

Welcome to the September 2007 edition of Pragma's China Newsletter, prepared by Jesa Consulting

### ➔ FOCUS ON: Reductions of Export VAT Rebates



One of the most highlighted issues concerning the Chinese market has been the constant increase of its foreign trade surplus. In yet another move to counteract this rising figure, the People's Republic of China (PRC) announced on 19<sup>th</sup> June 2007 that it will impose major downward adjustments to export VAT rebate rates, consequently lowering profits of exporters in many industries. Indeed, reductions and, in some cases, complete eliminations of export VAT rebates will apply to a broad range of products, including socially/environmentally harmful products, low value-added products and even strong export products.

This article is based on official documents released by Deloitte Group Asia. It outlines the major expected changes and the actions that exporters who have been negatively affected can take.

- 1) The VAT export tax rebate has been fully repealed for 533 "high energy consuming, high polluting, and scarce resource-consuming" products. This means that there will be no rebate of VAT paid on inputs. For these products, it is also expected that output VAT will be required despite being exports. Such products previously had export rebate rates of between 5% and 13%.
- 2) The VAT export rebate rate has been reduced for 2,268 commodities likely to trigger trade disputes. These products will have their VAT export rebate rates reduced by percentages ranging from 2% to 8%.
- 3) The VAT export tax rebate has been fully repealed for 10 items (including peanut kernels and oil paintings) but their export sale will still be VAT exempted.
- 4) All changes have been effective since 1<sup>st</sup> July 2007.

Please refer to the table below for a brief summary of the changes:

| Commodity   | Previous Rate % | New Rate % |
|---|-----------------|------------|
| Clothing  | 13%             | 11%        |
| Certain electronic machinery, machine tools, auto vehicles                  | 17 / 13%        | 11/9%      |
| Toys  | 13%             | 11%        |
| Plastics, rubber and their products   | 13%             | 5%         |
| Hats and shoes  | 13%             | 11%        |
| Certain base metals and their products, such as copper, zinc and molybdenum | 13%             | 5%         |
| Certain chemical products   | 13/11%          | 9/5%       |
| Vegetable oils  | 13/11%          | 5%         |

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### What is Jesa?



Jesa is a service company headquartered in Shanghai specialising in facilitating start-up of new

industrial productions while providing reliable management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia).

Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 technicians following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on every single commercial and technical issue.

Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources. Jesa is currently expanding its services to provide support to those companies seeking to develop environmental projects in china, such as alternative energies and environmental management.

It is important to note that there will not be any transitional rules which will apply except for one exception: for contracts covering the export of ships and equipment and building materials involved in long term construction projects.

The changes will significantly raise tax costs for many exporting companies. Some of the decreases are so large (up to 8%) that the profit and loss of some exporters could be quite detrimental to the sustainability of their business practices.

Deloitte outlines a number of decisions that exporters negatively affected by these changes can make to minimize their impact. Apart from simply increasing prices to foreign consumers, the following can also be done:

- *Tariff coding*: the description and tariff codes of the exported goods should be reviewed to ensure that all commodities are correctly labelled;
- *Supply chain model*: the tax efficiency of the currently used export business model in the supply chain should be evaluated, e.g. the effect of contract manufacturing versus toll manufacturing;
- *Functions and risks*: the functions and risks undertaken by the China operation should be reviewed to see if some functions could be performed and risks assumed outside China in order to lower FOB prices of related-party exports;
- *Transfer pricing*: some benchmarking exercise could be conducted on the functions and risks undertaken in China to ensure that the existing transfer pricing policy for related-party exports is proper;
- *Special purpose vehicles*: special purpose vehicles, e.g. the use of Chinese foreign-invested commercial enterprises could potentially reduce the impact of the rebate reductions;
- *Designated zones*: designated special purpose zones, e.g. export processing zones could be considered to reduce the potential impact;
- *Increase of bonded imports*: increase of imports or conversion of domestic purchases into imports can also reduce the VAT cost increase (the use of bonded logistics parks can help facilitate this process);
- *Vertical integration/segregation*: changes in the operations undertaken in China potentially may change the exported products and, hence, the applicable tariff code for each product.

We can consider these changes as positive for the overall future stability of China's financial system and we urge all exporters concerned by these changes to seek professional advice on how to improve their situation.

## New Tax Preference Policy for engaging Disabled Workers

On 1<sup>st</sup> July 2007, China implemented a new tax preference policy for both foreign and local companies aimed at hiring disabled people all over the country.

The chief of the National Tax Bureau highlighted that companies employing disabled workers will profit from preferential tax rules concerning turnover taxes and business taxes.

Regarding turnover tax, depending on the number of disabled workers employed, the Tax Bureau will give back value added tax to a certain extent or decrease the overall turnover tax. The limits of value added tax returned and turnover tax decrease for every worker is set as 6 times the local minimum wage; however, the maximum returned can not exceed 35 thousand RMB (≈3.5 thousand Euro) per year for each worker.

Regarding business income tax, the business income tax of companies employing disabled workers will be deducted by twice as much as the salary of the disabled worker. Moreover, the firm income tax will be exonerated from VAT, refunded legally, or the revenue of the business tax will be decreased.

In this preferential policy, a disabled person is defined as a person with eyesight impairment, auditory impairment, language impairment, intellectual impairment or mental impairment. Compared to previous rules, this new rule includes intellectual impairment and mental impairment to enlarge the scope of protection for disabled workers.

To make the most of this tax policy, companies employing disabled workers have to comply with five conditions:

1. Companies must sign labour contracts or service agreements for more than one year with each disabled worker. Each disabled person must keep the job assigned;
2. Disabled workers must represent more than 25% of the total staff and the number of disabled workers actually employed must be more than 10 people. Companies whose proportion of disabled workers is more than 1.5% and

less than 25%, and more than 5 disabled workers can profit from the rule but not from the added value tax or turnover tax preference rule;

3. Companies must pay social insurance including basic endowment insurance, basic hospitalisation insurance, unemployment insurance and injury insurance (according to the county government regulation) for every disabled worker;
4. They must pay wages which are not less than the local lowest wage standard to each disabled worker through a proper bank institution;
5. Companies must comply with basic establishment regulations to employ disabled workers.

Compared with the previous tax preference rule, the new rule brings the following improvements:

- Enlargement of the scope of companies that can benefit from the policy (different kinds of ownership) and the scope of disabled people (intellectual and mental impairments are included);
- Improvement of the protection of the rights and interests of the disabled: to benefit from the tax preference, companies have to sign a labour contract, to pay social insurance according to the local government regulation, to pay salaries which are not lower than local salaries, to pay the wages through financial institutions and to have facilities adapted for disabled workers;
- Political engagement to maintain this policy: to employ 1.5% of disabled employees is the duty and responsibility of each company. The rule set up win-win situations: disabled workers create value and bring financial advantages to companies.

In case of non compliance of these rules, the penalty applicable is the following: if companies sign false labour contracts or service agreements, invent or reuse disabled certificates or disabled soldier certificates, make false reports of the proportion of disabled employees, employ disabled workers without paying them (or paying them less than the minimal recommended wage), take back salary of disabled employees, companies will have to pay the tax immediately and they will not be allowed to profit from this tax preference for a period of three years.

This new tax preference policy contributes to creating equitable tax competition and encourages more companies to employ disabled workers. At the same time, regulations exist to prevent a breach of the law. Concerning foreign companies – which will be able to benefit from this rule from 1st January 2008, the new policy gives them the opportunity to show positive corporate social responsibility practices.

## Highlights from Around China

### NDRC issues warning over the rise in the price of food

China warned local governments to be alert to recent rising consumer price. The consumer price index grew 4.4 percent in June and 3.2 percent in the first half from a year earlier, driven by the surging cost of food. About 10 major Chinese instant noodle makers began to add up to 20 percent to the price.

### Polluting industries lose their loan access

SEPA (State Environmental Protection Administration of China) has submitted to the financial institutions a blacklist of 30 companies that violated environmental rules. Companies that fail to pass environmental assessments or to implement environmental protection regulations are disqualified from getting loans from any bank or financial institution.

### China warns economy on brink of overheating

Industrial added-value rose 18.5% over the first half of the year, while new loans have added up to 2.54 trillion RMB (≈254 billion Euro) in just six months. M1 (cash and demand deposits) keeps increasing but with little effect on prices.

### Steps to limit steel exports expected to gain traction soon

Steel export may rise only 20 percent this year, due to new trade policies. A new batch of taxes will try to control the industry's growth, to smooth out trade frictions. US has indeed complained that China was selling too cheaply last year.

## China tightens bank credit to cool economy

For the sixth time this year, banks have been ordered to increase reserves, after the economy grew 11.9% in the last quarter. The pool of money available for lending has risen to 12% from 11.5%. The currency has showed no significant reaction.

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