot Scheme to Convert Business Tax to VAT (Caishui [2011] No. 110) ("Circular 110"); and
- The Notice for Converting from Business Tax to VAT in the Transportation Industry and Certain Modern Service Sectors in Shanghai (Caishui [2011] No. 111) ("Circular 111").

These two policy documents signal the official kick off of the long-awaited transformation from the business tax ("BT") to the VAT for service industries in China.

Pilot Industries and Rates

The Pilot Program will initially apply to the transportation industry and certain "modern service industries" ("Pilot Industries") in Shanghai and may possibly extend countrywide for selected industries, if the circumstances warrant it.

In addition to the prevailing 17% and 13% VAT rates, two additional VAT rates of 11% and 6% will be added as follows:

Pilot Industries	Applicable VAT Rates	Prevailing BT Rates
Leasing of tangible movable property	17%	5%
Transportation services	11%	3%
Research and development (R&D) and technical services	6%	5%
Information technology (IT) services	6%	5%
Cultural and creative services	6%	5%
Logistics and ancillary services	6%	5%
Certification and consulting services	6%	5%

General VAT Payers and Small-Scale VAT Payers

As operators in the above Pilot Industries transition to paying a VAT, the most fundamental change they should be aware of is that output VAT will be charged based on their service income (ex-price VAT) at the relevant VAT rate, and that their input VAT paid for the VAT-applicable purchases of goods and services will be creditable. The net amount will be their VAT payable to the tax bureau.
Operators in the above Pilot Industries qualify as General VAT Payers if their minimum annual VAT-applicable sales amounts to at least RMB 5 million. Small Scale Pilot Enterprises, i.e., operators in the Pilot Industries that do not qualify as General VAT Payers, will be charged with a VAT rate of 3%. These Small Scale Pilot Enterprises are not allowed to claim input VAT credits, even under the Pilot Program.

Supporting Evidence

Input VAT supporting evidence includes:

- Special VAT invoice
- Import VAT Payment Certificate by Customs
- Purchase voucher for agricultural products,
- Recipient of transportation services with/out special VAT invoice
- Services provided by overseas entities or individuals and received in China where the VAT is withheld

by the recipient in Shanghai

Foreign Service Providers and Recipients

For service providers located outside China, the Pilot Program will affect the import of services into China. The general rule is if either the service provider or the service recipient is located in China, under the Pilot Program, the provision of services will be considered to be provided in China and thus subject to VAT. Therefore, all services provided from outside China to Shanghai will be taxable in Shanghai.

Circular 111 provides a withholding mechanism for charging a VAT on services provided by overseas suppliers in Shanghai where a VAT charge applies but there is no VAT-registered organization in Shanghai. In these circumstances, the pilot taxpayer will have to withhold the VAT payable on behalf of the overseas provider at the applicable rate. Such VAT can be recovered by service recipients that have General VAT Payer status.

For service recipients located outside China, the Pilot Program will affect the export of services from China. An important change is that services provided to a recipient outside China will be without VAT. However, it is unclear now whether such export of services will be exempt from the VAT or zero-rated. Understanding the correct VAT treatment is critical as it will have an immediate impact on whether the input VAT associated with services is recoverable (as costs attributable to a zero rated supply) or not (as costs attributable to an exempt supply).

Prepared by: Dr. Zhou Ye
(+86 21) 2308 3000
Ye.zhou@bryancave.com

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Bryan Cave LLP International Trade Client Service Group

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*Non-legal professionals