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TAX NEWS VAT Rebate Rate Cut

Foreign Trade Volume Likely to Hit US\$800 bln in 2003

Foreign Investors in State-Owned Enterprises Welcomed

VAT Rebate Rate Cut

Value Added Tax (VAT) is both the most complex and often most important tax payable by Foreign Invested Enterprises (FIEs) in China. Though the processes behind VAT payment are relatively simple, for exporting companies (including both manufacturers and trading companies) the issue of export VAT rebates complicates the tax declaration and collection/payment procedures and amounts.

When the VAT rebate system was first introduced in 1985, it was done so in order to increase China's international competitiveness, boost export growth, and decrease unemployment. It was seen as a means to attract more foreign investment in the foreign trade and manufacturing industries. At that time the rebate rates were mostly around the 17 percent mark.

The incentives offered by the VAT rebate policy have been a very influential instrument in attracting FIEs to establish manufacturing and trading companies in China. However, when it comes to actually receiving the rebate, many FIEs have been left in the cold or waiting for many months (and some upwards of over a year) to receive their refund.

Basic Overview

For all FIEs registered after January 1st 1994, the VAT refund for export method is referred to as the "Exemption, Deduction and Refund." Exemption refers to the exemption of the output VAT on the production or sales of the exported self-manufactured products. Deduction refers to the offsetting of the input VAT, imposed on the raw materials and components purchased for the production of exported goods, against the output VAT payable on domestic sales. Refund is calculated according to one of two scenarios:

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1. If export sales constitute greater than 50% of the total sales of the same period and the offsetting input VAT exceeds the amount of output VAT, the excess input VAT credit will be refunded to the taxpayer after approval from the tax authority.

2. If export sales constitute less than 50% of the total sales of the same period, the excess input VAT credit will be carried forward.

This is a simplified overview of the VAT system in China and the system can become quite complex since different types of entities and products require different documentation and procedures.

The Key Problems

VAT refunds are calculated at a provincial level where the Central Government provides funding for each of the provinces to then on-pay the companies. However, over recent years, the Central Government has let out its belt and now faces an estimated 300 billion RMB in outstanding VAT tax refunds.

Two main reasons have contributed to the huge backlog of tax refund payments. Firstly, the government was overly aggressive when it first introduced VAT refunds, without, some argue, careful consideration of the long-term financial impact. Secondly, since VAT revenue is shared between the local and national tax bureaus but VAT refunds are entirely the responsibility of the national tax bureau, the provinces have aggressively approved large capital infrastructure budgets using funding from VAT collection, and the government has been left to cover the burden when VAT rebates were due to be paid back.

While FIEs in the wealthier provinces have not been so badly affected, it is in the smaller, developing provinces, with predominately export-manufacturing investments, where some companies have large outstanding VAT claims. With Chinese exports predicted to increase at an even faster rate over the coming years, the problem is only likely to get worse.

At the same time, China's huge trade surplus has sparked intense international debate regarding the re-valuation of the RMB. Reducing the VAT rebate would have a direct effect on the pricing (and competitiveness) of export products from China, as manufacturers pass-on the additional tax burdens to consumers and hopefully therefore ease the pressure on the Chinese government to revalue the RMB.

What the Government is Doing

With the above two issues in mind, the Ministry of Finance and the State Administration of Taxation (SAT) released a notice in the middle of October regarding a reduction in VAT rebate rates for export companies (*cai shui* [2003] No.222), with effect from January 1st, 2004.

VAT rebates for exported goods will fall by an average of three percentage points. The new VAT rebate rates by major industry categories are summarised as follows:

Industry	Original Rate %	New Rate %
Coking and semi-coking coal	13	5
Thermal coal	13	11
Rare earth concentrate	13	0
Rare earth metal	17	5
Power generation equipment	13	11
Engineering equipment	17	17
Marine vessels	17	17
Car and car parts	17	17
Agricultural products	13	13

Taxation Terms

增值税

"Zeng Zhi Shui"

(Value Added Tax)

营业税

"Ying Ye Shui"

(Business Tax)

消费税

"Xiao Fei Shui"

(Consumption Tax)

Crude oil and most refined oil	13	0
Raw wood	5	0
Processed wood products	13	0
Most mineral concentrates	13	0
Combed goat wool	13	0

Source: Ministry of Finance

所得税

"Suo De Shui"

(Income Tax)

The Effect

With the reduction in rebates, it is expected that exporters who source raw materials domestically are expected to be hurt the most. This is because the VAT they pay on domestic products will be increasingly greater than what they claim through export rebates. Firms that import raw materials and then export their finished goods enjoy high VAT exemptions and therefore the new policy should have a minimal impact.

For exported goods that are nationally encouraged by the government, the tax rebate will remain mostly unchanged. This includes VAT rebates for goods such as cars and car accessories which will remain as high as 17 percent.

For ordinary consumer goods, tax rebates will be cut substantially with the rate for goods such as garments, knitted thread and accessories dropped from 17 percent to 13 percent.

The worst hit will be those goods that are restricted or categorised as 'natural resource' goods. VAT rebates for natural resources such as pulp, oil and lumber have been cancelled altogether.

Below are a few examples to assess financial impact on certain industries:

Industry	2002 Total Export Value RMB	Old Rate %	2002 Total VAT Rebate RMB	New Rate %	2003 Total VAT Rebate RMB	Difference RMB
	[A]	[B]	[C] = [A] * [B]	[D]	[E] = [A] * [D]	[F] = [C] - [E]
Coal	2,532,964,610	13	329,285,399	11	278,626,107	50,659,292
Garments	33,897,461,201	17	5,762,568,404	13	4,406,669,956	1,355,898,448
Knitted thread	9,055,683,027	17	1,539,466,115	13	1,177,238,794	362,227,321
Shoes	11,091,608,967	15	1,663,741,345	13	1,441,909,166	221,832,179
Steel	2,188,277,724	15	328,241,659	13	284,476,104	43,765,555
Toys	5,576,108,762	15	836,416,314	13	724,894,139	111,522,175

Source: China Customs

It should be noted that for those export enterprises that have entered into export contracts before October 15th 2003 with the date of export after 1 January 2004 are still able to enjoy the current applicable export VAT rebate rates if they have completed a registration form with the tax bureau. Any export enterprise that has signed a contract for complete sets of equipment valued at US\$2 million or above or for large mechanical and electrical products valued at US\$1 million or above must present the original copy of the contract for registration and filing at the department in charge of tax rebates before 15th November 2003.

Impact

The macro-level effect of the reduction in VAT rebates will be quite large, as outlined above. However, many individual company level representatives do not feel the rate cut to be as significant as the numbers might suggest. The majority of manufacturing and trading companies are establishing operations in China for much more compelling reasons than just to receive VAT rebates.

Simply put, a company's decision to establish operations in China is not merely built upon saving tax, as one company asserts, "we are not in China just to export only "C we want to tap into the local market." Another company executive in China suggests "we will be paying none or very little corporate tax anyway for the next 5-10 years, the VAT rebate reductions are minor compared to the corporate taxes we pay in most other countries around the world."

The reduction in VAT rebates will by no means signal the end for the many manufacturing or trading FIEs established in China. Instead, it will work to ease the financial pressure on the government to repay large outstanding debts and, at the same time, provide much needed revenue to fund key infrastructure policies, possibly even assisting the companies which effectively pay the additional VAT amount.

Foreign Trade Volume Likely to Hit US\$800 Bln in 2003

The foreign trade volume of China will surpass US\$780 billion this year, and is likely to reach US\$800 billion according to the Ministry of Commerce. China's total trade volume in the first three quarters of this year has reached US\$606.3 billion, increasing 36 percent year-on-year, in which the import sector surged 41 percent to US\$298.6 billion.

China became the sixth largest importer in the world last year, with total imports at US\$300 billion. From January to September this year, China's contracted foreign direct investment reached US\$79.2 billion, a year-on-year rise of 36 percent. The actually used foreign direct investment hit 40.2 billion, up 12 percent.

China still has a long way to go before becoming a world manufacturing centre however, according to one of the senior Chinese economic government officials overseeing macro-economic matters. A country's gross domestic product (GDP) has to account for more than 10 percent of the world's total before it can be considered a world centre, according to the official.

In addition, its manufacturing output has to account for more than 15 percent of the world's total and its manufacturing industry has to account for more than 10 percent of the global total. In 2002, China's GDP reached US\$1.27 trillion, ranking sixth in the world. However, it only accounted for about 3.7 percent of the world's total.

Despite not having significant international clout in manufacturing, the majority of China's industrial products are used to meet domestic demand. China produced 200 million tons of steel last year, accounting for 20 percent of the world's total. The country has also imported more than 30 million tons so far this year due to booming demand.

Foreign Investors in State-Owned Enterprises Welcomed

Amid a tide of economic restructuring, there will be few wholly State-owned enterprises (SOEs) in the near future. Following the current trend of mergers and acquisitions with non-State and foreign investors, most SOEs will begin to adopt a shareholding structure and introduce investors.

China welcomes overseas investors to take over its state-owned enterprises, said the State-owned Assets Supervision Administration Commission (SASAC). The supervisory body has already approved the property right and asset transfers of 48 SOEs, involving 22.5 billion yuan (US\$2.7 billion) worth of capital and rights. Among the transfers in the SOEs, those large ones directly supervised by the central government, as much as 83 per cent of the assets were transferred to domestic private firms and foreign investors.

The purpose of the growing push towards mergers and acquisitions is to better allocate resources and improve profitability. The market in China still has a high potential for growth. So far, that market only accounts for about 5 per cent of foreign investment in the country.

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