

Managing China VAT issues effectively in turbulent times

February 2020



Background and purpose

The coronavirus outbreak is expected to cause disruption to many businesses operating in China; to present challenges in businesses' managing their tax obligations on a timely basis; their cashflow commitments; and in dealing with suppliers and customers.

VAT liabilities have a significant impact on cashflow, primarily because VAT often needs to be accounted for on sales before the underlying revenue from those sales is received; and from a purchase perspective there is often a lead time between the payment of expenses and obtaining the benefit of input VAT credits. These timing differences can be exacerbated further in China where businesses have a VAT credit balance which is not refundable.

It is also the case that in China the obligation to account for VAT on sales may itself not be recovered from the purchaser in full, even though economically VAT is not intended to be a tax on business itself. This is a function of many factors, including the use of differential VAT rates; businesses unable to claim VAT credits on their costs through the use of simplified VAT methods; situations where VAT credit balances are not refundable; and the inability to claim input VAT credits (in full) for activities subject to exemption and even zero rated sales of certain goods.

All of these factors mean that the efficient management of VAT cashflow obligations, and optimising VAT liabilities, will be under the spotlight during this period. Furthermore, it is anticipated that the government will issue further measures to mitigate the VAT impact on businesses, especially those in key affected sectors. This material is current as of 7 February 2020.

This material has been put together with the objective of supporting businesses in 3 key areas set out below.



1 What are the specific VAT issues we see as commonly arising for business in the current environment

2 What are the policy responses we may see from the government to assist business

3 What are some of the ways in which businesses can legitimately apply to effectively optimise their VAT liabilities and cashflow



Specific VAT issues

Specific issues for businesses arising from the current situation

Order cancellations & changes

- Due to the coronavirus outbreak, many businesses in the tourism, hospitality, transportation and extracurricular education sectors have been particularly affected by cancellations from customers. In some cases, those cancellations may have occurred after an invoice may have been issued or when the contract required payment, resulting in output VAT having been accounted for which is not matched by later sales revenues. This necessitates the need to issue 'red letter' VAT invoices;
- Similarly, many contract terms may need to be adjusted in light of supply chain delays, and to avoid accruing further output VAT obligations (which is not matched by sales revenues), those contracts should be amended so as to ensure the obligation to pay is documented as being delayed.
- In certain cases, contracts may be terminated or fall into default, triggering obligations to pay penalties, additional fees, interest or forfeiture of deposits. In each case, careful consideration needs to be paid to whether an obligation to account for output VAT applies to those receipts.



Charity and Donations

- Many businesses have generously made donations to support the fight against Novel Coronavirus, including monetary amounts, as well as the provision of 'free' goods and services.
- The provision of monetary donations should not generally trigger VAT implications for the donor. The provision of free services for welfare purposes should not generally trigger VAT implications either. In addition, STA Announcement (2020) No.9 further provides that the donation of goods related to coronavirus containment is exempted during the epidemic period. However, the input VAT in relation to the VAT exempt items may be denied (transferred out) .
- Businesses should carefully consider how to structure such donations, especially for goods. Even in light of the new policy, the donation of goods unrelated to coronavirus containment may trigger a deemed sale, though ultimately the question of how widely the relationship with coronavirus containment must be will depend on the facts and local interpretations.

Specific issues for businesses arising from the current situation

Employee Safety and Welfare related costs

- Many businesses have justifiably focused on supporting staff welfare during the coronavirus outbreak, including providing face masks, hand sanitizer and protective supplies as well as online training and relevant support for remote work.
- Based on the China VAT regulations, input VAT related to purchases for staff welfare purposes are not creditable. However, differentiating this from safety equipment necessary for an employee to carry out their work (which should be creditable) may not always be clear.



Abnormal Losses

- Many businesses may incur losses during the outbreak of the coronavirus. For example, the revenue of many restaurants may decrease since people are less willing to venture out. However, stock may need to be scrapped, leading to a loss.
- China's VAT regulations provide that input VAT claims in relation to the procurement of goods, and related labour and transportation services due to abnormal losses are not allowed to be credited.
- The distinction between 'normal' and 'abnormal' losses can often be a fine distinction indeed. It would be recommended to closely negotiate these matters with tax authorities, and to ensure records are kept which may validate any such distinction.
- A critical question which the tax authorities should address on a national basis is the extent to which losses incurred during this period which are directly attributable to the coronavirus outbreak should be regarded as 'abnormal', and whether a policy response is needed.

Specific issues for businesses arising from the current situation

Rent reductions, waivers & renegotiations

- Some local governments have appealed to landlords to consider reducing or even waiving rent for businesses and individuals.
- Landlords should ensure the form of any adjustment is carefully managed, so as to avoid a situation where there is a bad debt upon which the landlord will be unable to recover output VAT that may have already been accounted for.
- Where a reduction or waiver of rent is given in respect of a period for which the landlord has already accounted for output VAT, then 'red letter' invoicing may be needed to ensure a compensating adjustment is made.
- Likewise, where there is a rent renegotiation between a landlord and a tenant which applies on a prospective basis, then this should be clearly documented so as to ensure that VAT liabilities do not continue to accrue under the previously agreed basis. China's VAT regulations also do not apply a deemed sales rule to rent-free periods given by landlords.

Bad Debts

- In an economic downturn, many businesses encounter cash flow issues and potential bad debts. Given that many businesses which are registered as general VAT taxpayers effectively account for VAT on an accruals basis, there is ordinarily an obligation to account for output VAT at the earlier of when the obligation to pay arises under the contract, or the issuance of an invoice.
- China's VAT system does not provide for bad debt relief generally - the exception to this is lending activities where it is possible to cease accruing output VAT on interest after 90 days.
- Businesses in this situation may be better off considering ways in which to renegotiate, or provide renewed supply or payment terms with their customers, which may in turn allow for an adjustment rather than the recognition of a bad debt which precludes the write-off of accrued VAT.



Specific issues for businesses arising from the current situation

VAT cashflow management generally

- The cashflow of businesses will be a significant challenge during the period business is affected by the coronavirus outbreak, and even after it dissipates.
- Finance and tax managers for those businesses need to carefully consider the cashflow impact of VAT on creditors and debtors. Generally, businesses should seek to minimize the timeframe between invoice issuance and collection of cash so as to manage the associated output VAT within a reasonable period of time.
- From a cash debtor perspective, If the inflow of cash cannot be guaranteed, the outflow of cash should be managed properly to avoid potential cashflow issues. For example, companies are recommended to obtain special VAT invoices in advance of payment settlement. In this case, companies can claim input VAT credits and receive the VAT cash inflow before settling their vendor payments.

Deferral in Tax Filing and Payments

- Due to the coronavirus outbreak and continuation of the Chinese New Year holiday, Tax and Customs authorities have announced the deferral of tax and customs duty filing and collection obligations in February 2020.
- Businesses should keep track of the announcements from their in-charge tax authority. In the meantime, they could consider possible alternatives when faced with cashflow issues:
 - Applying for deferral in tax filing and payment with tax authorities.
 - Applying for VAT refunds at their earliest opportunity to ensure cash inflow from tax authorities.





Incentive policy responses to assist business

VAT incentive policies

Various national VAT incentive policies have already been released (as of 7 February 2020) to help combat the impact of the coronavirus. At present, many of those policies have been focused on alleviating the direct impact in terms of facilitating the fight against the virus itself from a health perspective. Experience suggests that further tax policies may be issued by the government in the near future to seek to stimulate economic demand. We have also included reference to policy incentives issued during the SARS period back in 2003-2004 as a guide to what may occur here.

Current Incentives	Incentives during SARS	Observations
<p>MOF and STA Announcement (2020) No.8</p> <ul style="list-style-type: none"> Companies producing key supplies related to novel coronavirus containment are eligible to get a full refund of the incremental VAT credit balance amount from 1 Jan 2020. Transportation services in connection with key protective supplies will be exempted from VAT. Public transportation, life science services, postal and express services for essential necessities of residents would be exempted from VAT. <p>MOF and STA Announcement (2020) No.9</p> <ul style="list-style-type: none"> Organizations and individuals who donate goods through charity organizations and government authorities or directly to the hospitals related to the coronavirus containment could be exempted from VAT, consumption tax and surcharges. 	<p>Caishui (2003) No. 113 Air transportation services for passengers and tourism industry is exempted from Business Tax ("BT") and surcharges from 1 May 2003 to 30 Sep 2003. Local government at provincial level could decide whether BT and surcharges should be reduced, exempted or delayed in catering, hospitality, taxi and urban public transportation industries.</p> <p>Caishui (2003) No. 227 Air transportation of passengers and tourism industry is exempted from BT and surcharges from 1 Oct 2003 to 31 Dec 2003.</p> <p>Caishui (2003) No. 231 Railway transportation of passengers is exempted from BT and surcharges from 1 May 2003 to 30 Sep 2003.</p> <p>Caishui (2003) No. 232 Rental gained from providing space and facilities to operators in farmer's market is exempted from BT and surcharges from 1 May 2003 to 31 Jul 2003.</p>	<p>Based on the incentives in SARS, we anticipate more fiscal and tax policies may be issued by the government in the near future. Those incentives may include a broad indirect tax exemption in particular services sector affected. When other countries have faced challenging economic times, VAT rate reductions (even for a temporary period) have commonly been deployed, given that they are typically effective in stimulating demand.</p>
<p>MoF Announcement (2020) No.6 Donations from companies, organizations and individuals could be exempted from Customs duty and import VAT. The donations eligible for exemption include reagents, disinfection articles, protective equipment, ambulances, epidemic prevention vehicles, disinfection vehicles, emergency command vehicles.</p>	<p>Caishui (2003) No. 110 Donations from overseas could be exempted from Customs duty and VAT. The eligible donation for exemption includes protective products, diagnostic equipment, treatment and monitoring equipment.</p>	<p>We note the similar incentives in these two epidemic periods, but with a broader scope of exempt items being used now.</p>

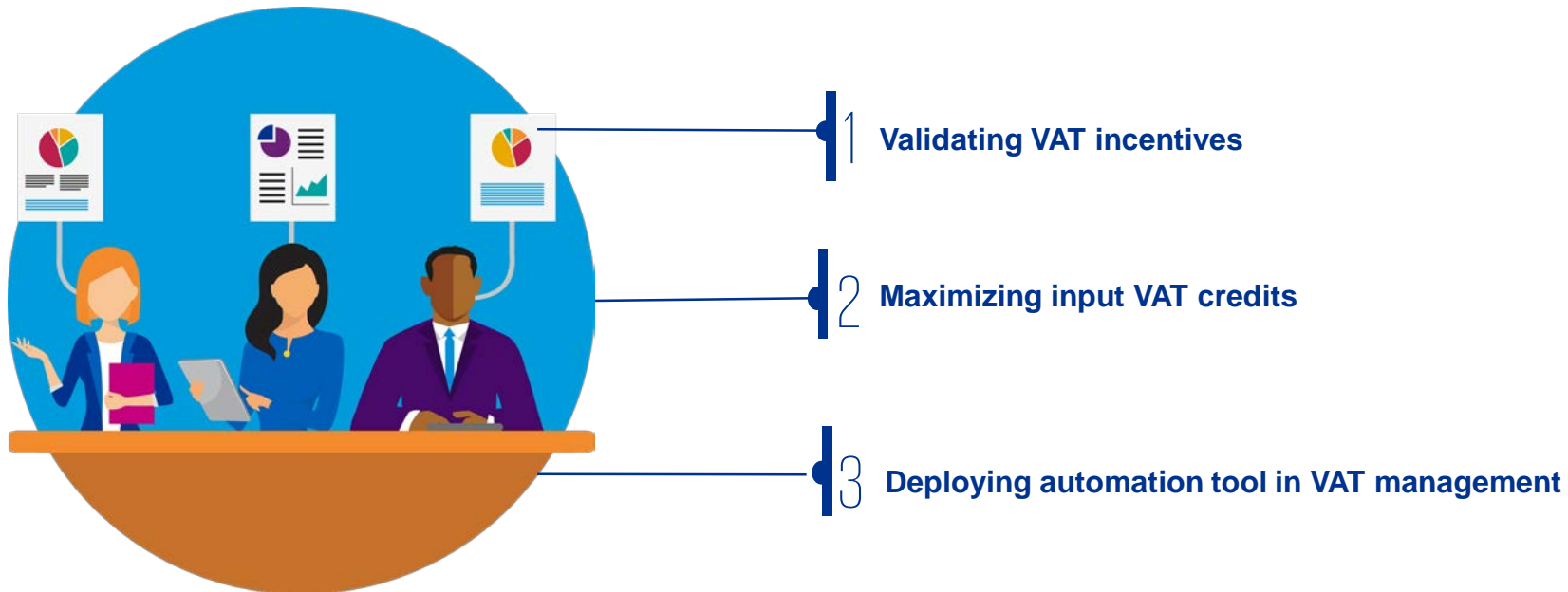


VAT optimisation

Temporary and permanent VAT savings - overview

There is a number of examples where, in our experience, businesses have been underclaiming benefits they are lawfully entitled to receive. Often this is due to the need to implement new or improved internal policies (such as for domestic passenger transport services), new tax incentive policies, or simply more robust finance function processes and systems. In times of crisis and where cashflow is key to business survival, tax and finance professionals can expect these issues to be in the spotlight.

For the benefit of businesses, we provide some high-level temporary and permanent VAT saving measures which may be deployed.



VAT incentives for certain export activities

Under Circular 36 and SAT Announcement (2016) No.29, exported services may be eligible for VAT exemption/zero-rating treatment, especially for intercompany services.

Challenges

- Some local tax officials appear to confuse the place of consumption of services (“destination principle”) with the place where services are performed (“origin principle”)
- Claim for exemption can be made on a self-assessed basis by lodging a record filing form. However, this is still subject to potential audit by the tax authorities
- Narrow interpretation of categories of eligible services
- Limited scope of exemption for exported financial services

Risks

How to overcome these hurdles?

- Revisit existing agreements and assess whether they fall within the eligible scope. Consider whether any changes are required to better align the service description with the categories of VAT exemption / zero rating
- If unsure, try to conduct meetings with the tax officials. Such a meeting would mitigate the risk of the tax authorities later conducting an audit and assessing the company if they determine that a claim for exemption is not available

Opportunities

Entitlement to VAT 'Super Deductions'

SAT Announcement (2019) No.39 provides VAT taxpayers whose major business falls within certain types of eligible services to be entitled to a 10% 'super deduction' of input VAT credits, effective from 1 April 2019. In our experience, many businesses in China are claiming these VAT 'Super Deductions'. Whether this measure may be expanded now to other sectors remains to be seen.

Threshold

$$\frac{\text{Sales for eligible services}}{\text{Total sales of the general VAT taxpayer}} > 50\%$$

Eligible services sector

- Postal services
 - Telecommunications services
 - Modern services (e.g. R&D, Logistics and ancillary services, Consulting services, etc.)
 - Lifestyle services (e.g. Cultural and sports services, Education and healthcare, Travel and entertainment, Food and beverage, Accommodation, etc.)
- ✘ **Financial services sector not eligible**



Applicable period: 1 April 2019 – 31 December 2021

Maximising input VAT credits

A VAT taxpayer is generally allowed to claim input VAT credits against its output VAT when calculating the VAT payable. However, they may need to deny (or 'transfer out') certain input VAT credits that are non-creditable under the VAT rules. Business are encouraged to effectively apportion creditable and non-creditable input VAT and maximize input VAT credits. In our experience, some affected businesses are not fully applying these policies correctly.

1

Fixed assets, immovable property and intangibles – fully creditable

- Full input VAT credits available even if the business is partially a taxable business
- Purchase of fixed assets should be fully creditable
- Intangibles such as software licensing costs should be fully creditable – this should equally apply to cross border payments
- The rule seems to allow for full input VAT credits in respect of purchase and lease of immovable property

2

Direct attribution

Identify expenses that solely relate to taxable or exempt supplies

3

Apportionment

The VAT rules provide that the revenue basis is the default method for apportioning input VAT credits.

1. Clarify the treatment of capital items and non-capital items
2. Rigorously apply direct attribution to reduce the impact of any unfavorable result in applying a revenue based apportionment method

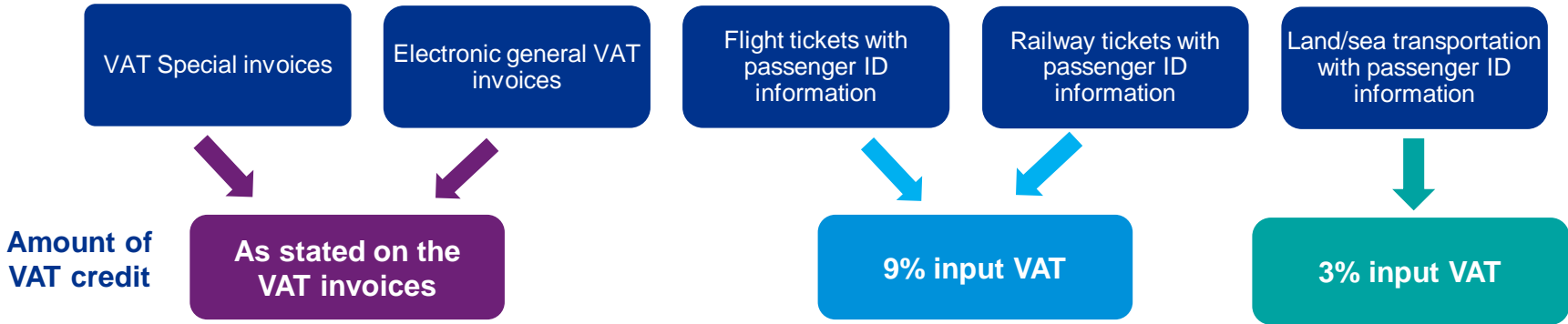


Maximising input VAT credits - Input VAT credits for domestic passenger transport services

Since 1 April 2019, businesses have been eligible to claim input VAT credits for passenger transportation services for their employees for business purposes. However, the ability to do so is closely linked to the policies and procedures which businesses adopt for reimbursement of their employees, and getting the necessary documentary evidence. In our experience, many businesses are not currently claiming these, but may wish to do so.



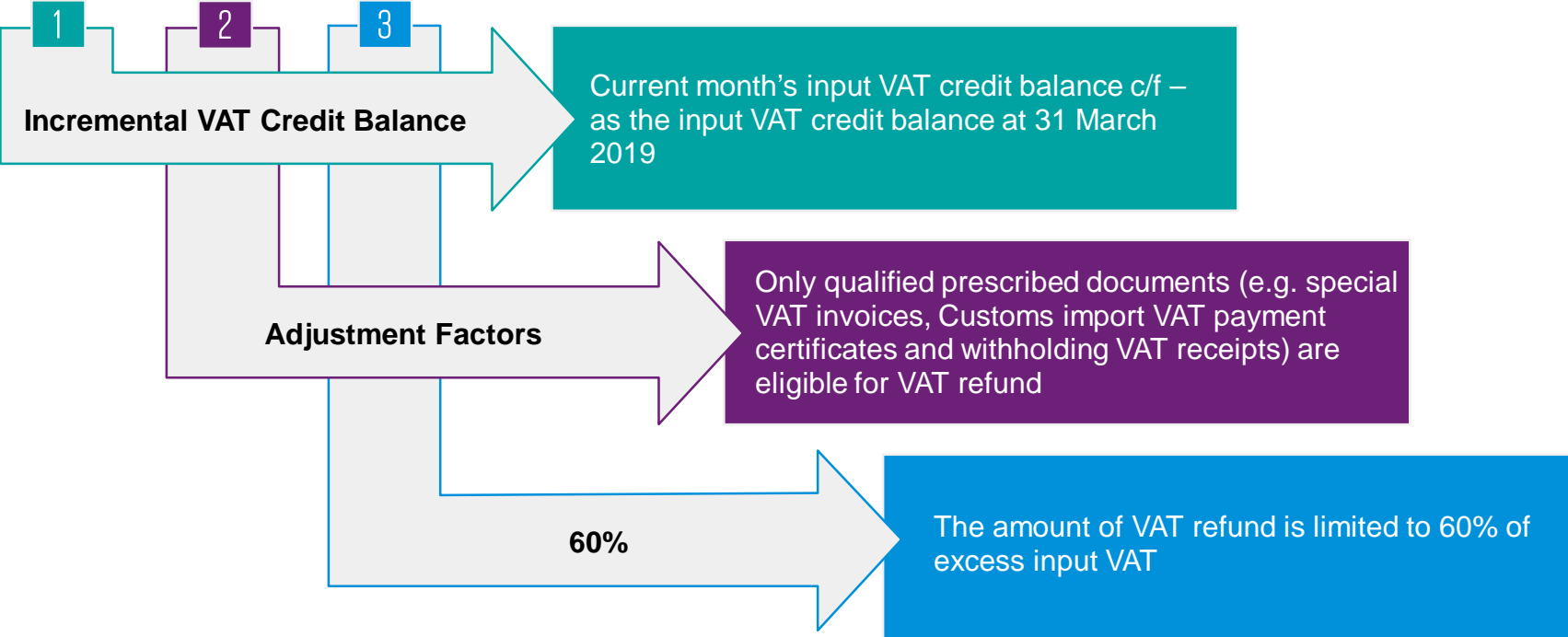
Input VAT on domestic transportation services for business trips are creditable, subject to obtaining the below supporting documents



- How to handle implementation challenges?
- Separating business travel
 - Updating corporate reimbursement policies
 - Entering VAT amounts in system
 - Training staff

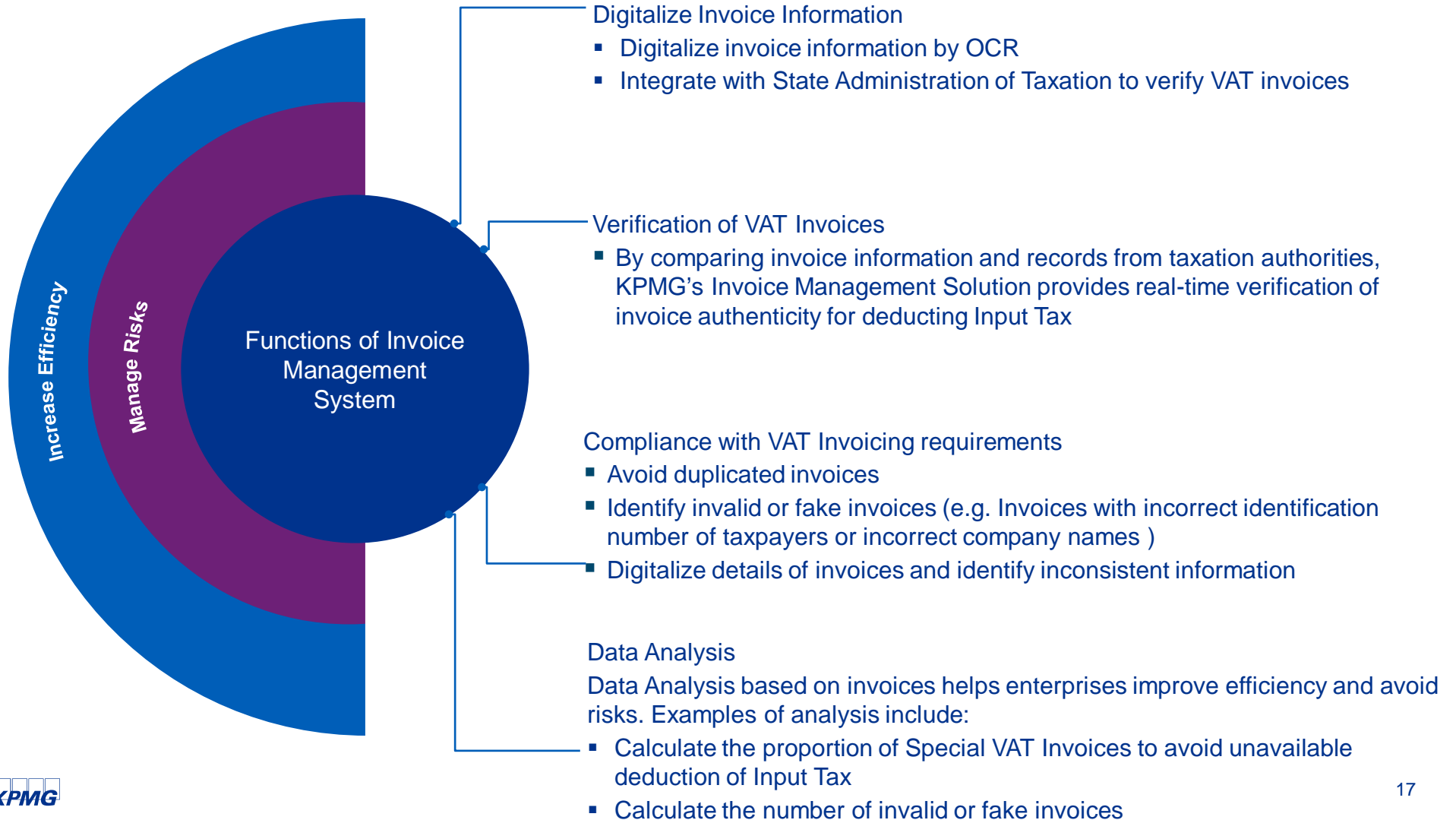
Claiming excess VAT refunds

In China, any excess input VAT credit balance was not refundable to 1 April 2019, except for a limited range of taxpayers such as exporters or businesses in specific industries. However, from 1 April 2019 the Chinese government has introduced a pilot input VAT refund scheme which allows VAT taxpayers to claim a partial refund on its excess input VAT credit balance. More specifically, qualified taxpayers are allowed to claim a 60% refund of the 'incremental VAT credit balance' (subject to an adjustment factors). Businesses are encouraged to apply for VAT refunds at their earliest opportunity to optimize their VAT and cash flow position. Companies engaged in key supplies related to novel coronavirus containment should pay attention to the newly issued tax circular (MOF and STA announcement No.8) which allows qualified taxpayers to get a full refund of the incremental VAT credit balance amount from 1 Jan 2020.



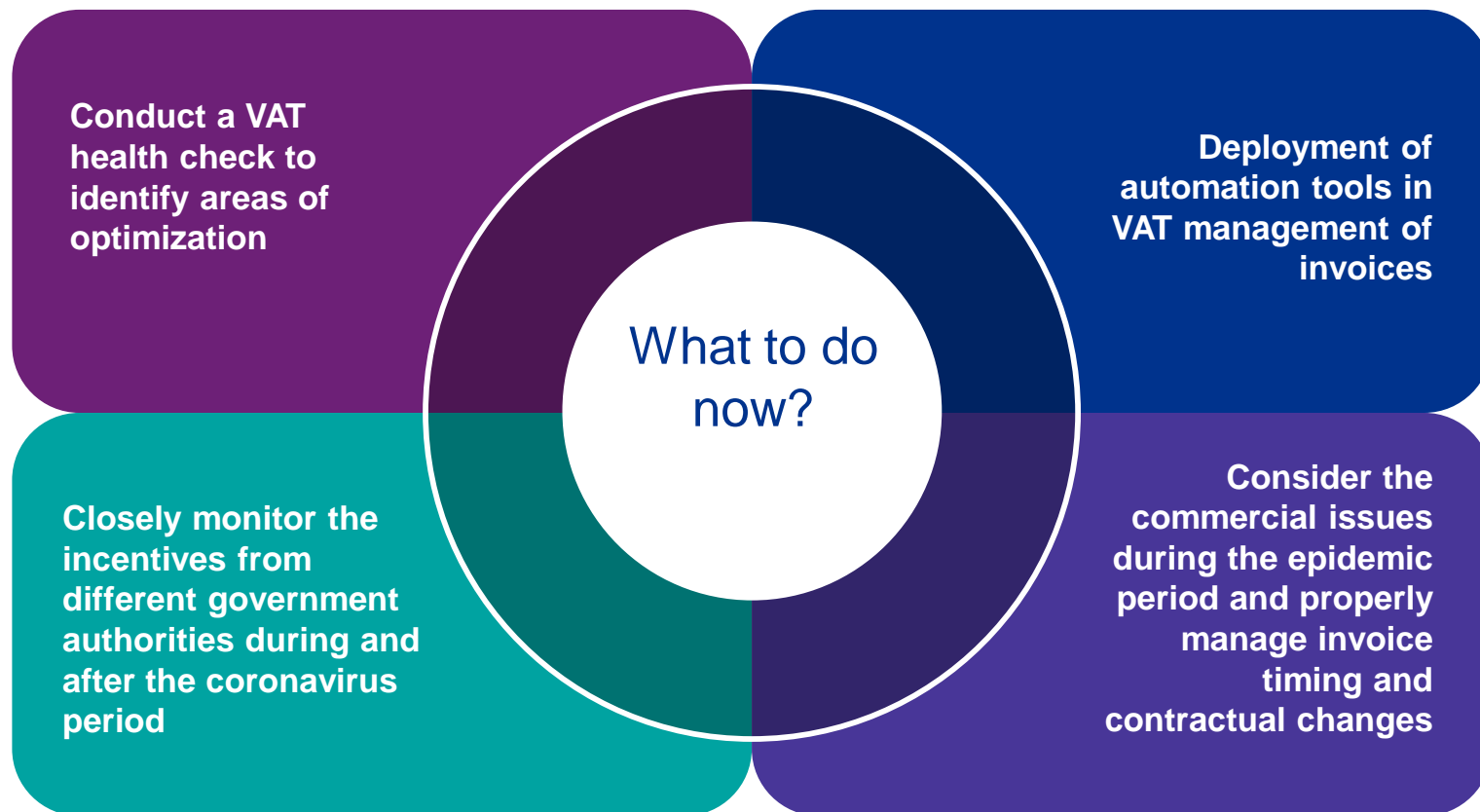
Invoice Management Automation Solution

Businesses can consider automation solutions to digitalize invoice information, including various VAT invoices and non-VAT invoices.



Take action now

As emphasized, in times of crisis, management of cashflow is key to business survival, and in our experience VAT is an area which usually has a significant impact to a company's cashflow, and is frequently not effectively optimized. We highly recommend you to consider taking the following actions immediately to optimize the relevant VAT position for your business.



Key contacts

China



Lewis Lu

Head of Tax
KPMG China
T: +86 (21) 2212 3421
E: lewis.lu@kpmg.com

National Leader and Hong Kong



Lachlan Wolfers

Head of Indirect Tax
KPMG China
T: +852 2685 7791
E: Lachlan.wolfers@kpmg.com

Northern Region



Fiona Yu

Tax Director
KPMG China – Beijing
T: +86 (10) 8508 7663
E: fiona.yu@kpmg.com

Eastern and Western Region



Michael Li

Tax Partner
KPMG China – Shanghai
T: +86 (21) 2212 3463
E: Michael.y.li@kpmg.com

Southern Region



Grace Luo

Tax Partner
KPMG China – Guangzhou
T: +86 (20) 3813 8609
E: grace.luo@kpmg.com

China Tax Centre, United States



Shirley Shen

Leader, China Tax Center
KPMG United States
T: +1 (408) 367 6088
E: yinghuashen1@kpmg.com



kpmg.com/cn/socialmedia

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2020 KPMG, a Hong Kong partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. Printed in Hong Kong.

The KPMG name, logo are registered trademarks or trademarks of KPMG International.