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CHINA REDUCES TAX ON SALES

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The Office of the State Council revealed on October 26, that a decision had been made to eliminate a couple of anomalies in China's sales tax system. The decision will take effect on January 1 next year with the introduction of a pilot scheme in Shanghai and it is anticipated that the changes will result in a general reduction in indirect tax on sales of goods and services.

Sale of goods is subject to value added tax ("VAT") and the sale of services, subject to business tax ("BT"). China's VAT system is a consumption based creditable tax on the sale of goods; whereas BT is a tax on the sale of services that is not creditable against VAT or BT. Therefore, the tax base of the existing Chinese sales tax system is much broader than the consumption component of the GDP, as a result of two anomalies as compared to the standard design of a VAT system on sales as being applied in other countries: (1) tax on services as inputs at any stage of the production or value adding chain is in general not creditable against tax on other outputs, whether services or goods; and (2) tax on services has a cascading effect, because a taxed service as an input into a downstream service will be taxed again. Due to such anomalies, the scope of a consumption based VAT is expanded, putting extra burden on producers and consumers generally.

According to the State Council briefing, the approach to eliminating the above anomalies is that BT payers will become VAT payers and hence VAT paid on services they provide will become creditable against the output VAT payable on the downstream sales of goods and services. BT payers are in general paying 5% tax on the gross amount of a sale of services but the standard VAT rate is 17% with a lower rate of 13% applied mainly to basic goods. Therefore, service providers may have to pay more tax if they have to pay 17% on a sale of service as output without sufficient input VAT credit against this output tax. To address this potential dilemma, the State Council decision has also introduced two lower VAT rates, 11% and 6% to ensure that the proposed change can really reduce the tax burden of service providers.

We welcome this move. As explained in our recent Notes, it is our view that the proportion of revenue raised from indirect taxes should be reduced as a general orientation of China tax rationalization. This is particularly relevant when China is encouraging consumption as a way to shift the emphasis of the country's economic growth.