

CHINA MESSENGER

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Beijing completes landmark economic reform to roll out VAT across the board

By Xinhua writers Wu Xia, Wang Shang and Deng Yushan

China has expanded a pilot programme to finally put all its industries under a unified value-added tax (VAT) regime as part of a wider push to deepen the country's structural economic reform.

Experts have described it as the most significant tax and fiscal reform in decades as it further improves the tax structure of the world's second largest economy and will sustain economic growth in the long run.

Rani Jarkas, chairman of the Hong Kong-headquartered financial services firm Cedrus Investments, said: "The reform will reinforce the current performance of the economy, allow the market to play a decisive role, and eventually sustain momentum of its future development."

From yesterday, VAT replaced business tax (BT) in construction, real estate, financial services and consumer services sectors to avoid double taxation, a move expected to slash taxes by more than 500 billion yuan (\$76.9 billion) in 2016 alone. The latest extension came four years after the first trial run of the services sector VAT reform in Shanghai. With that, VAT has essentially taken the place of BT in all sectors.

The VAT taxes only the value added at each link in the production chain. It is in line with international practices and more efficient as it avoids the double taxation of the BT regime, which is based on the gross revenue of a business, including the cost of input.

China has long been collecting VAT on tangible goods, but many services remained under the BT regime until yesterday.

The VAT reform serves as a vital tool in China's vast supply-side structural overhaul. Premier Li Keqiang has urged solid efforts to deliver the reform and pledged lower taxes across the board. It is expected to directly help the services industry, which makes up more than half of China's economy and is critical for economic transition. Traditional manufacturing businesses also stand to benefit as they enjoy more deductibles under the unified tax regime.

Promoting the market's role

Jarkas said the VAT reform helps align China's tax policies with international practice and creates



Chinese Premier Li Keqiang with entrepreneurs in Zhongguancun, a district in Beijing known as China's Silicon Valley. Many start-ups expect to benefit from the VAT reform (Xinhua/Ding Lin)

a fairer market. By avoiding double taxation, it corrects the distortion in the economy under the BT system, which led to redundant in-house operations for tax advantages. Experts say the unified tax structure encourages finer and more natural division of labour.

Liu Shangxi, head of the Research Institute for Fiscal Science under the Chinese Ministry of Finance, said: "The unified tax system covering the production, circulation and consumption of all goods and services is more neutral and provides a better tax environment for the market to play a decisive role in allocating resources." Zhang Bin, a researcher at the Chinese Academy of Social Sciences, said the VAT reform will promote the fair development of all sectors.

The VAT change is the most significant step for tax reduction in recent years. Premier Li told the national legislature in March that

the Chinese government will ensure that tax burdens on all industries are reduced.

Wang Jianfan, director of the tax policy department at the Ministry of Finance, said the government has pledged to prop up the economy "even if it has to face some losses in fiscal revenue in the short run".

China faces the challenging task of pushing through vast economic restructuring while keeping its economic growth rate within a target range, set at between 6.5 per cent and 7 per cent this year. VAT and BT together contribute a large proportion of China's tax revenue. "The sheer scale tells the significance of this reform, and the completion of the switch is far-reaching," Zhang told Xinhua.

Boosting the services sector

A unified tax regime will help to foster a level playing field for all businesses, especially those in the

services industries that were the last to be placed in the VAT regime.

Li Wanfu, the director of the Institute of Tax Science (ITS), a research arm of China's State Administration of Taxation, said: "The business tax imposes a tax on tax, while the VAT levies only on the value added, which is fairer and more precise." Purchased services are deductible under the VAT scheme, which encourages companies to outsource more services rather than adopt a do-it-all business model, according to a report by China International Capital Corp, an investment bank.

Gao Liqun, head of Deloitte's indirect tax group in eastern China, said the final step toward a full VAT scheme benefits the services sector with lower tax burdens and greater demand from other industries.

"Firms will thus have more capital to invest in research and innovation

that propel the growth of the services sector," she told Xinhua.

According to Liu, the VAT system will speed up the upgrade of traditional manufacturing companies as it creates tax incentives for them to purchase services such as research and development, technology transfer and consulting.

Ke Bin, a professor at the business school of the National University of Singapore (NUS), said that consumers also stand to gain from the VAT reform as the benefits of a broad tax cut will eventually trickle down to them.

Creating more jobs

A more socially significant impact of the VAT reform is that it eases tax burdens for small and medium-sized enterprises (SMEs), which experts say will encourage entrepreneurship and add more jobs in the face of economic

headwinds. Zhang said: "SMEs used to pay a 5 per cent or 3 per cent business tax on sales, but they now only need to pay a VAT of 3 per cent."

According to Li, the ITS director, many SMEs are in the services sector and so are now included in the tax reform. "Moreover, the business tax imposed on sales ignores the fact that some SMEs are actually not earning any profit," he said. "Now they only need to pay tax for the gain, and at a lower rate."

Li stressed the social implication of favouring SMEs in the VAT reform. "The boom of the SMEs not only offers more jobs, but also improves employment quality, promoting balanced and sustainable growth in both economic and social sense," he said.

Most important tax reform since 1994

Experts said that the VAT reform might be a key to unlocking wider reforms down the road, as it not only changes the overall tax structure but also influences how central and local government share tax revenue.

"Tax and central-local reforms are the thorniest and most fundamental elements of a true overhaul of China's economic system," said Daniel H Rosen, a partner at the Rhodium Group, in a report.

While all BT went to local governments, making it a major source of their revenue, VAT receipts have typically been allocated so that the central government takes the lion's share.

A final decision on how to divide VAT revenue between central and local governments is under internal discussion, sources said.

The reform of VAT is seen as the most important fiscal and taxation change in China in more than two decades since a major reform in 1994. The need for further changes, including the VAT reform, has been increasingly obvious in recent years.

The VAT pilot programme for services was first rolled out in Shanghai in 2012, covering transport and other services. It has since been expanded across the nation to cover more activities in the service sectors.

The formal final completion of the Chinese VAT reform process is expected to take place with the enactment of a VAT law in a few years' time.

"Taxation reform is an important component that goes along with the central government's overall plan for economic reforms," said Ke in Singapore.

Reduced tax burden on business will benefit foreign firms as well as domestic enterprises

By Xinhua writers Jin Zheng, Chen Jipeng and Sun Ding

The overall tax burden on enterprises operating in China is lower as a result of the VAT reform fully implemented yesterday.

Experts said that while many businesses in the service sectors directly benefit from it, a host of manufacturing companies are also now better off as their purchased services are now deductible.

Li Wanhai, a businessman based in the central Chinese province of Henan, said that businesses in the middle of a long supply chain will be the biggest beneficiaries.

Gao Liqun, head of Deloitte's indirect tax group in eastern China, said that foreign businesses operating within China will generally have a lower tax burden and those outside may profit from the reform as they are able to negotiate better deals in doing business with Chinese firms.

Entrepreneurs pleased to see VAT reform

Offices of tax authorities in Beijing have often been crowded recently with people making inquiries about tax rule changes.

Many entrepreneurs are thrilled at the news of the VAT reform. Cheng Yue, investment director at InnoSpring, an incubator services provider, said that the reform is beneficial to start-ups and their

service suppliers. InnoSpring provides services such as mentoring, workshops and access to venture capital, and angel investment and physical space.

"Companies, start-ups in particular, hesitated to purchase services. The VAT reform encourages outsourcing of services, reducing the burden on start-ups and allowing the service industries to grow," Cheng said.

Partly thanks to efforts to streamline government procedures and improve investment support, China saw a record start-up boom in 2015, with 4.44 million new companies registered, up 21.6 per cent year on year.

Broad range of services to benefit

The last four service sectors placed under the VAT reform represent a fairly big proportion of overall economic activities.

Consumer services, for instance, cover a broad range of activities meeting the needs of daily life, including education, healthcare, sport, tourism, entertainment, catering and accommodation, among many others.

The service industries account for slightly more than 50 per cent of the Chinese economy and are growing at a faster pace than manufacturing, driving China through a much needed economic transition. "China is still a developing economy and the service sector is not very developed. The reduced tax burden will help grow it," Gao said.



Tourists outside a Disney retail shop in Pudong, Shanghai's financial district. Financial services is one of the last sectors to be moved to the new VAT regime in a landmark reform introduced yesterday (Xinhua/Fang Zhe)

Traditional VAT payers win as well

Gao said many manufacturing companies that had been paying VAT are also big winners, as the services they purchase, such as financial services, real-estate rental and sales services, are now deductibles.

Likewise, internet start-ups will also now enjoy more deductibles. Hotel expenses, for instance, are now under the scope of VAT, meaning that managers' hotel fees

and flight tickets from business trips are deductible.

The overall tax costs for products and services are bound to drop after the reform, making them more competitive. Providers of such services and products, therefore, will have more resources to invest in research and development.

Foreign firms are also set to benefit

Gao said that foreign businesses operating in China's services sector

will, like local enterprises, now have a lower tax burden, while foreign manufacturing companies will enjoy the benefit of having more deductibles when paying tax.

Moreover, foreign buyers of Chinese services and products may negotiate better prices as the lighter tax burden will lower the costs of their suppliers, and certain cross-border services are zero-rated.

"Even foreign suppliers of services to Chinese companies

may get opportunities to negotiate better deals, as their Chinese buyers can list such purchased services as deductibles," Gao said.

Experts said that the VAT reform will make the Chinese market more attractive.

Jarkas, of Cedrus Investments, added: "As China grows in power and influence with an ever expanding market, the country has become more attractive to start-ups."

VAT RATES AND COLLECTION RATE IN CHINA AFTER THE REFORM	
VAT rates (%)	Taxable transactions
6	Value-added telecommunication services, financial services, modern services and consumer services, sales of intangible assets other than land use rights
11	Transport services, postal services, basic telecommunication services, leasing of real estate, sales of real estate/land use rights
17	Leasing of movable and tangible assets
0	Certain cross-border taxable activities specified by the Ministry of Finance and the State Administration of Taxation
3	Small-scale VAT payers can use the collection rate of 3 per cent. It is calculated using the formula [sales/(1+3%)]*3%. The result is slightly lower than the 3 per cent business tax

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