



China Introduces a VAT Pilot Program Applicable to Certain Foreign Law Firms in Shanghai

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On January 1, 2012, a Pilot Program was formally introduced in Shanghai for selected industries to gradually expand the scope of Value Added Tax ("VAT") to cover industries that are currently subject to Business Tax ("BT") -- including some foreign law firms operating in China. Following the initial announcement, the Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT") on 16 November 2011, released two implementation circulars, Circular Caishui [2011] 110 and Circular Caishui [2011] 111, which set out the framework and the transitional rules for the operation of the Pilot Program.

- **Scope of application:** This first round of the Pilot Program will start with the transportation industry and certain "modern service industries" (collectively called "Pilot Industries") in Shanghai, which may possibly be extended countrywide for selected industries, when the circumstances warrant it. Our colleagues at PwC China report that foreign law firms have been included under the "Certification and Consulting" services category, and PwC is aware that some representative offices of foreign law firms have already been approached to participate in the Pilot Program. Firms selected to participate in the Pilot Program will need to transition to VAT, to start charging 6% VAT, and to cease to account for BT on its legal services, beginning January 1, 2012. Firms that do not participate will continue to remain in the BT system and account for 5% business tax. Any BT tax paid will continue to be non-creditable.
- **Range of VAT rates:** In addition to the current 17% and 13% VAT rates, two additional VAT rates, -- 11% (transportation) and 6% ("modern services" excluding leasing services) -- will be added. The 6% rate will apply to participating law firms.
- **Allocation of tax revenue:** During the Pilot Program, the VAT revenue collected after the transformation from BT to VAT, will still be kept by the pilot location governments, i.e., Shanghai in this round.
- **Continuity of existing preferential BT treatment for Pilot Industries:** BT incentives for the Pilot Industries may continue but will be adjusted according to VAT.
- **Credit mechanism:** VAT paid by taxpayers in the Pilot Industries can be taken as input VAT credits on any VAT incurred on business costs. This includes costs that include VAT at 17%, 13%, 11% and the 6% rates. To the extent firms in the Pilot Program incur expenses that are subject to China business tax, these expenses will remain noncreditable.
- **Export of Certain Services May be Exempted:** The MOF and the SAT jointly released Circular Caishui [2011] No. 131 to clarify the scope of VAT zero rated and exempted Pilot Services in relation to the VAT reform in Shanghai. The Circular states that the export of certain services are eligible for VAT exemption. Although no further definition was provided, certain items identified in the Circular could be part of foreign law firm's business, including the transfer of trademarks and copyrights services, intellectual property services, certification services, authentication services and consulting services rendered to entities outside China. From the perspective of a law firm in China providing services to a foreign entity, this represents a good outcome in comparison to the current BT treatment, which imposes BT on the provision of such services. This is not expected to be disadvantageous to law firms participating in the Pilot Program but it has the potential to impact negatively those law firms that are not in the Pilot Program.

The potential impacts of the Pilot Program

The transformation from BT to VAT will have a profound impact upon those businesses within the Pilot Program, as well as most businesses. Some obvious impacts are listed below:

- For those BT payers (service providers) in the Pilot Industries, it is likely that this change will reduce the indirect tax burden for BT payers since the input VAT incurred will now be creditable. The BT which the BT payers had to pay before joining the Pilot Program will now become VAT which will be collected from their clients. This change is expected to impact this group of service providers' Profit and Loss Account because, theoretically, BT should no longer appear as a cost of doing business.
- If the client of a participating service provider is also a general VAT payer, this may be a welcomed change for the client since the VAT paid will now be creditable by the client, whereas the BT paid was not creditable against the output VAT. These clients will now be in a position to claim input VAT credits on the 6% VAT charged by the law firm. On the other hand, if the client is a BT (or small-scale VAT payer), VAT charged by a service provider would not be entitled to any credits and the VAT would be an additional cost to the client (comparing the new VAT rates of 11% and 6% against BT rates of 3% and 5%). This raises the issue whether there may be a need to revisit the firm's pricing structure and likely leads one to ask: how is this accomplished? To the extent that a client is a general VAT payer, it would prefer to acquire services subject to VAT (as opposed to BT) since it would be entitled to credits under the VAT system (but not under the BT system). However, as mentioned above, this will be an additional cost for clients that are subject to BT or, are small-scale VAT payers. Ultimately, it will be a commercial decision, and the firm will need to discuss the transitional and pricing impact directly with its customers. Although this round of the Pilot Program is to be implemented in Shanghai, it is inevitable that firms will have business dealings with customers and suppliers in other provinces. To the extent that those customers and suppliers are VAT payers, this transition will be beneficial as VAT incurred can be claimed as an input VAT credit. However, to the extent that customers or suppliers are not VAT payers, the VAT incurred would be a cost. Businesses should review both their customer mix and supply chain to assess what the impact will be to pricing and whether any contracts or arrangements need to be restructured.
- Systems will need to be adjusted to capture all information needed for VAT compliance purposes, e.g., how to collect all the necessary information from the clients to issue a VAT invoice; when and how to issue a VAT invoice and credit note; how to do VAT reporting and accounting; can the ERP system generate the necessary information for VAT compliance; staff training; how to handle existing contracts, etc. What are all the changes required and how long does it take to get them done?
- Similarly, the systems within the Shanghai (and other Chinese tax authorities) will also need to be adjusted to accommodate all these changes.

Getting prepared for the transformation will require consideration of many commercial, operational and technical issues.

What to do next?

- Firms that have been approached to participate in the Pilot Program should take the following actions immediately:
 - i) Firms should study the two policy documents and their appendices thoroughly and immediately, paying particular focus on their own Pilot Industries. Furthermore, firms should carry out impact studies to assess the financial implications of shifting from BT to VAT (through some simulation modeling), examining not only the profit and loss account but also cash flow.

- ii) Firms should review their existing clientele and service contracts to see whether (or how) to formulate a new pricing strategy and the best way to facilitate their clients who are VAT payers in order to claim / recover the input VAT. A decision should also be made on how to handle new client contracts under the VAT regime.
 - iii) Firms should also consider how to deal with service providers, whether domestic or foreign, or whether Pilot Enterprises or non-Pilot Enterprises, for both existing service arrangements and new contracts and how best to facilitate their own claim / recovery of the input VAT.
 - iv) Firms should prepare for the Shanghai tax bureau's upcoming detailed compliance procedures and requirements and take swift actions to comply and ensure they do not fall into the traps and pitfalls of VAT administration.
 - v) Obviously, the Pilot Program demands remarkable changes to the internal financial, accounting and tax systems to adapt to the new VAT system, or even the overall tax function effectiveness of the Pilot Enterprise. Firms should review and revise their ERP system and other control checkpoints to get ready to achieve full compliance as per the VAT regulations.
- At a first glance, the Pilot Program seems not to be a concern for non-Shanghai law firms. However, those firms should be aware of the following anticipated, indirect impact:
 - i) The non-Shanghai firms should re-examine their value chains and re-visit the portability of service delivery functions, to see if it is more advantageous to shift their operations to an office in Shanghai.
 - ii) They should get ready to deal with Pilot Enterprises in terms of price strategy and invoice issues.

PricewaterhouseCoopers' team of professionals is ready to assist its law firm clients that have been approached to participate in the Pilot Program, in understanding the possible effects of participating and considering whether to join the Program. Please contact Stanley Kolodziejczak at (646) 471-3160, Gregg Sincoff at (646) 471-1335 or Nancy Regan at (646) 471-6104 in New York; and Rex Chan at +86 (10) 6533 2022, Michael Ho at +86 (10) 6533 2783 in China, and Alan Wu at +86 (10)6533 2889.

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