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Guidance Issued on New VAT Rate Reductions and Changes Relating to Small-scale VAT Payers

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On 4 April 2018, China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) issued two sets of guidance (Caishui [2018] No. 32 and 33 (Circular 32 and 33)) on the VAT rate reductions and changes to the annual sales threshold for small-scale VAT payers that are part of a package of VAT measures announced by the State Council on 28 March 2018. Both circulars will apply as from 1 May 2018.

Circular 32

Reduction of VAT rates

Taxable supplies that are currently subject to the 17% and 11% VAT rates will be subject to 16% and 10% VAT rates, respectively. The relevant taxable activities and their applicable rates can be summarized as follows:

Taxable activities	Applicable VAT rate	
	Before	After
Sales and importation of general goods; provision of processing, repair and replacement services; and provision of leasing services of tangible and moveable assets	17%	16%
Sales and importation of specified goods*; provision of transportation, postal, basic telecom services, construction services and leasing services of immoveable property; and sales of land use rights or immovable property	11%	10%
Provision of value-added telecom services, financial services, modern services and lifestyle services; and sales of intangible assets other than land use rights	6%	6%

* Specified goods include agricultural products (including grains), tap water, heat, liquefied petroleum gas, natural gas, edible vegetable oil, air conditioning, hot water, coal gas, coal products for residential use, edible salt, agricultural machinery, feed, pesticide, agricultural film, fertilizer, methane, dimethyl ether, books, newspapers, magazines, audio and visual products, and electronic publications.

Reduction of input VAT calculation rate for agricultural products

The input VAT calculation rate for a general VAT payer that purchases agricultural products in certain situations (e.g. purchasing VAT-exempt agricultural products from the farmer that produced the products) will be reduced from 11% of the purchase price to 10%.

However, if the agricultural products are purchased for further processing into goods to be sold at the 16% VAT rate, the calculation rate will be changed to 12%.

Reduction of export VAT refund rate

The export VAT refund rate for goods that currently are subject to the 17% VAT rate and export VAT refund rate will be reduced to 16%. For goods and other supplies whose current VAT rate and export VAT refund rate are both 11%, the export VAT refund rate will be reduced to 10%.

Transitional rules will apply to exports of affected supplies until 31 July 2018, with the export date being the date shown on the export customs declaration form for exports of goods and the export invoice date for exports of services:

- *Trading enterprises:* The 17%/11% export VAT refund rate will apply if the goods were subject to the 17%/11% VAT when they were purchased by a trading enterprise. The 16%/10% export VAT refund rate will apply if the goods were subject to the 16%/10% VAT when they were purchased by a trading enterprise.

- *Manufacturing enterprises:* The 17%/11% export VAT refund rate will apply.

Circular 33

Consolidation of annual sales threshold for small-scale VAT payers

There currently are three thresholds for different groups of small-scale VAT payers: (i) RMB 500,000 for manufacturing enterprises; (ii) RMB 800,000 for trading enterprises; and (iii) RMB 5 million for taxpayers under the VAT reform program whose business would have been subject to Business Tax rather than VAT before the reform. Once a small-scale VAT payer's annual taxable sales reach the threshold, it must change its VAT payer status and register as a general VAT payer.

As from 1 May 2018, the annual sales threshold will be RMB 5 million for all small-scale VAT payers.

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Conversion to small-scale VAT payer status

A manufacturing or trading enterprise whose sales reached the threshold (i.e. RMB 500,000/800,000) and, therefore, had to register as a general VAT payer may convert to small-scale VAT payer status by 31 December 2018 if the annual sales of the enterprise has not reached the new threshold of RMB 5 million when the enterprise applies for the conversion.

When an eligible taxpayer converts to small-scale VAT payer status, any uncredited input VAT at the time point of conversion no longer will be creditable and will have to be borne by the taxpayer as a cost.

Comments

Reduction of VAT rates

The government has reduced the VAT rates to relieve the tax burden on businesses and promote the development of the economy. Considering the VAT rate increases in other jurisdictions (e.g. by EU member states), the rate reduction in China should enhance the competitiveness of the VAT system overall.

It should be noted that all taxable activities that currently are subject to the 17%/11% VAT rates will be eligible for a lower rate (i.e. 16%/10%) as from 1 May 2018. When the rate reductions initially were reported in the press release of the executive meeting of the State Council on 28 March, only certain sectors (i.e. manufacturing, transportation, construction, basic telecom services and agricultural products) were mentioned as being able to enjoy the new lower rate. The circulars confirm that other sectors (notably, trading companies, leasing services and sales of immovable property) also will benefit from the rate reduction.

The 6% VAT rate that is applied to the service sectors will remain unchanged, and many believe the likelihood of further changes to this rate in the near future is low.

Technically, the new rates will apply to taxable transactions whose VAT liability arises on or after 1 May 2018. The rules to determine the date on which the VAT liability arises could be complex and the date may be different from the date of payment or sales recognition for financial accounting purposes. For example, VAT liability could arise on date goods are delivered if the supplier already received advance payment of the goods, but VAT liability will arise on the date a service provider received advance payment in the case of leasing services. Affected taxpayers should be aware of these rules and apply the VAT rates correctly to account for their VAT liabilities. On the other hand, they also may be able to time transactions to achieve desired tax positions.

Manufacturing enterprises that export self-manufactured goods may benefit from a lower irrecoverable VAT cost due to the VAT rate reduction if the applicable VAT refund rate is lower than the VAT rate (e.g. goods on which a 13% or 15% export VAT refund rate is applied), even though Circular 32 does not change the VAT refund rate.

Consolidation of threshold for small-scale VAT payers

Raising the annual sales threshold for small-scale VAT payers in the manufacturing and trading sectors and allowing certain general VAT payers to convert to small-scale VAT payer status could expand the scope of small-scale VAT payers that can enjoy a simplified taxing method to lower their tax compliance costs. Also, the consolidation of the threshold across different sectors should help the tax authorities enhance the efficiency of tax administration.

From a supply chain perspective, general VAT payers should be aware of the potential impact of a status change of their suppliers. If a supplier converts from general VAT payer to small-scale VAT payer status, the purchaser will not be able to obtain a special VAT invoice with 16%/10% VAT rate from that supplier in the future, and thus could have less creditable input VAT and higher purchase costs, if the VAT-inclusive purchase price remains unchanged.

Refund of excess input VAT

The press release of the State Council's executive meeting stated that a one-time refund for input VAT in excess of output VAT would be introduced for eligible companies (including equipment manufacturing and other advanced manufacturing enterprises, R&D and other modern service enterprises) and electric power grid enterprises within a certain period of time. However, this incentive is not covered in Circulars 32 and 33, so further guidance is expected to be issued.

Recommendations

Since the effective date of both circulars is less than a month away, affected businesses have little time to prepare for the changes. Businesses should begin to assess the impact of the new rules on their operations as soon as possible and, if commercially viable, take appropriate actions.

- If the VAT-inclusive price remains unchanged, a seller may benefit from the reduced VAT rate by deferring the sales until after 1 May 2018. Affected businesses should review their sales business and explore the feasibility of amending sales contracts and the related transaction arrangements. Meanwhile, enterprises also should review the sales prices of products and consider whether the prices should be reduced to balance the need to maintain a competitive price and enjoy the benefits of the VAT rate reduction.

  Conversely, if the VAT-inclusive price remains unchanged, a buyer generally may wish to carry out the transaction before the rate reduction takes effect so it can obtain a higher input VAT. Enterprises that purchase affected goods may wish to consider similar arrangements.

- Exporters whose exported goods will be subject to lower VAT refund rates after 1 May 2018 should try to fully utilize the transitional rules to arrange their exports.

  Exporters that are trading enterprises should try to avoid the situation where goods are purchased when a higher VAT rate applies and exported when a lower export VAT refund rate applies. For example, if goods are purchased before 1 May (i.e. when a 17%/11% VAT rate applies), the enterprise should ensure that goods are exported by 31 July 2018 so that a 17%/11% refund rate will apply. If the enterprise does not expect the goods to be exported by the end of the transitional period, it should consider arranging the purchase to take place after 1 May 2018.

  Affected exporters that are manufacturing enterprise may wish to consider exporting as many products as possible before 31 July 2018 to enjoy a higher export VAT refund rate.

- Affected enterprises should make timely adjustments to their internal systems to ensure the tax rate change is correctly reflected in relevant documents (e.g. sales or purchase orders, invoices) and for financial accounting purposes. For example, affected export enterprises should make sure that as from 1 May 2018, the applicable VAT rates and export VAT refund rates in their financial systems are timely updated (if necessary) so they can accurately compute the export VAT refund.

- Enterprises that qualify for the conversion to small-scale VAT payer status should conduct a thorough cost-benefit analysis against their business plans to decide whether to apply for the conversion. Factors to consider may include whether the conversion would make the enterprise lose customers that prefer suppliers with general VAT payer status, and the extent to which compliance costs could be reduced, etc. If an enterprise decides to convert to small-scale VAT payer status, it also may consider the timing of the conversion and ensure all the input VAT has been recovered before the conversion.

The SAT likely will be issuing more implementation guidance, so enterprises should continue to monitor developments, maintain communications with the tax authorities on unclarified issues or seek professional advice.

Deloitte's indirect tax service team will continue to follow the progress of China′s VAT reform. We have been assisting and supporting relevant authorities on the VAT-related regulations, as well as helping clients to prepare for changes. Please feel free to contact us if you have any questions.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

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