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China Alert

The Pilot Program of VAT Reform in Shanghai

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On 16 November 2011, the Ministry of Finance ('MOF') and the State Administration of Taxation ('SAT') jointly issued two circulars to provide important guidance on the pilot program of VAT reform in Shanghai with effect from 1 January 2012:

- CaiShui [2011] No.110 – Notice of the Pilot Scheme for Transforming Business Tax ('BT') to Value Added Tax ('VAT') ("Circular 110")
- CaiShui [2011] No.111 – Notice regarding the Pilot Program for the Transformation of BT to VAT in the Transportation Industry and Certain Modern Service Sectors in Shanghai (Pilot location) ("Circular 111"); Circular 111 contains 3 appendices which set out the implementation and transitional measures.

The release of Circulars 110 and 111 marked the official rollout of the pilot program for the transformation of BT to VAT for service industries. The launch of the pilot program represents an important milestone in the history of turnover tax reform in China.

On 29 December 2011, the MOF and the SAT issued two additional circulars to clarify the relevant issues and address the transitional and implementation requirements under the pilot program:

- CaiShui [2011] No. 131 – Notice of VAT Policies regarding Zero Tax Rate and Tax Exemption for Taxable Services ("Circular 131"); and
- CaiShui [2011] No. 133 – Notice of Certain Tax Policies regarding the Transformation of BT to VAT in the Transportation Industry and Certain Modern Service Sectors

The pilot program has commenced from 1 January 2012 in Shanghai and is expected to be rolled out nationwide.

This article summarizes the salient points of the above circulars.

VAT taxpayer and the withholding agent

A VAT taxpayer is defined as a unit or an individual providing services in transportation or certain modern service sectors within China. The taxpayer is subject to VAT instead of BT when it provides pilot taxable services in China.

For a foreign company or an individual ("Foreign Service Provider") providing taxable services in China, the withholding agent is defined as:

1) The agent of the Foreign Service Provider if the Foreign Service provider does not have an operating establishment in China; or

2) The service recipient if the Foreign Service Provider does not have any agent in China.

Applicable VAT rate

The table below sets out the applicable VAT rates for pilot taxable services ("Taxable Services"):

Taxable Services	Applicable VAT Rate
Leasing of tangible and movable assets	17%
Transportation services by land (excluding railway), water, air and pipeline (e.g. for liquid and gas)	11%
▪ Research / development and technology services (Note 1) ▪ Information technology services (Note 2) ▪ Creative culture services (Note 3) ▪ Logistics ancillary services ▪ Attestation and consulting services (Note 4)	6%
Other taxable services stipulated by the MOF and the SAT	0%
Simplified taxing method	3%

Note 1: include technology transfer services, technical consultation services, contract energy management services and services of engineering and exploring

Note 2: include sofware services, circuit design and testing services, information system services and business process management services

Note 3: include design services, trademark and copyright transfer services, intellectual property services, advertising services as well as conference and exhibition services

Note 4: include certification, attestation and consulting services

Mechanics of the pilot program in Shanghai

Basically, the pilot program can be analysed from two transactional perspectives, i.e. 1) Cross-region transactions within China, and 2) Cross-border transactions between China and overseas.

Cross-region transactions within China

1) Taxable Services rendered by a pilot taxpayer in Shanghai region to a company outside Shanghai region

- A pilot VAT payer in Shanghai can issue special VAT invoice to the service recipient provided that the service recipient is not an individual consumer and the services are not VAT-exempted.
- If the service recipient is a general VAT payer, it can deduct the input VAT paid.
- VAT should be settled at the place where the establishment of the pilot taxpayer is located. When services are rendered by a pilot taxpayer outside Shanghai and BT was paid to the tax authority where the services were rendered, the amount of BT paid could be deducted from the VAT payable of the pilot taxpayer.

2) Taxable Services rendered by a service provider outside Shanghai region to a pilot taxpayer in Shanghai

- The company outside Shanghai region should file and pay BT in accordance with the current BT law.

Cross-border transactions

- Taxable services rendered from overseas to China

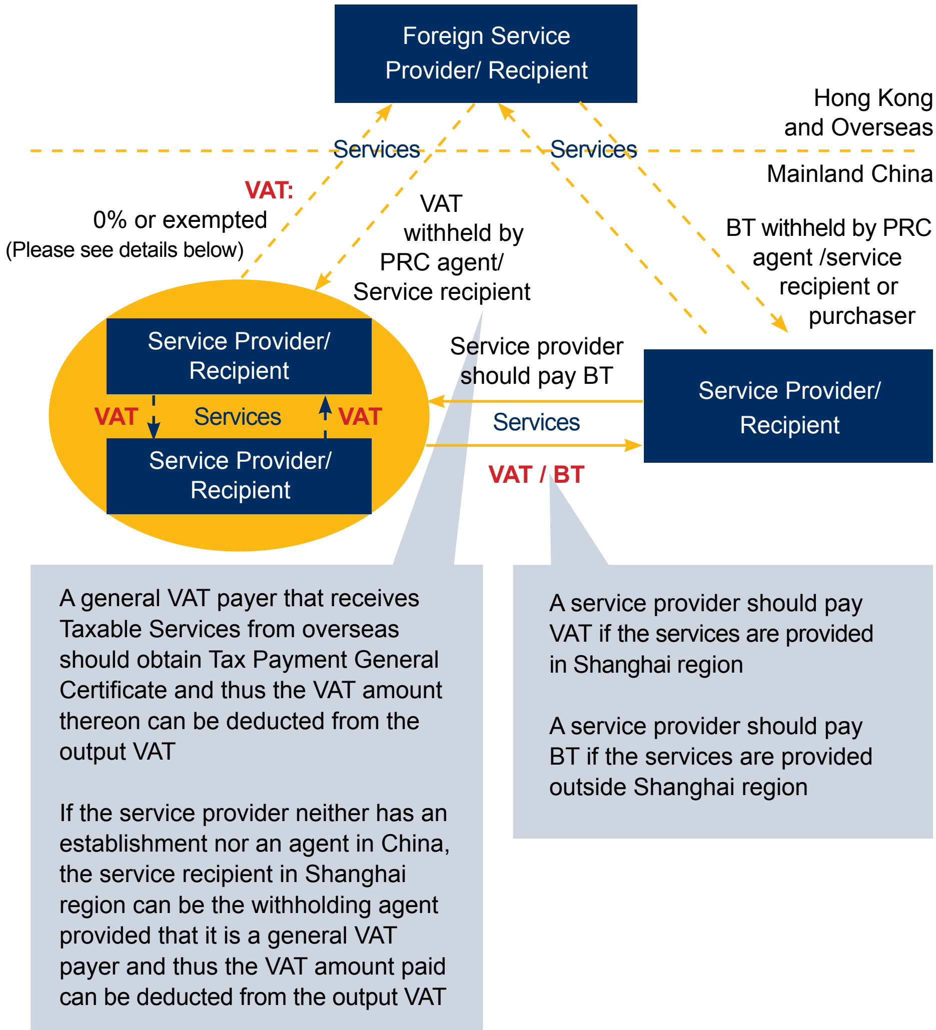
  Under the pilot program, the company or the individual that provides Taxable Services in China is subject to VAT instead of BT. According to Circular 111, such Taxable Services will be considered as provided in China and be subject to VAT if either the service provider or the service recipient is located in China, except for following situations:

  1) Taxable Services provided by foreign companies or individuals to Chinese companies or individuals are entirely consumed outside China;
  2) Leasing of tangible and movable assets by foreign companies or individuals to Chinese companies or individuals and the assets are entirely used outside China; or
  3) Other circumstances as stipulated by the MOF and the SAT.

- Taxable Services rendered from China to overseas

  Taxable Services rendered by a pilot taxpayer in Shanghai to overseas are free of VAT. Such services are either subject to VAT at zero rate or VAT-exempted.

The following diagram summarizes the mechanics of the VAT pilot program for illustration purpose:



Circular 131 sets out details in relation to Taxable Services that are subject to either zero rate or exemption treatment as follows:

Zero VAT Treatment

The following Taxable Services are subject to zero VAT treatment:

- International transportation services with relevant permits (whereas international transportation services cover transportation of passengers or goods out of China, transportation of passengers or goods into China and transportation of passengers or goods outside China)
- Research and development services provided to overseas entities
- Design services provided to overseas entities (however, design services provided to overseas entities in relation to immovable properties situated in China are not eligible for zero VAT treatment)

VAT Exemption Treatment

VAT exemption applies to the following Taxable Services:

- International transportation services without relevant permits
- Engineering and exploration services whereby the relevant projects or mineral resources are located overseas
- Convention and exhibition services with venues located overseas
- Warehousing services provided through warehouses located overseas
- Leasing of movable properties situated overseas

VAT exemption is only applicable to services provided to foreign recipients excluding foreign individuals:

- Technology transfer and technology consulting services provided to overseas recipients
- Energy management services provided to overseas recipients (however, energy management services with contracted objects located in China are specifically excluded)
- Software services, circuit design and testing services, information system services and business process management services provided to overseas recipients
- Trademark and copyright transfer services, intellectual property services provided to overseas recipients
- Logistics ancillary services (which do not fall into the category of warehousing services) provided to overseas recipients
- Certification, verification and consulting services provided to overseas recipients (except for services in relation to goods or immovable properties situated in China)
- Advertising services with advertisements released outside China

According to Article 10 of the PRC VAT Law, input VAT incurred on purchased goods or taxable services used for tax exempt items cannot be credited against output VAT. In this connection, input VAT incurred for the provision of VAT exempted services cannot be credited. Instead, such input VAT should be transferred out and be treated as the cost of the taxpayer. On the contrary, a general VAT payer may claim input VAT credit incurred for provision of taxable services subject to zero VAT rate.

Our observation and comments

1. Overseas service providers who provide Taxable Services to pilot taxpayers in Shanghai will likely suffer an increase in tax burden where the applicable VAT rates are higher than the BT rates (e.g. VAT at 6% v.s. BT at 5% for consulting services) before the pilot program. To the overseas service providers, the increase in withholding VAT paid will become part of the costs of providing services.

2. The pilot program enhances the competitiveness of Shanghai service providers, as they may now attract service recipients who have a general VAT payer status and would like to replace non-creditable BT purchases from non-Shanghai providers with creditable VAT purchases from Shanghai providers.

3. It is worth noting that the pilot program affects not only the Shanghai service providers but also other domestic or foreign enterprises or individuals who provide services to Shanghai recipients. All affected enterprises should fully understand the tax implications and compliance requirements under the VAT reform.

4. It is possible that the program could be rolled out to other cities or regions in the near future. Foreign investors and enterprises in China should keep track of the latest development.

5. The above circulars also contain detailed compliance procedures, registration requirements and measures in relation to small-scale VAT payers, cross-year transactions and disposal of used fixed assets. For more information or advice on the pilot program, please contact our PRC tax team.

Hong Kong Budgetary Review – 2012/13

Government Surplus Leads to Return of Wealth to the Community

On 1 February 2012, Mr John Tsang, the Financial Secretary ("FS") of Hong Kong, presented the Budget for the fiscal year 2012/13 against the background of global economic uncertainty and rising inflationary pressures. Despite fluctuating economic and financial conditions, the FS was able to announce a projected consolidated surplus of HK$66.7 billion for 2011/12, which far exceeds the originally forecast deficit of HK$8.5 billion. A small deficit of HK$3.4 billion is forecast for 2012/13. In response to calls from the community for tax relief measures, the FS announced a series of "one-off" concessions in form of tax and fee waivers to salaries tax payers and businesses.

In general, the Budget provides reasonable financial relief to the middle income group, small and medium sized enterprises ("SMEs") and new businesses. It would be better received than the last one even though there is no cash payment this time.

Encouraging New Business

The various measures proposed by the FS to encourage new business and company are set out in Sch. (1)(a) and (c) below.

Providing Assistance to SMEs

The FS also provides financial assistance to the existing SMEs, as set out in Sch. (1)(b), (2), and (3)(a).

Reducing the Financial Burden of the Middle Income Group

Middle income group would benefit the most from the Budget. Relief measures include reduction in tax for 2011/12, increase in various personal allowances and extension of home loan interest deductions etc. Please refer to Sch. (2), (4)(a) and (c).

Clamping Down on Property Speculation

The government continues to enforce the Special Stamp Duty introduced on 20 November 2010 as a powerful measure to clamp down on property speculation despite rumour of abolition in view of quiet property market, Sch. (6)(a).

Planning for Long Term Development

Although the Budget should be well received by the middle income group as it provides reasonable financial relief to them, it fails to look forward to improving Hong Kong's competitiveness in the financial industry which has now become our most important industry. In a survey published last year, Hong Kong ranked first in business competitiveness worldwide. However, Shanghai is moving up fast and could overtake Hong Kong in less than 10 years if we are satisfied with what we have achieved, especially when foreign exchange control is uplifted in China. Also, the rise of Hong Kong in the ranking last year could be a result of the financial turmoil in the US and debt crisis in Europe. Given that Singapore also has strong economic fundamentals and has in some areas surpassed Hong Kong according to certain economic indicators, the Hong Kong Government should develop long-term measures to enhance international competitiveness and economic resilience.

Please note that the budget proposal is subject to review and amendment before enactment.

Schedule of Budget Proposals- 2012/13

(1) Business

(a) Waiver of business registration fees for 2012/13

(b) 50% reduction of charges for import and export declarations

(c) Abolition of capital duty levied on local companies

(2) Rates

Waiver of rates for 2012/13, subject to a ceiling of $2,500 per quarter for each rateable property.

(3) Profits Tax

(a) Reduction of Profits Tax for 2011/12 by 75 %, subject to a ceiling of HK$12,000. The reduction will be reflected in the taxpayer's final tax payable for 2011/12

(b) Profits Tax rate will remain unchanged as follows:

	2011/12 and 2012/13
Companies	16.5%
Unincorporated businesses (sole proprietorships and partnerships)	15%

(4) Salaries Tax and Personal Assessment

(a) Reduction of Salaries Tax and Tax under Personal Assessment for 2011/12 by 75%, subject to a ceiling of HK$12,000. The reduction will be reflected in the taxpayer's final tax payable for 2011/12.

(b) Salaries Tax is computed on the basis of the lower of standard rate (at 15% without allowances) on net assessable income or at progressive rates (after deduction of allowances) on net chargeable income:

	2011/12 and 2012/13
Progressive rates	
First $40,000 at	2%
Next $40,000 at	7%
Next $40,000 at	12%
Balance at	17%
Standard rate	15%

(c) Personal Allowances and Deductions

	2011/12 HK$	Proposed 2012/13 HK$
Allowances		
Basic Allowance	108,000	120,000
Married Person's Allowance	216,000	240,000
Child Allowance (each of the 1st to 9th child)		
- year of birth	120,000	126,000
- other years	60,000	63,000
Dependent Brother/ Sister Allowance (each)	30,000	33,000
Dependent Parent/ Grandparent Allowance (each)		
- aged 60 or above or is eligible to claim an allowance under the Government's Disability Allowance Scheme	36,000	38,000
- aged 55 or above but below 60	18,000	19,000
Additional Dependent Parent/ Grandparent Allowance (each)		
- aged 60 or above or is eligible to claim an allowance under the Government's Disability Allowance Scheme	36,000	38,000
- aged 55 or above but below 60	18,000	19,000
Single Parent Allowance	108,000	120,000
Disabled Dependent Allowance	60,000	66,000
Deductions (maximum limits)		
Self-education Expenses	60,000	60,000
Elderly Residential Care Expenses	72,000	76,000
Home Loan Interest (Number of years of deduction)	100,000 10 years	100,000 15 years
Mandatory Contributions to Recognized Retirement Schemes*	12,000	15,000
Approved Charitable Donations (cap based on assessable income)	35%	35%

* The maximum level of relevant income under the Mandatory Provident Fund Schemes Ordinance will be increased to $25,000 with effect from 1 June 2012. Hence, the maximum amount of deductible contributions is $14,500 for the year of assessment 2012/13 and $15,000 for the year of assessment 2013/14 onwards.

(5) Property Tax

Property Tax rate will remain unchanged at 15% for 2012/13.

(6) Stamp Duty

(a) Stamp Duty on property transactions will remain unchanged, maximum rate being 4.25% and Special Stamp Duty ranging from 5% to 15% will continue to apply to sales proceeds of a residential property purchased on or after 20 November 2010 and disposed within 24 months.

(b) Stamp Duty on stock transactions will remain the same being 0.2%.

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