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VAT reduction policy package introduced

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Further to Premier Li Keqiang's announcement in the government work report presentation to reduce value added tax (VAT) rates on 5 March 2019, a press release of the State Council's executive meeting on 20 March provides additional details about the package of VAT policy changes. The changes, which were confirmed in circulars (notably Bulletin 39, the key circular among them) published by the tax authorities on 21 March, apply as from 1 April 2019.

VAT rates reduction

With effect from 1 April, the VAT rates for VAT taxable supplies and import of goods for general VAT payers will be reduced from 16% to 13% and 10% to 9% respectively. The 6% VAT rate will remain unchanged (see table).

Taxable activities	VAT rate	
	Before	After
Sales and imports of general goods; provision of processing, repair and replacement services; and provision of leasing services of tangible and movable assets	16%	13%
Sales and imports of specified goods; provision of transportation, postal, basic telecom services, construction services and leasing services of immovable property and sales of land use rights or immovable property	10%	9%
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%

For a transaction whose original VAT invoice had been issued by a general VAT payer at the 16% or 10% VAT rate before 1 April, if the taxpayer has to issue a "red-letter" VAT invoice (which functions as an amendment to the original invoice to reduce the sales price and VAT amount) after 1 April for that transaction because the relevant goods were returned or an allowance was granted or the original invoice was incorrectly issued, the red-letter VAT invoice must be issued at the original 16% or 10% VAT rate.

If no VAT invoice has been issued for a taxable sale before 1 April and a general VAT payer wishes to issue a VAT invoice after 1 April 2019 for that transaction, the invoice must be issued at the old VAT rate (i.e. 16% or 10%).

Comments

The reduction of the VAT rates aims to further ease the tax burden of businesses and consumers. Considering that the VAT and goods and services tax rates of China's neighboring countries generally are lower than 12%, the rate reduction will reduce the tax rate gap between China and other countries, and help to enhance the competitiveness of Chinese businesses.

It is worth noting that the government has indicated that the three VAT rate bands (i.e., 6%, 9% and 13%) after this round of reductions will be further streamlined to two bands in the future. Potentially affected businesses should continue to monitor developments.

Given the limited time to prepare for the changes, affected businesses should consider acting immediately to:

- Assess the impact of the rate reductions on the business operations and consider whether prices need to be re-negotiated and the timing of transactions adjusted. Where the VAT-inclusive price remains unchanged, a seller may tend to defer the sale until after the rate reduction to apply the reduced VAT rate; on the contrary, a buyer generally would prefer to carry out a transaction before the rate reduction in order to obtain more input VAT. Businesses may need to consider how to balance the need to maintain pricing competitiveness and enjoy the benefits of the VAT rate reductions.

- Adapt internal systems and arrange the transition for invoice management and VAT filing/calculation to ensure that the relevant documents (including orders, invoices and accounting book) can support the rate changes, and contact the competent tax authorities and suppliers of invoicing machines to resolve any practical issues arising from the rate reductions.

Increasing input VAT credit

1. Passenger transportation services

Under current rules, input VAT associated with the purchase of passenger transportation services is not creditable. This restriction will be removed on 1 April.

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Bulletin 39 provides that the following documents may be used to support an input VAT credit arising from the purchase of passenger transportation services:

- **VAT special invoices or VAT electronic general invoices issued by transportation service providers, where the creditable input VAT is indicated on the invoice;**

- **Qualifying tickets (i.e. itinerary/e-ticket receipt for air transportation, railways/highways/waterway tickets) indicating the passengers' identity on the ticket, where the creditable input VAT would be calculated based on the ticket price and the relevant VAT rates (or VAT collection rates).**

2. Immovable property

For immovable property acquired after 1 May 2016 and treated as fixed assets in financial books or construction work in progress acquired after 1 May 2016, the associated input VAT currently may be credited against the output VAT over a period of two years, i.e. 60% of the input VAT is creditable in the first year and the remaining 40% is creditable in the second year.

The two-instalment credit method will be abolished so that all input VAT can be credited at once after 1 April. Any input VAT that is not yet creditable due to the application of the two-instalment credit method will become creditable on 1 April.

3. "Super credit" of VAT

A qualifying general VAT payer will be granted a "super credit" of VAT for the period 1 April 2019 through 31 December 2021. The super credit, which will be computed as 10% of creditable input VAT, may be used to offset VAT payables. In other words, an additional 10% credit will be granted in addition to the creditable input VAT.

Applicants - The super credit policy applies to general VAT payers that mainly are engaged in providing postal services, telecommunication services, modern services and lifestyle services. An applicant must file a declaration to confirm that its sales from the above service activities accounts more than 50% of total sales (i.e. the "50% sales test") before the applicant can enjoy the credit for the first time in a year.

When applying the 50% sales test to determine whether a taxpayer is eligible for the super-credit, (i) the sales percentage for the period April 2018 through March 2019 will be used if the taxpayer was established on or before 31 March; and (ii) the sales percentage for the first three months will be used if the taxpayer is established on or after 1 April.

A taxpayer that meets the test in i) can enjoy the credit as from 1 April 2019.

A taxpayer that meets the test in ii) can enjoy the credit from the date the taxpayer is registered as a general VAT payer.

After the taxpayer meets the 50% sales test and files the declaration, the taxpayer will be allowed to enjoy the credit until the end of that year. The sales percentage for that year will be used to determine whether the taxpayer continues to be eligible for the super credit for the next year.

Computation - The accrual of the super credit is computed as follows:

Super credit to be accrued for the current period = Creditable input VAT of the current period x 10%

- **If the VAT payable is zero for the current period, the super credit accrued for the current period may be carried forward to the next period. However, any unutilized super credit cannot be used to offset against VAT payables after the expiration of the policy (i.e. 31 December 2021).**

- **Where input VAT may not be credited against output VAT, the super credit will not be available.**

  Where the input VAT has been credited against output VAT but subsequently becomes uncreditable, the accrual of the super credit must be reversed.

- No corresponding accrual of the super credit is allowed for input VAT arising from purchase of goods and services for export business purposes.

  If a taxpayer is engaged in both export and domestic sales, the taxpayer must separately account for the input VAT for which an accrual of the super credit is not allowed. If no separate accounting is provided, the taxpayer may have to apportion the total input VAT according to the ratio of exports to total sales.

Comments

In addition to the VAT rate reductions, an adjustment to input VAT credit policies is another important tax tool for the government. The measures to increase input VAT credit aim to ensure that the VAT burden on all business sectors is reduced, especially the service sector in which most taxpayers' VAT rates would remain unchanged after 1 April.

A group with multiple manufacturing subsidiaries but each also has a relatively small portion of service business may wish to consider restructuring to centralize the service business to a member entity to have it qualify for the super credit.

Companies that wish to enjoy the 10% super credits should update their accounting systems and compliance procedures in relation to the input VAT management to avoid over-/under-accrual of super credits.

Affected businesses also should consider whether to adjust their business arrangements to ensure the super credits are fully utilized before 31 December 2021.

Refund of input VAT

A new pilot program will be launched on 1 April to allow qualifying general VAT payers to claim a partial refund of unutilized input VAT (i.e. the portion of creditable input VAT in excess of output VAT). Under the current rules, the unutilized input VAT normally cannot be refunded, and only may be carried forward to offset against future output VAT.

Qualifying taxpayers - To be eligible for the input VAT refund, a taxpayer must meet all of the following requirements:

- Starting from the VAT assessment period of April 2019, the newly increased unutilized input VAT has been greater than zero for six consecutive months (or two consecutive quarters if the taxpayer's VAT is assessed on a quarterly basis), and the amount of newly increased unutilized input VAT at the end of the sixth month (or the second quarter) is RMB 500,000 or more;

  The "newly increased unutilized input VAT" is computed by comparing the unutilized input VAT at the end of an assessment period against that on 31 March 2019;

- The taxpayer has a tax compliance rating of A or B;

- There are no records of tax fraud or noncompliance in relation to the issuance of VAT special invoices, export VAT refunds, etc. for the taxpayer for the 36-month period before the input VAT refund application;

- The taxpayer has not been subject to two or more penalties by the tax authorities due to tax evasion within the 36-month before the input VAT refund application;

- The taxpayer has not enjoyed certain industry-specific VAT preferential (refund) policies (e.g. refund of VAT for qualifying software products if the VAT burden is greater than 3%) since 1 April 2019.

Computation of refund - Refundable amount of newly increased unutilized input VAT for the current period = Newly increased unutilized input VAT x input VAT component ratio x 60%

The "input VAT component ratio" refers to the percentage of creditable input VAT supported by VAT special invoices (including unified invoice for sales of motor vehicles), customs import VAT certificates and withholding tax clearance certificates, to the total creditable input VAT, for the period 1 April 2019 through the tax assessment period preceding the refund application.

Others - Exporters that are entitled to an export VAT refund under the "Exempt, Credit and Refund" method (notably where a manufacturer exports its products) also may enjoy the refund of unutilized input VAT under the pilot program if they meet the relevant requirements.

However, exporters that are entitled to an export VAT refund under the "Exempt and Refund" method (notably where a trading company exports the goods it purchased from domestic suppliers) are not allowed to claim a refund of unutilized input VAT under the pilot program.

Comments

Unlike some countries that allow a refund of unutilized input VAT, the current Chinese VAT rules generally do not allow such a refund; instead, the unutilized input VAT may be carried forward to offset future output VAT. This system has the potential to create cash flow issues for enterprises, especially those with large initial capital investments and long construction cycles. In recent years, the Chinese government has expedited the studies and pilots regarding the refund of unutilized input VAT in specific industries; for example, a one-time refund of unutilized input VAT was granted for various industries throughout the country in 2018. The new pilot program is expanded to cover all industries.

Businesses that intend to apply for an input VAT refund should consider taking the following actions:

- Conduct a self-assessment on an entity basis to examine whether the calculation of input VAT is correct and whether the taxpayer is eligible for the refund, and evaluate the potential costs and benefits of applying for the refund;

- Improve internal control systems to ensure the correct computation of input VAT and that all compliance obligations are fulfilled, so that the taxpayer would not be disqualified for the refund due to noncompliance records; and

- Communicate with the tax authorities to understand the application procedure and apply for the refunds in a timely manner.

Miscellaneous

Export VAT refund rates - The export VAT refund rates will be as follows as from 1 April:

- 13% for goods and services that currently are subject to a 16% VAT rate and a 16% export VAT refund rate; and
- 9% for goods and services that currently are subject to a 10% VAT rate and a 10% export VAT refund rate.

Similar to the previous rounds of adjustments to the export VAT refund rates, a three-month transition period is granted. For exports before 30 June 2019:

- Where the exporter is entitled to an export VAT refund under the "Exempt and Refund" method (notably trading companies), the 16%/10% export VAT refund rate will apply if the goods or services were subject to a 16%/10% VAT rate when they were purchased by the exporter; the 13%/9% export VAT refund rate will apply if the goods or services were subject to a 13%/9% VAT rate when they were purchased by the exporter.

- Where the exporter is entitled to an export VAT refund under the "Exempt, Credit and Refund" method (notably manufacturing companies), the 16%/10% export VAT refund rate will apply.

Comments

Exporters that are trading enterprises should try to avoid a situation where goods were purchased with a higher VAT rate but then exported with a lower export VAT refund rate. Thus, if the goods were purchased when a 16%/10% VAT rate applied, the enterprise should try to export the goods by the end of the transition period. If the trading enterprise does not expect the goods to be exported by the end of the transition period, it should consider arranging the purchase to take place after 1 April 2019. Exporters that are manufacturing enterprises may wish to export as many products as possible before the end of transition period to enjoy a higher export VAT refund rate.

Input VAT calculation rate for agricultural products - As from 1 April, the input VAT calculation rate for a general VAT payer that purchases agricultural products will generally be reduced from 10% to 9%. However, if the taxpayer purchases agricultural products for further producing into products subject to a 13% VAT rate, the input VAT calculation rate should be 10%.

VAT refund rates for goods purchased by overseas tourists ("purchased goods") - As from 1 April, the VAT refund rate for purchased goods will be 11% if the goods are subject to a 13% VAT rate; the refund rate will be 8% if the goods are subject to a 9% VAT rate. A three-month transition period is granted until 30 June 2019 during which the old VAT refund rate is used if the goods were subject to a 16%/10% VAT rate when they were purchased.

Conclusion

As mentioned by Premier Li Keqiang in his presentation of the government work report, the package of VAT policies aims to reduce the VAT burden of enterprises and consumers. Affected businesses should take immediate action to prepare for the implementation by improving internal control systems and VAT management, assess the business impacts and consider possible adjustments to business arrangements.

We anticipate that the government will continue to issue more guidance about the new VAT policies in the near future. Enterprises should continue to monitor regulatory and practice developments and seek professional assistance where necessary.

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