

## Understanding Export VAT Refund in China

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Many overseas companies doing business in China suspect that Chinese manufacturers and trading firms enjoy a special or unfair competitive advantage on their pricing due to hidden government sponsored 'Export VAT Rebates' or 'Export VAT Refunds'. But in fact, both Chinese and foreign registered companies in China incur an indirect cost on exports due to non-recoverable Input VAT<sup>1</sup> which leads to higher prices.

### Tax on Exports

As opposed to the standard destination-based VAT system of the 'Organization of Economic Cooperation and Development' (OECD) including the EU countries and the USA, where companies receive a full refund on Input VAT when exporting, China operates a non-neutral system in which the refund rate (partial or full) depends on the Harmonized Standard (HS) Customs classification code of the individual goods for export.

In effect, China imposes an export tax as the Input VAT refund rate is often lower than the applied VAT rate. This makes it less beneficial to export goods than to sell domestically where the Input VAT is fully recovered. The term Export VAT Rebates is thus misleading as it only represents a partial refund of the paid Input VAT.

### Trade Policy Tool

China has been using its Export VAT Refund system as an active trade policy tool to regulate prices on its exports and improve its international competitiveness. Over the years, the VAT refund rates have often

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<sup>1</sup> Input VAT is paid on the bought e.g. the raw materials and components used in the final product while Output VAT is received on domestic sales.

been adjusted according to the state of the global economy. At times, China has lowered the VAT refund rates to manage its large trade surpluses or increased them to boost exports during economic downturns.

As an example, the average Export VAT Refund rates fell continuously from 2002 where exporters recovered 84% of their VAT costs but dropped to 51% in 2008. With the start of the global financial crisis, the ratio increased to 58% in 2009<sup>2</sup>.

### **VAT Refund Rates**

When exporting goods, no Output VAT is charged on the exporter but with only a partial refund on Input VAT, the difference between the two is an added cost on the exporter. As mentioned, the actual refund rate depends on the HS code but also on whether the exporter is a trading or manufacturing company.

To secure the optimal VAT refund rates and protect margins, it is thus essential that the exporter conducts a detailed review of the Customs classification codes and matching VAT refund rates. This can sometimes be contentious as the chosen HS code by the company ultimately needs to be confirmed by Customs.

The current VAT refund rates are 0%, 5%, 6%, 9%, 11%, 13%, 15% and 17%<sup>3</sup>. Please check with the State Administration of Taxation (SAT: [www.chinatax.gov.cn](http://www.chinatax.gov.cn)).

In China, the standard VAT rate on goods is 16%. If the VAT refund rate is 12% points, the unrecoverable cost of 4% points is either added to the sales price of the manufacturer or the purchase price of the trading firm.

### **VAT Reform**

On 1 May 2018, China introduced a reform to the VAT system in which the standard VAT rate on goods was lowered from 17% to 16% and on certain items from 11% to 10%. The standard VAT rate on services was kept at 6%. The current Export VAT Refund rates are expected to be adjusted accordingly.

Moreover, the previous criteria for qualifying as a Small-scale VAT Taxpayer were merged and increased to an annual turnover of up to RMB 5 million. This is significant as only General VAT Taxpayers with a higher annual turnover can offset Input VAT credits with Output VAT credits and qualify for an Export VAT Refund.

### **VAT Recovery Process**

To recover part of the Input VAT, the licensed exporter must file the monthly Export VAT Refund claim and include such documents as the Export Customs Declaration Form, Foreign Exchange Cancellation Form, Business License and Invoice with VAT. It is important to have proper document handling and control

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<sup>2</sup> Julien Gourdon et al.: "How effective are VAT export taxes? Evidence from China" (February 2017), Page 12

<sup>3</sup> KPMG: China Tax Alert, Issue 9 (March 2018), Page 5

system in place as any errors or insufficient documentation can result in a rejection by SAT. From the application is filed, it generally takes 2-3 months to receive the VAT refund<sup>4</sup>.

### **Escalating Trade War?**

The perception that Chinese export companies receive special tax incentives through the VAT system are unfounded as both domestic and foreign registered companies in China face the same indirect tax on their exports. In practice, the non-recoverable Input VAT on exports is passed along in the supply chain through higher prices. However, this does not imply that China does not subsidize its own exports in other ways.

The Chinese Export VAT Refund system is instead being used as another interventionist trade policy tool to regulate export prices on different goods depending on domestic and global economic conditions.

With the escalating trade war between China and the US, the Chinese government has so far chosen to gradually devalue the Chinese Yuan compared with the US Dollar, and it remains to be seen if China will also use its VAT system to further cushion the impact of higher trade tariffs by the US.

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<sup>4</sup> China Briefing: Export Tax Rebates in China by Gidon Gautel (August 17, 2017)