China’s VAT Reform: Experiences and Lessons Learned

While China’s VAT was formally enacted in 1994, there have been a number of steps in the country’s adoption of a true VAT, with the goal finally being achieved in 2016 when supplies of services were shifted from a separate turnover tax into the VAT system. In this article, the authors explain the main aspects of the VAT reform and compare them with a model VAT.

1. Introduction

On 1 May 2016, China completed its VAT reforms, bringing remaining supplies subject to the business tax (BT) into the value added tax (VAT) regime. The last stages of the VAT reforms were extremely ambitious and challenging for businesses and the tax administration. The scope of VAT was widely expanded to include the financial and insurance services, real estate and construction services, and lifestyle services sectors. Although the VAT reforms were long overdue, businesses were only given a very short period of time, six weeks, to adapt to the changes and effectively implement the new rules. The VAT reforms have now been fully implemented, resulting in China’s VAT system being very unique due to the broad application of VAT to financial services and immovable property and their related services.

It is anticipated that revenue authorities around the world will take an interest in China’s VAT reforms with the outcomes potentially encouraging reconsideration of the optimal VAT treatment of financial supplies and immovable property elsewhere, although some will consider the actual rules adopted in China as problematic from policy and technical perspectives. However, this is not the only interesting feature of China’s VAT system. China’s VAT system presents other unusual characteristics that may not exist in other countries which have implemented a VAT or equivalent tax. This article addresses and analyses these particular features of the China’s VAT system.

2. Background to the VAT Reforms in China

For the past three decades, China has had a dual system of indirect taxes with the application of separate taxes to goods and services. A VAT applied to the supply and importation of movable goods and specific services directly related to those goods, such as processing, repairs and replacement services. A separate BT, a turnover tax derived from earlier precedents, applied to the remaining services including the transfer of immovable properties. A further turnover levy labelled the “simplified VAT method” and incorporated into the VAT applied to low-turnover enterprises.

Like all turnover taxes, the BT was essentially a tax on business that cascaded throughout a supply chain. Service providers were not allowed to claim input tax credits on the services and the goods they purchased, and their customers were unable to deduct input tax imposed on supplies made to them. This tax cascading effect in business-to-business (B2B) transactions affected businesses’ competitiveness, and created market distortions and industry inefficiencies. Compounding the shortcomings was the fact that suppliers subject to the VAT often made acquisitions that were subject to the BT, resulting in a break in the input VAT deduction chain from the flows of services in the business cycle. Overall, the majority of taxable persons and professionals shared the view that the BT was an inefficient form of taxation.

With the rapid growth of China’s economy in the last decade and market globalization, it became crucial for China to modernize its indirect tax system to remain attractive and competitive both domestically and internationally. However, the coexistence of parallel taxes seemed incompatible with a growing economy. The abolition of the BT and its tax cascading effects has allowed businesses to fully benefit from a credit invoice-based VAT system and to reflect the value added processes in their business cycles. Many tax professionals saw this as one of the main drivers of the VAT reforms undertaken by the Chinese government.

Another important driver for the change was the promotion of the development and expansion of the services sector in China, which was part of the 12th and 13th five-
year plans.7 To stimulate and support the services sectors, a reform of the tax on services was necessary.

A third driver for reform was the “impurity” of China’s VAT system prior to the commencement of the VAT reforms,8 apart from the separate taxation of services not directly related to goods such as warranty services.9 For example, in place of a conventional zero rating for exported goods, China applied a variable VAT rate determined by the type of goods that were exported.

Aware of the peculiarities of its VAT system, the Chinese government sought to bring China’s VAT system more in line with modern VAT systems, shift all types of supplies into the VAT regime, and adopt the OECD VAT guidelines and the international best practices.

3. The Progressive Shift from BT to VAT

The ambitious project of replacing the BT with VAT across the entire service sectors commenced officially on 26 October 2011, when Premier Wen Jiabao announced that the transition of the turnover tax to the VAT would start in 2012, although the reform had been foreshadowed at an earlier point by academics and government officials.10 To ease the integration of services into a VAT system, the VAT reform was implemented progressively, first by location, before being rolled out nationwide. The VAT reforms were also gradually implemented by the service sectors, beginning with the least policy-sensitive sectors and concluding with the most challenging sectors.

The VAT reforms first commenced with a VAT pilot programme in Shanghai on 1 January 2012.11 Shanghai was selected because of the support provided by the local Shanghai government to promote the development of transportation and modern services (the first sectors to transition from BT to VAT), the strong fiscal position of the local Shanghai government, and the specific features of Shanghai’s tax administrative system (i.e. the state tax bureau collecting the VAT and the local tax bureau collecting BT) were essentially the same team while in other cities the two taxes were collected by two separate tax bureaux). The VAT pilot programme included a selection of service sectors such as the transportation sector and certain “modern services industries”,12 initially being research and development and technical services, information technology services, cultural and creative services, logistics and ancillary services, and certification and consulting services.

During the second half of 2012, the pilot programme was rapidly expanded to ten other provinces and cities13 in mainland China as a result of the local governments of these locations becoming aware of the benefits brought by the VAT pilot programme. Later in 2013, China’s State Council announced that the VAT pilot programme would be expanded across mainland China from 1 August 2013,14 a development that was well received by local governments. The scope of the VAT pilot programme was also expanded to include broadcasting, film and television services.

Five months after the first expansion of the VAT pilot programme, its scope was significantly expanded to include new industries, specifically railway transportation and postal services from 1 January 201415 and telecommunications from 1 June 2014.16 Only three industries remained subject to BT: the financial services, real estate and construction, and lifestyle services sectors (including hospitality, food and beverage, health care, education, cultural and entertainment services, and a general residual category of any other services still subject to BT). The Chinese government initially planned to transition these remaining sectors within the 12th five-year plan. In July 2015, the proposed policies for the remaining sectors to transition were submitted to the State Council for approval. However, this occurred at a time when the Chinese economy was in an unstable state. The Shanghai and Shenzhen stock markets were extremely volatile, economic growth was unexpectedly slowing down and the price of property in Tier-one and Tier-two cities remained static.17 In difficult times and an inhospitable economic climate, the State Council decided to postpone the VAT reform implementation.

On 5 March 2016, China’s Premier Li Keqiang announced, at the opening ceremony of the National People’s Congress, the expansion of VAT to the remaining sectors with effect from 1 May 2016, completing the tasks originally set in the 12th five-year plan. The changes were implemented by way of a “Circular” or administrative ruling
jointly issued by the Ministry of Finance and the State Administration of Taxation, the agency responsible for administering the VAT.\(^{18}\) Businesses and tax offices had six weeks to prepare, a timetable that led to some confusion and concern, echoing to some extent the disquiet of taxable persons when the VAT was first introduced in 1994 with a very short implementation timetable.\(^{19}\)

The transition of the financial services, immovable property and construction, and lifestyle services sectors from BT to VAT was left to last as these sectors represented the most challenging part of the VAT reform from both policy and financial perspectives. The industries were amongst the most difficult industries to bring into a VAT and they were the most significant industries contributing to local government revenues, adding a substantial political revenue sharing challenge to the equation.

Each category of service raised its own policy challenges. The value added in financial services is difficult to measure on a transaction-by-transaction basis, which is the main reason why most countries exempt financial services from VAT. Many countries exempt, broadly or not, immovable property transactions for both technical reasons (the value of housing often exceeds the registration threshold but the seller makes a one-off transaction and housing has elements of both savings and consumption) and policy reasons (a VAT on residential housing is thought to be regressive because lower-income households spend a far higher percentage of income on housing than do high-income households). Some countries also exempt immovable property transactions from VAT because they are taxed separately under other taxes such as stamp duties and land taxes. In addition, it can be difficult from a policy perspective to differentiate passive gains, i.e. simple increases in property values, from gains attributable to improvements to the property, such as building and construction. Furthermore, the real estate industry affects a broad range of stakeholders, from experienced developers, to investors, speculators and private individuals who are already subject to many other types of taxation.\(^{20}\) Imposing VAT on lifestyle services can be problematic from a compliance perspective in respect of both the supplier (in many cases lifestyle services are primarily cash-based businesses) and the customer (where it becomes necessary to distinguish business and private acquisition purposes).

Importantly, the final sectors to transition from BT to VAT were also the major contributors of China’s BT revenue, accounting for almost 80% of all BT revenue, and thus to local governments’ revenues. In 2011, their BT contributions were as follow: 26.2% for supplies of immovable property, 22.7% for the construction industry and 15.8% (RMB 216.39 billion) for supplies of financial services. Besides these major contributors, supplies of transportation services contributed 6.6% (RMB 90.66 billion), accommodation and catering services contributed 3.8% (RMB 51.69 billion), and post and telecommunication services contributed 2.2% (RMB 30.76 billion) of the total 2011 BT revenue.\(^{21}\)

The relative importance of these final sectors to be shifted from the BT to the VAT continued to grow over the reform period. By 2015, the BT on supplies of immovable property contributed 31.6% (RMB 610.4 billion) of China’s total BT revenue, the BT on the construction industry contributed a further 23.6% (RMB 513.6 billion) and the BT on the financial services industry contributed 23.6% (RMB 456.1 billion) of the total BT revenue, all of which flowed to local governments.\(^{22}\)

4. **An Overview of the VAT Policy – Financial Services Focus**

A common view that has emerged amongst tax professionals and financial services businesses is that the China VAT rules for financial services are drafted too broadly, and presumably were drawn up too quickly as well. As a result, China’s VAT rules do not address the specificities and complexity of many financial services businesses.

China’s VAT rules define and categorize financial services under four distinct types of supplies, being loan services, fee-based services, insurance services and the trading of financial products.\(^{23}\) The definitions and rules which apply to these supplies are arguably too vague and ambiguous. The main difficulty faced by financial institutions is the categorization of their services, a problem mirrored to some extent in every jurisdiction that treats financial supplies differently from other types of supplies. As is the case elsewhere, mixed and composite supplies with multiple elements that would be treated differently if provided as separate supplies are especially problematic.

The characterization of financial supplies is important because China’s new VAT rules prescribe different VAT treatment and calculation methods for each category of financial services. The value of loan services, defined as the gross interest payable on a loan, is subject to VAT at the rate of 6% under the general method with borrowers denied input tax credits for VAT imposed on their interest payments and any fee-based services directly associated with their loans. Interest on loans between financial institutions approved by the People’s Bank of China\(^{24}\) and other authorized government authorities in mainland China is exempt from VAT. Financial services that fall into the fee-based category are also subject to 6% VAT but, unlike the case with loan services, registered enterprises acquiring these services are entitled to input VAT credits.

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20. These taxes include stamp duty, real estate tax, deed tax, land value added tax, urban and township land use tax.


24. The People’s Bank of China is the central bank in China.
The trading of financial products is subject to VAT on a margin basis, meaning that the purchase costs are deductible from the sale price, with VAT imposed on the net margin. Liability for VAT imposed on the supply of financial products is borne by the supplier. It is not calculated on a transaction-by-transaction basis. Rather, it is imposed on the net margin for a tax period and gains and losses within the same period can be offset between different categories of financial products (i.e. bonds, shares, foreign exchange, etc.). While the supplier is liable for VAT at the rate of 6% on net margins, the counterparty will be ineligible for an input VAT credit. Losses can be carried forward to the next VAT filing period within a year, but not backwards. Thus, if a financial supplier has a loss in one period and gain in the next (within the same calendar year) the carried-forward loss can be used to reduce the margin on which VAT is payable. No offset is available if the supplier has a gain in one period followed by a loss.

Lastly, premium income derived from insurance products is subject to 6% VAT. There is, however, an exemption from VAT for life insurance policies, pension annuity insurance and health care insurance with a term greater than one year.

The classification of financial services into one category or another results in different VAT treatments and outcomes that may significantly influence the VAT position of financial services businesses. However, the ambiguity and lack of details in the regulations have created practical issues and compliance risks for these financial services businesses. To resolve the ambiguities, the Ministry of Finance and the State Administration of Taxation have released additional Circulars clarifying the VAT treatment of certain financial services. In practice, given the skeletal nature of the primary regulation and the extreme rarity of challenge to Circulars, they amount to de facto legislation. The latest Circular issued has clarified and expanded the scope of a VAT exemption applicable to interbank funding (derived from a similar exemption that formerly applied when financial services were subject to BT).

When transitioning from BT to VAT, financial services businesses, as well as other businesses that have transitioned to VAT, have had to adapt to the changes, although some areas remained unclear. Under these circumstances, tax professionals have witnessed a change in financial services businesses’ behaviour to cope as much as possible with the new VAT regulations and their compliance obligations.

The approach adopted in China with respect to loan intermediary services, imposing VAT on gross interest rather than the value of services provided by financial intermediaries, is problematic from a tax policy perspective and has been subject to some criticism. Nevertheless, the comprehensive nature of the Chinese reforms – imposing VAT on all four categories of financial services, has attracted attention. The general rule elsewhere in both traditional (the European Union) and modern VAT systems (for example, Australia, New Zealand and South Africa) has been to exempt all or many types of financial supplies. Certainly, there are exceptions to the rule: for example, South Africa and Malaysia apply VAT to financial services which are remunerated on an explicit fee or commission basis and countries such as New Zealand, Australia, Malaysia, South Africa and Singapore also apply VAT to general insurance policies. In other cases, jurisdictions may use surrogate taxes such as duties or taxes on insurance premiums to substitute for VAT on these supplies. However, no jurisdiction has gone as far as China in seeking to tax all types of financial services supplies within the VAT system, albeit in a manner far different from that found in practice elsewhere or that advocated in the theoretical literature.

One factor that made it easier for China to adopt a “big bang” approach to VAT taxation of financial services supplies, to include all explicit fees for financial services, including fees for general banking services, asset management services, securities and trust-related services, and margins on the supply of financial products, as well as insurance premiums and gross interest payments, was the fact that, prior to the reform, most of these were subject to BT at the rate of 5%. In addition, the high level of market concentration amongst China’s state-owned enterprise banks and insurers was also an element that facilitated the change of tax.

Significantly, China’s VAT rules do not provide a general VAT exemption for exports of financial services. Except for the provision of fee-based financial services related to monetary financing and other financial services carried out among foreign entities and exported insurance services, exports of financial services are generally subject to VAT. However, the export of financial consultancy services may be characterized as a VAT-exempt supply. Notwithstanding this concession, China’s VAT rules do not provide a clear definition of exported financial consultancy services, which leads to practical difficulties when it comes to distinguishing financial consulting services from general consulting services. It remains to be seen whether the denial of input tax credits as well as the lack of VAT exemption for exported financial services will or will not be a permanent feature of China’s VAT system.

5. Multiple VAT Rate System

Another obstacle in the transition from BT to VAT lay in determining the VAT rates. Supplies of services transitioning from BT to VAT would be subject to higher rates under a VAT than they historically had been under the BT (the standard VAT rate in China is 17%). Some taxable

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25. A Circular is an administrative document that provides an interpretation of the law or regulation under which a tax is levied.


27. Wolters et al., supra n. 17.

28. China’s big four domestic banks are Industrial & Commercial Bank of China (ICBC), China Construction Bank (CCB), Agricultural Bank of China (ABC), and Bank of China (BoC) and are amongst the largest ten banks in the world by market capitalization.
persons had difficulties accepting that an increase in the tax rate (for example from 3% or 5% BT to a much higher VAT rate) might actually benefit them due to VAT being a creditable tax. This was only true for those taxable persons not subject to the simplified VAT rules. Such input tax credits were also of inconsequential value to businesses with relatively few inputs providing services to final consumers. There was great concern that a sharp rise in tax rate could seriously affect the profitability of businesses subject to the simplified VAT rules – and hence unable to claim input tax credits – and businesses providing services to final consumers.

To mitigate the potential negative financial impacts on these suppliers, the Chinese government endeavoured to maintain the same tax burden under the VAT regime as existed under the BT regime by introducing two new VAT rates to smooth the transition from BT to VAT. The Chinese government also considered other factors, such as the interest of the stakeholders in the sectors to be covered by the reform when assessing the appropriateness of multiple VAT rates. The policymakers in China conducted internal studies and financial modelling research to analyse the potential impacts of the transition to VAT on service sectors transferred to the VAT to determine the appropriate VAT rates for each of them. Different authorities and bodies of the Chinese government also conducted meetings with various industries to understand their concerns and needs. The results of the financial studies combined with the outcomes of the meetings assisted the Chinese government to determine the appropriate VAT rates applicable to each service. As a result, China’s VAT system now contains nine different VAT rates, while most countries have one standard VAT rate or one standard rate and a reduced rate.

Prior to the VAT reforms, China’s VAT system had one standard rate, one reduced rate and one zero rate, which continue to apply under the consolidated VAT regime. The standard rate of 17% applies to tangible goods and related services. The reduced rate of 13% applied primarily to what were considered essential goods and services and lastly the export of goods was in theory subject to zero rating (although, as noted, the actual recovery of input VAT varied from industry to industry and time to time). In addition, a 2% rate applied to the sale of used fixed assets, with no input VAT credits for purchasers. Separately, the simplified VAT method applies to small businesses below the general VAT registration threshold with a 3% rate applicable to supplies made by enterprises subject to this method.

All these rates were followed by new VAT reforms, along with two new VAT rates with broader application: an 11% rate which applies to transportation services, immovable property and construction services, postal services, and basic telecommunications services; and a 6% rate which applies to financial services and insurance, modern services and lifestyle services. In addition to these two reduced rates, the Chinese government also introduced a 5% simplified VAT rate which applies to immovable property services where the business has opted for grandfathering relief, a 3% rate which applies to construction services where the business has opted for the grandfathering relief, and a 1.5% VAT rate that applies to the lease of immovable property by an individual.

The table summarizes the VAT rates currently applicable to goods and services in China.

Although the intention of the Chinese government was to mitigate the financial impact of the tax rate increase from BT to VAT, the use of multiple VAT rates has been problematic for businesses. The use of multiple VAT rates creates confusion and practical issues in determining which VAT rate to apply, particularly when similar services are subject to VAT at different rates. A typical example occurs in the transportation industry where actual transportation services are subject to 11% VAT but ancillary services, such as freight forwarding and logistics services (i.e. goods packaging services, carriage services, transit services, etc.) are subject to 6% VAT. The confusion is replicated on the input tax side when different types of expenses generate different levels of credit.

Many observers have suggested that ultimately the Chinese government will have to reduce the number of VAT rates in the future in order to ensure cohesion in VAT treatment and eliminate practical uncertainties and difficulties.

6. Impact on Government Revenue

The third obstacle to overcome was probably the most contentious one for provincial governments as it was political in nature. The allocation of the BT and VAT revenue between the central and provincial governments in China was agreed by the governments in 1993, with effect from 1994. Under the arrangement put in place, 100% of the

30. The China government has used tax burden as one of key factors to determine the success of the VAT reform although it is not commonly used under a VAT regime. Tax burden is the proportion of tax on the price of goods or services.
31. The reduced VAT rate of 13% applies to foodstuffs, edible vegetable oils, tap water, heating, air conditioning, hot water, gas and coal, books, magazines, newspapers, animal feeds, fertilizers, pesticides, agricultural chemicals and machinery.
32. Deduction of input VAT incurred on acquisition of fixed assets in all industries has been allowed since January 2009.
33. The modern services include research and development and technical services, information technology services, cultural and creative services, logistics and ancillary services, and certification and consulting services, broadcasting and film and television services, commercial auxiliary and other modern services.
34. A simplified VAT rate available to taxable persons who have opted for the grandfathering relief operates in a similar fashion to the simplified VAT system that applies to small businesses with turnovers below the general VAT threshold. Output VAT is payable at the reduced rate, but the supplier cannot claim input VAT credits for its expenses. As such, it more closely resembles a gross turnover tax. A vendor using the grandfathering rule can issue a VAT special invoice for the supply if the purchaser is a general VAT taxable person seeking to claim input tax credits.
35. The grandfather rules allow vendors to use the lower rate provided they claim no input tax credits. The VAT rate is the same as the BT rate applicable to immovable property under the BT regime.
36. Ethisham Ahmad, Ben Lockwood & Raju Singh, Financial Consequences of the Chinese VAT Reform, 16 Intl. VAT Monitor 3, p. 181 (2005), Journals IBFD. For a comprehensive overview of the place of tax revenue
revenue derived from BT and 25% of the revenue derived from VAT went to provincial governments. The remaining 75% of VAT revenue was retained by the central government. Had there been no change to the division of tax revenues, the abolition of BT would have had a significant impact on the revenue of provincial governments and the financial relationship between the central government and provincial governments.

To compensate provincial governments for the revenue loss, the central government agreed, in the VAT pilot programme, that all VAT revenue from service sectors transitioning from BT to VAT would be allocated to the provincial governments. This concession was, at that time, a necessity to overcome the political resistance of provincial governments to the VAT reforms. However, this arrangement was not viable long term and therefore both the central government and provincial governments agreed to revise the distribution of revenues and seek alternative solutions. Premier Li Keqiang repeated the government’s commitment to a long-term solution in the annual government work released on 5 March 2016. He indicated that the Chinese government would change the VAT revenue sharing between the central government and provincial governments during 2016.

Shortly after the announcement, on 29 April 2016, the State Council issued a Notice in relation to the adjustment of the VAT revenue sharing between the central and provincial governments post the VAT reforms. The Notice states that VAT revenue is to be equally shared (50%-50%) between the central and provincial governments with effect from 1 May 2016. The Notice also states that the new revenue arrangement will be in effect for a transitional period of two to three years and after such time both the central and provincial governments can examine and readjust the allocation ratio based on the responsibilities, expenses and the progress made in the reform.

### 7. The Coexistence of Two Types of Taxable Persons for VAT Purposes

As explained earlier, unlike other VAT systems which exempt businesses with a low turnover from any VAT registration and obligations (i.e. a registration threshold), the Chinese VAT system imposes a turnover tax on small businesses, that is labelled a type of “simplified VAT method” in the regulation establishing the VAT.

The threshold borderline distinguishing VAT taxable persons subject to the full VAT method (known as “general” VAT taxable persons) and small businesses subject to the simplified VAT method is based primarily on assumptions about accounting systems used by the two categories of business. Larger businesses with annual turnovers higher than the full VAT threshold are assumed to have

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**Table: VAT rates on goods and services**

<table>
<thead>
<tr>
<th>Applies to</th>
<th>VAT/levy rates (%)</th>
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</thead>
<tbody>
<tr>
<td>Selling goods, processing, repair and replacement services</td>
<td>17</td>
</tr>
<tr>
<td>Leasing of movable properties (excluding the sale and leaseback activities)</td>
<td>17</td>
</tr>
<tr>
<td>Certain food items and utilities</td>
<td>13</td>
</tr>
<tr>
<td>Immovable property and construction services</td>
<td>11</td>
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<tr>
<td>Transportation services</td>
<td>11</td>
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<tr>
<td>Postal services</td>
<td>11</td>
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<tr>
<td>Basic telecommunication services</td>
<td>11</td>
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<tr>
<td>Financial and insurance services (including sale and leaseback activities)</td>
<td>6</td>
</tr>
<tr>
<td>Research and development (R&amp;D) and technical services</td>
<td>6</td>
</tr>
<tr>
<td>Information technology (IT) services</td>
<td>6</td>
</tr>
<tr>
<td>Cultural and creative services</td>
<td>6</td>
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<tr>
<td>Logistics and ancillary services</td>
<td>6</td>
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<tr>
<td>Certification and consulting services</td>
<td>6</td>
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<tr>
<td>Lifestyle services</td>
<td>6</td>
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<tr>
<td>Immovable property grandfather relief simplified rate</td>
<td>5</td>
</tr>
<tr>
<td>Construction services grandfather relief simplified rate</td>
<td>3</td>
</tr>
<tr>
<td>Sale of used fixed assets</td>
<td>2</td>
</tr>
<tr>
<td>Immovable property leases by individuals</td>
<td>1.5</td>
</tr>
<tr>
<td>Turnover tax rate (“simplified VAT”) applied to small business1</td>
<td>3</td>
</tr>
</tbody>
</table>

1. As noted, while the simplified VAT applicable to small business is in substance a turnover tax but is nevertheless included in the VAT regulation and considered part of the VAT regime.

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38. Id.

sound accounting systems that allow tax authorities to carry out VAT audits accurately while small businesses with annual turnovers below the full VAT threshold are considered as having accounting records insufficient to accurately calculate the VAT payable. 40

A general VAT taxable person must register for the general VAT regime and is potentially entitled to claim input VAT credits incurred on its purchases and issue VAT special invoices. 41 A small-scale taxable person (small business) must register for the simplified VAT and remit VAT at a flat rate of 3% of its gross revenue with no entitlement to claim input VAT. As a result, a small-scale taxable person may be in a less favourable position than a large business, which can benefit from the credit-based system, though the output VAT rates for small-scale taxable persons are lower.

The difference between these two types of taxable persons is also amplified by the fact that small-scale taxable persons cannot issue VAT special invoices. This simply means that a taxable person subject to the general VAT is unable to recover the input VAT included in the cost of goods or services acquired from a small-scale taxable person, although it is possible for a small-scale taxable person to make a request to its tax bureau to issue the VAT special invoices on its behalf. A general taxable person in receipt of one of these tax bureau-issued receipts can claim input tax credits for the 3% tax shown on the VAT special invoice. The process is often time consuming, however, and not often invoked. Compared to a large business, a small business is in a less competitive position in terms of supplies to general VAT taxable persons due to its inability to issue VAT special invoices.

Before the VAT reforms, two different thresholds applied based on the type of industry; a CNY 500,000 (approximately USD 75,380) threshold applied to manufacturing and wholesale and retail enterprises. These two thresholds remain after the VAT reforms, but the shift of services from the business tax to the VAT has led to the adoption of a third threshold for persons in the service sectors who are only required to register as a general VAT taxable person if their annual turnover exceeds CNY 5 million (approximately USD 750,000).

This newly introduced threshold is very high by international standards and therefore many of the businesses which transitioned from BT to the VAT system did not have an annual turnover exceeding that threshold. Consequently, a large proportion of newly VAT-transitioned service suppliers fell into the category of small-scale taxable persons.

The coexistence of two types of taxable persons and two types of VAT in the same VAT system generates economic distortions between small and large businesses. The high threshold for businesses formerly subject only to the BT has effectively shifted the distorting turnover tax feature of the BT into the VAT, undermining many of the potential beneficial goals of reform in the eyes of some observers. 42 Some tax professionals and observers have suggested the abolition of the status of small-scale taxable person to re-establish equality amongst businesses.

8. Conclusion and Way Forward

The VAT reforms have now been fully implemented in China, resulting in China’s VAT system being amongst the broadest-based VAT systems of the (approximately) 160 countries in the world which have implemented a VAT/GST. However, China’s VAT system still differs from those VAT systems commonly found in other countries.

The merger of the BT and VAT has resulted in a single tax applying to goods and services, a fundamental feature of any VAT system. It has, however, led to some difficulties. The progressive shift from BT to VAT has led to financial distortions for taxable persons who are now dealing with multiple VAT rates. The establishment of three different thresholds for registration as a general VAT taxable person has led to further distortions, as has the application of a “simplified VAT method” for enterprises with turnovers below the thresholds, particularly for those small businesses seeking to make supplies to VAT taxable persons but which are unable to issue VAT special invoices. Finally, the hybrid application of indirect tax to financial services, with VAT imposed on gross interest payments but some types of financial supplies, such as insurance, effectively treated as VAT-exempt supplies, has led to further economic distortions.

China is aware of the work that still needs to be done to modernize its VAT system and remove the remaining BT features. China is considering replacing the current VAT regulations issued by the executive branch of government, the State Council, with a VAT law approved by the legislature, the National People’s Congress. The adoption of a VAT law could offer the opportunity to simplify VAT rates and adopt additional OECD guidelines not yet incorporated in the existing VAT regulations. The Chinese government has begun to study the impact of further changes and is anticipated to begin drafting the VAT law in the second half of 2017. The National People’s Congress has proposed a timetable that would see draft legislation submitted to the Congress for discussion within the period 2018 to 2020.

40. A small business can apply for registration as a general VAT taxable person if it can prove to the tax authority in charge that it has complete and reliable accounting records.

41. The VAT special invoice is an invoice printed from the government-authorized golden tax system which serves as the supporting document to claim input VAT credits for a general VAT taxable person.

42. See, for example, supra n. 29.