

China VAT Alert

September 2006



Major Revision to the Chinese VAT Export Refund

Background

On 14 September 2006, the Ministry of Finance, the National Development & Reform Commission, the Ministry of Commerce, the General Administration of Customs and the State Administration of Taxation jointly announced a major revision to the Chinese VAT export refund policy.

The revision is detailed in the Cai Shui (2006) Document No. 139, which has come into effect on 15 September 2006, and represents another structural change to the VAT export refund policy of China, whereby the Chinese government may intend to make use of it to direct and monitor economic activities.

The revision has raised the VAT cost of businesses exporting "high energy consumption and high polluting" products while eliminating the VAT cost on the exportation of goods which fall under the "high technology and other encouraged industries". The revision has also stopped certain products to be manufactured under process trade arrangements.

China VAT Export Refund and Processing Trade in Brief

On most of the products manufactured in China and exported to overseas, producers normally incurred Chinese input VAT for raw materials or component imported or purchased locally. However, the current Chinese VAT export refund system generally disallows full recovery of the input VAT. In consequence, many China based producers who currently incurred Chinese input VAT at 17% are suffering a VAT cost equivalent to 4% of the raw materials or component associated to the exported goods as the VAT export refund rate is 13%.

It is possible for certain business to incorporate structures to mitigate the abovementioned VAT cost and processing trade is one of the popular arrangements used by manufacturers who produce goods primarily for export and rely heavily on imported raw materials.

Under processing trade arrangement, the materials and components would be imported free of import customs duty and VAT under bonded conditions. The Chinese producers would then convert the imported materials and components into finished goods and export the finished goods to overseas destination.

However, it is important to note that not all exports are eligible for the processing trade arrangements. Any products listed on the official Prohibited Commodity Catalogue for Processing Trading are not allowed to be imported on bonded basis and are subject to import duty and VAT upon importation.

The Revision

The revision is set out in two parts. The first part is related to the changes made to the VAT export refund rate while the second part specified the additions to the Prohibited Commodity Catalogue for Processing Trading.

Part 1 - Changes Made to the VAT Export Refund Rate

The changes made to the VAT export refund rate and their implications are highlighted below:

Changes	Summary of changes	Implications
Cancellation of VAT export refund	<p>VAT export refund is cancelled for the following products*:</p> <ol style="list-style-type: none"> 1. All non-metallic products (except salt and cement) listed in Article 25 of the Import and Export Tariff Regulations; coal, natural gas, olefin, bitumen, silicon, arsenic, stone materials, non-ferrous metals as well as certain scrap materials etc 2. Metallic ceramic, 25 kinds of pesticides and their intermediary products, certain finished products of leather, lead-acid battery, mercuric oxide battery. 3. Thin fleece of goat, charcoal, crosstie, cork products, certain processed primary wood products. 	<p><i>The types of businesses taking the most serious hit from the changes are the businesses exporting goods that are removed from the VAT export refund regime and the businesses exporting goods subject to significant reduction on the VAT export refund rates.</i></p>
Reduction of VAT export refund rates	<p>VAT export refund is reduced for the following categories of products*:</p> <ol style="list-style-type: none"> 1. The refund rate for steel products under 142 tariff heading has been reduced from 11% to 8%. 2. The refund rate for ceramic products, certain finished products of leather and glass products has been reduced from 13% to either 8% or 11%. 3. The refund rate for certain non-ferrous metallic materials has been reduced from 13% to either 5%, 8%, or 11%. 4. The refund rate for textile, furnishings, plastic, lighter, and specific wood products has been reduced from 13% to 11% 5. The refund rate for non-mechanically propelled vehicles and certain component parts has been reduced from 17% to 13%. 	<p><i>The increase in the associated VAT costs due to the revision will certainly hit their profit margin depending on their ability to share the extra tax costs with the suppliers and the customers.</i></p>
Increase of VAT export refund rates	<p>VAT export refund is increased for the following categories of products*:</p> <ol style="list-style-type: none"> 1. The refund rate has been increased from 13% to 17% for significant technical equipments, certain IT products, and bio-medical products as well as certain "encouraged" high-tech products. 2. The refund rates will be increase from 5% or 11% to 13% for certain processed products made from agricultural products. 	<p><i>The businesses exporting products with the increased VAT export refund rate may benefit from the additional 4% VAT recovery.</i></p>

**Category of products shown for illustrative purposes only. Please refer to the HS code of the specific products to be exported to confirm whether the changes apply.*

The above changes have come into effect on 15 September 2006. However, export contracts signed by 14 September 2006 can still be entitled to the old rebates as long as the products have been declared to export by 14 December 2006. The export contract must be taken to the relevant Chinese tax authorities responsible for the administration of the export VAT refund for filing before 30 September 2006.

Goods relating to the non-filed export contracts or goods export on or after 15 December 2006 would be subject to the revised VAT export refund rules.

Part 2 - Additions to Prohibited Commodity Catalogue for Processing Trading

The categories of products subject to the cancellation of VAT export refund treatment have been added to the existing Prohibited Commodity Catalogue for Processing Trading (Prohibited Catalogue). MOFCOM will revise and publish the Prohibited Catalogue with the specific HS code of the products prohibited from conducting processing trade. The products on the Prohibited Catalogue are subject to import duty and VAT at the time of importation.

Businesses operating processing trade arrangements which have been approved by the relevant authorities will be allowed to continue importing items free of import VAT and customs duty until the expiry of the approved processing trade arrangements. No extension would be granted to uncompleted projects. Import duty/VAT on bonded materials will be levied if the finished goods are not exported within the required period of time.

Actions to be Taken

Businesses are advised to take an active role in managing the risk and opportunities under the revised VAT export refund rules. Some actions are suggested below:

Immediate Actions Required

Businesses which are affected by the cancellation of VAT export refund or reduction of VAT export refund rates should:

1. Identify whether the goods they produce are affected by the revised rules. This can be done by a detailed analysis of the HS code of the goods to be exported to ensure these goods have been most properly classified
2. Ensure that the relevant export contracts signed on or before 14 September 2006, together with other supporting documents, are taken to the relevant tax authorities for filing.
3. Draw up necessary resource allocation planning and clear implementation steps for the projects already filed with a view to export the goods on or before 14 December 2005.

For the processing trade businesses adversely affected by the new rules should:

1. Identify whether the goods they produce are included in the Prohibited Catalogue
2. Review their current processing trade arrangements to ensure that the goods to be exported would leave China before the expiry date of the approved processing trade arrangements.
3. Be updated with respect to the detailed implementation steps of the revised rules to be published by the relevant authorities and ensure that necessary actions are followed.

Businesses should also review their existing and/ or future pricing arrangements of their sales/ procurement contracts to identify the parties responsible to bear the tax hit hence identify any potential risk and opportunities.

Mid / Long Term Considerations on Setting up a Cost-efficient Structure or Supply Chain

Although the revised rules have already come into effect and there is relatively little businesses can do on a short term basis, businesses may also wish to take this opportunity to fully explore the efficiency of their supply chain from both the direct tax (ie, transfer pricing) and indirect tax (ie, VAT and customs duty) perspective.

Businesses should review their own circumstances to determine what benefits, or potential adverse consequences the new rules will create, and take appropriate actions.

Conclusion

As China is now playing an increasingly significant role in the global supply chain, this revision of the VAT export refund rules will certainly bring implications to the cost structures and pricing policies to a vast number of businesses which exports from China.

The revised rules will inadvertently trigger negotiations between the exporters and their down-stream customers as well as up-stream suppliers.

In the context of this China VAT Alert, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PricewaterhouseCoopers client service team.

Please contact your PricewaterhouseCoopers professionals in order to ensure that the new requirements will be complied with and that planning opportunities are appropriately explored.

Northern China

Beijing

Tel: (86) (10) 6533 2889
Fax: (86) (10) 6533 8800

Alan Wu
alan.wu@cn.pwc.com

Tel: (86) (10) 6533 3198
Fax: (86) (10) 6533 8800

Kenneth Leung
kenneth.leung@cn.pwc.com

Central China

Shanghai

Tel: (86) (21) 6123 3111
Fax: (86) (21) 6123 8800

Derek Chow
derek.chow@cn.pwc.com

Southern China

Guangzhou

Tel: (86) (20) 3819 2193
Fax: 86 (20) 3819 2100

Janet Xu
janet.xu@cn.pwc.com

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