Value-added Tax Flash

A Washington National Tax Services (WNTS) Publication

November 14, 2011

Update on Indirect Tax Reform in China

Global Indirect Taxes

Background

Complexities and ambiguities around China's current indirect tax system, coupled with an increased number of intricate and sophisticated transactions resulting from a more globalised economy, have led the Chinese Government to consider an overhaul of its indirect tax system. Consequently, indirect tax reform was incorporated into the State's 12th Five-year Plan and was discussed in July 2011 by the Minister of Finance. On October 26, 2011, Premier Wen Jibao officially announced that a Pilot Program will be introduced to assess the impact of the new policies before they are fully implemented country-wide. The program will be piloted in Shanghai.

Pilot Program

On January 1, 2012, the Pilot Program will be formally introduced in selected locations and for selected industries to gradually expand the scope of value added tax (VAT) to cover industries that are currently covered by the business tax (BT) in order to mitigate the multiple taxation complexities associated with goods and services, to improve collections, and to help develop a modern service industry in China.

Key features of the Pilot Program include:

1. **Scope of application -** the Pilot Program will apply first in Shanghai and cover the Transportation industry and "certain modern service industries" (yet to be defined). Selected industries may be covered at a later time, if warranted.

pwc

2. **Range of VAT rates -** in addition to the current 17% and 13% VAT rates, two other VAT rates of 11% and 6% will be introduced.

3. **Tax revenue allocation -** VAT revenues derived from the Pilot Program, after the conversion from BT to VAT, will continue to be kept by the governments participating in the Pilot Program (i.e., Shanghai).

4. **Credit mechanism** - VAT paid on purchases in the Pilot industries can be taken as an input credit.

5. **Continuity of preferential BT treatment for Pilot industries** - BT incentives applicable to Pilot industries will continue but will be adjusted according to VAT.

Open Questions

Many questions remain regarding the impact of the Pilot Program, including (1) how to determine what qualifies as a "certain modern service industries"; (2) the appropriate VAT treatment for each transaction (e.g. transactions between Pilot VAT payers and other BT payers both in and outside of Shanghai); (3) the criteria for taxpayers to choose the additional two VAT rates; (4) how the existing BT incentives for the Pilot industries will be adjusted for VAT; (5) how the Pilot Program fits into the existing VAT invoice regulation and system; (6) whether input credits will be limited to Shanghai taxpayers only or extend countrywide; (7) how entities with branch structures will be impacted; (8) what process changes are required to ensure that taxpayers correctly account for VAT on sales and claim all available input credits; (9) what changes are required of taxpayers' ERP systems; (10) impact on a taxpayer's current pricing structure; (11) whether there are any savings from moving to VAT; (12) determination of the cash flow issues that could arise from the application of higher rates; (13) how to address existing transitional issues such as existing WIP, contracts and services spanning the start date of VAT; and (14) how to manage key customers, vendors and stakeholders.

It is expected that the Ministry of Finance and the State Administration of Taxation will issue detailed guidelines with respect to the Pilot Program that will address some of the issues noted above as well as other issues. Nevertheless, given that the Pilot Program is officially commencing on January 1, 2012, companies doing business in China should now begin to assess and understand how the new changes will impact their operations.

Global VAT Online Service

Many of the developments above are described in more detail on Global VAT Online (referred by many as "GVO") -- PwC's online subscription service which provides up-to-date business critical information on VAT/GST rates, rules and requirements around the world. This information will help you maintain control, mitigate risk, and improve the overall effectiveness of your VAT/GST function. For further information, please speak to your usual PwC advisor or a member of the U.S. VAT Team below.

PwC has a global network of 1,900 indirect tax professionals in 130 countries worldwide, including a dedicated VAT team located in the U.S. who is available to provide real-time VAT advice. This News Flash does not provide a comprehensive or complete statement of the taxation law of the countries concerned. It is intended only to highlight general issues, which may be of interest to our clients. For issues relating to this News Alert, please contact your local Indirect Tax Practice advisor or the specialists listed.

For more information, please do not hesitate to contact your U.S. VAT Team:

Tom Boniface	*(646) 471-4579*	*thomas.boniface@us.pwc.com*
Reena Reynolds	*(312) 298-2171*	*reena.k.reynolds@us.pwc.com*
Camilo Martinez	*(617) 530-5483*	*camilo.r.martinez@us.pwc.com*
Nathan Trautwein	*(415) 498-6342*	*nathan.a.trautwein@us.pwc.com*
Evelyn Lam	*(646) 471-5697*	*evelyn.g.lam@us.pwc.com*