

China Tax Alert

Issue 9, March 2018

State Council announces reduction to VAT rates and other significant VAT changes

Regulations discussed in this issue:

- Announcement by China's State Council on 28 March 2018

Background

China's State Council announced on 28 March 2018 that the 17% and 11% VAT rates applicable to the supply of certain goods and services would be reduced with effect from 1 May 2018 to 16% and 10% respectively. This change will certainly bring welcome relief to businesses and goes a step further in ensuring the international competitiveness of China's VAT system. While this change may not seem significant from a tax implementation perspective, as this Alert highlights, there are many issues for businesses to consider.

In addition to the rates change announcement, the State Council also announced changes to VAT registration thresholds which seek to align those used for goods with those used for services. New incentives were also announced for businesses engaged in advance manufacturing and research and development (R&D) activities.

These announcements will affect businesses in virtually all sectors in China.

VAT rate changes

Following the State Council meeting held on 28 March 2018, an announcement was issued that the VAT rates would be adjusted as follows with effect from 1 May 2018. Although the announcement did not clearly mention that all the sectors subject to 17% and 11% rates will be entitled to the newly reduced rates, i.e. 16% and 10% respectively, it is reasonable to anticipate the rate changes will be applicable to the following sectors while detailed implementation rules expected to be issued by the Ministry of Finance and the State Administration of Taxation shortly.

Applies to:	Current rate	New rate from 1 May 2018
Sales of goods, importation of goods, leasing of tangible movable property; Repair and processing services	17%	16%

Transportation services, sales and leases of immovable property, basic telecommunications services, construction services, postal services, agricultural products and water and gas supplies	11%	10%
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The State Council announcement did not indicate there would be any change to the 6% VAT rate.

Further, for the avoidance of any doubt, the State Council announcement did not specifically reference any changes to the 16% rate for the leasing of tangible movable property, nor did it specifically reference any change to the 10% rate for sale or leasing of immovable property. However, it would seem likely that these services would be similarly affected so as to avoid a multiplicity of rates in effect.

Changes to VAT registration thresholds

When the VAT pilot program first commenced back in 2012 for the services sectors, the threshold for compulsory registration as a general VAT taxpayer was RMB5 million of annual turnover. By contrast, the threshold for compulsory registration as a general VAT taxpayer for industrial companies was RMB500,000 per annum and for trading companies it was RMB800,000 per annum. The State Council's announcement seeks to ensure uniformity by applying a RMB5 million threshold of annual turnover for all taxpayers.

Any business below this threshold will be able to register as a small scale VAT taxpayer (and pay 3% VAT on their outputs, without entitlement to claim input VAT credits), unless they choose (and are approved) to register as general VAT taxpayer ("GTP").

This change will likely result in some small taxpayers in sectors such as manufacturing, wholesaling, distribution, importation with annual turnover in the range of RMB 500,000 to RMB 5 million potentially ceasing to register as general VAT taxpayers. This will have a flow on impact for businesses who receive goods from them now potentially being unable to obtain special VAT invoices at standard VAT rate from them for crediting purposes.

Refunds of excess input VAT credits

The State Council further announced that businesses engaged in advanced manufacturing, qualified modern service companies such as those carrying out R&D services, and companies operating electrical grids will be entitled to a one-off refund of excess input VAT credits accumulated over a specific period of time. Further details of these arrangements will likely follow to clarify the potential impact.

The entitlement to a VAT refund has been available for certain industries already such as integrated circuits, large aerobus, naphtha, fuel oil as part of a pilot in certain provinces such as Shandong. This now appears to be extended nationally, though for specific sectors only.

The entitlement to claim refunds of excess input VAT credits has long been a source of challenge for businesses, particularly those in early stage of development or investment, and so this represents a step in the right direction.

General VAT taxpayers converting into small scale taxpayers

The State Council announced that GTPs can choose to convert back to being small scale taxpayers within a certain period of time. However, it is not clear whether a GTP will be entitled to a VAT refund if it has excess input VAT credits at the time of conversion, or whether such a balance can be carried forward to offset its future VAT payable. This will be awaited with interest.

KPMG comments

While businesses and consumers will no doubt be pleased with the reduction to VAT rates, especially the reduction in the main 17% VAT rate to 16%, it is important to recognize that this is likely a first step in a longer-term process by which the government will reduce the number of VAT rates in operation from three rates (currently 6%, 11% and 17%) to two rates. While the 6% VAT rate was unchanged as a result of this announcement, it is premature to conclude that the two rates will end up being 10% and 16%. However, it may be reasonable to conclude this is a transitory step in the process of reducing the number of different VAT rates in operation.

It is important to recognize that a reduction in these two VAT rates of 17% and 11% to 16% and 10% respectively can still give rise to significant implications for businesses. Specifically, businesses need to consider the following issues, many of which will likely require further clarification pending the implementation rules in the coming months and also from the tax officials, or which will potentially cause some confusion and complexity:

Issue	Impact
Time of supply	<p>It is presently unclear whether the reduction in VAT rates takes effect from 1 May 2018 by reference to:</p> <ul style="list-style-type: none">(a) When the supply was made;(b) When the supplier was required to account for the output VAT; or(c) When the special VAT invoice was issued. <p>This will need to be clarified. When similar changes have taken place in China, the general principle has been to apply the approach in paragraph (b).</p>
Advance payments	<p>Issues will arise as to whether advance payments received before 1 May 2018 for the purchase of goods or services which take place on or after 1 May 2018 are subject to the new VAT rates or the current VAT rates. The airline industry is a primary example where customers may pre-book tickets before 1 May 2018 for flights on or after 1 May 2018.</p>
Deemed sales	<p>Where a supplier buys goods pre-1 May 2018 (and claims an input VAT credit at 17%), an issue arises as to the applicable VAT rate under the deemed sales rules if those goods are given away on or after 1 May 2018.</p>

Goods returns	Goods sold before 1 May 2018 but returned on or after 1 May 2018 will need to be issued with a red letter invoice to cancel the supplier's output VAT and recipient's input VAT at 17%, not 16%. But when goods are returned and replaced, issues will arise in practice as to whether or not that is a new supply subject to 16% VAT taking place on or after 1 May 2018, or even 3% without special VAT invoice in case the supplier has ceased to register as a general VAT taxpayer. Similarly, suppliers may anticipate some impact on demand as customers hold off purchasing major items until 1 May 2018 to benefit from the lower VAT rates.
Contracting	Contracts which provide for VAT to be added to the price can readily adjusted to reflect the new VAT rates simply by adding say VAT at 16% instead of 17% to sales of goods. However, contracts in which the price is inclusive of VAT may give rise to commercial uncertainties as to whether the 1% reduction in rates needs to be passed on to the service recipient or not. This will often be a matter for negotiation between the parties. Given the potential for VAT rates to change again in the future, especially as a result of a move to a two rate structure, it does highlight how VAT-inclusive pricing can be problematic.
Pricing	Businesses with advertised or displayed pricing will likely need to consider changing their displays with effect from 1 May 2018 so as to pass on the tax savings to customers – otherwise it may detrimentally impact on their market competitiveness.
Annual price lists	It is common in certain industries for suppliers to agree or advertise prices on an annual basis at the commencement of each year, say by way of a standard rate card. Where this occurs, questions will arise as to whether those annual price lists should be revisited in light of the reduction in VAT rates.
Trading stock	Businesses may be in the position of having purchased trading stock on hand at 17% VAT, but then sell that stock on or after 1 May 2018 with a 16% VAT rate.
Rebates and discounts	It is common that volume rebates and discounts are applied to the price of the next sale transaction or invoice amount, rather than the current sale (which would then necessitate the issuance of a 'red letter' invoice). If a rebate or discount is earned before 1 May 2018 but then applied to a sale on or after 1 May 2018, the value of the 'credit' is effectively reduced.

Rounded pricing	It is common in certain industries for the prices of various products to be rounded to particular amounts, such as RMB1, or for pricing to be targeted at specific amounts such as RMB888. In these instances, a reduction in the VAT rate may not necessarily result in a price reduction and therefore increases the seller's margin. This will be a commercial decision to be made on a case-by-case basis.
Purchase of immovable property	Circular Caishui [2016] 36 provides that purchases of immovable property and construction costs for immovable properties are potentially eligible for a staged 60% input VAT credit in year 1 and a 40% input VAT credit in year 2. When 1 May 2018 straddles this 2 year period, there is an issue as to whether the input VAT credit is calculated for year 2 at the 10% rate or at the original 11% rate. The latter would seem more appropriate.
Change in use of capital assets	Circular Caishui [2016] 36 also provides for adjustments to input VAT credits based on the change in use of capital assets – for example, where the use changes from a creditable to a non-creditable purpose (or vice versa). The question is whether those changes should be calculated at the new VAT rates or the originally applied VAT rates. Again, the latter would seem more appropriate.
Refund rates for exports of goods	While exports of goods are zero rated, there are different VAT refund rates applicable to the inputs, depending upon the HS code of the goods being exported. The current VAT refund rates are 0%, 5%, 6%, 9%, 11%, 13%, 15% and 17%. These refund rates will presumably need to be adjusted in light of the State Council's announcement.
Systems changes	Businesses will need to ensure they have additional tax codes in their systems to recognize both output tax and input tax at 16% and 10%.

Further assistance

For assistance with these issues, please contact a member of our VAT team or your usual KPMG adviser.



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