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China Tax Update

In brief

In this March issue of China Tax Update, we will discuss the following tax developments in China:

1. Tax proposals in the 2022 government work report
2. Input VAT refund policy for qualified enterprises
3. Notice regarding formulating the 2022 list of integrated circuit enterprises/projects and software enterprises eligible for the preferential tax policies
4. VAT exemption and relief measures
5. Individual income tax additional special deduction for nursing expenses for infants and toddlers

1. Tax proposals in the 2022 government work report

In brief

On 5 March 2022, China's Premier Li Keqiang delivered a government work report at the opening meeting of the fifth session of the 13th National People's Congress ("**Government Work Report**"),[1] which highlights the government's tax policy priorities for 2022: (i) implement tax and fee cuts for small and medium enterprises (SMEs); (ii) encourage R&D activities; and (3) support enterprises in the manufacturing industries.

Of particular importance to multinational companies (MNCs), the Government Work Report proposes to refine the excess input value-added tax (VAT) refund policy, increase the R&D super deduction ratio, and implement the accelerated depreciation policy for qualified enterprises.

In more detail

Tax and fee cuts will continue to be the theme of the year. The Government Work Report proposes a number of tax policies that would support SMEs, including (i) a VAT exemption policy for small-scale VAT taxpayers, which are currently taxed at a 1% VAT levy rate;[2] and (ii) an additional 50% reduction of enterprise income tax (EIT) (i.e., reduction of effective tax rate from 10% to 5%) on small and micro enterprises' annual taxable income between RMB 1 million and RMB 3 million.[3]

With respect to R&D, the Government Work Report proposes to increase the R&D expense super deduction ratio from 75% to 100% for small and medium science and technology enterprises. Previously, the ratio was increased from 75% to 100% for qualified enterprises in the specified manufacturing industries.[4] The proposal is implemented

[1] Available at http://www.gov.cn/zhuanti/2022lhzfgzbg/index.htm.

[2] Bulletin of Ministry of Finance and State Taxation Administration on Continuously Implementing the Tax Relief Measures in Response to the COVID-19 Pandemic, Bulletin [2021] No. 7, dated and effective from 17 March 2021.

[3] See Bulletin [2022] No. 5 for the administrative guidance on applying the preferential EIT policy for small and micro enterprises.

[4] See our 2021 China Tax Review, which is available at https://insightplus.bakermckenzie.com/bm/tax.

by Bulletin [2022] No. 16,[5] which provides that qualified enterprises would be able to deduct 200% of the eligible R&D expense actually incurred or amortize 200% of the actual cost of the intangible assets where the eligible R&D expense is capitalized. The definition of small and medium science and technology enterprises is provided under Circular [2017] No. 115.[6] For purposes of enjoying the policy, an enterprise needs to satisfy both the quantitative standard (i.e., annual revenue of not more than RMB 200 million, a workforce of not more than 500 employees and total assets of not more than RMB 200 million) and the qualitative standard (i.e., scientific and technological staff, R&D investment and scientific and technological results) specified under Circular [2017] No. 115.

The Government Work Report also proposes an accelerated depreciation policy for qualified enterprises, i.e., micro, small and medium enterprises (MSMEs). Shortly after the government meeting, the Ministry of Finance (MOF) and State Taxation Administration (STA) jointly issued Cai Shui [2022] No. 12, which clarifies the definition of MSMEs and the mechanism for the accelerated depreciation policy.[7] In order to be considered as MSMEs, enterprises in the telecommunication, construction, and leasing and commercial services industries should have an annual revenue of less than RMB 1 billion, or total assets of less than RMB 1.2 billion, or a workforce of less than 2,000 employees; enterprises in the real estate development business should have an annual revenue of less than RMB 2 billion or total assets of less than RMB 100 million; and enterprises in other industries should have an annual revenue of less than RMB 400 million or a workforce of less than 1,000 employees. Qualified enterprises can choose to immediately expense 100% of the cost of the newly purchased equipment and instrument with a unit value greater than RMB 5 million in 2022 if the items have a minimum tax depreciation life of three years, or 50% of the cost if the items have a minimum tax depreciation life of more than three years. Tax losses due to the up-front EIT deduction can be carried forward for five tax years or extended loss carry-forward period if applicable.

Of particular importance to MNCs, the Government Work Report proposes to refine the excess input VAT policy that was introduced as a pilot program in 2019. The government noted that approximately RMB 1.5 trillion (i.e., equivalent to USD 235.8 billion at an exchange rate of 6.36) excess input VAT is expected to be refunded to SMEs and qualified enterprises in the specified manufacturing industries. Shortly after the meeting, the MOF and the STA issued Bulletin [2022] No. 14 ("**Bulletin 14**")[8] and Bulletin [2022] No. 4[9] implementing the tax proposal, which are discussed in section 2.

Our observation

The tax proposals noted in the Government Work Report indicate that the government continues to focus on tax policies that support SMEs, encourage R&D activities, and support enterprises in the manufacturing industries. MNCs that incur a material amount of R&D expenses or contemplate purchasing and upgrading equipment should evaluate whether they would be eligible for the R&D super deduction and accelerated depreciation policies and comply with the relevant documentation requirements.

2. Input VAT refund policy for qualified enterprises

In brief

On 21 March and 22 March 2022, the MOF and the STA issued Bulletin 14 and Bulletin [2022] No. 4 implementing the excess input VAT refund policy proposed under the Government Work Report. The new policy represents a significant step taken by the Chinese government to refine China's VAT system and reduce the tax burden on

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[5] Bulletin of MOF, STA and Ministry of Science and Technology on Increasing the R&D Expense Super Deduction Ratio for Small and Medium Science and Technology Enterprises, Bulletin [2022] No. 16, dated 23 March 2022 and effective from 1 January 2022.

[6] Circular of MOF, STA and Ministry of Science and Technology on Issuing the Measures for Evaluating Small and Medium Science and Technology Enterprises, Circular [2017] No. 115, dated and effective from 3 May 2017

[7] Notice of MOF and STA on Issuing the Accelerated Depreciation Policy for Micro, Small and Medium Enterprises, Notice [2022] No. 12, dated and effective from 2 March 2022.

[8] Bulletin of MOF and STA on Further Implementing the Excess Input VAT Refund Policy, Bulletin [2022] No. 14, dated 21 March 2022 and effective from 1 April 2022.

[9] Bulletin of STA on Administrative Matters Related to Further Implementing the Excess Input VAT Refund Policy, Bulletin [2022] No. 4, dated 22 March 2022 and effective from 1 April 2022.

businesses. MNCs should evaluate whether they would be able to benefit from the new policy and discuss with their tax advisers on the procedures and requirements to apply for the refund.

In more detail

The excess input VAT refund policy was initially introduced under Bulletin [2019] No. 39 ("**Bulletin 39**") on a trial basis starting from 1 April 2019.[10] Prior to the introduction of the policy, enterprises were only allowed to carry forward their excess input VAT to offset their future output VAT. Bulletin 39 sets out the conditions and calculation methods of the VAT refund mechanism that are still relevant today. Only incremental excess input VAT arising on or after 1 April 2019 is allowed for refund. Stated differently, any accumulated balance of excess input VAT prior to 1 April 2019 remains nonrefundable and can only be carried forward under the general rule. The formula for purposes of calculating the incremental excess input VAT refund is: Incremental excess input VAT refund = Incremental balance of excess input VAT * Input VAT composition ratio[11] * 60%. As the formula illustrates, only 60% of the incremental balance is refundable.

Bulletin [2019] No. 84[12] and Bulletin [2021] No. 15 ("**Bulletin 15**")[13] slightly revised the conditions and calculation methods under Bulletin 39 for qualified enterprises in the specified advanced manufacturing industries. Among other changes, Bulletin 15 increases the incremental excess input VAT refund percentage from 60% to 100%. However, Bulletin 15 limits its application to qualified enterprises in the specified advanced manufacturing industries[14]. However, the accumulated balance of excess input VAT prior to 1 April 2019 remains nonrefundable.

Bulletin 14 expands the quantum of refundable excess input VAT to cover the accumulated balance of excess input VAT for SMEs and qualified enterprises in the manufacturing industries, meaning SMEs and qualified enterprises would be able to apply for a 100% refund of their accumulated balance of excess input VAT.

- Scope: Qualified industries include manufacturing, scientific research and technological services; electricity, heat, gas and water supply, software and information technology services; ecological protection and environmental protection; and public transportation, warehousing and postal services.
- Refund mechanism for accumulated balance of excess input VAT: Qualified enterprises are allowed to apply for a 100% refund of their accumulated balance of excess input VAT using the formula: Accumulated excess input VAT refund = Accumulated balance of excess input VAT * Input VAT composition ratio * 100%. The accumulated balance of excess input VAT is the lesser of the accumulated balance in March 2019 and the month preceding the VAT refund application. To manage the fiscal pressure on the local governments, different groups of enterprises are scheduled to apply for the VAT refund starting from different months, e.g., medium-sized and large-sized enterprises in the manufacturing industries are allowed to apply for the VAT refund starting from July 2022 or October 2022, respectively, and other enterprises are allowed to apply for the VAT refund in April or May 2022. In order to implement the VAT refund, it is anticipated that the central government will deploy special funds to the local governments.
- Refund mechanism for incremental excess input VAT: In addition to the refund of the accumulated balance of excess input VAT, qualified enterprises can apply for the refund of incremental excess input VAT on a regular basis going forward using the formula: Incremental excess input VAT refund = Incremental balance of excess input VAT * Input VAT composition ratio * 100%. If an enterprise applies the refund of accumulated balance of excess input VAT first, then the accumulated balance would be reduced to zero, and the incremental balance

[10] Bulletin of MOF, STA and General Administration of Customs on Relevant Policies Deepening the VAT Reform, Bulletin [2019] No. 39, dated 20 March 2019 and effective from 1 April 2019.

[11] The input composition ratio is the fraction with the total input VAT on certain invoices (i.e., special VAT invoice, customs import special VAT payment certificate, and withholding tax clearance certificate) as the numerator and the total creditable input VAT as the denominator, for the period from 1 April 2019 through the tax period preceding the VAT refund application.

[12] Bulletin of MOF and STA on Clarifying the Excess Input VAT Refund Policy for Taxpayers in the Advanced Manufacturing Industry, Bulletin [2019] No. 84, dated and effective from 31 August 2019.

[13] Bulletin of the MOF and STA on Clarifying the Excess Input VAT Refund Policy for Taxpayers in the Advanced Manufacturing Industry, Bulletin [2021] No. 15, dated and effective from 31 April 2021.

[14] See Article 2 of Bulletin 15.

of excess input VAT in the formula that the enterprise can apply for refund would be the enterprise's remaining balance of excess input VAT.

- Conditions: Bulletin 14 partially inherits the conditions under Bulletin 39 with some modifications. In general, an enterprise needs to satisfy the following conditions to be eligible for the input VAT refund policy, including (i) the enterprise should have a tax credit rating of Grade A or B; (ii) the enterprise should have no records of tax fraud or noncompliance in relation to the issuance of VAT special invoices, export VAT refunds, etc., for the 36-month period before the input VAT refund application; (iii) the enterprise should not be subject to two or more penalties by the tax authorities due to tax evasion within the 36-month period before the input VAT refund application; and (iv) the enterprise should not enjoy VAT refund upon collection and VAT refund (rebate) after collection starting from 1 April 2019. Further, enterprises in the specified manufacturing industries should derive more than 50% revenue from the specified manufacturing industries.

Our observation

Previously, enterprises were only allowed to carry forward their excess input VAT to offset their future output VAT. Such mechanism may create cash flow issues for some enterprises, in particular, those with large initial capital expenditure and timing mismatch of cost and revenue. Bulletin 14 represents a significant step forward taken by the government in refining China's VAT system by adjusting its mechanism to better align with the international best practices. It will benefit a wide spectrum of enterprises in different sizes and different industries. Compared to Bulletin 39 and Bulletin 15, Bulletin 14 is very generous by expanding the scope of applicable enterprises and allowing them to apply for a refund of 100% of the accumulated balance of excess input VAT.

The new policy is very complicated from a tax technical perspective. MNCs that intend to apply for the excess input VAT refund should review their current input VAT position and evaluate whether they would be able to meet the conditions. MNCs are recommended to discuss and work with their tax advisers to develop a plan for the refund and start preparing application documents. Last but not least, compliance is always an important component of VAT management, from collecting VAT invoices from vendors for input VAT invoices verification to issuing VAT invoices and filing monthly VAT returns. As part of the implementation of the policy, it is reasonable to anticipate that the tax authorities would review the taxpayers' application to assess their eligibility as well as their historical status of compliance. MNCs are recommended to take the opportunity to review their internal VAT management process to ensure compliance and identify tax risks.

3. Notice regarding formulating the 2022 list of integrated circuit enterprises/projects and software enterprises eligible for the preferential tax policies

In brief

On 14 March 2022, the National Development and Reform Commission (NDRC), MOF, Ministry of Industry and Information Technology (MIIT), STA and General Administration of Customs (GAC) jointly issued Fa Gai Gao Ji [2022] No. 390 ("**Circular 390**"),[15] which clarifies certain administrative guidance on formulating the list of Integrated Circuit (IC) enterprises/projects and software enterprises that would be eligible for the preferential tax policies in 2022.

In more detail

Procedure: Enterprises applying for being included in the 2022 list to enjoy the preferential tax policies must submit their application to the information reporting system by 16 April 2022, followed by submitting application documents and supporting documents to the relevant government authorities. Key IC design enterprises and software enterprises that failed to enjoy the preferential tax policies in 2021 due to certain practical reasons may submit supplementary applications to the same system by 21 March 2022. Enterprises can apply the preferential tax policies based on self-assessment before the release of the 2022 list. To the extent an enterprise is eventually not included in the 2022 list, it should pay the incremental taxes.

Preferential tax policies: The government has issued a series of preferential tax policies including EIT, VAT and import duty to support enterprises in the IC and software sectors. We have summarized the preferential EIT policies

[15] Circular of NDRC, MOF, MIIT, STA and GAC on Formulating the 2022 List of Integrated Circuit Enterprises/Projects and Software Enterprises Eligible for the Preferential Tax Policies, Circular [2022] No. 390, dated and effective from 14 March 2022.

under Bulletin [2020] No. 45 ("**Bulletin 45**")[16] in the following table. IC manufacturing enterprises/projects with a linewidth of 130 nanometers or less are also entitled to a 10-year loss carryforward period (five years under the general EIT rule).

Qualified enterprises	Preferential EIT policies	Conditions
IC manufacturing enterprises/projects	10-year exemption	Linewidth of 28 nanometers or less and an operating period longer than 15 years
	Five-year exemption followed by a five-year 50% reduction of EIT	Linewidth of 65 nanometers or less and an operating period longer than 15 years
	Two-year exemption followed by a three-year 50% reduction of EIT	Linewidth of 130 nanometers or less and an operating period longer than 10 years
IC design, encapsulation, testing, or equipment and materials manufacturing enterprises, and software enterprises	Two-year exemption followed by a three-year 50% reduction of EIT from the first profit-making year	
Encouraged key IC design and software enterprises	Five-year exemption from the first profit-making year plus a reduced EIT rate of 10% thereafter	

Further, qualified software enterprises are entitled to the preferential VAT refund/rebate for effective VAT cost of more than 3% under Notice [2011] No. 100.[17] Also, qualified IC and software enterprises are entitled to the preferential import duty treatment on importation of qualified equipment, parts, raw materials, consumables, etc., under Circular [2021] No. 4.[18]

Our observation

For purposes of enjoying the preferential tax policies, enterprises should take immediate actions in preparing application documents and supporting documents, and submit the application by the deadline. Further, Article 6 of Bulletin 45 states that where an enterprise is eligible for multiple tax incentives, it should choose one of the incentives. Therefore, enterprises that intend to apply for being included on the 2022 list should determine which incentive may maximize the benefits based on their financial forecast. Last but not least, enterprises should ensure that they meet the compliance and documentation requirements.

4. VAT exemption and relief measures

4.1 VAT relief measures

In addition to the input VAT refund policy, the MOF and the SAT jointly issued Bulletin [2022] No. 11 ("**Bulletin 11**"),[19] which extends the VAT relief measures for VAT taxpayers in the postal services, telecommunication, modern services, living services, and airline and railway public transportation industries.

[16] Bulletin of NDRC, MOF, MIIT and STA on the Enterprise Income Tax Policies for Promoting the High-Quality Development of the Integrated Circuit Industry and the Software Industry, Bulletin [2020] No. 45, dated 11 December 2020 and effective from 1 January 2020.

[17] Notice of MOF and STA on Value-Added Tax Policy on Software Products, Notice [2011] No. 100, dated 13 October 2011 and effective from 1 January 2011.

[18] Circular of MOF, STA and GAC on the Import Tax Policy in Support of the Development of Integrated Circuit Industry and Software Industry, Circular [2021] No. 4, dated 16 March 2021 and effective from 27 July 2020.

[19] Bulletin of MOF and STA on Extending the VAT Relief Measures for Taxpayers in Certain Services Industries, Bulletin [2022] No. 11, dated and effective from 3 March 2022.

Under Bulletin 11, the super input VAT credit policy and VAT exemption policy under Bulletin 39 and Bulletin [2019] No. 87[20] are extended until 31 December 2022. The super input VAT credit policy allows VAT taxpayers in the (i) postal, telecommunication, and modern services industries, and (ii) living services industry to take an additional 10% or 15% input VAT credit against their output VAT. For purposes of applying the super input VAT credit policy, VAT taxpayers need to derive at least 50% revenue from the specified industries. VAT taxpayers that provide airline and railway public transportation services are exempt from VAT on their public transportation income under Bulletin 11.

4.2 VAT exemption for VAT small-scale taxpayers

Last but not least, in implementing the VAT exemption policy for VAT small-scale taxpayers proposed by the Government Work Report, the SAT issued Bulletin [2022] No. 15[21] and Bulletin [2022] No. 6,[22] which provide that VAT small-scale taxpayers would be exempt from VAT on their VAT taxable income that would otherwise be subject to the 3% VAT levy rate. VAT small-scale taxpayers that enjoy the VAT exemption policy should only issue normal VAT invoices.

5. Individual income tax additional special deduction for nursing expenses for infants and toddlers

On 19 March 2022, the State Council issued Guo Fa [2022] No. 8 ("**Circular 8**"), which adds nursing expenses for children under 3 years old to the existing list of individual income tax (IIT) additional special deduction items.[23] Shortly after the issuance of Circular 8, the STA issued Bulletin [2022] No. 7 ("**Bulletin 7**"),[24] which provides administrative guidance on the application of Circular 8. Under Circular 8, parents can divide a monthly standard deduction of RMB 1,000 (around USD 157) for each child on their respective income tax return or one of them can take the full deduction. Joint return filing method is not allowed in China.

The policy is a series of measures to encourage larger families. Human resources departments of MNCs should ensure that they comply with the administrative guidance under Bulletin 7 when withholding IIT for their employees.

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[20] Bulletin of MOF and STA on Clarifying the VAT Relief Measure for Taxpayers in the Living Services Industry, Bulletin [2019] No. 87, dated and effective from 30 September 2021.

[21] Bulletin of MOF and STA on Implementing the VAT Exemption Policy for VAT Small-Scale Taxpayers, Bulletin [2022] No. 15, dated and effective from 24 March 2022.

[22] Bulletin of MOF and STA on Administrative Matters Implementing the VAT Exemption Policy for VAT Small-Scale Taxpayers, Bulletin [2022] No. 6, dated and effective from 24 March 2022.

[23] Circular of State Council on Establishing the Individual Income Tax Special additional Deduction for Nursing Expenses for Infants and Toddlers, Circular [2022] No. 8, dated 19 March 2022 and effective from 1 January 2022.

[24] Bulletin of STA on Revising and Issuing the Operating Measures for the Individual Income Tax Special additional Deductions Items, Bulletin [2022] No. 7, dated 25 March 2022 and effective from 1 January 2022.

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