Review and Outlook of Consumption Tax Reform - Moving Ahead Steadily and Getting Ready for Further Actions

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In brief

The current Consumption Tax (CT) regime in China has been implemented since 1994. As a turnover tax imposed on certain specific consumer goods, CT played a positive role in collecting fiscal revenue, guiding industry development, promoting energy conservation and environment protection as well as optimising consumption structure. With the continuous economic growth, change in consumption pattern of residents as well as the need for energy conservation and environmental protection, the taxable scope, tax rate, collection stage as well as administration measures of CT need to be reformed. To respond, the Ministry of Finance (MoF) and the State Administration of Taxation (SAT) are in the process of reforming CT in China.

We observed that China has gradually implemented CT reform measures in recent years. For example, levying CT on super-luxury small motor cars at the retail stage; narrowing the taxable scope of cosmetics goods as well as reducing the tax rate for certain cosmetics goods; raising the ad valorem CT rate plus levying an additional CT based on quantity on cigarettes sold at the wholesale stage; raising the per litre tax payment on certain refined oil; imposing CT on batteries and coatings. These measures not only changed the taxable scope and tax rate, but also the collection stage, which indicates the strategy and the direction of the CT reform in China, that is constantly improving the CT regime by steady adjustments and advancing the CT reform at appropriate time. In this issue of China Tax/Business News Flash, we will look back at the CT reform implemented during the recent years, look forward to its development, analyse the impact on taxpayers and share our observations and views.

In detail

Overview of CT reform for the recent 3 years

Since the end of 2014, the important CT reform measures implemented by the MoF and SAT have launched a series of circulars to implement the CT reform:

- From December 2014: motor vehicle tyres, alcohol, and small-displacement motorcycles have been removed from CT taxable scope;
- In January 2015: the per litre tax amount levied on certain refined oil was increased;
- From February 2015: batteries and coatings was added to the CT taxable scope and taxed at the rate of 4%;
- In May 2015: the wholesale cigarette ad valorem tax rate was increased from 5% to 11% plus an additional CT levied based on quantity;
- From October 2016, CT has been removed on ordinary beauty and decorative cosmetics and the applicable tax rate for high-end beauty and decorative cosmetics has decreased from 30% to 15%;
- From December 2016, an additional CT at the rate of 10% would be imposed at the retail stage on super-luxury small motor cars.

Moreover, the SAT has released a series of follow-up circulars to clarify the tax collection and administration matters after the policy adjustments.

Adjusting the taxable scope

Distinctly different from Valued-Added Tax (VAT) regime that is widely imposed on all industries, CT is imposed on a selected number of consumer goods, which reflects policymakers’ direction in guiding industry development, promoting energy conservation...
and environment protection as well as optimising consumption structures. From the series of adjustments implemented by the MoF and SAT in recent years on the taxable scope and tax rate of CT, we can analyse their position towards certain industries and goods. For instance, levying CT on batteries and coatings, raising per litre tax amount levied on refined oil and removing low pollution, low energy consumption small-displacement motorcycles from the CT taxable scope are for energy conservation and environment protection; raising CT on cigarettes to increase the cost of both tobacco enterprises and consumers is to deter smoking behaviour and protect public health; by levying additional CT on super-luxury small motor cars is to guide rational consumption; CT has been removed on ordinary beauty and decorative cosmetics and the applicable tax rate for high-end beauty and decorative cosmetics has decreased from 30% to 15% as cosmetics have gradually become necessities for residents.

Going forward, it is anticipated that the policymakers will continue adjusting the taxable scope by including more high-pollution, high-energy consumption and high-end consumer goods in the taxable scope to be in line with the above mentioned principles. Taxpayers engaged in these consumer goods should timely focus on the policy updates and get well-prepared for this. Meanwhile, the CT imposed on high-end consumer goods will have negative impact on stimulating consumption and expanding domestic demand, as such, the policymakers should seriously consider this impact. Moreover, the taxable thresholds for certain taxable items under the CT regime are quite low, which may need to be adjusted in future policies by using the cosmetics adjustments as reference. It is also worth noting that the CT reform may also be influenced by the VAT regulations. Under the previous Business Tax (BT) regime, entertainment sector is subject to BT with the rates ranging from 5% to 20% and all provinces are allowed to determine their own applicable tax rate within this range. In practice, quite a number of provinces adopted the 20% rate for certain high-value-added entertainment services. After the BT to VAT transformation pilot program (B2V Reform), entertainment service is now subject to VAT at the tax rate of 6% and can also claim input VAT credit. Hence, the tax burdens of these taxpayers have reduced significantly. In the BT regime, high tax rate has the function of guiding consumption behaviours in China to some extent. Now, after the B2V Reform, it is worth noting whether such function undertaken by BT would go back again to CT and those high-value-added entertainment services would be added to the taxable scope of CT.

**Pros and cons of adjusting collection stage**

According to the current CT regulations, most taxable items are only subject to CT at the manufacturing stage except certain for consumer goods such as gold and silver jewellery, cigarettes and small motor cars. Generally speaking, wholesale and retail enterprises would obtain invoices in purchasing goods from manufacturing enterprises as valid vouchers for VAT credit and corporate income tax deduction purpose, as such, invoices would help tax authority to collect CT, which reduces the difficulty of tax collection and administration. In practice, in order to decrease the CT burden, some corporate groups would establish a related sales company which would purchase the CT taxable goods from the related manufacturing enterprises and on sell to the public in order to control the CT payable by the manufacturing enterprises. In order to address the impact on CT under this business model, the policymakers have stipulated the lowest taxable price for certain goods, CT should be levied according to the lowest taxable price even though the sales price of the manufacturing enterprise is lower. Collecting CT at the manufacturing stage would enhance the collection and administration of BT by the tax authority through invoices administration, however, it will also weaken CT's moderation functions and have less impact on consumers' behaviour. Meanwhile, despite the provisions of the lowest taxable price, the tax authority still do not have a thorough solution to the problem that the consumption tax base is eroded by the factory price. Hence, it is frequently recommended that CT should be collected at the retail stage but not the manufacturing stage so as to solve the above problem. From the fundamental principles of CT, collecting CT at the retail stage could achieve the function of guiding consumption behaviour to the fullest extent. Currently, only gold and silver jewellery as well as the newly added super-luxury small motor cars are subject to CT at the retail stage. Practically, there are certain difficulties in levying CT of all consumer goods at the retail stage within a short period of time.

Compared with gold and silver jewellery, in collecting CT on super-luxury small motor cars at the retail stage, tax authority can rely on the motor vehicle invoices, vehicle purchase tax data, and the registered information from the vehicle administration department to enhance collection. Based on the comprehensive analysis of the reasons mentioned above, it is anticipated that tax authority still be cautious on adjusting the collection stage and have to fully consider their collection and administrative capability, sectors which are supervised or sectors with third party information support may be the first ones to move to collection at the retail stage.

**Potential changes in the competent authority and revenue allocation ratio**

As a central government tax, CT revenue belongs to the central government and is collected by the state tax bureaus. With the completion of the B2V Reform, the VAT revenue allocation ratio has been readjusted. At the same time, China’s local tax system also has to be reorganised. The taxable items under CT that are closely related to local environment and consumption behaviour are likely to be adjusted as local revenue and collected by local tax bureaus. Furthermore, after the CT revenue are jointly shared by the central and local governments, it will stimulate the local governments to be more active in guiding industry development, promoting energy conservation and environment protection, optimising consumption structures, and will also facilitate tax collection and administration.

**The takeaway**

After the completion of the B2V Reform, CT, as another major turnover tax in China, will be the next main target of tax reform. After a period “small and quick step” adjustments, the CT reform would be more intense. Both existing CT taxpayers and taxpayers whose business may potentially be included in the CT taxable scope should pay close attention to the policies direction.
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and circulars on the detailed implementation measures, timely analyse the impact on their own business and act accordingly.

Given CT is a price inclusive tax and is recorded as an expense in the income statement, taxpayers should conduct a comprehensive assessment on the impact to profits, adjust their operational strategies based on the potential impact on their sales volume. In addition, taxpayers need to fully understand the CT regulation and administration measures to ensure tax compliance.

We will follow the development of the CT reform and share our observations and insights with you timely. Please stay tuned.
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Let’s talk

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