

China releases ground breaking VAT policies to re-energize the Economy – Key changes and actions taxpayers should consider

Synopsis

On 21 March 2019, the Chinese authorities issued a suite of tax circulars which set out ground breaking Value-Added Tax (“VAT”) rules¹ to materialize the decision made by the State Council to re-energize the Chinese economy.

Economic rationale behind the formulation of the ground breaking VAT measures

The master plan for the above-mentioned changes was first unveiled in the Report on the Work of the Government 2019 (“Government Report 2019”)² on the 5 March 2019 by Chinese Premier Li Keqiang (“Premier Li”). It was made clear in the Government Report 2019 that the key purpose for this round of VAT changes is to stimulate sustainable financial growth by lightening the tax burden to taxpayers. It is expected that the tax savings to be generated would fuel further economic developments and ultimately help re-energizing the market.

One important point to note is that the well-received statement “The tax burden for all industries should be reduced but not increased” has been reiterated in the Premier’s announcement. This demonstrates the Chinese government’s determination and continuous efforts on tax reduction. It has been reported that the Chinese government has budgeted CNY2,000 billion² to fund the VAT changes and other reduction measures such as social security changes.

1. source: <http://www.chinatax.gov.cn/n810341/n810755/index.html>

2. source: http://www.gov.cn/premier/2019-03/16/content_5374314.htm

The key features of the circulars have been summarized below:

Circular name and issuing authorities	Key areas of changes
Public Notice [2019] No. 39 jointly issued by the Ministry of Finance ("MOF"), State Administration of Taxation ("SAT") and the General Administration of Customs ("GAC") ("PN 39")	<ul style="list-style-type: none"> ▶ Setting out the VAT rates reductions ▶ Revising input VAT recovery rates for the purchase of agricultural products ▶ Setting out changes to the export VAT refund rates for regular export and tourists refund ▶ Relaxation to input VAT recovery to the acquisition of immovable properties and passenger transport ▶ Introduction of the 10% additional "super input VAT credit" regime to taxpayers mainly engaging in postal and telecommunication services, modern services, and lifestyle services ▶ Setting out the revised refund arrangement for incremental excess input VAT
SAT Announcement [2019] No. 14 ("Announcement 14")	<ul style="list-style-type: none"> ▶ Transitional measures relating to the reversal of transactions over the VAT rates adjustment period ▶ Input VAT transfer out/ claw-back arrangements when there are changes to the use of immovable property ▶ The administrative procedures for the new "super input VAT credit" regime, including the template of the declaration taxpayers would have to make for the purposes of adopting the "super input VAT credit"
SAT Announcement [2019] No. 15 ("Announcement 15")	Setting out the detailed changes made towards the VAT return filing arrangements

In this issue of Indirect Tax Alert, we would set out our observations and interpretations of these new VAT rules and how they would impact taxpayers.

Significant VAT rates adjustments

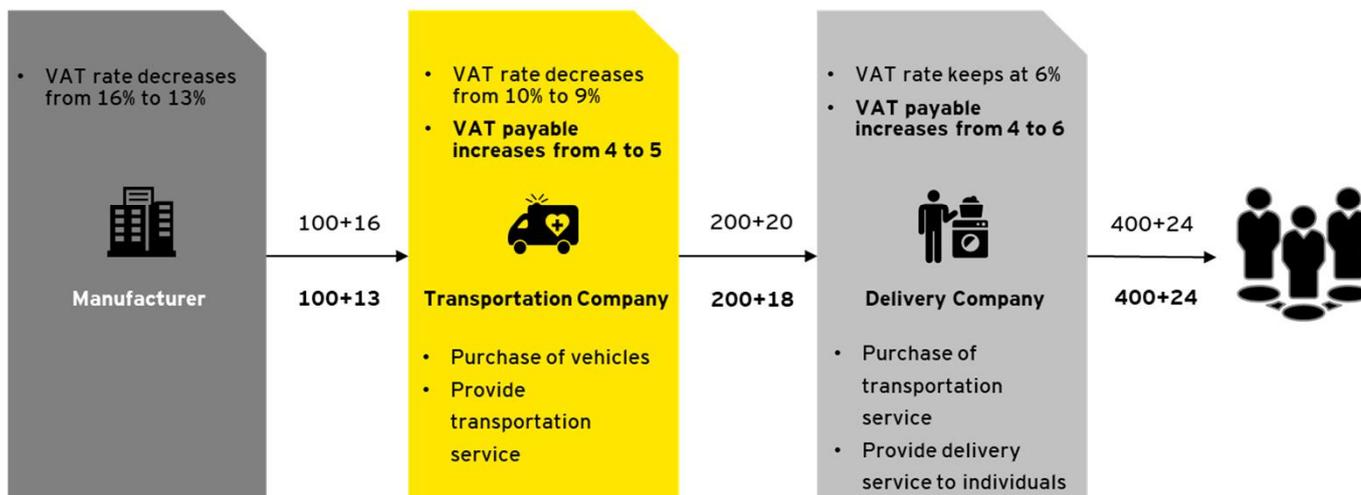
PN 39 has set out VAT rates of 16% and 10% would be reduced to 13% and 9% respectively. We list out below the details of the VAT rates adjustments based on the existing VAT regulations and rules for ease of reference:

No.	Sales of goods/provision of taxable activities	VAT rate
1	Supply of goods, manufacturing and repair services, leasing of tangible movable assets or importation of goods other than those stipulated in Items 2 and 5	13%
2	Supply of transportation, postal, basic telecommunications and construction services, supply of real estate leasing of immovable assets, transfer of land use rights. The supply or importation of specific goods: <ul style="list-style-type: none"> i. Agricultural products such as food grains, edible vegetable oils and salt ii. Tap water, heat, air conditioning, hot water, coal gas, liquefied petroleum gas, natural gas, dimethyl ether, methane gas, coal products for residents iii. Books, newspapers, magazines, audio-visual products, electronic publications iv. Feeds, chemical fertilizers, agricultural chemicals, agricultural machinery and covering plastic-film for farming v. Other goods as regulated by the State Council 	9%
3	Supply of services and intangible assets, other than those stipulated in Items 1, 2 and 5.	6%
4	Collection rate applicable to specific taxpayers (e.g., small scale taxpayers) and transactions (e.g., supply of certain public transportation services)	3% (collection rate)
5	Exportation of goods and Cross-border supply of services and intangible assets as prescribed by the State Council.	0%

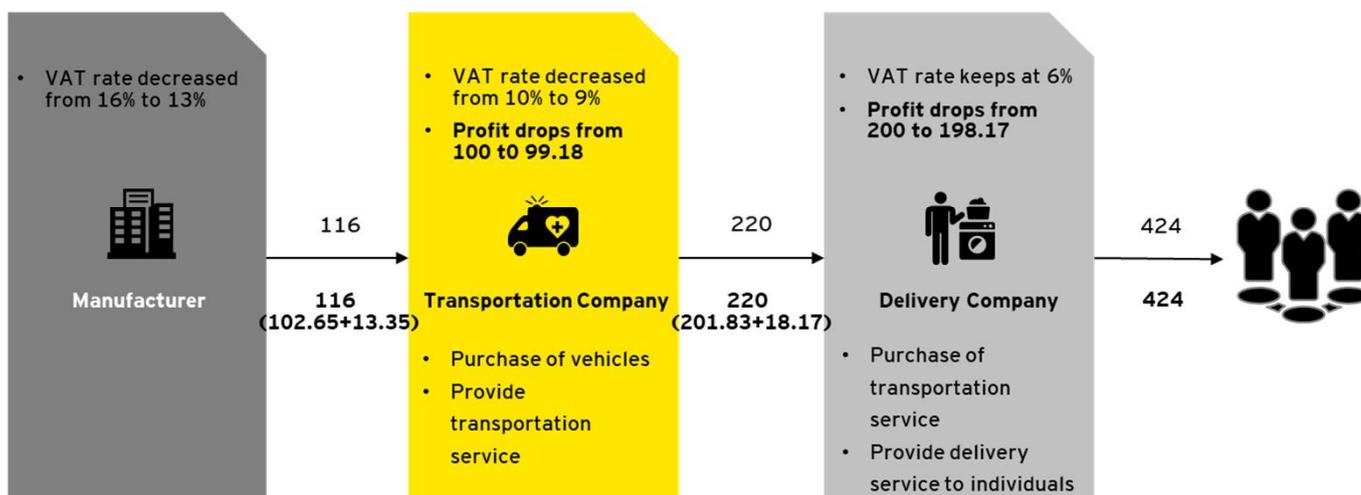
PN 39 has also set out detailed changes to the input VAT recovery rates for agricultural product purchase as well as the export VAT refund rates, and also how the export VAT refund rates should be applied in different export scenarios, including transitional VAT rules for domestic as well as export transactions.

While the business community generally welcomes the significant VAT rates reduction and is excited about the benefits to be brought by the VAT measures, some business arrangements could face pressure on increased VAT cashflow and reduced margin. We have illustrated an example below to show how the VAT rate changes could potentially affect the VAT cashflow and in some cases margin as well.

Scenario 1: Price arrangement - VAT exclusive



Scenario 2: Price arrangement - VAT inclusive



Note: Please note for the purposes of illustration of the VAT cashflow change the 10% super input VAT credit and also incremental excess input VAT refund are NOT taken into account in the examples.

It can be observed from the above examples that VAT rate reductions may not necessarily bring VAT cashflow benefits and improvements to margins. The transportation company in the example is a capital intensive business having to invest in capital equipment. The input VAT stemming from the purchase of transportation equipment would be reduced as a result of the VAT rate reduction from 16% to 13%. Although the output VAT rate for the supply of transportation services has also been reduced, the decrement is 1% only and this could not compensate for the loss on input VAT (e.g., 3%).

Under the second example, it can be demonstrated that if the pricing structure between the various parties in the supply chain is VAT inclusive (which is rather common commercial practice in China), the profits for the transportation companies and the logistic service provider could be slightly reduced respectively.

We understand that the Chinese authorities have already anticipated the above potential impacts and have formulated mitigating measures in form of the input VAT enhancement policy package which would be elaborated below.

The new “super input VAT credit” regime

From 1 April 2019 to 31 December 2021, taxpayers providing the following four types of “qualifying services” would be entitled to an additional 10% super input VAT credit.

Postal services	Telecommunication services
Modern Services	Lifestyle services

**The definition of the above four services can be found in Caishui [2016] No36.*

PN 39 has set out the conditions to be met before obtaining the super input VAT credit and the key conditions have been set out below:

- ▶ Taxpayers would need to submit [Declaration on Adopting Super Input VAT Credit Policy] on the Online Electronic Tax Office before they can enjoy the new VAT policy.
- ▶ The sum of the sales revenue generated from the above four types of services would need to exceed 50% of the total sales revenue.
- ▶ The 10% additional super input VAT credit would be computed based on the amount of recoverable input VAT. Please note that it is not all the input VAT but “recoverable” input VAT.
- ▶ The super input VAT credit treatment is not applicable to taxpayers making export sales of goods or providing cross border services.
- ▶ If the taxpayers perform both “qualifying services” and export sales of goods or provision of cross border services, input VAT that could not be distinguished between the two types of services would need to be separated according to the proportion of sales revenue.
- ▶ Excess super input VAT credit can be carried forwarded to the next VAT return period, up to the last VAT return period ending 31 December 2021.

Expansion and Acceleration of input VAT recovery

The following three input VAT recovery changes have been set out in PN 39:

Accelerate input VAT recovery to the acquisition of immovable properties

Under the current VAT rules, taxpayers are required to split the recovery of input VAT incurred on the acquisition of immovable properties in two years (i.e., Recovery in the first year is 60%. The remaining 40% would be recovered in the second year). PN 39 has enhanced the VAT cashflow for the immovable property purchasers by enabling a one off VAT recovery (i.e., in the month of purchase) of the input VAT incurred for the purchase of immovable property.

Announcement 14 has set out the detailed rules for input VAT transfer out/ claw-back arrangements when there are changes to the use of immovable property (e.g., the immovable property has changed from taxable use to VAT exempt use).

Expanding input VAT recovery for domestic passenger transportation services

Under the current Chinese VAT rules, there are specific provisions which disallow the recovery of input VAT. One of these is related to recovery of input VAT incurred on the costs associated with passenger transport. This input VAT disallowance applies even in the case where the passengers in question are employees of the business and the travelling arrangements are solely made for business purposes.

Over the years, the business community has been suggesting relaxation of the input VAT recovery policy and PN 39 has eventually facilitated a breakthrough. From 1 April 2019, taxpayers would be allowed to recover input VAT when they have collected specific documentary evidence for the travel costs / expenses.

Type of documentary evidence	Amount of Input VAT	Remarks
Special VAT invoice	VAT amount indicated on the special VAT invoice	
Electronic normal VAT invoice	Tax amount indicated on the invoice	
Air travel e-ticket itinerary	$(\text{fare} + \text{fuel surcharge}) \div (1 + 9\%)$	Passenger identity information needs to be shown on the documentary evidence
Railway ticket	$\text{Ticket face value} \div (1+9\%) \times 9\%$	
Road, water and other transport tickets/ voucher	$\text{Ticket face value} \div (1+3\%) \times 3\%$	

As an observation of EY, at the moment regular taxi receipts would not be able to support input VAT recovery because taxi receipts would not contain passengers' information.

Businesses would need to review its procurement and expenses processes and procedures in order to benefit from the new input VAT rules. Many large businesses would have engaged travel management companies to arrange their business travels. Taxpayers would need to start communicating closely with their service providers, either the actual transportation service providers or the travel agents/ travel management companies, in order to ensure the types of documents required to support the input VAT credit could be obtained after 1 April 2019. Businesses would also need to revise their staff expense reimbursement processes in order to properly and efficiently capture the input VAT associated with the travel costs paid by their staff for accounting and also VAT filing purposes.

Revision to the incremental excess input VAT refund treatment

PN 39 has set out rules for the incremental excess input VAT refund regime which would come into effect from 1 April 2019. The key features of the rules are set out below:

Qualification of taxpayers	<p>The following five criteria have to be fulfilled simultaneously:</p> <ul style="list-style-type: none"> ▶ Starting from the tax filing period of April 2019, the incremental excess input VAT credit is more than zero for a consecutive six months (or consecutive two quarters if the filing is on a quarterly basis), and the incremental excess input VAT at the sixth month is not lower than CNY500,000 ▶ The taxpayer's Tax Credit Rating would need to reach Grade A or Grade B ▶ Within the 36 months before applying for the excess input VAT refund, the taxpayer has not committed any fraudulent application for tax refund from (1) excess input VAT (2) export VAT refund (3) false issuance of special VAT invoice ▶ Within the 36 months before applying for VAT refund, the tax authorities have not punished the taxpayer for more than two times (including two times) due to tax evasion ▶ Have not adopted any of the Refund Upon Collection as well as Collection First Refund Later measures <p><i>Incremental excess input tax refers to the incremental portion of input tax balance compared against the input tax balance as at the end of March 2019</i></p>
Quantification of excess input VAT	<p>Amount of excess input VAT refund = Incremental amount of excess input VAT X 60% X Input VAT ratio*</p> <p>*Please refer to Article 8 of PN 39 for the definition of Input VAT ratio</p>
Export enterprises	Exporters of goods and suppliers of export services which have adopted "Exempt, Credit, Refund" method could still be eligible for excess input VAT refund if the taxpayers' can meet with all the criteria set for the excess input VAT treatment after the taxpayers have completed the "Exempt, Credit, Refund" procedures
Administration requirements	Application should be made to the taxpayers' in-charge tax bureau at the same filing period when the VAT return is filed

PN 39 is silent as to the exact month the incremental excess input VAT refund application could be made. Following the 6 month period rule, we consider the first incremental excess input VAT refund application could be made in October 2019. PN 39 is also silent whether, when, and how taxpayers can make their second incremental excess input VAT refund after they have successfully obtained the first refund. We expect more clarification on the procedures related to the first and subsequent refund application should come from tax authorities as we approach the time of the first refund application.

In many countries/locations which operate a VAT/ Goods and Services Tax ("GST") regime, refund would be given to taxpayers when the amount of input VAT incurred over the VAT filing period is higher than that of the output VAT. However, China has been adopting a different approach by only allowing taxpayers to carry forward the excess input VAT balance to the new VAT return period. There has been relaxation on allowing excess input VAT refund for a limited number of industries before, and in 2018 the Chinese tax authorities made another attempt on widening the excess input VAT refund regime by enabling taxpayers in 18 industry sectors to apply for excess input VAT refund when conditions are met (please refer to Caishui [2018] No 70 for further details).

The revision to the excess input VAT refund policy is welcomed by the business community as the refund can relieve VAT cashflow stress, particularly for taxpayers which consistently have higher input VAT than output VAT (e.g., such as a multi-phased real estate project company having sales or rental income from Phase 1 of the project but at the same time intensively making construction cost payments for over six months for a close-to-completed Phase 2 of the project). Taxpayers should review whether they could utilize their input VAT soon enough or they would need to apply the incremental excess input VAT refund policy in order to gain VAT cashflow benefits.

Revision to the VAT return form

In light of the significant changes, the SAT has issued Announcement 15 to refresh the VAT return form. Changes have been made to the main form as well as Appendix 1, 2, 3 and 4. Announcement 15 has also waived the requirement for taxpayers to complete *Appendix 5 to the main VAT return form and the Tax Burden Analysis Form*. Taxpayers should study Announcement 15 and its explanatory note in detail before submitting their first VAT return from 1 May 2019.

Conclusion

The new VAT policy should undoubtedly be welcomed by the business community. However, in order for taxpayers to actually benefit from these changes, they would need to consider undertaking the following actions:

Action item	Action plan
Re-engineer procurement and expense processes and arrangements	<ul style="list-style-type: none"> ▶ Taxpayers should study its current procurement and expense procedures in order to identify any gaps between the requirements set under the new input VAT recovery regime and the current arrangement. ▶ Negotiation on purchase prices and fapiao issuing arrangements could be made in order to create win-win positions for all parties.
Adjust VAT compliance process and system	<ul style="list-style-type: none"> ▶ The VAT changes have triggered changes to the VAT compliance forms. Businesses should study its existing compliance process to ensure clarity regarding what these changes mean to the data to be ultimately entered into the VAT return forms ▶ New procedures should be set up for the new 10% super input VAT credit, refund of incremental excess input VAT and input VAT credit for immovable property. ▶ Special attention should be paid by those taxpayers who have automated its tax compliance. Changes to their automated system would need to be made in a timely fashion to ensure the system's deliverables would reflect the significant VAT changes.
Review contract clauses	<ul style="list-style-type: none"> ▶ As it is expected this round of VAT rate reductions would be followed by further VAT rate simplifications (e.g., from three VAT rates to two VAT rates), adjustments to make to the contractual terms should factor the VAT changes that are going to take place in order to avoid frequent changes. ▶ The apparent factor to consider would be whether the transaction would be VAT inclusive or exclusive and more importantly, how the contractual terms are going to address that issue. ▶ Failing to have clear contractual terms to reflect the commercial arrangements could lead to an adverse financial outcome.

Action item	Action plan
Review client-facing documents (e.g., billing, fapiao and other documents)	<ul style="list-style-type: none"> Design transitional measures on fapiao managements would help avoid commercial disputes – for instance, if VAT invoices have not been issued for sales which have already taken place with VAT paid in February 2019, companies may want to consider issuing the VAT invoices before 1 April 2019 in order to avoid the complexity in handling customers' requests on obtaining their VAT invoices after 1 April 2019 (i.e., it is uncertain for how long the tax authorities would allow VAT invoices to be issued at 16% after 1 April 2019).

These significant VAT changes would come into effect soon; implementing the changes within a short window of time is going to be challenging for businesses given the VAT regulatory and business changes that are going to take place. It is advised that suitable resources be dedicated and actions planned to convert their business operations and prepare for the changes.

EY has been assisting VAT policy makers as well as businesses on VAT reform including VAT policy developments, VAT impact study and analysis as well as VAT management system set up. EY will closely follow up with the latest VAT reform policy and will provide timely updates to help businesses to stay tuned to the VAT changes.

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