

## Brief analysis on value-added tax transformation and its influence on enterprises

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**Abstract:** From Jan. 1st, 2009, the value-added tax transformation will be performed in all industries around the country. Based on value-added tax types and retrospection of reform practices, this article analyzes the background of the national value-added tax transformation and points out the influence of full implementation of the value-added tax transformation on various enterprises.

**Key words:** value-added tax; value-added tax transformation; production value-added tax; consumption value-added tax

In order to expand domestic demand, reduce tax payment of equipment investment of enterprises, boost technological improvement and industrial structure adjustment of enterprises and change the pattern of economic growth, on Nov. 11th, 2008, a standing conference of the State Council decided to perform value-added tax (VAT) transformation in all industries around China from Jan. 1st, 2009. It is estimated that the revenue will be decreased over 120 billion RMB, strikingly influencing enterprises as the greatest tax cutting in China's history of individual tax reform.

### 1. VAT types and retrospection of reform practices

VAT is a circulation tax imposed on the value generated in the process of manufacturing and selling goods or providing such services as processing, repair and maintenance. Depending on whether the purchased permanent assets can be offset, VAT falls into three types: production VAT, consumption VAT and income VAT. When counting the added value, consumption VAT allows all VAT on purchase contained in the purchased permanent assets deducted at a time, that is, the remains, obtained by the income of commodity sales of a taxpayer deducting the expenditure on purchasing goods and labor in a certain period of tax payment, and then deducting the expenditure on purchasing permanent assets for the same period, are taken as the taxable income. For the production VAT, when counting the added value, it is not allowed to set all VAT on purchase contained in the purchased permanent assets but take the remains, got by the income of commodity sales of a taxpayer deducting the expenditure on purchasing goods and labor, as the taxable income. For the income VAT, when counting the added value, it is allowed deducting all VAT on purchase contained in the purchased permanent assets time by time depending on the proportion of depreciation allowed of a given period, that is, the VAT is counted based on the remains generated by the sales income of taxpayer deducting the expenditure on goods and labor along with depreciation of permanent assets. At present, the consumption VAT is adopted by most countries around the world

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except for such a few countries as Indonesia and China, which take the production VAT policy.

### **1.1 Implementation of production VAT**

When reforming the taxation in 1994, the production VAT was chosen, depending on the productivity and economic development environment at that time. On the one hand, the domestic revenue was considered; on the other hand, the reform was to inhibit investment expansion. However, with the further development of market economy, the domestic macro-economy changed, leading to the deflation and insufficient market demand. Boosting the investment became urgent. Although we took active fiscal policy and monetary policy, expected to boost the non-official investment by increasing the issue of national bonds and performing governmental investment, but failed to reach the desired effect. It is obviously not enough to treat insufficient demand and deflation depending on the two previously mentioned policies without the cooperation of active tax policies. Problems generated by current production VAT policy show that reforming the existing VAT is an urgent request to boost the national economical development.

### **1.2 Production VAT and consumption VAT in parallel – Pilot VAT transformation**

Since the production VAT policy leads to double taxation and is unfavorable for enterprises to improve technologies, meanwhile, a great deal of traditional enterprises face the plight of bankruptcy in the process of market system reform due to equipment aging and heavy burden of social responsibilities; therefore, the third Plenary Session of the 16th Communist Party of China Central Committee made the decision to perform “changing VAT from production type to consumption type, including the equipment investment in VAT offset”, making clear the direction of domestic VAT reform. Started from Jul. 1<sup>st</sup>, 2004, the pilot VAT transformation reform is performed in eight industries of old industrial bases of Northeast China. In the same year, the GDP increase of Northeast China provinces is 2.8 percent, which is higher than the national average level. Started from Jul. 1<sup>st</sup>, 2007, that is, next to the pilot VAT transformation in Northeast China, the pilot VAT offset expansion is performed in 12,000 enterprises of 26 old industrial cities in six provinces of central China. By the end of 2007, 3.45 billion RMB in total are returned to these enterprises. Moreover, in the Report on the Work of the Government 2007, making the scheme and measures of full implementation of VAT transformation is clearly scheduled as the work deployment of central government.

### **1.3 Overall implementation of consumption VAT**

The pilot VAT transformation being performed in some industries of some areas propels the waking and rising of these areas in a given period, but this is a favorite policy for some taxpayers. If such a situation last for a long term, it is inevitable to bring unequal competition to various taxpayers in other areas, damaging the interest of most taxpayers. To avoid the negative effect and protect taxpayer’s right of equal tax payment, a standing conference of the State Council decided to perform the VAT transformation reform from Jan. 1<sup>st</sup>, 2009 in all industries around the country. Main contents of the reform are as follows: allowing enterprises to offset VAT contained in the newly purchased equipment, meanwhile, canceling the VAT exemption policy for imported equipment and VAT refund policy for foreign enterprises purchasing domestically manufactured equipment; uniformly lowering the VAT taxation of small-scale enterprise taxpayers to three percent; and resuming the VAT taxation of mineral products to 17 percent. It is calculated that the implementation of the reform may cut the VAT revenue by about 120 billion RMB.

## **2. Background analysis of VAT transformation**

### **2.1 Financial crisis offers opening for VAT transformation**

At present, the financial crisis caused by the American sub-prime mortgage crunch has affected Europe, Asia and Latin America, resulting in the distinct slowdown of global economic growth, even economic recession in some countries. The financial crisis is now a dramatic negative influence on the real economy. Under the circumstances, the VAT transformation reform is very good for enhancing the further development of enterprises, improving their competitiveness and capability of risk resistance and removing the negative influence brought by the global financial crisis. It is estimated that the reform leads to over 120 billion decrease of domestic revenue, as the greatest tax cutting in China's history of individual tax reform. It is believed that the issue of the policy is expected to actively boost the national economical development in a continuous, steady and faster way.

### **2.2 Slowdown of economic growth propels overall implementation process of VAT transformation**

The slowdown of current economic growth creates the overall implementation of VAT transformation. In the first half year of 2008, the domestic GDP growth is 10.4%, which is higher than that of the same period last year. The growth speed is 1.8 percentages down compared with last year. Multiple elements work and make medium and small-scale enterprises face with hard operations. In the first half year there are 67,000 of them collapsed around the country. Objectively, the VAT transformation reform in fact ease enterprises with lower tax load, helping them smoothly pass through the hard time, which is also beneficial to the realization of macro-control goals.

### **2.3 Greater financial surplus provides reform conditions for VAT transformation**

In the first seven months of 2008, the accumulated domestic revenue reached 4,088.171 billion with 30.5% growth, compared with last year. Experts forecasted that there was almost no problem to expect a domestic revenue of more than 6,000 billion for 2008. The revenue budget for the first half year of 2008 reaches 3,480.819 billion, which is up 33.27 percent compared with the same period of last year; the expenditure budget is 2,288.202 billion RMB, which is up 27.69 percent compared with the same period of last year, resulting in a surplus of 1,192.617 billion RMB. According to the Ministry of Finance, the implementation of VAT transformation reform around the country may lead to a revenue decrease of 150 to 200 billion RMB, resulting in a heavy burden of the financial system. However, the present sufficient surplus provides support for the VAT transformation reform from the other hand.

### **2.4 Pilot VAT transformation offers precious experience for overall reform**

The pilot VAT transformation takes the responsibility for supporting the waking of Northeast China, the rising of the central China, exploring and consummating the VAT system. And the terminal goal is to collect valuable experiences for further implementation of VAT transformation around the country later and building regularized consumption VAT policy. At the same time, changing it from a preferential policy to a system arrangement, embodying the neutral principles of taxation then realize equal taxation. Looking at the VAT practices at home and abroad, it is found that the equality and neutrality of VAT can be truly embodies unless the overall offset of consumption VAT is adopted to remove double taxation and protect the interest and rights of the taxpayer. After an over four-year long pilot implementation, we have notice the advantages of consumption VAT policy such as boosting the technological improvement of enterprises and promoting the global competition of products. But shortcomings exist too, therefore, particular regulations are given to permanent assets in the cover of VAT taxation in the transformation, including the machine, mechanicals, transportation tools and other equipment, tools and instruments related to production and business operation, but houses and buildings cannot be offset when counting VAT.

## **3. Influence of VAT transformation reform on various enterprises**

### **3.1 Stimulating development of high-tech enterprises**

For many years, the production VAT policy has been adopted in China. It is not allowed deducting the value of permanent assets, making the industries with high organic capital constitution pay higher tax than the industries with low organic capital constitution, then inhibiting the investment of enterprises on high-tech and worsening the development of originally backward fundamental industries whose overall development is poor and opposite to the development of social industrial structure. The developmental level of our society is going to enhance the industrial structure from a low position to a high one, more particularly, making the proportional advantageous labor-intensive industries evolve into capital-intensive and technology-intensive industries occupying a proportional advantage. It is allowed offsetting the permanent assets for relieving the tax burden of high-tech industries, removing double taxation, reducing investment cost, promoting investment interest rate, shortening investment recovery period, and objectively stimulating capital investment of high-tech industries to realize upgrade of equipment and technologies.

### **3.2 Realizing equality between domestic and foreign enterprises**

According to related regulations, domestic enterprises cannot offset the purchased permanent assets, but the foreign enterprises enjoy the preferential policy of refund or VAT exemption for purchasing fixed assets like equipment, objectively resulting in the implementation of production VAT in domestic enterprises while the implementation of consumption VAT in foreign enterprises. From the very beginning, domestic and foreign enterprises are in an unfair competition. The adoption of consumption VAT allows both enterprises offsetting purchased fixed assets, facing the same tax policy and therefore forming a fair competitive environment.

### **3.3 Boosting the development of fundamental industries and capital-intensive enterprises**

For the fundamental industries and capital-intensive enterprises, the consumption VAT policy is much better for them due to their higher proportion of fixed assets, compared with the processing industries and labor-intensive enterprises. The transformation will boost the development of fundamental industries and capital-intensive enterprises relieve the bottleneck problem of raw material based fundamental industries, step up the technological advance and equipment upgrade, promote the international competition of domestic products, and also be along the direction of national industrial policies.

### **3.4 Strengthening international competition of export-oriented enterprises**

The production VAT policy imposes double taxation on the taxable commodity, making enterprises in a disadvantageous position in the international competition. To strengthen the competition of domestic products in the global market, many countries impose no tax on their exported products. The production VAT is adopted in China. When counting VAT, the fixed assets are not offset; therefore, the refund does not include the paid tax for purchasing fixed assets to manufacture the exported products. In this sense, when using the same tax ratio, a higher VAT goes to the domestic products when entering the foreign markets, compared with same foreign products. When using the consumption VAT, offsetting the paid VAT or refunding is allowed for exporting machines or equipment. In this sense, the inner value of the product is lowered and more exactly presents the price of the product, strengthening the international competition of exported products. This measure absolutely has significance for export-oriented enterprises.

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