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Consequences of Reduction in VAT Rate Bands

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On 19 April 2017, the Chinese government announced that the four VAT rate band system (i.e. 17%, 13%, 11% and 6%) would be streamlined by eliminating the 13% VAT rate and moving goods subject to that rate to the 11% rate, effective 1 July 2017. This multiple rate system has created numerous challenges for taxpayers, particularly in determining which VAT rate applies, so rationalizing the VAT rate brackets and simplifying tax compliance have become a key focus for the government.

The Ministry of Finance and State Administration of Taxation issued Circular 37 on 28 April 2017 to provide further guidance on the new rate structure.

Domestic sales and imports

According to Circular 37, domestic sales and imports of goods that were subject to the 13% rate are subject to the 11% rate beginning on 1 July 2017. The elimination of the 13% VAT rate mainly affects the following categories of products:

- Agricultural products, including grains, edible vegetable oils, feed, chemical fertilizers, pesticides, etc.;
- Public utilities, including tap water, heating, natural gas, coal gas, coal products for household use, etc.; and
- Cultural products, including books, newspapers, magazines, audio-visual products, electronic publications, etc.

VAT on domestic sales and imports are collected by the State Tax Bureaus (STBs) and Customs, respectively. In the past, the two authorities have adopted different VAT rates for the same goods in a few situations (e.g. certain goods may be considered agricultural products by STBs that are subject to the 13% rate, but the same goods are considered general goods by Customs, which are subject to the 17% rate), leading to inconsistent treatment and confusion for taxpayers. The Customs authorities are expected to issue a list of tariff headings of goods that will be affected by the elimination of the 13% rate and that now are subject to the 11% rate.

Input VAT credit on purchase of agricultural products

Article 2 of Circular 37 provides guidance on the availability of an input VAT credit on the purchase of agricultural products under the new rules in three specific cases:

1. Article 2(1) applies where agricultural products are purchased for the following purposes:

- Trading without being processed;
- Further processing into goods to be sold where those goods are subject to the 11% rate; and
- For the provision of VAT-able services.

Under article 2(1), the creditable VAT input is calculated according to the following rules:

- Where agricultural products are purchased from general VAT payers and supported by VAT special invoices, or imported and supported by Customs import VAT payment certificates, the creditable input VAT is determined based on the VAT amount indicated in the invoices or certificates;
- Where agricultural products are purchased from small-scale VAT payers and supported by VAT special invoices, the creditable VAT input is determined as 11% of the VAT-inclusive price indicated in the invoices; and
- Where agricultural products are purchased from VAT-exempt farmers who produce the products and supported by general invoices, the creditable VAT input is determined as 11% of the price indicated in the invoices.

An input VAT credit is not available where agricultural products are purchased from VAT-exempt wholesaler or retailers, even if supported by general invoices.

2. Article 2(2) applies where agricultural products are purchased for further processing into goods to be sold and those goods are subject to the 17% rate. Circular 37 loosely confirms that an input VAT credit will be available "to the same extent (as under the previous rules)." It is commonly believed that the creditable VAT input will be 13% of the purchase price indicated on the relevant invoice ("13% credit"), although the authorities still need to clarify this issue.

Where agricultural products are purchased for purposes prescribed under article 2(1) and 2(2), Circular 37 requires the taxpayer to account separately for the products to calculate the creditable input VAT. If the taxpayer fails to do so, the "13% credit" likely will not be available, although Circular 37 is silent on this issue.

3. Article 2(3) applies where the credit of input VAT is subject to the pilot scheme launched in 2012 in specified business sectors and under which the input VAT credit on the purchase of agricultural products is based on the consumption volume of the products in the current period instead of the purchase volume.

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In this case, the creditable input VAT is calculated according to the following rules:

- **The pilot rules generally still apply since the creditable input VAT is calculated according to the VAT rate applicable to the finished goods rather than that applicable to agricultural products;**
- **Where agricultural products are sold directly without being processed, the creditable input VAT is calculated based on 11% rate, not the 13% rate; and**
- **Where agricultural products are used for business purposes but they do not form a major part of the finished goods (e.g. used as packaging materials, supplementary materials, low-value consumables, etc.), the taxpayer should refer to article 2(1) and 2(2) to make the separate accounting and calculate the creditable input VAT accordingly.**

Export VAT refund

For goods whose VAT rates are reduced from 13% to 11%, the same reduction will apply to their export VAT refund rates as from 1 July 2017. However, Circular 37 grants a two-month transition period for exports of affected goods:

- ***Foreign trade enterprises:* A 13% export VAT refund rate will apply until 31 August 2017 for goods that were subject to the 13% VAT rate when they were purchased by a foreign trade enterprise; and**
- ***Manufacturing enterprises:* A 13% export VAT refund rate will apply until 31 August 2017 for goods that were subject to the 13% VAT rate before 1 July 2017.**

Exports of affected goods after 31 August 2017 will be subject to the 11% export VAT refund rate. Affected exporters should examine their purchase systems to avoid the situation where the goods were purchased when they were still subject to the 13% VAT rate, but were not exported until after 31 August 2017.

Comments

The reduction of the VAT bands and the shifting of goods into the 11% rate band generally should be welcome by affected industries since the VAT burden of the goods will be reduced.

However, under current Chinese VAT regulations, if the creditable input VAT is greater than the output VAT, the excess cannot be refunded in most situations and must be carried forward to offset output VAT in the future. If the input VAT continues to exceed the output VAT, that excess may be irrecoverable. Some businesses have suffered from this issue where the VAT rate of their raw materials (e.g. 17%) is higher than that of the finished goods (e.g. 13%)—this issue could become more prevalent with the VAT rate of finished goods being lowered to 11%.

The impact of Circular 37 can differ for companies that purchase agricultural products:

- **Where agricultural products are purchased for trading or being processed into other agricultural products, there likely will be no or only a minimal impact since the VAT rates for both raw materials and finished goods are reduced from 13% to 11%.**
- **Where agricultural products are purchased for further processing into goods that are subject to the 17% VAT rate, a limited impact is expected since the input VAT credit will be available to the same extent as under the previous rules (although details still need to be released).**
- **Where agricultural products are purchased to be used for the provision of VAT-able services (e.g. catering services), the input VAT will drop and the cost of materials will increase if the (VAT-inclusive) purchase price of agricultural products remains unchanged. In this case, affected taxpayers should renegotiate the purchase price in its agreements with suppliers.**

Overall, affected businesses should closely monitor further developments (e.g. guidance on article 2(2)), evaluate the impact of Circular 37, understand whether imports are subject to the rate adjustment and consider appropriate actions (e.g. business model adjustments, contract renegotiations with clients or suppliers, etc.) to improve operating efficiency.

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