

China Further Reduces VAT Refunds on Export Goods

Changes Will Impact Most Businesses and Mean Higher Export Costs for Thousands of Products



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China has been employing a number of different strategies to address overheating export growth and to manage the ballooning trade surplus. A number of “tools” have been employed by the Government to achieve their goals. One recently favored “tool” is to revise the VAT refund rates given to companies exporting goods out of China.

Export VAT refunds have played an important role in keeping export prices low. By changing (either by increasing or decreasing) the VAT refund rates on certain products, the Government can, to a certain extent, either encourage or discourage exportation of the affected products. In many cases, the quantum of the export VAT refund can make the difference between a profitable and a non-profitable transaction. Therefore, any change to a VAT refund rate will impact the prices charged on export goods as well as the profitability of exporters.

The New Circular

Effective July 1, 2007, China will slash VAT rebates on 2,831 classification of products. This represents 37% of the total number of classifications in the China Customs tariff. This is the third such change in refund rates since 2005. In an announcement jointly released by the Ministry of Finance and State Administration of Taxation on 19 June, 2007 through a Circular titled "Adjustment to Export Rebate Rates on Certain Export Goods" (Cai Shui [2007] No. 90), cuts in VAT rebates on exports of affected products will be in one of the following three forms:

1. Complete cancellation of any VAT refund (i.e. refund rate reduced to 0%);
2. Reduction in VAT refund rates (some of these are significant reductions); and
3. VAT-exempt status granted.

Details for each of the three categories are expanded below.

1) Cancellation of VAT Rebates – 553 Products

The Authorities have identified certain types of products or production that will incur additional export costs through the complete cancellation, to 0%, of the VAT refund rate. Most of these products fall under categories which the Chinese Government has been reporting as high polluting; high energy consumption; or exporting of China’s natural resources. Such products, and their exportation, are being closely monitored and somewhat discouraged by this cancellation.

Table 1 below provides a high-level indicative list¹ of the product categories that will now have a VAT refund rate of 0% vs. the rate prior to July 1. As can be seen, a number of the rate reductions are material.

¹ This list is not a comprehensive list of all the changes in this category, but is given as an indication only as to the extent of products affected and the quantum of the rate reductions.

Table 1 : Summary List of Goods Subject to Cancellation of Export VAT Rebate

HS Chapters	Product Description	Current VAT Rebate Rate
1-12	Endangered Animals	5%
13-22	Endangered Plants and Products Thereof; Preparations of Meat from Endangered Animals	13%
25	Salt, Cement	11%
27	Solvent, Liquefied Propane, Liquefied Butanes, Liquefied Petroleum Gas, and Relevant Minerals Products	13%, 11%
28	Inorganic Chemicals - Fluorine , Chlorine, Bromine, Iodine, Sulphur, Carbon, Hydrogen, Rare Gases, Calcium, Hydrogen Chloride, Sulphuric Acid, Halides, Ammonia, Hydrazine, etc.	13%, 5%
29	Organic Chemicals - Propylene Oxide, Epichlorohydrin, Sodium Glutamate, Amino-alcohol-phenols, etc.	13%
30	Pharmaceutical Products - Extracts of Glands, Organs, Substances, Blood Preparations, Medicaments of Endangered Animals, etc.	13%
31	Fertilizers	11%, 5%
32	Tanning or Dyeing Extracts; Dyes, Pigments and other Coloring Matter;	13%
33	Essential Oils, Resinoids, Beauty and Make-up Preparations of Endangered Animals, etc.	13%
34	Artificial Waxes, Candles Made From Endangered Animals, etc.	13%
38	Miscellaneous Chemical Products - Metallic Carbonated and Activated Carbon	13%
41-42	Leather or Leather Preparation, Leather Products of Endangered Animals, Bovine Animals, Goats, Swine	13%, 8%
43	Fur Skins, Fur, and Products Thereof of Endangered Animals	13%
44	Certain Wood Panels and One-off Wood Products	13%, 11%
51	Wool, Fine or Coarse Animal Hair Made of Endangered Animals	13%, 5%
64	Footwear - Boots, Ski-boots, Snow boots and Non-sport Footwear with Outer Soles and Uppers of Rubber or Plastic with Hair of Endangered Animals	13%
71	Articles of Silver and Jewellery In-laid with Article of Endangered Species	13%
73	General Welded Pipes and Tubes Products (Except Petroleum Tubes and Pipes Set)	13%
76	Of Aluminium, Not Alloyed Bars and Rods; Simple Metallic Colored Processing Products	11%, 8%
89 ²	Other Vessels, Segment of Vessels	17%, 11%
90-97 (Except 93)	Frames, Mountings for Spectacles, Wrist Watches, Musical Instruments, Furniture, Decorative Plaques, and Sculptures of Endangered Animals	13%, 11%

² There are some specific rules for shipbuilding contracts under HS Chapter 89 that should be addressed before July 20, 2007.

With the cancellation of the prescribed export VAT refund rate to 0%, the likely impact to exporters may include:

- For Chinese VAT purposes, the export shipment will be deemed as a "domestic" sale upon which VAT would be payable.
- An exporter's FOB export price will be deemed to be inclusive of the applicable VAT charge. In other words, the "deemed" VAT output charge will be calculated as follows :-

$$= \frac{(\text{FOB export price} \times \text{RMB exchange rate}) \times \text{VAT rate}}{(1 + \text{VAT rate})}$$
- Input VAT costs incurred by the exporter would however be creditable against the "deemed" VAT output charge, as calculated based on the above formula.

Currently, many products with a VAT refund rate of 0% are also prohibited from using Processing Trade to import raw materials free of customs duty and VAT for export production. And in the past, changes to VAT refund rates and the Processing Trade

prohibition list have occurred around the same time. However, it still remains to be seen whether the Ministry of Commerce and the General Administration of Customs would also subsequently update the existing list of "Prohibited Goods for Processing Trade" to include these 553 additional products. It will be important for companies with products newly introduced to this category to also monitor the development in the prohibition list if they are manufacturing for export.

2) Reduction in Export VAT Refund Rates – 2,268 Products

China has elected to reduce the VAT refund rates on thousands of products. Again some of the reductions are material and also affect many products which have not been hit with previous rate revisions.

Table 2 below provides an indicative list³ of some of the affected products and the extent of the VAT refund rate reductions:

HS Chapters	Product Description	Current VAT Rebate Rate	VAT Rebate Rate (1 July, 07)	Difference
15	Vegetable Oil	13%, 11%	5%	-8%, -6%
28	Certain Inorganic Chemicals	13%	5%	-8%
29	Certain Organic Chemicals	13%	5%	-8%
33	Essential Oils, Resinoids, Mixtures of Odoriferous Substances, Perfumes, Beauty and Make-up Preparations, Shampoos, Toothpastes, Shaving Preparations, etc.	13%	5%	-8%
34	Soap, Organic Surface-Active Agents, Polishes and Cream, Dental Waxes, Dental Plaster	13%	9%	-4%
36	Explosives, Pyrotechnic Products; Matches; Prophetic Alloys; Certain Combustible Preparations	13%	5%	-8%
38	Certain Miscellaneous Chemical Products	13%, 11%	5%	-8%, -6%
39	Plastics & Articles Thereof	11%	5%	-6%
40	Rubber & Articles Thereof	13%	5%	-8%
42	Certain Articles of Leather and Artificial Leather	13%	11%, 5%	-2%, -8%
43	Certain Fur skins (Mink, Blue Fox, Rabbit, Other Animals, etc) and Artificial Fur; Manufactures Thereof	13%	5%	-8%
44	Fibreboard of Wood or Ligneous Materials, Certain Plywood, Veneered Panels and Similar Laminated Wood, Densified Wood, Certain Wooden Frames, Certain Packing Cases/boxes, Certain Windows, Bamboo Chopsticks, Wooden Tableware and Kitchenware, etc.	13%, 11%	5%	-8%, -6%

³ This list is not a comprehensive list of all the changes in this category, but is given as an indication only as to the extent of products affected and the quantum of the rate reductions.

Table 2 : Summary List of Goods Subject to Reduction of Export VAT Rebate

HS Chapters	Product Description	Current VAT Rebate Rate	VAT Rebate Rate (1 July, 07)	Difference
48	Envelopes, Cards, Boxes, Cartons, Bags, Packing Containers, Books and Note Books, Labels etc. of Paper or Paperboards, Toilet Paper, and Other Products	13%	5%	-8%
54-55	Certain Man-made Filaments and Staple Fibres	11%	5%	-6%
61-62	Articles of Apparel and Clothing Accessories	13%	11%	-2%
64	Footwear, Headgear, Umbrellas, Walking-Sticks, Whips, Prepared Feathers, Down, Articles Made of Feathers or of Down, Artificial Flowers, etc.	13%	11%	-2%
68	Certain Articles of Stone, Asbestos, Mica, etc.	13%	5%	-8%
69	Certain Ceramic Products	13%, 8%	5%	-8%, -3%
70	Glass & Glassware	11%	5%	-6%
71	Natural or Cultured Pearls, Precious Stones, Precious Metal and Articles Thereof	13%, 11%	5%	-8%, -6%
73	Certain Articles of Iron or Steel	13%	5%	-8%
75, 78-80	Nickel, Lead, Zinc or Tin and Articles Thereof	13%, 8%	5%	-8%, 3%
81	Other Base Metals; Cermets; Articles Thereof	13%	5%	-8%
82	Tools, Implements, Cutlery, Spoons and Forks and Parts Thereof of Base Metal	11%	5%	-6%
83	Miscellaneous Articles of Base Metal	13%	5%	-8%
84	Petrol Engine Not More Than 50cc, Diesel Engines for Motor Cars, and Other Engines with Output Below 14kw, Pumps, Fans, Blowers, Sewing Machine, Machine Tools for Shaping, Slotting, Sawing, Hand Tools, Valves	17%, 13%, 11%	11%, 9%	-8%, -6%, -4%, -2%
85	Soldering Irons and Guns, Lamp-Holders, Cables, Electrical Conductors	13%	9%	-4%
87	Golf Cars, Snow Mobile, Windowpane Raisers, Motorcycles and Parts, Bicycles and Parts, Carriages for Disabled Person, Saddles, Trailers	17%, 13%	9%	-8%, -4%
91	Clocks and Watches and Parts Thereof	13%	11%	-2%
94	Seats, Office Furniture, Mattresses, Lamps and Lighting Fittings, Prefabricated Buildings, etc.	13%, 11%	11%, 9%	-2%
95	Toys, Games, and Sports Requisites; Parts and Accessories Thereof	13%	11%	-2%
96	Miscellaneous Manufactured Articles	13%	11%	-4%, -2%

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As can be seen above, the extent of the reductions is unprecedented and touches almost every type of business. The rate reductions result in additional export costs that must either be absorbed by the exporter or passed on to the overseas customer.

3) "VAT-Exempt" Status on Exports – 10 Products

Under this category, export shipments of selected products will be treated as "VAT-exempt" supplies and thus not subject to output VAT charge upon export. However, exporters will not be entitled to claim a VAT rebate in relation to VAT-exempt supplies.

Table 3 outlines the two main categories of products impacted by this change.

HS Chapters	Product Description	Current VAT Rebate Rate
12	Ground-nuts	5%
97	Painting, Drawing, Collages and Decorative Plaques, Original Engravings, Sculptures, Postage and Revenue Stamps	13%

Conclusion

Most companies even slightly connected with China will not escape unscathed from the impact of this latest Circular. If your company exports goods from China, manufactures in China for export markets and/or procures goods from China, then there will be additional costs in the supply chain incurred at the time of exportation. These costs can be referred to as "VAT leakage" and will come in the form of lower VAT refund rates. The VAT leakage costs will vary from product to product and must be understood in order to avoid "hidden" indirect tax costs on China exports.

Frequent revisions to the export VAT refund rate structure can wreak havoc on a company's supply chain and long-term strategic plans as well as pricing models. Companies may have to revisit the way they sell and price goods from China in order to take into account the additional VAT leakage costs. This is especially true when considering how export sales of products with a 0% refund rate will be treated as "domestic sales". Sellers will likely try and pass on the increased cost burden to buyers and buyers must be aware of how such costs are being rolled into the export price. This may require increased due diligence when pricing goods to/from China.

The increased export costs further undermine China's historic position, and major reason why many companies have moved operations to China, as a low-cost supply and manufacturing base. Due to the material ramifications of these changes many companies will be reviewing their supply chain and cost structures to revisit whether China still makes sense. Fortunately, there are certain supply chain strategies businesses can consider or adopt in China to mitigate these increased "VAT leakage" costs and the impact of the Circular.

Ernst & Young would be happy to assist you in understanding what this Circular means for your business and what alternatives are available to address the situation.