



REDUCING TAX ON A SUPPLY CHAIN – 1

Integrating Business Tax into VAT by extending the VAT Charge

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The Ministry of Finance and the State Administration of Taxation have issued several directives to implement the State Council decision to gradually integrate China's two major indirect taxes. See our Note dated October 31, 2011.

The reform provides a good opportunity for businesses to reconsider the approach to indirect tax management. On VAT, this Note suggests, the focus of management effort should be on minimizing the loss of input credits, reducing the overall tax burden on a supply chain, thus helping to expand production and consumption.

Before explaining this view to our readers, we would firstly summarize the main features of the extended VAT charge in the pilot reform program introduced in Shanghai effective January 1, 2012. As we understand it, the pilot program will later be extended to Beijing, but its effect has already begun permeating throughout China as a consequence of transactions entered into between businesses in Shanghai and those in other cities.

The Extended VAT Charge

CS [2011] 110 and 111 provide the policy guidelines and implementation rules of the pilot program ("PPIR"); CS [2011] 113 and subsequent notices have further details. PPIR 1 extends the VAT charge on any person or unit providing taxable services, as prescribed, in China.

Person or unit includes natural persons, incorporated and unincorporated entities or units. A person carrying on business registered in the name of another person is the chargeable person unless the other person continues to undertake legal obligations arising from the carrying on of the business. (PPIR 1 and 2)

Taxable services are prescribed in the rules to include the provision of services in relation to (A) the transfer of matters by conduit, and the transfer of goods or passengers by various means of transport; and (B) modern services: that is, (B1) research, development, and technical transfers, (B2) information technologies, (B3) cultural and creative activities, (B4)

logistic support, (B5) movable properties under operating and finance leases, and (B6) accreditation, assurance and consulting on business, legal and financial matters.

Provision of services means services provided for a fee in money or in kind. Note however that unpaid services provided by a business or non business units can also be deemed to be taxable services. That is, any form of organization, incorporated or not, is presumed to provide services for gainful purposes.

Provision of services in China means either the service provider or the service recipient is in China except for situations where a foreign provider provides to a domestic recipient an otherwise taxable service for consumption entirely outside China or provides movable property for use entirely outside China. The authorities may of course specify other situations to be excluded.

Tax Rates

The VAT charge rate applicable to group (A) transport services is **11%**; group (B) modern services, **6%**, except for group (B5) leasing of movable properties, **17%**.

And certain services to be specified by the Ministry of Finance and the State Administration of Taxation are **zero** rated.

PPIR 13 provides a collection rate of **3%** to be used for simplified assessment of tax.

Tax Administration, Assessment and Collection

A tax charge needs well defined particularization in terms of form and procedure in order to bring about a legally valid demand for payment, or claim for credit and refund. In this respect, the extended VAT charge on the provision of services is basically the same as that currently applied to the sale of goods under the existing VAT regime.

For purposes of our discussion, we would highlight a specific point: that is, the pilot program also provides two tax administration approaches: general and simplified assessment and collection of tax. The general approach applies to general VAT payers, and simplified approach applies to small VAT payers.

General VAT payers are those whose annual revenue from taxable services exceeds a specified threshold (RMB 5 million per SAT Notice [2011] 65, contrast this with that for manufacturing concern RMB 500,000, and retail 800,000 per existing VAT regulations). A small business with smaller turnover that keeps proper books and records may however apply for registration as a general VAT payer.

Broadly speaking, under the general approach, the amount of VAT payable for a period is the difference between the output tax at applicable rates (6% to 17% as above) on total

sales or service fees made during the period and total creditable input taxes paid for that period, subject to stringent compliance with documentary proof.

Under the simplified approach, the amount of VAT payable by a small VAT payer for a period is the product of the amount of ex tax sales/service fees made in that period and the 3% VAT collection rate, which is much lower than the usual VAT charge rates being 6% for modern services, 11% for transport, and 17% for others.

Some traders thus believe they can be better off by staying "anonymous" or just registering themselves as small VAT payers. We are going to explain this is not necessarily true, in our next Note.