



J.BRACIC & ASSOCIATES
TRADE REMEDY ADVISORS

PO Box 3026
Manuka, ACT 2603
Mobile: +61 499 056 729
Email: john@jbracic.com.au
Web: www.jbracic.com.au

15 September 2017

Director Operations 2
Anti-Dumping Commission
Level 35, 55 Collins Street
Melbourne VIC 3000

Review of measures applying to aluminium extrusions exported from China

Dear Director,

This submission is made on behalf of PanAsia Aluminium (China) Co. Ltd (PanAsia China) and in response to the Anti-Dumping Commission's (the Commission) preliminary findings outlined in Statement of Essential Facts Report No. 392 (SEF 392).

Error in profit calculation

PanAsia China has discovered an error in the Commission's calculation of domestic profit. The pivot used to calculate profit includes domestic sales which had no finish designation and were recorded as "N/A". For those domestic sales, the Commission's OCOT spreadsheet does not attribute any cost to the goods and as such, the full sales value is reflected as profit.

To rectify this error, PanAsia China proposes that the small volume of those domestic sales be excluded from the profit calculation, which results in the average rate of profit reducing from ■■■% to ■■■%.

Profit – inclusion of high end powder coated products

PanAsia China considers the Commission's calculation of domestic profit to be significantly overstated as it includes sales of powder coated products which are not considered to be 'ordinary sales' and therefore ought to be excluded from the determination of profit.

As the Commission has verified, PanAsia China manufactures and sells high end integrated window and door systems under its "■■■■" brand. The powder coated products sold domestically are for use in these systems and are priced at a significant premium, to reflect the substantial long-term investment required to develop and improve

PUBLIC VERSION

those systems. This contrasts to the standard lengths of powder coated product exported to Australia which are sold individually in bundles and purchased by Australian customers for use in their own developed window and door systems.

In addition, the domestic powder coated products require a near perfect surface finish and as such have a higher rejection rate than compared to the standard powder coated profiles exported to Australia. This higher rejection rate results in a higher average unit cost, which again requires PanAsia China to attach a significant price premium to the product when sold into the market.

PanAsia China contends that the unique product and production characteristics of these domestic powder coated products, support a finding that those domestic sales do not reflect sales made in the ordinary course of trade. This is further supported by a comparison of profit rates across the different finishes, which shows that profit rates achieved on ordinary domestic sales of extrusions ranged from ■■■% to ■■■% for mill and anodised respectively, compared to ■■■% for powder coated extrusions.

On that basis, PanAsia China requests the Commission to treat the domestic sales of powder coated products as sales not made in the ordinary course of trade, and calculate profit using only domestic sales of mill and anodised extrusions sold in the ordinary course of trade.

Profit to be calculated using uplifted CTMS

It is noted that the Commission's calculation of profit in this review is not consistent with the Commission's original approach determined during the original investigation in REP 148. During the original investigation, the Commission calculated PanAsia's profit by comparing '*selling prices for comparable domestic models to the corresponding monthly revised CTMS*'. That is, profit was calculated by reference to the uplifted CTMS which included the substituted primary aluminium benchmark costs.

During this review, the Commission has instead calculated profit on the basis of PanAsia's costs without the inclusion of the substitute benchmark cost for primary aluminium. PanAsia disagrees with this approach as it does not accurately reflect the profit rate that could be achieved in the domestic market, in the face of higher raw material costs. As considered by the Commission during the original investigation, it is too simplistic a notion to assume that domestic prices will increase proportionately to the increase in costs and that producers will be able to maintain a fixed profit margin in those circumstances.

Therefore, PanAsia China requests the Commission to reconsider its methodology for calculating profit and to revert to its original approach whereby the rate of profit is determined by reference to the uplifted CTMS following the substitution of the primary aluminium benchmark costs.

PUBLIC VERSION

Due allowance – non-refundable VAT

The PanAsia China exporter visit report correctly highlights that

PanAsia incurs a non-refundable VAT expense on export sales to Australia of 4 per cent, being the difference between the VAT rate of 17 per cent less 13 per cent VAT refunded on export sales of aluminium extrusions. Therefore, the visit team applied an upward adjustment of 4 per cent to the normal value.

However, the Commission's report does not accurately reflect the point at which the adjustment was made to the normal values.

As confirmed and verified by the Commission during its visit to PanAsia China, and consistent with the Commission's long-standing understanding and practice, the export VAT and non-refundable VAT component are calculated by reference to the free-on-board export price of the goods. This reflects the point at which goods are exported from China.

This is further confirmed and supported by the Commission's policy position which stemmed from its VAT issues paper (**Attachment A**) and independent accounting advice provided by Ernst & Young (**Attachment B**) during the original investigation into aluminium extrusions (REP 148).

Therefore, the 4% non-refundable VAT adjustment is required to be calculated and applied on PanAsia's FOB normal value ex-China. Instead the Commission's preliminary calculation incorrectly applies the 4% VAT to the FOB normal value ex-Macau. That is, the 4% VAT adjustment is applied to a constructed normal value that includes OPAL Macao's SG&A and export credit terms.

Given that the Commission's policy and practice is to apply the VAT adjustment to the FOB value of the goods at the Chinese border, the Commission has erred by applying the VAT adjustment in PanAsia's case at the Macau border. Therefore, PanAsia requests the Commission to amend the preliminary calculations by adding the 4% VAT adjustment at PanAsia's FOB normal value (ex-China). This has the effect of reducing the normal values and the corresponding dumping margin.

Due allowance – export credit terms

PanAsia contends that the Commission's calculation of the adjustment for export credit terms to be flawed as it misinterprets the nature of the arrangement agreed between importer and the exporter.

As explained to the Commission, PanAsia Australia was only recently established in late 2015 and continues to operate in a start-up phase requiring working capital for salaries, warehouse rental, and to grow and maintain its operating inventory levels. In these circumstances, rather than requiring PanAsia China to inject additional funding into

PUBLIC VERSION

PanAsia Australia, PanAsia China agreed to reinvest the value of certain account receivables back into the Australian business.

This arrangement did not result in credit terms being extended beyond the originally agreed ■ days as considered by the Commission. The arrangement simply provided administrative expediency as it avoided PanAsia Australia having to make payment as per the agreed ■ days terms, and for PanAsia China to then immediately transfer the funds back to the Australian business as working capital.

Therefore, the Commission has incorrectly calculated export credit terms on the basis of the average number of payment days, as this figure is distorted by PanAsia China's decision to automatically transfer the value of some accounts receivables into working capital. To rectify this error, PanAsia China requests the Commission to amend the export credit term calculation using the invoiced ■ day export credit terms.

Yours sincerely

John Bracic



Australian Government

**Australian Customs and
Border Protection Service**

**Investigation into the alleged dumping and subsidisation of
aluminium extrusions
exported to Australia from the People's Republic of China**

VAT issues paper:

Treatment of VAT in normal value calculations

1 Executive Summary

The Australian Customs and Border Protection Service (Customs and Border Protection) is currently investigating whether dumping and subsidisation of aluminium extrusions exported to Australia from the People's Republic of China (China) has caused material injury to the Australian industry producing like goods.

On 1 March 2010, Customs and Border Protection issued Statement of Essential Facts No. 148 (SEF 148). SEF 148 sets out the facts on which the Chief Executive Officer (CEO) of Customs and Border Protection proposes to base his recommendations in relation to this investigation to the Minister for Home Affairs (the Minister). In SEF No. 148, Customs and Border Protection stated the following:

"Details of the Capral claim in relation to input VAT and the related Customs and Border Protection assessments are contained in a separate VAT issues paper that will be released as soon as practicable after the SEF. The paper will include reference to expert accounting advice that Customs and Border Protection sought on the issues. Customs and Border Protection will consider submissions in response to the VAT issues paper that are received within 20 days of the day that paper is placed on the public record when deciding on the recommendations to be made to the Minister in the final report"¹.

This paper presents an assessment by Customs and Border Protection as to what is the most appropriate treatment of VAT when calculating dumping margins for Chinese exporters of aluminium extrusions.

The paper has been formulated in the interests of informing all interested parties, but responds in particular to some of the claims made by Capral Limited². More specifically, Customs and Border Protection examines:

- claims that exporters of aluminium extrusions classified exported products incorrectly in relation to tariff classification;
- whether Customs and Border Protection's approach to adjusting normal value to account for differences in VAT treatment between domestic and export sales is correct; and
- whether Customs and Border Protection must take account of any input VAT other than to the extent it is a factor in the point above.

Customs and Border Protection considers that, for the reasons outlined in this paper, no changes are warranted to its approach in this investigation when assessing the nature and magnitude of the upwards adjustments to normal values for VAT issues.

¹ SEF 148, p. 27

² "Capral submission on Customs treatment of value added tax in assessing constructed normal values" - January 2010.

2 Independent accounting advice

At the time of publication of this paper, Customs and Border Protection is not in a position to publish the accounting advice it obtained on the VAT issues. This is due to unresolved contractual issues between Customs and Border Protection and the provider of the advice.

Therefore, Customs and Border Protection has prepared this paper based on its own understanding of the VAT issues. However, while there are no references to the accounting advice provided, Customs and Border Protection considers its understanding of the VAT issues, and the application of that understanding in this investigation, are consistent with the accounting advice in all material aspects.

Customs and Border Protection will persist in its efforts to publish a copy of the accounting advice, but cannot at this stage provide a definitive timeframe nor guarantee that publication of this advice will be possible given the afore-mentioned contractual issues. Interested parties should treat this paper as Customs and Border Protection's position on the VAT issues for the purposes of making submissions.

3 Responses to this paper

In the circumstances, and having regard to the investigation timeline, Customs and Border Protection considers it important to issue this paper to give interested parties sufficient time to comment on the VAT issues. Customs and Border Protection will consider timely interested party responses when formulating the final report and recommendations to the Minister.

Submissions in response to this VAT issues paper should be received by Customs and Border Protection by 1 April 2010.

4 Background

In determining whether, and to what extent, dumping exists, Customs and Border Protection must ensure that normal values are properly comparable to export prices.

There are many differences which can affect this price comparability, including levels of trade, physical characteristics and timing of sales. Another important factor is differences in taxes. Customs and Border Protection considers that normal value calculations need to incorporate an adjustment to take account of any different treatments of VAT for domestic and export sales where those differences affect price comparability.

5 Legislation, policy and practice

5.1 Legislation

The Anti-Dumping Agreement requires that, when determining dumping, a fair comparison be made between export price and normal value. The Anti-Dumping Agreement states that the comparison shall be made at the same level of trade and in respect of sales made at as nearly as possible the same time. It requires that due allowance be made in each case, on its merits, for differences which "affect price comparability". Australia's anti-dumping legislation incorporates this obligation by requiring that:

- the prices of goods exported to Australia are compared with corresponding normal values (s. 269TACB of the Act); and
- any necessary adjustments are made to domestic prices (or constructed domestic prices) so that they can be fairly compared to export prices (s. 269TAC(8) and s. 269TAC(9) of the Act).

Under s. 269TAC(8) of the Act, where the domestic and export prices:

- relate to sales occurring at different times; or
- are not in respect of identical goods; or
- are modified in different ways by taxes or the terms or circumstances of the sales to which they relate;

the price paid or payable for like goods on the domestic market is a price adjusted to allow a fair comparison.

Section 269TAC(9) of the Act provides that, where the normal value is calculated using costs, the Minister must make adjustments, in determining the costs, to ensure the normal value so calculated is properly comparable to the export price.

5.2 Policy and practice

Customs and Border Protection's policy in relation to VAT on exports is provided in the Dumping and Subsidy Manual (June 2009, p. 48):

"The value added tax (VAT) liability may be different on domestic sales compared to export sales. In addition, the way in which a company captures VAT information on sale transactions is likely to be different on domestic sales compared to export sales. This may require adjustment to the normal value.

Export sales are not subject to output VAT liability, as domestic sales are, however they may be subject to a VAT liability equivalent to the FOB value x (VAT rate – VAT refund rate). In other words, although export sales are technically not subject to output VAT liability they effectively incur a VAT liability, which may be at a lesser rate than domestic sales.

For example, if the VAT rate is 17% and the VAT refund rate 5%, domestic sales incur output VAT liability of 17%, whereas export sales incur a VAT liability of 12%.

The main issue in relation to normal value determination is that the exporter usually provides domestic sale prices that are VAT-exclusive. This is because most companies separately capture the output VAT amount on each individual sale. Conversely, most companies do not separately capture the VAT liability associated with export sales because it is not strictly output VAT.

The assumption is that the company's VAT liability is built in to the export price. Accordingly the normal value, which is based on VAT-exclusive sale prices, needs to be adjusted upwards to be comparable to the VAT-inclusive export prices.

Where adjustment to the normal value is warranted due to evidence showing that a different VAT liability exists between domestic and export sales, Customs and Border Protection will carefully consider the information presented by exporters in calculating the amount of the adjustment."

In this context, and in the case of goods exported from China, Customs and Border Protection's experience in recent years has been that goods exported often attract VAT liability at the rate of 17% of the free-on-board (FOB) export price, but the goods are often eligible for VAT refund for export at rates between zero and 15% of FOB value. Customs and Border Protection assumes that exporters will seek to recover any component of residual export VAT liability in their export prices and therefore the export price is affected by a tax that has not affected the (VAT-exclusive) domestic selling price.

Normal values based on (VAT-exclusive) domestic selling prices therefore require upward adjustments to make them properly comparable to export price. For example, where the applicable VAT rate is 17%, and the VAT refund for export rate is 13%, then Customs and Border Protection will increase the (VAT-exclusive) domestic selling prices by 4% for proper comparison. A similar approach is taken for constructed normal values.

6 Capral's view

Capral considers that there is an accounting standard (contained in both Australian and International Accounting Standards) that addresses the accounting treatment of VAT on inputs used in the manufacture of certain goods. Capral submits that International Accounting Standard IAS2 Clause 11 provides the following:

"Costs of purchase

11 The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods,

materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase"

Capral contends that the words "other than those subsequently recoverable by the entity from the taxing authorities" mean that in establishing the true cost of products, the amount of the input VAT needs to be taken into account in the cost of the goods sold in cases where there is no VAT refund for export.

On the point of "no VAT refund for export", Capral further submitted that most, if not all, aluminium extrusions exported from China since July 2007 should have been classified to tariff classification 7604 (zero VAT refund for export during the investigation period) rather than 7610 (13% VAT refund for export during the investigation period). Capral considers that Customs and Border Protection should therefore uplift all taxed inputs by 17% for its cost to make and sell calculations and its constructed normal values.

Capral considers that the adjustments to normal value that Customs and Border Protection has made are significantly understated.

7 Customs and Border Protection's assessment

There are three issues arising from Capral's claims that require attention in order to properly address the questions involving treatment of VAT for the purpose of calculating dumping margins. These are:

- claims that exporters of aluminium extrusions classified exported products incorrectly in relation to tariff classification;
- whether Customs and Border Protection's approach to adjusting normal value to account for differences in VAT treatment between domestic and export sales is correct; and
- whether Customs and Border Protection must take account of any input VAT other than to the extent it is a factor in the point above.

7.1 Aluminium extrusion export tariff classifications

Customs and Border Protection considers the evidence provided by Capral in relation to all exporters other than Panasia indicates that while there may have been some identifiable changes of export tariff classification in mid-July 2007, this was largely if not entirely reversed by mid 2008, i.e. the start of the investigation period.

Indeed, Capral itself notes:

"A comparison of exports with selected other exporters in Panasia's peer group shows a similar reaction to the tax rebate change, then a return to what appears to be a proper classification..."³ (emphasis added)

³ Capral response to Customs Preliminary Visit Report – Pan Asia Aluminium (China) Limited and Opal (Macao Commercial Offshore) Limited, 12 February 2010, p. 6.

Customs and Border Protection is therefore inclined to regard changes to export tariff classification by exporters other than Panasia as not being of a nature or extent that warrants further inquiry.

Customs and Border Protection sought a response from Panasia in relation to Capral's allegations. In its response, Panasia emphasised that Customs and Border Protection had already calculated a weighted average amount of non-recoverable VAT relevant to its exports to Australia. Panasia confirmed it had made a substantial change in the relative proportions of its exports classified to 7604 and 7610. Panasia explained that prior to July 2007 both classifications attracted VAT export rebates and consequently the tariff classification was not treated as a significant issue. However, Panasia further explained that a review of product classifications revealed that a substantial proportion of products formerly attributable to 7604 were properly classifiable to 7610. Panasia also stated:

"A significant factor in the shift in classifications was the application of the international rule that where goods fall within the terms of two or more headings the most specific description of the goods is to be the determining classification factor. Across most of Panasia's product range 7610 clearly provides the most specific description".

In light of the tariff classifications that apply to aluminium extrusions, and the apparent uncertainty surrounding the most correct tariff classification for particular aluminium extrusion products, Customs and Border Protection considers there is insufficient evidence to warrant any further inquiries in relation to the Panasia tariff classifications for exports.

7.2 Treatment of differences in VAT for dumping assessments

During its visit to the Government of China (GOC), Customs and Border Protection was provided a GOC briefing paper on VAT refund for export. On the basis of this briefing paper, Customs and Border Protection compiled a spreadsheet containing its mathematical representation of the GOC paper.

Customs and Border Protection considers that the spreadsheet provides for a reasonable assessment of the quantum of residual export VAT liability, given any particular set of independent variables. Customs and Border Protection considers this amount of residual export VAT liability represents a cost that is incurred in relation to export sales but not domestic sales. In this regard it provides a suitable basis for an upward adjustment to normal values that are based on domestic selling prices (or constructed selling prices) that are exclusive of VAT.

The magnitude of the upward adjustment is, as a maximum, the difference between the VAT rates for normal supply and the rate of VAT refund for export. This adjustment can be lower than the full difference between those rates where VAT-exempt raw materials have been used in the manufacture of the goods. However, Customs and Border Protection will not adjust using such a lesser rate unless the

exporter provides sufficient and reliable evidence in support (eg. evidence of the effect on export VAT liability due to use of VAT-exempt raw materials).

In the case of aluminium extrusions, where goods were exported with no VAT refund for export, a 17% upward adjustment was effectively incorporated within the corresponding normal value calculation. However, any weighted average expression of the magnitude of the adjustment for export VAT liability will be less than the 17% to the extent there are:

- any export transactions with VAT refund for export rates greater than zero⁴;
or
- any VAT-exempt raw materials used in the manufacture of the goods⁵

A copy of the Customs and Border Protection spreadsheet, with minor amendments to the version that formed non-confidential attachment 14 to the GOC visit report, is at **non-confidential Appendix 1**.

7.3 Treatment of input VAT

Customs and Border Protection considers it is important to emphasise that its adjustments to the normal value calculations for export VAT liability already take account of any non-recoverable VAT (a cost) for exports. While this amount is calculated with reference to the FOB value of exports, Customs and Border Protection considers it is essentially a conversion of input VAT to a cost because that component of input VAT is not recoverable from the taxation authority. To this extent, Customs and Border Protection's understanding and treatment of the input VAT align with Capral's interpretation of the accounting standard.

As noted above, Customs and Border Protection considers the export VAT liability is a cost that is particular to the exported goods, and not applicable to domestic sales. Therefore there is no need to take account of such costs in comparing full exporter CTMS with domestic selling prices for ordinary course of trade tests. However, when determining normal value, Customs and Border Protection takes account of the differences in treatment of VAT for domestic and export sales by making an upward adjustment to normal value. This would be the case whether that normal value is based on domestic selling prices or constructed domestic selling prices.

7.4 Customs Assessment

Having regard to the above, Customs and Border Protection considers the evidence demonstrates that it would be inappropriate, as Capral submits, to uplift all taxed inputs by 17% for cost to make and sell calculations and constructed normal values.

Customs and Border Protection has taken an approach to assessing the differences in VAT between domestic and export sales that is consistent with the GOC briefing paper, and the spreadsheet (as amended) that emanated from that paper. Equally,

⁴ Refer to Appendix 1 – independent variable described as "VAT-refundable rate (%)"

⁵ Refer to Appendix 1 – independent variable described as "VAT-exempt raw materials (RMB)"

the manner in which these differences were applied in adjustments to normal value for fair comparison with export price is entirely consistent with the GOC briefing paper and the Customs and Border Protection spreadsheet.

Accordingly, Customs and Border Protection proposes no changes in the nature or magnitude of its upwards adjustments to normal values for export VAT liability.

8 Attachments

The following appendices are non-confidential documents

Appendix 1 Revised Customs and Border Protection spreadsheet for calculating the residual export VAT liability

Government of China Visit Report - Non-Confidential Attachment 14 (amended for the Customs and Border Protection VAT paper - March 2010)

Calculation of residual VAT liability in export sales from China

Enter data only in the green cells (all variables required for the period in question)

Independent variables

VAT rate (%)	17%
VAT refundable rate (%)	0%
Raw materials purchases - domestic (RMB), exc VAT	4,000
VAT exempt raw materials (RMB)	0
Domestic sales value of finished goods (RMB), exc VAT	0
Export sales value of finished goods at FOB (RMB)	5,000
Deductible balance of VAT at the end of last period	0

Step 1 - Find an amount ("A") of VAT, exemptible, deductible or refundable on M's exports for current term

- A VAT amount exemptible, deductible or refundable on the export
 theoretical VAT amount of non-exemptible and non-refundable on those VAT-exempt raw materials

Do not enter data below

= (FOB value of exports (RMB) x rate of VAT (refund) - B

+ Import price of imported raw materials (RMB) x rate of VAT refund

Step 2 - Find an amount ("C") of VAT payable for current term

- C Current VAT payable in the current period
 Non-exemptible and non-deductible (assumed) VAT amount on materials imported duty free

170 Payable(Refundable)

= VAT on current domestic sales - (VAT on current purchased inputs - E)

= Raw materials purchases imported duty free (RMB) x (VAT rate - refundable rate)

- E Non-exemptible and non-deductible VAT amount on export sales = (Export sales value of finished goods at FOB (RMB) x (VAT rate - refundable rate)) - D

950 17.00% Residual export VAT liability

Step 3 - Find the deductible/refundable balance of VAT for current term

- F deductible balance of VAT at the end of period

= deductible balance at end of last term + C (current VAT deductible/refundable)

170 Payable(Refundable)

Step 4 - Find the amount of refundable VAT ("G") for current term

- G amount of refundable VAT

The refundable amount of VAT is the smaller of "F" and "A"

170 Payable(Refundable)



Australian Government
Australian Customs and
Border Protection Service

**Investigation into the alleged dumping and subsidisation of
aluminium extrusions
exported to Australia from the People's Republic of China**

Treatment of VAT in normal value calculations

Independent accounting advice

The VAT issues paper was placed on the public record on 12 March 2010. At that time, Customs and Border Protection was not in a position to publish the independent accounting advice it obtained on the VAT issues. The advice provided by Ernst & Young ("the Report") is now attached.

PLEASE READ - IMPORTANT NOTICE AND DISCLAIMER

This Report is provided for general information only and should not be taken as providing specific advice on any issue.

You should exercise your own skill and care with respect to use of this Report, and obtain independent advice on any specific issues concerning you.

Neither the Australian Customs and Border Protection Service, nor the parties which have endorsed or been involved in the development of the Report, accept any responsibility for use of the information contained in the Report and make no guarantee nor accept any legal liability whatsoever arising from or connected to, the accuracy, reliability, currency or completeness of any material contained in this Report.

The Commonwealth of Australia and all other parties involved in the preparation and publication of this Report expressly disclaim all liability for any loss, damage, injury or other consequence, howsoever caused (including without limitation by way of negligence) which may arise directly or indirectly from use of, or reliance on, the Report.



PUBLIC
FILE
22

Ernst & Young House
51 Allara Street
Canberra ACT 2600 Australia
GPO Box 281 Canberra ACT 2601
Tel: +61 2 6267 3888
Fax: +61 2 6245 1500
www.ey.com/au

18 March 2010

Mr Geoffrey Gleeson
The Australian Customs and Border Protection Service
Customs House
5 Constitution Avenue
CANBERRA CITY ACT 2601

VAT refunds for export and input VAT in China

Geoff

We have set out below details in relation to queries raised by the Australian Customs and Border Protection Service ("Customs") on VAT refunds for export and input VAT in China. We appreciate you providing us with the relevant information used in our analysis. Following our review of the information provided, we set out below our understanding of the background facts and present our analysis on the relevant issues for your reference.

Scope

This advice is based on the limited information provided by Customs to Ernst & Young Canberra via email on 11 February 2010. With your consent, we have relied upon this information to form the analysis and conclusions included in this advice. In addition, where appropriate, we have made certain assumptions that are stated separately in the relevant sections. To the extent that the underlying factual circumstances or assumptions upon which we have based our analysis change, our analysis and conclusions may also differ materially. It is therefore important that you carefully review the facts and assumptions set out in this advice and inform us of any discrepancies or changes so that we may assess their impact on our comments made in this advice.

Our comments set out in this advice are based on the relevant PRC indirect tax regulations prevailing at the time of the issuance of this advice. In the event of any changes, either retroactive or not, we shall not be held responsible for our analysis provided in this advice. The VAT treatment of exports from China would depend on a number of parameters and the nature of the export items is one of the key parameters. The VAT treatment set out in this document is of a generic nature and may not cover certain specific export transactions. We have not been provided with any specific information with respect to the export products and there could be circumstances where the VAT treatments set out in this advice would not be applicable. Moreover, we shall not be held responsible for updating our analysis after the advice issuance date to reflect such changes to the regulations unless an adequate and separate engagement letter exists.

Background

We understand that the background is as follows:

- ▶ There are two issues concerning the accounting treatment of VAT in China that are of interest to Customs. These issues involve the proper accounting for VAT refund for exports and input VAT in general.

- ▶ In relation to VAT refund for exports, the Government of China ("GOC") provided Customs with a briefing paper setting out the legal basis for the issues concerned and a worked example in relation thereto.
- ▶ Customs used the GOC briefing paper to develop an Excel spreadsheet ("the Spreadsheet") to calculate what Customs describes as the "residual VAT liability for export sales".
- ▶ Customs considers that the residual VAT liability for export sales may cause the export price to differ from the domestic selling price.
- ▶ Customs has drawn our attention to International Accounting Standard IAS2 Clause 11, which prescribes that:

The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

- ▶ In relation to the above, Customs has queried whether the words "other than those subsequently recoverable by the entity from the taxing authorities" mean that, in establishing the true cost of products, the amount of the input VAT needs to be taken into account in the cost of the goods sold in cases where there is no VAT refund for export.

Based on the background points outlined above, we are being asked to comment on whether the input VAT costs paid in China should be treated as a "non-recoverable" purchase cost.

Additionally, we understand that the briefing paper and the Spreadsheet are based on the assumption that the export company is a manufacturing enterprise with the status of a general VAT taxpayer. Our comments in this advice, therefore, are focus on the Chinese regulations and rules concerning VAT and VAT refund for export from the perspective of a manufacturing enterprise with the status of a general VAT taxpayer.

China tax regulatory references

We will refer to the following regulations and circulars as the basis of our analysis.

- ▶ Article 3 of Circular by the Ministry of Finance and the State Administration of Taxation regarding further implementation of the VAT exempt, deduct and refund treatment on exported Commodities (Caishui [2002] No. 7) which states as follows:

The Relevant Method of Calculation.

(I) Calculation of the VAT payable for current period.

VAT payable for the current period = Output VAT payable on current domestic sales - (Input VAT for the current period - Non-exempt and non-deductible VAT amount on export sales).

(II) Calculation of the VAT exemptible, deductible and refundable amount for the current period.

VAT exemptible, deductible and refundable for the current period = FOB value of exports [RMB] x Rate of VAT Export Refund - Offset amount for the VAT exemptible, deductible and refundable).

1. The FOB value of exports is subject to the FOB price shown on the export invoices. In the case that export invoices fail to reflect the actual FOB price, enterprises must file a VAT return to the competent state tax authorities in accordance with the actual FOB price and the competent state tax authorities has the power to verify the VAT return in accordance with the Law of the People Republic of China on the Administration of Tax Collection, the Tentative Regulations on VAT of the People's Republic of China and other regulations.

2. Offset amount for the VAT exemptible, deductible and refundable = Price of raw materials whose purchase is exempted from VAT (RMB) x Rate of VAT Export Refund.

Raw materials whose purchase is exempted from VAT include raw materials exempted from VAT purchased in the domestic market and raw materials imported duty free. The price of the latter is the composite assessable value.

Composite assessable value of the raw materials imported duty free = CIF Price of the commodities + Custom Duty collected by China Customs + Consumption tax collected by China Customs.

(III) Calculation of refundable VAT and VAT exemptible, deductible for the period.

1. If the deductible balance of VAT at the end of the period \leq VAT exemptible, deductible and refundable for the current period, then:

- ▶ Refundable VAT for the current period = Deductible balance of VAT at the end of the period.
- ▶ VAT exemptible, deductible for the period = VAT exemptible, deductible and refundable for the current period - Refundable VAT for the current period.

2. If deductible balance of VAT at the end of the period $>$ the VAT exemptible, deductible and refundable for the current period, then:

- ▶ Refundable VAT for the current period = VAT exemptible, deductible and refundable for the current period.
- ▶ VAT exemptible, deductible for the period = 0.
- ▶ The deductible balance of VAT at the end of the period shall be ascertained in accordance with the deductible balance of VAT at the end of the period in the VAT Return for the current period.

(IV) Calculation of non-exemptible and non-deductible VAT amount on export sales.

Non-exemptible and non-deductible VAT amount on export sales = FOB value of exports (RMB) x (VAT rate - Rate of VAT export refund) - Offset amount for the non-exemptible and non-deductible VAT.

Offset amount for the non-exemptible and non-deductible VAT = Price of raw materials whose purchase is exempted from VAT (RMB) x (VAT rate - Rate of VAT export refund).



- ▶ Article 9 of the Revised Provisional Regulations on VAT of the People's Republic of China (Order of the State Council No. 538) which states as follows:

Where certificates for the deduction of VAT obtained by taxpayers purchasing goods or taxable services do not comply with laws, administrative regulations or relevant provisions of the competent taxation authority under the State Council, their input VAT shall not be credited against the output VAT involved.

- ▶ Article 10 of the Revised Provisional Regulations on VAT of the People's Republic of China (Order of the State Council No. 538) which states as follows:

Input tax for the following items shall not be credited against the output tax involved:

1. Goods or taxable services purchased for projects not subject to VAT, projects exempted from VAT, collective benefits or individual consumption;
2. Goods and relevant taxable services purchased that are lost in an unusual manner¹;
3. Goods or taxable services purchased that are consumed by products in progress or finished products that are lost in an unusual manner;
4. Consumer goods for the self-consumption of taxpayers which are specified by the competent authorities for financial and taxation affairs under the State Council; and
5. Transportation expenses for goods specified in Items 1 through 4 of this Article and for the sales of tax-free goods.

- ▶ Article 15 of the Revised Provisional Regulations on VAT of the People's Republic of China (Order of the State Council No. 538) which states as follows:

The following items shall be exempt from VAT:

1. Self-produced agricultural products sold by agricultural producers;
2. Contraceptive medicines and devices;
3. Antique books;
4. Instruments and equipment imported to be directly used in scientific research, scientific experiments and educational activities;
5. Materials and equipment imported from foreign governments and international organizations as free assistance;
6. Articles imported directly by organizations for the disabled for special use by the disabled; and
7. Self-used goods which are sold.

¹ These are commonly referred to as "abnormal losses".



Except as provided in the preceding paragraph, items to which VAT exemption and reduction is applicable shall be specified by the State Council. No region or authority shall specify any item to which VAT exemption and reduction is applicable.

- ▶ Article 24 of the revised Detailed Implementation rules for PRC VAT Provisional Regulations (Order of the Ministry of Finance and the State Administration of Taxation [2008] No. 50) which states as follows:

The term "abnormal losses" as used in Item 2 of Article 10 of the Regulations refers to losses incurred as a result of theft, loss, spoilage or deterioration resulting from improper management.

- ▶ Article 1 of the Circular of State Administration of Taxation (SAT) on Relevant Issues Concerning to Tax Refund (Exemption) for Exported Goods (Guoshuifa [2006] No. 102) which states as follows:

Export Enterprise export the following goods, except where there is other regulation, shall be treated as domestic sales and to declare the output VAT or shall be subject to VAT.

- 1. The goods of which the state has regulations that no VAT refund (exemption) would be entitled.*
- 2. The goods of which export enterprises failed to declare the tax refund (exemption) within the stipulated periods.*
- 3. The goods of which export enterprises failed to provide relevant documentations with tax authorities within the stipulated periods after it declare tax refund (exemption).*
- 4. The goods of which export enterprises failed to issue the export goods agency certificate within the stipulated periods.*
- 5. Other purchased goods by production enterprises which are not belong to the four categories and being treated as self-produce products.*

If general taxpayers (VAT) export the above goods in the method of general trade, then output VAT shall be calculated according to the following formulas:

Output VAT = FOB value of exports [RMB] / (1 + Applicable VAT rate) x Applicable VAT rate.

If general taxpayers export the above goods after processing with the import bonded materials or small scales taxpayers export the above goods, then the taxable payments shall be calculated according to the following formulas:

VAT payable = FOB value of exports [RMB] / (1 + tax collection rate) x tax collection rate.

For the above exported goods due to the calculation of output VAT, if the production enterprises have calculated the non-exemptible and non-deductible VAT amount, and have already booked these as cost, and such tax amounts can be transferred to input VAT from the account of cost; if foreign trade enterprises have calculated the balance between the tax collection rate and tax refund rate, and transferred such balance into the account of cost already, such enterprises can transfer such balance and the relevant receivable of tax refund into the input VAT.

If the above goods exported by export enterprises are subject to Consumption Tax (CT), except where there is other regulation, if export enterprises are manufacturing enterprises, then such enterprises should follow relevant existing regulations and policies to calculate and pay the CT; if export enterprises are foreign trading enterprises, then relevant CT shall not be refunded to such enterprises.

- ▶ Article 6 of Circular of the SAT Concerning Several Issues about Export Tax Refund (Caishuifa [2000] No. 165) which states as follows:

The following products exported by production enterprises themselves (including foreign-funded enterprises or through agencies are regarded as self-produced products to enjoy a tax refund (exemption) treatment.

(I) The goods that carry with the same brand name, function and trademark as goods produced by the production enterprise.

(II) The goods appear to be supplementary to the self-manufactured goods produced by the production enterprise.

(III) The goods that are purchased from another group companies which manufactured the goods (the group companies who need to be approved by the in-charge tax authorities).

(IV) The goods that are received from enterprises commissioned to provide processing and/or manufacturing services.

Analysis

Our comments as to the accuracy of the analysis undertaken and the conclusions made in Attachments 1 and 2

Customs has raised the following query:

Please provide your view as to whether attachments 1 and 2 provide an accurate assessment of the way VAT refund for export is calculated in relation to manufactured goods exported from China.

As requested, we have read through attachments 1 (ie the GOC briefing paper on VAT refund for export) and 2 (ie the Spreadsheet). We confirm that the analysis undertaken and the calculations conducted are in accordance with the rules set out in Caishui [2002] No. 7.

However, as set out in Article 3 of Caishui [2002] No. 7, the VAT- exempt raw materials purchased (rather than just raw materials imported duty free) would be used in both calculations of the offset amount for the VAT exemptible, deductible and refundable (ie, theoretical VAT amount of non-exemptible and non-refundable on raw materials purchased) and the non-exemptible, non-refundable VAT.

The VAT- exempt raw materials purchased include raw materials exempted from VAT purchased in domestic transactions and raw materials imported duty free. Article 15 of the Revised Provisional Regulations on VAT of the People's Republic of China (Order of the State Council No. 538) has set out examples of VAT-exempt items.

Advice in respect of the operation of the export VAT refund mechanism under the China VAT regime for exported goods

We provide analysis below in relation to your query regarding to the operation of the export VAT refund mechanism under the China VAT regime for exported goods as follows:

Please explain the extent, if any, to which the VAT refund for export in China has a relationship with the VAT paid on inputs to manufactured goods.

With the exception of certain types of export transactions (eg when deemed domestic sales VAT becomes applicable, see discussions on Page 9 of this document), exports of goods from China are generally exempt with the ability to utilize a credit. That is, input VAT previously paid on the purchase of goods and services used for the production of goods for export is recoverable, with certain limitations, under a refund process. This procedure is commonly known as the "VAT export refund". The limitation of input VAT recovery is discussed further below.

In accordance with the Article 3.3 of Caishui [2002] No. 7, the VAT export refund is equal to the lesser of the following amounts:

- ▶ The deductible balance of VAT at the end of the period; or
- ▶ The VAT exemptible, deductible or refundable on the export sales for the current period.

The VAT paid on inputs would directly affect the export VAT refund amount in the following three situations:

1. When the manufacturing enterprise has a positive deductible balance of VAT at the end of period, the manufacturing enterprise is entitled to a VAT export refund. But the amount of VAT to be refunded is subject to certain restrictions and limitations that we explain below.
2. Where the deductible balance of input VAT at the end of a period is smaller than or equal to the VAT amount exemptible, deductible or refundable on the export sales, the VAT refund is equal to the deductible balance of input VAT at the end of the period. In this respect, all the input VAT credit has been refunded. There would be no input VAT to be carried forward.
3. Where the deductible balance of VAT at the end of period is larger than the VAT amount exemptible, deductible or refundable on the exported sales, the VAT refund is equal to the VAT amount exemptible, deductible or refundable. That is, the manufacturing enterprise can have the entire VAT amount exemptible, deductible or refundable for that period refunded. Any unused input VAT balance, which is the difference between the deductible balance of the VAT at the end of the period less the VAT amount exemptible, deductible or refundable for that period, can be carried forward to future periods.

Deemed Domestic Sales

According to Guoshuifa [2006] No.102, when a manufacturing enterprise exports manufactured products with a zero export VAT refund rate those export sales would be deemed to be domestic sales and hence subject to output VAT.

The amount of output VAT due on the deemed domestic sales should be calculated by the following formulas:

1. Export under general trade

Deemed output VAT = Export FOB Value x Official RMB Exchange Rate/ (1+ Applicable VAT rate) x Applicable VAT rate.

2. Export under contract manufacturing arrangements or by small scale of VAT taxpayer

Deemed output VAT= Export FOB Value x official RMB Exchange Rate/ (1+ tax collection rate) x tax collection rate.

If the export is made under general trade, the input VAT incurred on the purchases of materials for manufacturing the finished products would be creditable, subject to VAT recovery rules. If the manufacturing enterprises have calculated the non-exemptible and non-deductible VAT amount and include it as costs, the costs should be transferred to input VAT when the deemed domestic sales VAT treatment becomes applicable.

The input VAT would not be recoverable if the export is made under bonded contract manufacturing arrangements or by small scale VAT taxpayer.

Non-recoverable input VAT for exports

We provide analysis below in relation to your queries regarding non-recoverable input VAT for exports. Specifically:

Please provide your view as to whether the "non-exemptible, non-refundable VAT on exports" must be included in cost of goods sold (for the exported goods) or can be offset in periodic VAT returns to the authorities.

For PRC VAT reporting purposes, the "non-exemptible, non-refundable VAT amount on exports" should be treated as a cost rather than allowed to be offset in future periodic VAT returns.

For those goods whose VAT export refund rates are less than the applicable VAT rates for normal supply (ie the VAT rates applicable to sales of goods if they are sold domestically), the taxable person must bear the difference as a cost, even though the goods are sold for export. Such VAT cost is commonly referred to as an "export VAT leakage" or "input VAT disallowance" and the calculation and amount would differ depending whether the China exporter is a manufacturing or a trading company.

For a manufacturing company, the export VAT leakage should be calculated as follows:

Export VAT leakage = (FOB export value - Price of raw materials whose purchase is exempted from VAT) x (VAT rate - export VAT refund rate)

The following will impact the export VAT leakage:

1. FOB export price: a lower export FOB price results in a lower export VAT leakage. Please note that the export VAT leakage costs could affect the FOB price that would be decided by the exporter.
2. VAT exempted purchase on raw material: a higher amount of VAT- exempt purchases on raw material will reduce the export VAT leakage.
3. HS code: the export VAT refund rate varies depending on the HS code declared to China Customs for the exported finished goods.

For a trading company, the export leakage should be calculated as follows:

Export VAT leakage = Price shown on the special VAT invoices obtained with respect to domestic purchase x (VAT rate - export VAT refund rate).

Please provide your view as to whether the "non-exemptible, non-refundable VAT on exports" may be regarded as a "residual VAT liability" (a cost) that is particular to export sales, and there can be no equivalent liability (cost) in relation to domestic sales.

The export VAT leakage, including the computation methodology and corresponding accounting treatments, are only applicable to export sales transactions and not to domestic sales transactions.

Different input VAT treatment

In general, exports sales of goods are "exempt with credit" (or taxable at 0%). This means that no VAT applies but the exporter may recover VAT paid and only is required to transfer out the non-exemptible, non-refundable VAT (if applicable).

For domestic sales, the VAT exemptible supplies are without credit. That is, the supplies are not liable to VAT, but the supplier may not recover input VAT paid on purchase goods or services used on the VAT exempt supplies as well.

VAT rate impact

As discussed in the previous section, the non-exemptible, non-refundable VAT would arise where the export VAT refund rates are less than the applicable VAT rates for normal supply (ie 17%).

There are no equivalent export VAT refund rates with respect to domestic sales. For domestic VAT exempt supplies, both of the applicable rate for output VAT and the creditable rate for input VAT are zero.

While there is no export VAT refund cost calculations related to domestic sales, there may still be situations where a company can incur additional VAT costs on these domestic sales through areas such as denial of input VAT credits for lack of supporting details or missing strict filing timelines for input VAT invoices.

Non-creditable input VAT for domestic sales

We provide analysis below in relation to your query regarding non-creditable input VAT under the China VAT regime. Specifically:



Can you please provide examples of the circumstances, if any, in which VAT paid on inputs (for manufactured goods) would in China need to be accounted for as part of the costs of goods sold, or as an expense.

We assume by "input" above you are referring to raw materials instead of including other items such as fixed assets and others. As set out in Article 9 and Article 10 of the Revised Tentative Regulations of the People's Republic of China on VAT (Order of the State Council No. 538), input VAT is not creditable on the acquisition or importation of the following items, which should be transferred out and accounted for as costs:

- ▶ The purchase is not supported by a valid VAT invoice or certificate issued by the PRC tax authorities or customs authorities etc.
- ▶ The purchase of taxable goods or services used in non VATable activities, except for fixed assets put into use for both VATable and non VATable activities.
- ▶ The purchase of taxable goods or services used in VAT-exempt activities (Article 15 of the Revised Provisional Regulations on VAT of the People's Republic of China (Order of the State Council No. 538) has set out examples of VAT-exempt items).
- ▶ The purchase of taxable goods or services for collective welfare or personal consumption.
- ▶ The "abnormal loss" of purchased taxable goods and associated taxable services.
- ▶ The abnormal wastage of purchased taxable goods or services consumed in the production of merchandise or finished products.
- ▶ Transportation expenses for goods specified in the above items and for the sales of VAT-exempt goods.

"Abnormal losses" include losses resulting from a range of events including theft, decay or deterioration of goods as a result of poor management, but excluding normal wear and tear sustained in the ordinary course of the taxable person's business.

.

If you have any questions please do not hesitate to contact me on 6267 3930.

Regards

A handwritten signature in black ink, appearing to read 'David Manton', written over a light blue horizontal line.

David Manton
Partner - Tax