

China Tax Update

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Business Tax Phases Out – China’s Turnover Taxation On Services Will Change

Unlike other countries, China adopts both business tax (“BT”) and value added tax (“VAT”) in its turnover tax system. While the VAT system mainly applies to the sale of goods, BT is primarily levied on taxable services. The difference in tax systems causes some industries to be double-taxed, particularly those that are currently covered by the BT regime. For example, service fees paid to a service company are subject to BT. But unlike a general VAT taxpayer, the service company cannot deduct the tax cost of the purchase of materials and other third party services. This puts the service company in a disadvantageous tax position, as part of its expenses are double-taxed.

China is aware of these problems and has for a long time planned an overall VAT reform which will eventually allow VAT to take the place of BT. As an initial step in this significant and complicated reform, the State Council meeting on 26 October 2011 announced that, a Pilot Program is to be launched on 1 January 2012 for selected industries in Shanghai to gradually expand the scope of VAT gradually to cover industries that are currently subject to BT. Detailed implementation rules of the VAT Pilot Program were published by the Ministry of Finance (“MOF”) and State Administration of Taxation (“SAT”) in mid-November in tax circular Caishui [2011] 111 (“Circular 111”).

Highlights of the Pilot Program

While aiming to impose basic VAT compliance requirements on taxpayers in the Pilot Program, Circular 111 creates ground-breaking rules and special policies for these taxpayers. The highlights of Circular 111 are:



“...a Pilot Program is to be launched on 1 January 2012 for selected industries in Shanghai to gradually expand the scope of VAT to cover industries that are currently subject to BT ”

- **Taxpayers in the Pilot Program:** (1) enterprises and individuals in Shanghai providing transport and some modern services (“Covered Services”); (2) overseas enterprises and individuals providing Covered Services to enterprises and individuals in Shanghai.

- **Covered Services:** The Pilot Program will be applied in the first instance to the transport industry and certain “modern service industries” in Shanghai.
 - ▶ The transport industry includes land (excluding railway), water, air and pipeline transport.
 - ▶ Modern service industries include the following six main categories, each covering several specific types of services:
 - R&D and technology services: R&D, technology transfer, technology consulting, energy contract management, and exploration and survey.
 - Information technology services: software, circuit design and test, information system, and process management.
 - Culture and creativity services: design, transfer of trademark, goodwill and copyright, intellectual property related, IP agent, advertisement, and conference and exhibition.
 - Logistics auxiliary services: aviation ground services or special aviation services (e.g. aviation photography), port, rescue, transportation agency, customs agency, warehousing, and unload/upload.
 - Tangible movable assets leasing services: operation and finance leasing.
 - Certification and consulting services: certification, assurance, and consulting.

- **Types of taxpayer:** like the current VAT rules, taxpayers in the Pilot Program are divided into small scale VAT taxpayers and general VAT taxpayers. To qualify as a general VAT taxpayer, the annual revenue from an entity’s Covered Services should be at least RMB 5 million. This threshold may be adjusted by MOF and SAT depending on the Pilot Program’s implementation results.

“The Pilot Program will first be applied to the transport industry and certain modern service industries in Shanghai.”

■ **Calculation of VAT liability:** the method of calculating VAT liability is the same as under the current VAT rules.

- ▶ General VAT taxpayer: deduct its input VAT cost on purchased goods or services from its output VAT on taxable revenue.

VAT liability = taxable revenue * VAT rate (see below) – input VAT amount

- ▶ Small scale taxpayer: VAT liability is calculated according to the taxable revenue and tax collection rate of 3%. The formula is:

VAT liability = taxable revenue * 3%

■ **VAT rates:** Circular 111 provides different rates for different industries:

- ▶ tangible assets leasing service: 17%,
- ▶ transportation service: 11%,
- ▶ modern service industries (other than leasing): 6%.

■ **VAT credit mechanism:** Like the current VAT regime, input VAT deduction for Covered Services should be supported by VAT special invoices and other certificates. For Covered Services provided by overseas enterprises or individuals, the input VAT deduction is based on the tax certificate issued by tax authority.

■ **Withholding mechanism:** VAT on the taxable activities of overseas enterprises with no establishment in China, or individuals, should be withheld by a Chinese withholding agent, which is similar to the current BT practice. However the withholding tax calculation formula is slightly different from the current BT regime:

Withholding tax = Payment to the Service Provider / (1+ tax (VAT) rate) * tax (VAT) rate

(In BT regime: Withholding tax = Payment to the Service Provider * tax (BT) rate)

■ **Special Policies:** In order not to affect the current BT benefits of taxpayers negatively, Circular 111 introduces special policies, for example:

- ▶ a taxpayer who calculates BT taxable income after deducting costs can still enjoy this treatment under the Pilot Program.

“For Covered Services provided by overseas enterprises or individuals, the input VAT deduction is based on the tax certificate issued by tax authority.”

- ▶ the current BT incentives — mainly BT exemption policies, such as BT exemption on technology transfer and BT exemption for service outsourcing industries — are transformed into VAT exemptions with the same conditions that apply to BT. If a taxpayer under the Pilot Program enjoyed BT incentives before 31 December 2011, then it can enjoy the relevant VAT incentives under Circular 111 for the remainder of the BT incentive term.
- **New VAT incentives:** Apparently, Circular 111 introduces two new preferential VAT policies for the following taxpayers:
 - ▶ General VAT taxpayers in the Pilot Program engaged in pipeline transport are entitled to VAT refunds on the portion of actual VAT costs exceeding 3%.
 - ▶ General VAT taxpayers in the Pilot Program that are approved to carry out financial lease services can enjoy VAT refund on the portion of actual VAT costs exceeding 3%.

Tax Burden Implications of the Pilot Program for Taxpayers

As a trial run of the VAT reform, the Pilot Program has profound implications both for taxpayers covered and not yet covered by the Pilot Program. The expected preliminary impact is likely to be:

General observation

For former BT taxpayers in the Pilot Industries, we believe that the change in rules is likely to lower their indirect tax basis (BT or VAT). This is because VAT is levied on the added-value, which is normally less than the BT taxable income (i.e. total turnover). But this may not be true in every case as a Pilot Industry taxpayer's actual tax burden depends on various factors, including the VAT rate applied, the deductibility of input VAT, its profit margin, etc.

Meanwhile, the Pilot Program might enable a customer of a Pilot Industry taxpayer to credit input VAT incurred on the purchase of services. (But, as discussed below, if the customer is a BT taxpayer outside the Pilot Program who cannot deduct input VAT, its tax burden may increase if it receives services provided by taxpayers in the Pilot Program but cannot deduct the VAT cost on the service.)

“For former BT taxpayers in the Pilot Industries, we believe that the change in rules is likely to lower their indirect tax basis (BT or VAT).”

For a better illustration, please see the case below:

Case I:

Company A is covered by the Pilot Program in Shanghai and is engaged in the IT service business which is currently subject to 5% BT. Its monthly turnover is RMB 100,000 and its costs are purchased equipments (not fixed assets), and materials of RMB 55,000 inclusive of 17% (input) VAT. For the purpose of this illustration, we assume that Company A has no other costs. In the Pilot Program, Company A is subject to 6% VAT, and we assume its input VAT can be fully deductible as a general VAT payer.

“... the increase or decrease of turnover tax and the impact brought by that to the EIT cost should both be considered.”

Company A	Before the Pilot Program	In the Pilot Program
Monthly revenue	100,000	100,000
Costs	55,000 (inclusive of VAT)	47,009 (exclusive of 17% VAT)
BT (5%)	5,000	N/A
VAT (6%)	N/A	-1,991
Gross profit	40,000	52,991
EIT (25%)	10,000	13,248
Net profit	30,000	39,743
<u>Tax burden</u>	<u>15,000</u>	<u>11,257</u>
<u>Total effective tax rate</u>	<u>15%</u>	<u>11%</u>

Based on this illustration, Company A's total tax cost is lower than before the Pilot Program due to the lower VAT rate of 6% and higher input VAT deduction of 17%. But if Company A does not have enough input VAT to deduct, its total tax cost may not be lowered under the Pilot Program. Besides the impact of applicable VAT rates and amount of added value subject to VAT, note that from the PRC Enterprise Income Tax ("EIT") perspective, BT is allowed to be deducted from EIT taxable income as a cost, whereas VAT paid by the taxpayer is not allowed to be deducted from EIT taxable income. So in considering the total tax cost of Company A, the increase or decrease of turnover tax and the impact brought by that to the EIT cost should both be considered.

A similar effect also exists from the withholding tax perspective. As we have mentioned, the Pilot Program sets a different withholding turnover

tax calculation formula from the current BT regime. For example when Company A pays 100 overseas service fees, royalties or transfer fees, the withholding turnover tax is 5.66 (i.e. $100/(1+6\%)*6\%$). But before the Pilot Program when it was subject to 5% BT, the withholding turnover tax was 5 (i.e. $100*5\%$). So, although the Pilot Program allows input VAT deduction, the overall tax cost of the transaction may still be higher than that under the BT regime if a company does not have enough input VAT to deduct.

In addition, the VAT reform affects companies with different business operations in different ways. For example a company with significant fixed asset investment may benefit from deducting VAT on fixed assets under the new policy. And a company transferring intangible assets such as trademark or technology may find that they can deduct the relevant input VAT as this activity is no longer subject to BT but VAT.

Leasing industry

Leasing companies in China have long been frustrated that they pay BT on the lease payments they collect but they cannot deduct VAT costs on equipment they buy to lease. To a certain extent, this has hindered the development of China's leasing industry. Now the Pilot Program allows covered leasing companies to: (1) issue VAT invoices and deduct the huge amount of input VAT cost on purchased movable assets, if they qualify as general VAT taxpayers; and (2) get immediate tax refunds if their VAT costs exceed 3% of taxable revenue. Below is an illustration of the effects of these new rules:

Case II:

Company B is a qualified financing lease company who is subject to 5% BT. In a typical financing lease case, as required by Company X, Company B purchases equipment at a cost of RMB117,000 (VAT inclusive) and realises total rental income of RMB 150,000 (VAT exclusive).

Under the current regulations, the BT of a financing lease shall be calculated as below:

BT payable= (Leasing income – actual costs)* 5%

“Leasing companies in China have long been frustrated that they pay BT on the lease payments they collect but they cannot deduct VAT costs on equipment they buy to lease.”

Actual costs include the purchase price, customs duty, VAT, transportation fees, insurance, installation fees paid by the lesser, etc.

In the Pilot Program, Company B pays 17% VAT instead of BT and its indirect tax cost on rental and purchasing equipment can be streamlined. Also, the actual VAT cost exceeding 3% is refundable. For this illustration, we assume that the purchased equipment can be fully depreciated without residual value over the term of the lease. We also assume that in the Pilot Program Company B is a general VAT taxpayer.

	Before the Pilot Program	In the Pilot Program
Purchase price	117,000 (inclusive of 17% VAT)	100,000 (exclusive of 17% VAT)
Leasing income	150,000	150,000
BT (5%)	1,650	N/A
VAT (17%)	N/A	8,500
Actual VAT cost after refund	N/A	4,500 ¹
Gross profit	31,350	50,000
EIT	7,838	12,500
Net Income	23,512	37,500
<u>Total tax burden</u>	9,488	17,000
<u>Total effective tax rate</u>	<u>6%</u>	<u>11%</u>

As with Case I, the Pilot Program does not guarantee an immediate drop in total tax cost of the lesser. Due to the different tax basis in calculating BT and effective VAT cost (based on total revenue), under the Pilot Program the lesser might have to pay a higher turnover tax cost than under the current regime.

¹ Circular 111 does not specify how the effective VAT cost is calculated. The calculation method is referred to a similar policy applicable to software industry. With future clarification, the overall tax cost may be further lowered.

Other Practical Implication

- Besides the changes to tax liability, the switch from BT to VAT may also give rise to other business considerations:
 - ▶ It can be envisaged that business competitiveness of the taxpayers under the Pilot Program may vary under different circumstances. If a customer outside Shanghai is a VAT taxpayer that can credit input VAT incurred on services bought under the Pilot Program, it would be more likely to choose suppliers under the Pilot Program rather than paying unrecoverable BT on services bought elsewhere. On the other hand, if a customer outside Shanghai is a BT taxpayer, the suppliers under the Pilot Program may be less competitive because the customer will bear higher VAT which they cannot collect as a BT taxpayer. Such differences and inconsistencies will expand the coverage and push the pace of PRC VAT reform at the national level.
 - ▶ The Pilot Program provides that all lease contracts signed before 31 December 2011 are subject to BT until they are fully performed. But for other service agreements entered before the end of 2011, the Pilot Program does not mention any transitional treatment. So theoretically taxpayers under those agreements should assess when their relevant turnover tax liabilities increase under the tax regulations. If the turnover tax liabilities arise after the effectiveness of the Pilot Program, they are subject to VAT instead of BT. Then they may have to clarify with the tax authorities on how to deduct the input VAT and to reach consent from contract parties on the change of invoice type (e.g. suppliers may have to issue VAT special invoices). We expect disputes will arise in cases where tax costs increase, due to the issue of VAT invoices.
 - ▶ The VAT system is a sophisticated system under the close supervisions of China's tax authorities. Former BT taxpayers may need much preparation and adaptation to fit the VAT system. For example, some conditions/equipments must be fulfilled/ installed by taxpayers to issue VAT special invoices, accounting systems and staff must be adjusted / trained for VAT management, VAT filing procedures and requirements must be taught etc. Although

“Former BT taxpayers may need much preparation and adaptation to fit the VAT system.”

there is no further guidance to show the steps, it can be expected that these adaptations and preparations will require significant effort with regard to commercial, operational and technical issues. Considering the tight timeline, it is important for those taxpayers under the Pilot Program to keep a close eye on developments and get ready for upcoming changes.

- ▶ Taxpayers engaged in Covered Services should scrutinise their pricing policies and look into cost components and relevant tax costs to understand the impact of the Pilot Program. Due to the change of tax cost, it is necessary to revisit previous pricing policies and business models to cover the VAT cost brought about under the Pilot Program. It is the general practice of some service providers to transfer their current BT cost to service recipients by grossing up their service quote. With the more complicated calculation method after the transition to the VAT system, service providers have to find a balance between their fee quote increase and the possible increase of VAT costs. Strategically, the restructuring of business models may be necessary, which in turn may lead to more procurement and hence more input VAT in China.

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Room for Supplement and Clarification

As a groundbreaking circular, Circular 111 leaves room for future additions in view of the implementation effect of the Pilot Program. In the meantime:

- Circular 111 allows two or more taxpayers — with the approval of the MOF and SAT — to make a consolidated VAT filing. The conditions for a consolidated filing are still unknown. Can the input VAT of one taxpayer be used by another taxpayer if they can file VAT on a consolidated basis?
- Circular 111 states that “taxable service stipulated by MOF and SAT” is subject to 0% VAT rate. “Taxable services” mean Covered Services provided by the industries covered under the Pilot Program. It seems that MOF and SAT might again lower the VAT cost of certain industries. In the current VAT regime, 0% VAT is granted for the export of intangible goods. It will be interesting to see if China provides similar VAT treatment to the export of services in the future.

- General VAT taxpayers providing services specified by MOF and SAT can choose to apply a simplified taxation method (3% on revenue without input VAT deduction). We expect detailed rules will be issued soon to clarify the implication of the “specified services”.

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