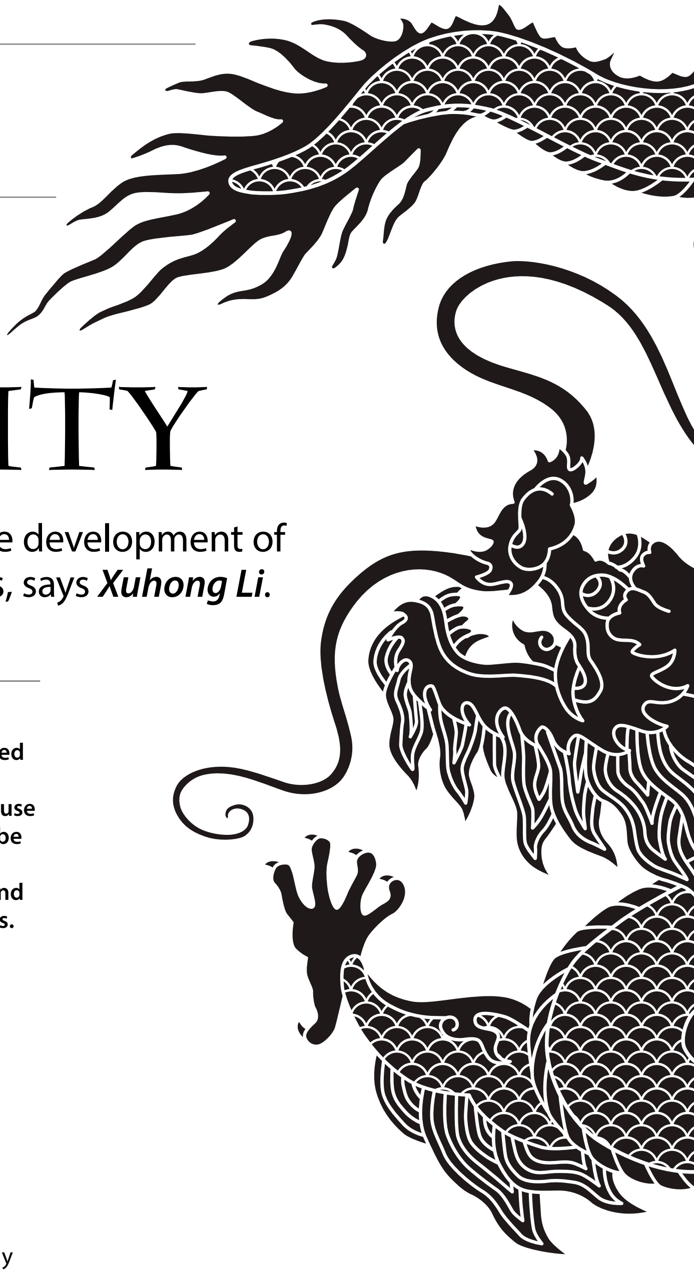

LAND OF OPPORTUNITY

China's recent VAT reforms should influence the development of SMEs and increase their business opportunities, says ***Xuhong Li***.

Professor Xuhong LI
PHD, FIPA is a Director of the China International Taxation Research Institute, Dean of the Beijing National Accounting Institute and Head of the Fiscal Policy and Applied Research Institute. She has worked for government agencies, state-owned enterprises, universities and a management consulting firm and has tax consulting experience in many business sectors. Professor Li started her teaching and research work at the Beijing National Accounting Institute in July 2005. She can be contacted by email on: lxhfufu@163.com. Visit: www.nai.edu.cn

TEN SECOND SUMMARY

1. **China is transforming its business tax into VAT and this programme should be completed by 2018.**
2. **SMEs can now expand their businesses because there is the potential for double taxation to be eliminated.**
3. **For cross-border trade, a nil rate is applied and this should encourage international business.**

From 1 May 2016, China transformed its business tax into VAT for the financial services, construction and real estate sectors among others. This was a very important step in China's business tax to VAT reform programme, which should be completed by the end of 2018.

VAT now makes the biggest contribution to China's taxation system. However, when it was introduced in 1994 the charge was imposed only on the sale of goods and some limited services; business tax being applied to most services. It is worth noting that business tax in China is quite different to the retail sales tax in the US.

The latter was imposed on the final consumer, while the former was imposed on business turnover. As time passed, business tax became increasingly unsuitable for China's economic development, hence the government's decision to undertake tax reform, transforming this into VAT.

This reform started in January 2012, when Shanghai was the first pilot city to undertake this tax transformation.

During the past five years, only 20% of business taxpayers became VAT taxpayers. This latest round of reform should affect many more corporations and SMEs. In the process, 80% of business taxpayers will move to the VAT regime.

SMEs play an important role in China's economy. They account for more than 90% of the registered corporations and contribute 60% of GDP and 40% of total tax revenue and are greatly affected by this reform.

Threshold and tax treatment for SMEs

According to China's VAT regulations, individuals with monthly sales of less than 5,000 to 20,000 Chinese yuan renminbi (CNY) – equal to about £600 to £2,400 – are VAT exempt.

As well as the above thresholds, there is another preferential tax treatment for SMEs. Those whose annual sales are less than CNY 5m would be categorised as small VAT taxpayers and could adopt lower tax rates (such as 3%), compared with the standard VAT tax rates of 11% or 17%.

However, if the small VAT taxpayer adopts this lower tax rate, they will not be allowed to deduct the input tax – which would be imposed on their purchases of goods or services from suppliers – from the output tax that they would impose on sales to their customers. Of course, because most SMEs are small VAT taxpayers they do not have enough input tax to deduct because they are purchasing from other small VAT taxpayers with deduction restrictions. Thus, the lower tax rate would benefit SMEs' operating business costs.

Supply chain integrity

The main difference between business tax and VAT lies in the integrity of the supply chain. Through

the deduction scheme, VAT facilitates specialisation which is a symbol of social progress. For example, big companies tended to produce all parts of their goods or services themselves because, if purchased from outside, they could not deduct the business tax those suppliers charged, which would increase the eventual cost. However, under the VAT system, purchasing from outside suppliers would not increase the tax cost because of the tax deduction.

As part of the supply chain, SMEs can now expand their businesses because, no matter how long the supply chain, double taxation is eliminated. The move to VAT could thus offer more opportunity to SMEs. Big enterprises may turn increasingly to small suppliers. On the one hand, this can reduce the cost because SMEs would adopt the lower tax rate adding to the sale price. On the other hand, the purchasing business can deduct the input tax.

Increasing the tax compliance cost

With business tax, the administration was simpler because this only related to the sale amount, which was multiplied by the tax rate to calculate the tax payable. Costs were ignored.

For VAT, tax administration is more restricted. The standard calculation method deducts the input tax from the output tax to arrive at the tax payable. As in the UK, the output tax is based on the sale amount multiplied by the tax rate and the input tax uses the purchase amount multiplied by the tax rate. China uses the VAT invoice to control the tax evasion risk with more than four kinds of VAT invoice; but the most popular ones are the normal invoice and the special invoice. Only the general VAT taxpayer can use the special VAT invoice to make the deduction. To do this, the deduction scheme is designed to use information in the system to identify the invoice and obtain the deduction permit.

The small VAT taxpayer cannot draw up the special tax invoice but, if the buyer is the normal taxpayer, they would require the special VAT invoice for deduction. In this circumstance, SMEs would be required to go to the tax bureau to draw up a special VAT invoice, and this increases the SME tax compliance cost.

SME development and opportunity

The aim of this round of VAT reform is to reduce tax to promote China's economic development. According to government data, China had cut its tax revenue by CNY 500bn through VAT reform by the end of 2016.

How would the government be able to cut so much tax? Mainly through the following methods.

- VAT uses the deduction scheme and because every normal taxpayer can get more deductions they will pay less VAT, reducing the tax revenue.
- VAT allows immovable property input tax to be deducted, which leads to a decline in VAT tax revenue. However, the immovable property input tax should be deducted over two years. A deduction of 60% is granted in the first year and 40% in the second.
- For cross-border trade, a nil rate is applied. This means that there is no output tax, but the input tax would be refundable. A zero tax rate encourages cross-border trade and eliminates double taxation. By comparison with business tax, although exports could be tax free, the business tax paid earlier in the supply chain would not be refunded. Without that deduction, this tax would accrue at the cost of the taxpayer. This change also reduces the tax burden and total VAT tax revenue.

Although the new VAT system in China can help to alleviate the tax burden, it is only the normal or general taxpayer that will achieve the full benefit of input tax deduction. The small-scale taxpayer will only benefit from the lower 3% rate. Consequently, if the business of SMEs can be developed so that they are treated as normal VAT taxpayers, they could increase the benefits and the opportunities that flow from the full input tax deduction.