

Status of the Value-added Tax Reform in the People's Republic of China¹

The Chinese government has launched a series of Value-added Tax (“VAT”) reforms over the past few years to align its VAT system with internationally accepted principles, and to adapt to the economic development in China and the world at large, with an aim to modernize the country's governance system and administration capabilities. On 1 July 2014, the multiple VAT rates of 6%, 4% and 3% (for small-scale VAT payers) were simplified and unified into a single rate of 3%. On 1 May 2016, the Business Tax (“BT”)-to-VAT reform was rolled out nationwide wherein BT on taxable services was replaced by VAT, such that input tax credit could be fully available along all cycles of value chains in order to avoid the cascading effect of BT. On 1 July 2017, the 4-tier VAT rates of 17%, 13%, 11% and 6% were simplified and unified into the 3-tier rates of 17%, 11% and 6%. All the above measures were made to continuously develop a simpler, clearer and more scientific VAT system.

In 2018, the Chinese government continued to deepen the VAT reform with three significant measures. First, from 1 May 2018, the VAT rates were appropriately lowered from 17% and 11% to 16% and 10% respectively, resulting in a 3-tier VAT rate structure comprising VAT rates of 16%, 10% and 6%. Second, the annual turnover thresholds of RMB500,000 (€66,800) and RMB800,000 (€106,900) applicable to small scale VAT payers engaged in manufacturing and trading respectively were unified and increased to a single threshold of RMB5,000,000 (€668,400). Third, the scope of excess input tax refund was extended. More specifically, the current scope of excess input tax refund for qualified sectors and enterprises has now been extended to qualified enterprises engaged in modern services (e.g. research and development) and advanced manufacturing (e.g. equipment manufacturing), as well as power grid enterprises. For these enterprises, one-off excess input tax refund is allowed.

The above three VAT reform measures were key decisions made by the government for building a modernized economic system, deepening the supply-side structural reform and improving the business environment, following a comprehensive analysis of the developmental trends of the global and domestic economies. These measures make a significant breakthrough for the goal of establishing a quality VAT system, as well as observing the fundamental principles of tax neutrality, efficiency, fairness and simplicity in formulating tax policy as advocated in the OECD International VAT/GST Guidelines. These reform measures demonstrate not only a continuously growing alignment of China's VAT system with the international standards on VAT design and operation embedded in the OECD Guidelines, but also China's commitment and contribution to the development of consistent and effective international VAT policies as a member of the OECD's Global Forum on VAT. The key features of this round of reforms are as follows:

Application of the principle of efficiency by optimizing the structures of VAT tiers and rates

The more tiers of VAT rates exist, the more complicated the VAT system is and correspondingly the higher the compliance and administration costs are for taxpayers and tax authorities respectively. The wider the gap between the VAT rates, the higher the risks of revenue losses from planning or abusive practices by taxpayers claiming the application of the lower rates. This can compromise the efficiency of the VAT system. On 1 July 2017, the 4-tier VAT rates of 17%, 13%, 11% and 6% were simplified and unified into the 3-tier rate structure of 17%, 11% and 6%. On 1 May 2018, the VAT rates of 17% and 11% were lowered to 16% and 10% respectively, resulting in a 3-tier VAT rate structure of 16%, 10%, and 6%. Narrowing the gap between VAT rates is a measure taken to enhance the compliance efficiency within the tax system. This aligns with the fundamental principle of efficiency promoted by the OECD International VAT/GST Guidelines and is an important step towards the realization of a more scientific and regulated VAT rate structure.

¹ This update was kindly prepared by the State Administration of Taxation of The People's Republic of China (SAT). It follows up on the earlier OECD publication in March 2017 on the assessment of China's VAT Reform; see www.oecd.org/tax/consumption/business-vat-tax-reform-china.pdf

Application of the principle of fairness and simplicity by unifying the threshold for small scale VAT payers

China lifted the annual turnover threshold for small-scale VAT payers to RMB 5,000,000 (approx. EUR 668,400) from the thresholds of RMB 500,000 (approx. EUR 66,800) and RMB 800,000 (approx. EUR 106,900) previously applicable to small-scale VAT payers engaged in manufacturing and trading respectively. Such measure enforces the principle of fairness by eliminating differences in the tax treatment between taxpayers in similar circumstances. The VAT system becomes simpler when more Small-and-Micro-sized enterprises (“SMEs”) are below the threshold and no longer required to compute their VAT payable based on the output tax and input tax credit method. Tax rules become clearer and easier to understand, financial accounting becomes simpler, and the tax filing process becomes more efficient, resulting in a lower cost of compliance for SMEs.

Application of the principle of neutrality by expanding the scope on excess input VAT refund

The principle of neutrality is the core principle of a VAT system. Neutrality of the VAT covers a wide range of areas, but one of its most important aspects is that it is a tax on final consumption that is collected by businesses without, in principle, imposing a burden on these businesses. This is achieved through a staged collection process, whereby VAT is imposed at every stage of the economic process and whereby the successive taxpayers are allowed to deduct the VAT they pay on their purchases while they account for the VAT they collect on their sales. The tax is thus effectively only collected on the “value added” at each stage of the economic process, until the appropriate amount of taxes is collected from the final consumer. This process avoids economically harmful and distortive tax cascading, i.e. the accumulation of tax burdens along the production and trading processes. In the past, only certain enterprises and industries in China were allowed to obtain a refund of excess recoverable input tax. The deepening of the VAT reform in 2018 has expanded the scope of such refunds to a wider range of industries, and the scale of VAT refund exceeded RMB100 billion (approx. EUR13 billion). China has been proactive and prudent in exploring new measures to improve the VAT refund mechanism. Guided by the principle of neutrality embedded in the OECD International VAT/GST Guidelines, China has continuously enhanced the robust implementation of the VAT system, and demonstrated a strong commitment to developing a scientific, modernized and internationally aligned VAT system.

Since the formal rollout of deepening the VAT reform in China on 1 May 2018, relevant policies have been carried out smoothly with positive feedback from the society. The reform not only achieved the objective of enhancing the tax system, but also had an obvious spillover effect that resulted in a reduction of the overall tax burden for taxpayers and consumers.

Optimistic expectation on tax reduction from major market players

As estimated, the three VAT reform measures mentioned above reduced the tax burden of the major market players by RMB400 billion (approx. EUR 53 billion) in one year, and more than 1/3 of the total tax reduction benefited the manufacturing sector. The effective reduction of tax burden significantly reduced the pressure on cash capital, encouraged fixed assets investment and expansion of production facilities, and boosted up confidence in future development, giving a momentum to trigger the hidden development potential of the China economy, propel its transformation and upgrade its manufacturing sector. At the same time, these contributed to the sustainable growth of the global economy.

Sharing the benefits of the reform with end consumers

The downward adjustment of VAT rates not only reduced the VAT payable of corporate suppliers and improved their cash flow directly, but also, to a certain extent, benefited the end consumers directly via the lowering of product prices. On the day when the VAT rates were adjusted, notably a range of leading international enterprises reacted promptly and announced a lowering of their retail prices in China. In return, the increase in consumption further stimulated market demand and facilitated the expansion of the market, resulting in a healthy business cycle and a win-win situation among suppliers and consumers.

Energizing the development of SMEs

The simplification and unification of VAT policies on SMEs enable such enterprises to choose between the general taxation method and the simplified taxation method based on their own business situation, achieving the goal of “one reduction, two simplifications” which refers to the reduction of tax burden, and the corresponding simplification of financial accounting and tax filing process.

The benefits brought by the reform do reduce the tax burden of SMEs, improve business environment, boost the confidence of SMEs in business development, help create employment and enhance market prosperity.

Going forward, China will further reinforce international tax co-operation, and continue to implement and actively contribute to the development of international standards and best practice policies by the OECD and its Global Forum on VAT. With the aim to foster a sustainable and healthy economic development of the society, China will continue its unremitting endeavors to deepen the VAT reform and to be dedicated to the establishment of a modernized VAT system.