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.
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. However, differentiating this from safety equipment necessary for an employee to carry out their work (which should be creditable) may not always be clear.
• 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.

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.
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.

<table>
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<th>Current Incentives</th>
<th>Incentives during SARS</th>
<th>Observations</th>
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| MOF and STA Announcement (2020) No.8                                              | 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.  
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.  
Caishui (2003) No. 231  
Railway transportation of passengers is exempted from BT and surcharges from 1 May 2003 to 30 Sep 2003.  
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. | 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. |
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. |                                                                                                                                            |
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. | We note the similar incentives in these two epidemic periods, but with a broader scope of exempt items being used now. |

- 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.

- 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.
- 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.

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.
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.

1. Validating VAT incentives
2. Maximizing input VAT credits
3. Deploying automation tool in VAT management
### 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

### 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

### Risks

### Opportunities
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. Businesses 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:

- VAT Special invoices
- Electronic general VAT invoices
- Flight tickets with passenger ID information
- Railway tickets with passenger ID information
- Land/sea transportation with passenger ID information

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

Amount of VAT credit:
- As stated on the VAT invoices
- 9% input VAT
- 3% input VAT
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.

1. **Incremental VAT Credit Balance**
   - Current month’s input VAT credit balance c/f – as the input VAT credit balance at 31 March 2019

2. **Adjustment Factors**
   - Only qualified prescribed documents (e.g. special VAT invoices, Customs import VAT payment certificates and withholding VAT receipts) are eligible for VAT refund

3. **60%**
   - The amount of VAT refund is limited to 60% of excess input VAT
Businesses can consider automation solutions to digitalize invoice information, including various VAT invoices and non-VAT invoices.

**Digitalize Invoice Information**
- Digitalize invoice information by OCR
- Integrate with State Administration of Taxation to verify VAT invoices

**Verification of VAT Invoices**
- By comparing invoice information and records from taxation authorities, KPMG’s Invoice Management Solution provides real-time verification of invoice authenticity for deducting Input Tax

**Compliance with VAT Invoicing requirements**
- Avoid duplicated invoices
- Identify invalid or fake invoices (e.g. Invoices with incorrect identification number of taxpayers or incorrect company names)
- Digitalize details of invoices and identify inconsistent information

**Data Analysis**
Data Analysis based on invoices helps enterprises improve efficiency and avoid risks. Examples of analysis include:
- Calculate the proportion of Special VAT Invoices to avoid unavailable deduction of Input Tax
- Calculate the number of invalid or fake invoices
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.

**Conduct a VAT health check to identify areas of optimization**

**Deployment of automation tools in VAT management of invoices**

**Closely monitor the incentives from different government authorities during and after the coronavirus period**

**Consider the commercial issues during the epidemic period and properly manage invoice timing and contractual changes**
Key contacts

**China**

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

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

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

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

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

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

**National Leader and Hong Kong**

**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
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