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Reprinted from *Tax Notes Int'l*, January 14, 2008, p. 159

PRACTITIONERS' CORNER

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China's tax rules provide for three export refund treatments: the tax-exempt treatment, the pay-first-and-refund-later treatment, and the exempt-offset-refund treatment. The tax-exempt treatment has two variations: the exporter has paid input VAT on the export goods, but the exporter is not entitled to any export refund; and the exporter has not previously paid any input VAT on the export goods, and therefore the exporter is not entitled to an export refund. The exporter who receives the exempt-credit-refund treatment will also have three different tax positions, depending on the refund policy the Chinese government adopts: getting a refund at the full rate; getting a refund at reduced rates; and having to pay VAT on export. In recent years, the Chinese government has adjusted its export refund policies in line with its pursued economic objectives, including reining in the growth of the type of export processing trade that has caused high levels of pollution, consumed high levels of energy and natural resources, and created friction with China's major trading partners in the international market. Since 2003, in addition to reducing the refund rates, the Chinese government has pursued a no-refund policy for some export goods, and it is observed that the Chinese government has increased the scope of goods falling under the no-refund treatment.¹ In this

connection, this article will examine how the rate reduction and the no-refund policy, together with the three treatments mentioned above, will affect the exporter's VAT position.

The Chinese government is constantly revising its export refund policy in line with its economic policy objectives. This article reflects China's export refund policy as of December 31, 2007.

Rules for Commercial Enterprises

For production enterprises, the amount used to compute the export refund is the free on board (FOB) value of the export goods. For commercial enterprises, the amount used to compute the export refund is the amount of purchase. The pay-first-and-refund-later method is used in export refunds for commercial enterprises. In that connection, the exporter pays VAT on export sales to the VAT collection unit at the tax bureau and applies for a VAT refund from the VAT refund unit at the tax bureau later. According to the input VAT paid for the purchase of the export goods, the amount of VAT refund is computed as follows:

- If the refund rate is the same as the standard rate (17 percent), VAT refundable amount = amount of purchase x refund rate.
- If the refund rate is lower than the standard rate (17 percent), VAT refundable amount will be amount of purchase x refund rate = input VAT on export - amount not refundable; when the input VAT on export is the purchase amount x standard rate, and the amount not refundable is purchase amount x (standard rate - refund rate).

¹The latest official document for export goods on the no-refund list or subject to reduced export refund rate is Cai Shui [2007] 169, jointly issued by the Ministry of Finance and the State Administration of Taxation, effective from December 20, 2007.

Whether under the pay-first-and-refund-later method or the exempt-offset-refund method, the exporter has no tax burden if the refund rate is equal to the 17 percent standard rate. The exporter has a tax burden if the refund rate is less than the 17 percent standard rate. The exporter will have a higher working capital requirement if the pay-first-and-refund-later is adopted. From January 1, 2002, all production-type enterprises will use the exempt-offset-refund method for export refund purposes.

Export Exemptions

No Credit for Input VAT Paid

Under the tax-exempt method, the buyer who exports his goods is not eligible for a refund of the VAT paid on purchases, and therefore the buyer bears the cost of the input VAT. The following goods on which VAT has been paid for local purchases are not eligible for export refunds, and receive the exemption treatment only:

- Goods that are banned from export under Chinese law, such as musk, bezoars (cow's gallstones), copper, platinum, crude oil, and diesel.
- Goods purchased by the exporter from a small-scale taxpayer who cannot provide a VAT special invoice to the exporter.² These are not eligible for export refunds even if they are actually shipped out of the P.R.C. as export. The VAT rules provide that if the exporter receives an ordinary tax invoice from the small taxpayer, the goods are not eligible for export refunds. However, if the small taxpayer pays the VAT, obtains a VAT invoice from the tax office, and passes the invoice to the import-export company, the goods are eligible for export refund.³
- Goods purchased locally for use in export processing with supplied materials. Export processing with supplied materials (*lai liao jia gong*) differs from export processing with purchased materials (*jin liao jia gong*) in that the former is only a contractual arrangement under which a Chinese party, situated inside the Chinese territories, undertakes processing or assembling work on materials provided by a foreign party, and is paid a processing fee. The title to the goods in export processing with supplied materials remains with the foreign party throughout the period while they stay inside the P.R.C., and therefore no export sales take place. In contrast, the legal title to the goods in export processing with purchased materi-

als passes from the foreign party to the Chinese party under a purchase contract, and then after processing and assembling the legal title passes back to the foreign party under a contract of sales for exports. The export processing enterprises (EPEs) that carry on export processing with purchased materials receive the exempt-credit-refund treatment, which is addressed below.

- Goods on which the general taxpayer pays VAT at the levy rate and not at the standard rate. These are exempted from export VAT because the goods subject to VAT at the levy rate are not entitled to input VAT credit in domestic sales.⁴

No Previous Payment of Input VAT

If the export enterprise has not previously paid any VAT on the purchase, these goods are not entitled to any export refunds. There are three originations of such goods:

- tax-exempt goods purchased locally for export, such as the agricultural produce directly purchased from local farmers and fishermen, or tax-exempt goods purchased for use in the manufacture of export goods;
- the bonded materials directly imported for use in export processing, indirectly imported from bonded warehouse or free trade zones; and
- semifinished bonded goods transferred from other EPEs (upstream EPEs) for further substantive processing.

Input VAT Paid and Refunded on Export

The exempt-credit-refund method will apply in the computation of export refunds for an exporter of self-produced goods. Regarding export sales from January 1, 2002, all production-type enterprise exporting products made from local materials, bonded materials, or both will adopt the exempt-credit-refund method in the computation of disallowed credit, VAT payable, VAT offset, and the VAT refundable. "Exempt" refers to the exemption of VAT for the export sales; "credit" means the input VAT paid for the purchase used in the manufacture of export sales will be offset against the output VAT collected on local sales; and "refund" means if the amount of input VAT, from which the disallowed credit has already been deducted, is bigger than the VAT payable for the current period (that is, a debit balance), the excess is refundable.⁵

²See Cai Shui [2003] 238, jointly issued by the Ministry of Finance and the State Administration of Taxation.

³See Guo Shui Han [2005] 248, issued by the State Administration of Taxation.

⁴See article 10 in Guo Shui Fa [2003] 139, issued by the State Administration of Taxation.

⁵See article 2 of Cai Shui [2002] 7, jointly issued by the Ministry of Finance and the State Administration of Taxation.

Table 1. VAT Liabilities for Manufacturing Company

Scenario	Flow of inputs and outputs	VAT implication
I	Domestic sales using imported inputs	Taxed with input credits
II	Domestic sales using domestically manufactured inputs	Taxed with input credits
III	Export processing using imported inputs, including the input transferred from upstream manufacturing units	Exempted from VAT, in whole or in part
IV	Export processing using domestically purchased inputs	Export exempted from VAT; input VAT entitled to rebates, in whole or in part

Tax Exemption and Zero-Rated Tax

When the export goods receive the full refund rate (17 percent), the exporter suffers no tax burden. When this happens, it pays a zero-rated tax. When the export goods receive a reduced refund rate, the exporter bears the input VAT cost in part. When the export goods receive a no-refund treatment, the exporter bears the cost of the input VAT in full and it has to charge the input VAT to the costs of production. When that happens, the export goods receive the tax-exempt treatment.

It is useful to make a comparison between tax exemption and zero-rated tax. They have something in common in that both sellers are not required to collect the VAT from the buyer. The difference is that tax exemption may occur in transactions between two parties in China, or between one party within China and one party outside China, but zero-rated tax only occurs in export transactions. The other difference is that the seller exempted from VAT bears the input VAT, except for the purchase of VAT-exempt goods, but the seller subject to zero-rated tax does not have to bear the input VAT.

Time to Apply Export Refund

It is provided that export enterprise should produce all the required documents and submit an application for export refund within 90 days from the date of export declaration. If the noncompliance is not rectified before the 15th day of the following month, all the export sales are deemed to be local sales and subject to VAT liability.⁶ The VAT payable for the EPE will be: output VAT - input VAT; the output VAT is computed as: FOB export value x (1 + 17%) x 17%.⁷

⁶See Guo Shui Fa [2004] 113, issued by the State Administration of Taxation.

⁷See Cai Shui [2004] 116, jointly issued by the Ministry of Finance and the State Administration of Taxation.

Claiming Export Refunds

The VAT paid for the purchase of export goods in the Chinese market, or for purchases used in the manufacture of export goods, can be refunded in whole or in part, given that the following requirements are satisfied:

- the goods are subject to VAT or consumption taxes under the Chinese tax rules;
- the nature of the export transaction must be treated as sales in the books of accounts for the exporter;
- the goods must have physically left the country (except for those shipped to export processing zones or bonded logistic parks); and
- the exporter has to produce evidence showing that the foreign exchange verification procedure governing the export collections has been completed.

To the individual exporter, the goods it buys for purpose of export and VAT rebates should not fall outside the scope of its business as approved by the Chinese government. The exporter should possess the general taxpayer status under the P.R.C. VAT tentative regulations. The taxpayer needs to submit the application for export rebates within 90 days of the export declaration. The taxpayer should produce the following documentary proof to the tax bureau in order to get the export refunds:

- special invoice for export goods;
- customs declaration for export goods (for export collection verification use);
- foreign exchange verification notes for export collections (for VAT refund use);
- VAT invoice for purchase of export goods;
- paid tax payment demand note; and
- VAT declaration forms.

VAT Liabilities

In broad terms, the VAT liabilities for a manufacturing company can be grouped under the four scenarios shown in Table 1.

In reality, the combination is not limited to the scenarios listed above. According to the origination of the input materials, the export goods may be made from bonded materials, locally manufactured materials, or a combination of both. In this case, scenarios III and IV occur at the same time. Likewise, a production-type foreign investment enterprise may use both imported and domestically purchased inputs to make goods for sales in the domestic market. So scenarios I and II will apply to this case. An FIE may export using both imported and domestically purchased inputs and at the same time, doing domestic sales using both imported and domestically purchased inputs. When this happens, all the scenarios will come into play.

Scenario III refers to processing trade with imported materials. The EPE buys the materials from the supplier outside China, converts the inputs into finished goods, and sells the goods to the buyers outside China. This is commonly referred as export processing with purchased materials (*jin liao jia gong*). The materials for use in export processing can be imported directly, indirectly from other EPEs (an interfactory transfer), or both. Under the P.R.C. foreign trade law, export processing trade is classified into three categories: prohibited, restricted, and permitted. In recent years, the government has banned the export processing trade on goods that receive the no-export refund treatment. The Ministry of Commerce, together with the State Environmental Protection Bureau, and the General Administration of Customs, jointly announced the list of goods falling under the prohibited category in Order 2007 No. 17, effective from April 26, 2007. Specifically, the government has grouped the prohibited goods for export processing into three lists: (a) list of imports; (b) list of exports; and (c) list of imports & exports.⁸ The government has also announced the list of goods under the restricted category, for which the EPE must put up a security deposit equal to 50 percent or 100 percent of the import duty and VAT. When the EPE receives a type-A or type-B classification, it must provide a deposit equal to 50 percent of the import duty and VAT. When the enterprise receives a type-C classification, it must provide a deposit equal to 100 percent of the import duty and VAT. Goods not in the prohibited and restricted categories are those falling under the permitted category, in respect of which both type-A and type-B enterprises are not required to place deposits while a type-C enterprise is required to put up deposit equal to the full amount of the import duty and VAT.⁹ The EPE is subject to VAT on the conversion cost or the value added in the conversion process. The materials imported directly and indirectly can receive tax-

exempt treatment upon obtaining administrative approval from the Chinese customs and tax bureaus, respectively. The exempt-credit-refund method will apply to the EPE, given that the EPE can satisfy the condition for being recognized as a VAT general taxpayer.

Scenario IV refers to export processing using locally manufactured materials on which input VAT has been paid. In principle, the exporter is entitled to VAT rebates or refunds on export goods. According to the category of the export goods, three different refund policies are now in force:

- There is no export refund. This happens when the export goods receive tax-exempt treatment.
- There is export refund at reduced rates. This happens when the amount of refundable VAT is divided into two portions — the allowed credit and disallowed credit portions. The disallowed credit is not refundable and will be charged to production costs. In other words, the disallowed credit is a tax liability since it reduces the amount of VAT refundable. When the amount of disallowed credit is bigger than the input VAT, the exporter must pay additional VAT on export.¹⁰
- There is full export refund. The exporter is subject to zero-rated tax and suffers no tax on export goods. For example, the exporter of IT products gets refunded at 17 percent. Since 2003 the government has been revising the refund policy for export goods falling under different categories, either by reducing the refund rates for some goods or increasing the scope of goods that receive no refund at all.

Exempt-Credit-Refund Computations

The disallowed credit is the amount of input VAT that is neither exempted from VAT nor credited against the output VAT. The disallowed credit should be deducted from the input VAT paid on the locally purchased materials (LM) for the current period. The disallowed credit, VAT payable, and the maximum VAT refundable for the current period are computed using the following formula:

- disallowed credit = (export sale - bonded material (BM)) x (standard rate - refund rate);
- VAT payable = output VAT on local sales - (input VAT on LM - disallowed credit); and
- maximum VAT refundable = (export sale - BM) x (refund rate)

⁸Since the release of document 17 (2007), documents 105 (2005), 63 (2006), and 83 (2006) have been repealed.

⁹See document 44 (2007), jointly issued by the Ministry of Commerce and the General Administration of Customs.

¹⁰See Cai Shui [2004] 52, jointly issued by the Ministry of Finance and the State Administration of Taxation on Mar. 3, 2004.

Table 2. VAT Implications for Exporters

	Case I (Disallowed credit > input VAT)	Case II (Input VAT > disallowed credit)	Case III (Disallowed credit = 0)
Disallowed credit = (export sales - BM) x (standard rate - refund rate)	$(150 - 0) \times (17\% - 5\%) = 150 \times 12\% = 18$	$(150 - 0) \times (17\% - 11\%) = 150 \times 6\% = 9$	$(150 - 0) \times (17\% - 17\%) = 150 \times 0\% = 0$
VAT payable = VAT on local sales - (VAT on LM - disallowed credit)	$0 - (70 \times 17\% - 18) = -11.9 + 18 = 6.1$	$0 - (70 \times 17\% - 9) = -11.9 + 9 = -2.9$ (debit balance)	$0 - (70 \times 17\% - 0) = -11.9$ (debit balance)
VAT refund or liability?	VAT liability = 6.1	Partial refund = 2.9	Full refund (zero rate tax) = 11.9
Max. refundable amount = (export sales - BM) x refund rate	N/A since the exporter has a VAT liability	$(150 - 0) \times 11\% = 16.5$	$(150 - 0) \times 17\% = 25.5$

Illustration

Show the VAT payable by the exporter assuming the goods attract a 5 percent export rebate. Assume input raw materials are all purchased in China. Use for example FOB export price of CNY 150 and raw material cost of CNY 70. No BMs are in use. Show the VAT liabilities if the export rebate is 11 percent and 17 percent respectively.

- Step 1: calculate the disallowed credits in the following formula (a tax liability) — disallowed credit = (export sales - BM) x (standard rate - refund rate).
- Step 2: apply the following formula to get the VAT refund if in the negative (VAT liability if in the positive) — VAT payable = VAT on local sale - (VAT on LM - disallowed credit).

The VAT implication for the exporter who pays VAT or receives a refund, in whole or in part, are shown in Table 2.

In Case I, the disallowed credit of 18 is a VAT liability. After offsetting the input VAT of 11.9, the exporter had to pay 6.1 to the tax bureau. The Chinese government is adopting a policy to discourage exports and imposing an export tax on the goods. When the EPE is receiving the exempt-credit-refund treatment, the output VAT for export is nil (exempt) and there are three possible tax positions: (i) Case I shows a VAT liability if the disallowed credit is bigger than the input VAT, (ii) Case II shows a partial VAT refund if the amount of input VAT is bigger than the disallowed credit; and (iii) Case III shows that there is a full VAT refund when the amount of disallowed credit is zero. That will happen if the refund rate is the same as the VAT standard rate (17 percent). (Note that 13 percent is applicable to some specified products.) In this case, the exporter is subject to zero-rated tax.

Summary

According to different types of refund rules, the exporter may receive tax exemption treatment, exempt-credit-refund treatment, or pay-first-and-refund-later treatment. According to the different policy objectives that the Chinese government may want to achieve, the exporter may receive no refund, get a refund in part, enjoy a zero-rate tax and get a refund in full, or pay VAT on exports. Now we have to deal with the deemed sales rules that directly result from the application of the no-refund policy or the taxpayer's noncompliance of the export refund procedures. The deemed sale rule will apply (a) when the goods are on the official no-refund lists; or (b) when the exporter either fails to comply with the export refund requirements for submitting the refund application or cannot provide the documentation within the prescribed time period for export refund purposes.¹¹

The amounts of export sales and the local purchases are CNY 150 and CNY 70, respectively; there is no importation of bonded materials.

When the EPE is exporting goods on the no-refund list, the exports will be deemed to be sales taking place in the domestic market. The VAT liability for the exporter will be: output VAT - input VAT = $(150/1.17 \times 17\%) - (70 \times 17\%) = 21.79 - 11.9 = 9.89$.¹²

When the exporter, who receives the exempt-credit-refund treatment, does not comply with the export refund rules, the deemed sales rule will apply. This happens if the exporter does not apply for export refund,

¹¹See Guo Shui Fa [2006] 102, issued by the State Administration of Taxation.

¹²Regarding the computation of sales for VAT purposes, see Cai Shui [2004] 116, jointly issued by the Ministry of Finance and the State Administration of Taxation.

Table 3. VAT Implications Under Different Refund Policies

	Major policy category	Subcategory	VAT	VAT/sales	VAT positions
1	Exempt-credit-refund	Disallowed credit = 0; taxpayer gets a 17% refund rate.	-11.90	-11.9/150 = -7.93%	Full refund
2	Exempt-credit-refund	Input VAT > disallowed credit; taxpayer gets reduced refund rate.	-2.90	-2.9/150 = -1.93%	Partial refund
3	Exempt-credit-refund	Disallowed credit > input VAT; reduced refund rate.	6.10	6.10/150 = 4.07%	VAT liability
4	Tax-exempt	With no credit for input VAT paid.	11.90	11.9/150 = 7.93%	VAT liability is input VAT
5	Tax-exempt	With no VAT payment on input purchase; it applies to processing trade with supplied materials. The Chinese government has imposed a ban on processing export goods on the no-refund lists.	0		
6	Deemed sales in domestic market	Export goods on no-refund lists; processing trade mode [using imported material as substitutes] is prohibited.	9.89	9.89/150 = 6.59%	VAT liability = output VAT - input VAT
7	Deemed sales in domestic market	Noncompliance to apply for refund or has applied but cannot provide complete information within 90 days of export declaration (general taxpayer).	9.89	9.89/150 = 6.59%	VAT liability = output VAT - input VAT
8	Deemed sales in domestic market	Same type of noncompliance (nongeneral taxpayer).	33.69	33.69/150 = 22.46%	Output VAT + input VAT

or has applied for it but cannot provide all the documentation for the export refund within 90 days of the export declaration.¹³ Consequently, all the exports are deemed to be domestic sales even if they have physically been shipped out of the Chinese customs territories. The exporter is a VAT general taxpayer, and it can claim input credit. The VAT liability will be: output VAT - input VAT = $(150/1.17 \times 17\%) - (70 \times 17\%) = 21.79 - 11.9 = 9.89$.

Note there is a variation for the noncompliance. The VAT position will be different if the exporter has not completed the procedure for getting recognized by the tax authority in charge as a VAT general taxpayer. In

¹³See Guo Shui Fa [2004] 64, issued by the State Administration of Taxation.

this case, the exporter is not entitled to an export refund. The exporter cannot claim input credit either because it is not a VAT general taxpayer. The VAT liability will be: output VAT - input VAT = $(150/1.17 \times 17\%) - 0 = 21.79$. Note that since the exporter has already paid an input VAT on the local purchase $70 \times 17\% = 11.9$, the total VAT paid and payable should be the sum of output VAT and input VAT, $33.69 = 21.79 + 11.9$.

Table 3 shows various VAT implications as a result of different export refund policies the Chinese government has adopted in recent years, given the same set of information. The VAT expressed as a percentage to export sales could range from -7.93 percent (refund) to 6.59 percent (liability). When the taxpayer is not receiving sufficient professional advice, the maximum VAT liability could be 22.46 percent on the sales amount. ◆