CLIFFORD CHANCE

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Detailed Rules Announced for Business Tax/VAT Integration Pilot Reform in Shanghai

On 17 November 2011, China's Ministry of Finance and State Administration of Taxation jointly issued a set of policy documents laying out both the general approach to the gradual and partial replacement of the business tax (BT) by the value added tax (VAT) in China and the specific legal framework for implementing such replacement for certain service industries in Shanghai. These documents follow upon the announcement by the State Council on 26 October 2011 that VAT/BT integration will be carried out on a trial basis in Shanghai, starting 1 January 2012. The new documents issued by the central tax authorities, particularly the three lengthy pieces of guidance under the "Notice regarding Carrying out the Shanghai Pilot for Substituting the VAT for the Business Tax for Transportation and Certain Modern Service Industries" (**Shanghai BT Reform Notice**), are detailed and likely intended to stand in parallel to current VAT and BT regulations and to have the force of law.

The two indirect taxes

The Chinese BT is a cascading tax on most services and on the transfers of both intangible and immovable properties. A taxpayer subject to the BT, unlike a VAT taxpayer, is generally unable to reduce the tax on its sales by tax paid on input purchases. Similarly, any BT paid on business purchases cannot be used to reduce VAT levied on sales. The impact of the BT on business transactions is thus quite unlike that of the VAT, and is much more likely to create tax-induced distortions.

Who will be most affected?

In particular, the parties directly affected by the Shanghai BT Reform Notice, which will take effect on 1 January 2012, include: (i) businesses (including branches) registered in Shanghai and engaged in the industries selected for making the BT-to-VAT switch (**Selected Industries**); (ii) VAT taxpayers (both in Shanghai and elsewhere in China) who make purchases from businesses under (i); and (iii) foreign providers of services to clients in Shanghai, where such services fall within the Selected Industries and are currently subject to the BT. Businesses in category (i) will be eligible to register as regular VAT taxpayers (subject to certain conditions), and those who do so (**Shanghai Pilot Taxpayers**) will collect VAT on their sales and issue VAT invoices to purchasers, and will be able to claim input credit for VAT charged on purchases of goods and services. Businesses in category (ii) will be able to deduct the VAT paid on purchases made from the Shanghai Pilot Taxpayers. Finally, the services provided by foreign parties in category (iii) will be subject to the VAT instead of the BT under "reverse charge"-like mechanisms, and if the recipients of the services in Shanghai are VAT taxpayers (including Shanghai Pilot Taxpayers), such VAT would be deductible against their output VAT (and therefore likely would not represent a transaction cost).

Key Issues

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What are the Selected Industries?

The Selected Industries are wide-ranging. They include in the first instance transportation by road, waterways, air, and pipeline, and the VAT rate applicable to such services will be 11%. They also include rental of tangible, movable properties (whether by finance or operating leases), for which the applicable VAT rate will be 17%. They also include the following varieties of “modern services” to which a 6% VAT rate will apply: R&D and technology services (including technology transfers and licensing); IT services; cultural innovation services, which encompass not only design, advertising, and IP-related services but also the transfer of trademarks, copyright, and business goodwill; logistical services; and attest and consulting services, including accounting, tax, legal, management and certain other services. Financial services, construction, and transfers/leases of immovable property are currently not included in the Selected Industries, although they will also be subject to BT/VAT integration once the Chinese government decides to take the Shanghai pilot further.

The Shanghai BT Reform Notice provides detailed definitions of the Selected Industries, as well as quite extensive rules about the choice of simplified VAT reporting, transition and the retention of BT preferences, matters of VAT compliance, and so on.

We expect the Shanghai BT/VAT integration pilot program to impact not only foreign parties doing business in, investing in, and offering services to customers located in Shanghai, but also foreign parties who compete with Shanghai businesses that benefit from the replacement of the BT by the VAT. Moreover, transactions conducted elsewhere in China may be affected both insofar as similar transactions in Shanghai offer substitutes (or competition), and insofar as expectations develop for the reform program to be extended to more cities.

Specific impact on aircraft finance and leasing

The aircraft finance and leasing industry is likely to be significantly affected by the Shanghai pilot program, and the relative competitive positions of Chinese and foreign parties may be altered. For instance:

- Airlines in Shanghai should be eligible to become VAT taxpayers, charging VAT on their sales and claiming input credit for VAT paid on all purchases of goods and services—including (i) aircraft purchases and (ii) leases (whether operating or financing) provided by Shanghai and foreign lessors.
- Domestic leasing companies located in Shanghai should be eligible to become VAT taxpayers, charging the VAT (instead of the BT) on rental but claiming input credit for VAT paid on purchases of goods and services—including import VAT on airplane purchases.
- The VAT should apply to lease agreements between foreign lessors to airlines or other lessees in Shanghai: lessees that are VAT taxpayers should be able to claim input credit for such VAT collected, but those that continue to be BT-taxpayers face dramatically-increased transactional costs.

Conclusion

The replacement of the BT by the VAT in the service sectors in China, once implemented, will make China’s indirect taxation of services much more similar to the VAT/GST systems of other countries. Even its trial implementation for several select industries in Shanghai will have far-reaching consequences, given the importance of Shanghai in China’s economy.