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China Adjusts Export VAT Rebate Rates

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1 Overview

According to a circular jointly released by the Ministry of Finance, the National Development and Reform Commission, the Ministry of Commerce, China Customs and the State Administration of Taxation, **China will adjust the Export VAT rebate rates** of some commodities. In addition, the Catalogue of Prohibited Commodities in Processing Trade has been updated.

In some more developed countries, Corporate and Individual Income Tax account for the majority of fiscal revenue. However, China relies heavily on indirect taxes, and thus Foreign Invested Enterprises (FIEs) and domestic enterprises pay either VAT or Business Tax depending on the nature of their business and the type of products involved. **VAT accounted for more 37% of China's fiscal revenue in 2004**. More than **50% of China´s exports currently come from FIEs present in this country**.

InterChina considers that this fiscal change may have a **considerable impact on many FIEs carrying business in China and exporting commodities abroad** this country. This brief note is oriented to explain InterChina´s client base how this new regulation may impact its existing investment in this country.

2 VAT Rebate Situation Before August 2006

The normal VAT rate is 17%, but necessities, such as agricultural and utility items, are taxed at 13%. VAT operation in China is largely similar to Europe. The **main difference between VAT operation in Europe and VAT operation in China is when it comes to VAT exemptions and VAT rebates.**

In an attempt to stimulate exports, VAT on exports is zero-rated, and the **relevant tax bureaus will return all or part of the input VAT on those exports too**. Input VAT rebates on exports are often a major concern for exporters as the rebate allows them to lower their sales prices, and some domestic enterprises even export their products below cost and then depend on the rebates to achieve profitability.

3 The New Regime: Adjusted Tax-refund Revisions

The rebates range from 5% to 17% of the 17%. Products that are strategic exports continue to enjoy full rebates (e.g. aircrafts, ships, automobiles, medical equipment etc). **Products** that have a strong domestic demand and **are not seen as strategic exports tend to have lower rebates** (coke, coal, concrete, unforged aluminum etc). There are also some products that are not entitled to rebates (e.g. crude oil, petrol, fuel oil etc).

China, in an attempt to **(i) increase its Customs revenue collection**, **(ii) to limit China´s aggressive trade balance** (that is becoming a source of political and macroeconomic tensions for the politburo) and **(iii) to encourage exports in key added value areas**, has made the following modifications on its Export VAT rebate system:

Cancellation of export tax rebates

- All non-metal mining products except salt and cement. This list includes coal, natural gas, paraffin wax, asphalt, silicon, arsenic, stone, non-ferrous metals, and scrap.
- Metallic ceramics, twenty-five kinds of pesticides and the intermediates, some finished leathers, lead-acid storage batteries; mercuric oxide batteries.
- Fine goat wool, charcoal, crosstie, cork, and some primary wood products.

Reduced export tax rebates

- Steel products, from 11% to 8%
- Ceramics, some finished leathers, cement and glass, from 13% to 11% or 8%
- Some non-ferrous metals, from 13% to 11%, 8% or 5%;
- Textiles, furniture, plastics, cigarette lighters, and a few wood products, from 13% to 11%;
- Non-engine vehicles (wheelbarrows) and parts, from 17% to 13%.

Higher export tax rebates

- Major technical equipment, some IT products, biological and medical products and other hi-tech products encouraged by the Chinese government, , from 13% to 17%;
- Some processed agricultural products, from 5% to 11% or from 11% to 13%.

Catalogue of Prohibited commodities in processing trade Revisions

- Those commodities without tax rebates will be included in the list of “Prohibited Commodities of Processed Trade”. Import tariff and import linkage taxes should be applied to these products, losing process trade benefits.

After discussions with local government officials from the Shanghai, Shenzhen and Beijing area, InterChina considers that **this tax reform will take place from 15th September, 2006 (official date) to the end of October.** The government will analyze export rebates based on the export declaration date.

All the export contracts signed before (and including) these dates must be approved by the Chinese tax authorities before 30th September 2006 in order to use prior tax rebate rates.

In InterChina's experience, there will also be **significant delays in receiving these input VAT rebates on exports**, sometimes up to one year or more, and rebate amounts are often miscalculated. Therefore, FIEs with substantial export volumes from China should take this delay into account when making their cash flow projections. FIEs should also make the effort to establish a close relationship with the local branch of the State Administration of Taxation (SAT), as this branch office will determine the priorities for input VAT rebates on exports.

About InterChina

Overview: Since its foundation in 1994, InterChina Consulting ("InterChina") has emerged as the leading management consultancy specialized in strategy and corporate services for companies doing business in China.

Client Value: As testament to client satisfaction, projects for existing clients account for one third of InterChina's project volume. InterChina's *Strategy Practice* has helped clients better understand and penetrate their markets in China with the conduct of over 400 market research and strategy development studies. InterChina's *Corporate Practice* has supported clients commence and expand operations in China by establishing and acquiring over 60 companies. And InterChina's *Human Resources Practice* has successfully searched and integrated over 150 senior executives into the operations of clients in China.

Core Competence: As InterChina's clients are international companies with demanding consultancy needs, InterChina has developed expertise in select sectors to further the delivery of valuable solutions. These sectors include, but are not limited to: automotive & auto components, machinery & machine tools, chemicals, energy & power, FMCG (food & beverages), distribution and financial services.

Consulting Team: InterChina's 40 consultants are not only extremely experienced and capable professionals, but with a retention rate of 95 %, the consultancy team is also one of the most stable in China. InterChina runs operations out of offices in Beijing, Shanghai and Shenzhen, supported by liaison offices in Madrid and Milan (and shortly also Washington DC).

For Further Information: Please refer to our website: www.interchinaconsulting.com, which provides practical information for companies doing business in China, or contact us at: interchina@interchinaconsulting.com