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Implementation of China's Indirect Tax Reform Pilot Program

Following the announcement of the indirect tax reform pilot program in Shanghai ("the Pilot Program"), the Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT") jointly released two important implementation circulars (Circular 110 and Circular 111) on November 14, 2011 regarding the Pilot Program.

The Pilot Program will be effective January 1, 2012.

Key points addressed in the Circulars 110 and 111

Circulars 110 and 111 detail the Pilot Program's scope and application, including covered taxpayers ("Pilot Enterprise"), scope of taxable services, tax rates, computation of tax payable, etc.

A summary of these measures is included in the table below.



Pilot Industries (Services)	Applicable VAT Rates	Prevailing BT Rates
Transportation Service Industry		
1. Road transportation services	11%	3%
2. Water transportation services		
3. Air transportation services		
Certain Modern Service industries		
1. Research, development and technical services		
2. Information technology services	6%	
3. Cultural creative services		5%
4. Logistic Auxiliary services		
5. Certification and consulting services		
6. Tangible movable property leasing services	17%	

- Taxpayers subject to the new indirect tax requirements in Shanghai will change from Business Tax ("BT") payers to general VAT payers. As a result, companies will incur output VAT based on their service income (ex-price VAT) at the relevant VAT rates. Input VAT paid for purchases of goods and services subject to VAT would be creditable. The net amount of the output and input VAT will be payable/refundable to the Shanghai tax bureau.
- Certain Pilot Enterprises, which will be allowed to file BT on a net margin basis under the BT regulations, may deduct payments to non-Pilot enterprises within or outside of Shanghai when computing their VAT turnover.
- The Pilot Enterprise will be allowed to claim a deemed input VAT at a 7% rate on transportation cost charges from transportation enterprises which cannot issue VAT invoices.

- The Pilot Program will subject foreign service to VAT instead of BT and the Pilot Enterprise service recipient will be able to claim the VAT paid as an input VAT credit.
- Current BT exemptions would still be valid until the expiration of relevant contracts. Leasing contracts entered into before December 31, 2011 but not completed by this date may still be eligible for the current BT treatment until the contract expires.

Observations

- In general the Pilot Program will reduce a Pilot Enterprise's indirect tax liabilities since it can now credit its input VAT incurred against its output VAT.
- The implementation Circulars 110 and 111 leave technical and practical issues unresolved, including:
 - How to adjust and coordinate the systems within Shanghai and other Chinese tax bureaus; and
 - The treatment of headquarters and branches that are located outside Shanghai.

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