China Tax Alert

Issue 13, May 2017

China VAT, CIT and IIT reductions to drive growth and innovation

Regulations discussed in this issue:

- Notice on simplifying value-added tax (VAT) rates (Cai Shui [2017] No. 37), issued by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) on 28 April 2017

Background

In the first quarter of 2017, China introduced a range of tax reduction measures to facilitate the development of the Chinese economy. Further planned tax reduction measures were set out in the *Report on the Work of the Government* by Premier Li at an executive meeting of the State Council held on 19 April 2017. These include:

I. Improve on the 2016 VAT reform policies and simplify the VAT rate structure. The VAT brackets will be reduced from four to three from 1 July 2017 onwards. The new VAT rates will be 17%, 11% and 6%. Agricultural products and natural gas, which used to be subject to the 13% rate, will be subject to the 11% rate going forward, and the 13% rate will be abolished. As the VAT rate for agricultural products will be reduced to 11% after 1 July 2017, this would have been expected to result in an increased tax burden for enterprises engaged in processing of agriculture products. In light of this, and in line with the government's focus on lowering tax burdens through the VAT reform, Premier Li indicated that input VAT entitlements in such cases would not change under the new rules. (This was confirmed in the subsequent Cai Shui [2017] No. 37 and is discussed further below).

II. From 1 January 2017 to 31 December 2019, eligible small enterprises whose taxable income falls under RMB500,000, may pay Corporate Income Tax (CIT) on 50% of their whole income at a rate of 20% (i.e., effective rate is 10%). The threshold was previously RMB300,000.

III. From 1 January 2017 to 31 December 2019, "science and technology-related Small and Medium Enterprises (SMEs)", whose research and development (R&D) expenses are incurred for the development of new technologies, new products and new processes, can benefit from an improved CIT bonus deduction. The bonus deduction will now be 75%; previously the bonus deduction for such enterprises was 50%, at which level it remains for larger enterprises.

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IV. Under the existing rules, where venture capital (VC) enterprises, taking either corporate or partnership form, invest in non-listed small and medium high and new technology enterprises (HNTE) by way of equity investment then the 70% tax deduction incentive may be obtained (solely for CIT, not for IIT, purposes). Investments made in science and technology enterprises at seed capital or start-up stage are now to be in scope of the incentive from 1 January 2017. The new tax incentive treatment will initially be piloted in eight designated locations, including Beijing-Tianjin-Hebei, Shanghai, Guangdong, Anhui, Sichuan, Wuhan, Xian, Shenyang, as well as Suzhou Industrial Park. Furthermore, individual investors who make such investments may now also enjoy the incentive, for IIT purposes, from 1 July 2017. The new tax incentive treatment also applies to investments made within two years prior to the new policy is in force.

V. Premiums paid to eligible commercial health insurance providers are allowed to be deducted up to RMB2,400 per person per year for IIT purposes. This has been piloted in certain regions, such as Beijing, Shanghai, Tianjin, Chongqing since 1 January 2016. Following this trial period the tax incentive is now to be applied nationwide starting from 1 July 2017, with the upper limit for tax deductions unchanged.

VI. A three-year extension will be applied to a package of current tax incentive policies that were due to expire by the end of 2016. These include, inter alia:

(i). 50% reduction of urban and township land use tax (UTLUT) levied on land used for construction of bulk commodity warehousing facilities owned by logistics enterprises;

(ii). A VAT exemption for interest income arising from small loans made to small farmer households by financial institutions. All finance companies (including smaller lenders) engaged in providing small loans to farmers are now in scope of this incentive, provided that their activities are in compliance with laws and regulations;

(iii). Reduction of VAT, urban maintenance & construction tax (UMCT), education surtax and IIT/CIT for new businesses or new employments (as relevant) set up or entered into by college graduates, the long term unemployed, or ex-servicemen (key groups). Specific procedures and qualifying criteria apply.

Following Premier Li's speech, the MOF and SAT jointly issued several implementing circulars to provide detailed clarifications on the measures. This China Tax Alert focuses on the measures on VAT rate simplification. KPMG China have also issued specific China Tax Alerts on the improved R&D expense "bonus deduction" (see China Tax Alert, Issue 14), the enhanced tax incentive treatment for VC enterprises (see China Tax Alert, Issue 15) and IIT preferential treatment for health insurance products (see China Tax Alert, Issue 17), at III, IV and V above.

Notice on simplifying VAT rates (Cai Shui [2017] No. 37, "Circular 37")

Circular 37 clarifies that the number of VAT brackets will be reduced from four to three from 1 July 2017 onwards and that the 13% rate will be abolished. It also clarifies the following:

- The 11% (previously 13%) VAT rate will be imposed on the sale or import of goods such as agricultural products, books, audio and video products, electronic publications.

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- For purchases of agricultural products a series of detailed rules apply for determining what input VAT credit may be claimed by taxpayers:
    - The first rule applies where the taxpayer obtains special VAT invoices issued by general VAT taxpayers or import VAT payment certificates issued by the customs authorities (customs payment notices). In such cases the input VAT amount will be the VAT amount stated on the special VAT invoice/customs payment notices. This rule is relevant to, inter alia, purchases from domestic wholesalers and from overseas suppliers;
    - The second rule applies where taxpayers obtain special VAT invoices issued by small-scale VAT taxpayers, who are subject to the simplified VAT rate of 3%. In such cases the input VAT amount shall be calculated by multiplying the invoice purchase price by 11%. This rule is relevant to, inter alia, purchases from small domestic wholesalers;
    - The third rule applies where taxpayers obtain sales invoices for agricultural products, or issue purchase invoices for agricultural products, in cases where the vendor of the products is not a VAT taxpayer. The input VAT amount shall be calculated by multiplying the price stated on the sales invoices or the purchase invoices by 11%. This rule is relevant to, inter alia, purchases from individual farmers or farmer's cooperatives.
- Taxpayers that purchase agricultural products, process them, and then sell them on as products subject to VAT at 17%, may claim an input VAT credit as before under special preferential arrangements. This rule is to apply during the VAT reform pilot period, which is still ongoing.

In addition, Circular 37 also adjusts export tax refund rates, subject to a transitional period. The export tax refund rate will still be 13%, where: (i). enterprises engaging in foreign trade business export goods set out in Appendix of Circular 37 before 31 August 2017, where these goods were subject to VAT at 13% at the time of purchase; or (ii). manufacturers export goods set out in Appendix of Circular 37.

KPMG observations

The VAT rate simplification should generally lower taxpayer tax burdens, reduce compliance costs and limit tax disputes. The special transitional policy set out for the processing enterprises (i.e. those purchasing agricultural products, processing them, and selling them on as products subject to VAT at 17%), which allows for continued preferential claims of input credit, should ensure the farming sector is not impacted.

It should be noted though that certain complexities enter the rules due to the challenges of reconciling the new Circular 37 rules with the deeming provisions for processing enterprises in the Provisional Regulations on VAT.[1]

[1] Revised in February 2016, see http://www.gov.cn/gongbao/content/2016/content_5139450.htm.

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- The existing rule (Article 8 of the Provisional Regulations on VAT) provides that processing enterprises that purchase agricultural products, process them, and then sell them on as products subject to VAT at 17%, may claim an input VAT credit calculated as the purchase value of the agricultural products multiplied by 13%. This is regardless of which of the three invoicing situations (outlined in the prior section above) is in point (i.e. whether the purchase is from a general VAT taxpayer, small VAT taxpayer, or non-VAT taxpaying farmer). Where the principal involved in arranging the processing and selling of the goods gets an enterprise acting on commission to process the goods, and the latter purchases the agricultural product inputs, then the latter can claim the deemed input VAT credit.
- Article 2 (5) of Circular 37 preserves this treatment so long as the processing and sale of goods subject to VAT at 17% can be tracked separately from other activities of the enterprise. Where it is not possible to separate the income streams then this special treatment is lost, and the three main rules outlined above are in point (i.e. input VAT credit in the amount of the VAT stated on the invoice, or deemed credit at 11%).

As such, so long as the processing activity can be tracked separately from other activities of the taxpayer, and regardless of which of the three invoicing situations is in point, a deemed input VAT credit at 13% may be claimed.

The simplification of the VAT rate structure makes the Chinese VAT system more economically neutral. Many countries with a VAT (or equivalent GST) use a single or two-bracket VAT rate structure for all goods and services. In the longer term China's VAT rate structure might be anticipated to be further simplified.

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