China tax: Understanding the China VAT rebate

Mike Bellamy (February 2008)

Value-added tax (VAT) is one of the most confusing and overlooked issues when purchasing from China.

So, how does the China VAT work for export products? At the risk of oversimplifying, a 17 percent tax is paid on the additional value at each step as a given product flows down the supply chain to the end users.

Take the example of a plastic comb. Raw plastic is purchased for injection molding, and tax is paid. The plastic is used to manufacture a molded comb which is then sold to a beauty product distributor, and tax is paid on the added value. The distributor in turn sells the comb to a trading company for eventual export, and tax is paid on the added value. When the comb is exported, there may be a VAT rebate of between zero and 17 percent (depending on the product classification) against the 17 percent tax paid.

Without going into the complex formulas, let's say the China VAT rebate for plastic combs is 10 percent. In this case, seven percent stays in government coffers (17 percent tax minus 10 percent rebate), while 10 percent goes back to the exporting company. In this fashion the VAT rebate amount is a tool the central government can use to either give more incentive (increase the rebate percentage) or less incentive (reduce the percentage) from industry to industry.

Impact of China VAT rebate cuts

In July 2007, thousands of product types had their VAT rebates reduced without notice. The move was part of the government's plan to promote "higher value" products, such as aviation and medical products, and reduce the export economy's reliance on "undesirable industries", such as low-end metals and plastics, which may pollute the environment and pay the lowest wages.

While this VAT adjustment has affected the bottom line for a number of exporters, some whose products were not affected have used the summer 2007 VAT shake-up as an opportunity to ask for a price increase from the buyer.

Overlooking the impact of VAT on your China importing project can lead to major complications.

Some examples:

- If you don't know the VAT rebate amount, then you don't really know your supplier's true costs and pricing. This can complicate negotiations and supplier comparisons. The supplier may be pocketing the VAT rebate without informing the buyer.
- To further complicate the situation, VAT and product classification can be negotiated with the local customs bureau, giving a supplier more leeway for manipulating the price. A supplier may tell you they are only getting a certain percentage back, when in reality they negotiated a classification that gives them a higher rebate.
- Many suppliers lack import-export rights and proper VAT processing facilities. They are therefore forced to use third-party trading companies which inflate the price and complicate the relationship.
- If the order is small, suppliers may find ways to fly under the tax radar and avoid paying the VAT, and

thereby offer a “non-VAT price”. While a “no tax price” may sound attractive at first, buyers can be unpleasantly surprised when:

(a) You buy direct from the factory (EXW) in China but find out later the goods can't be exported because of a lack of tax documentation; or

(b) The volume of business grows to a point that the supplier can’t avoid putting the tax payment on their books. So, while you are expecting the "standard" discount for your large order, out of the blue you get surprised with a price increase to cover a tax that now has to be paid.

Comparing apples to apples

To allow for an apples-to-apples comparison of quotes coming out of China, you will find it advantageous to ask for the price in three ways:

EXW (ex-works/ex-factory)

EXW means ownership of the goods transfers to the buyer at the factory’s door. This price does not include any taxes or shipping fees. The buyer or their representatives needs to organize customs clearance out of China. In practice, there are third parties that will arrange export of goods “without tax paid” by charging a one-time “processing fee” which is usually a few hundred US dollars per container. So for small, one-off orders, it may be possible to buy at the EXW price level. But we highly recommend that to be safe you base your long-term budgeting on the FOB pricing.

FOB China port

FOB, or freight on board, means the transfer of ownership takes place after the items have cleared outbound Chinese customs and are on the boat, ready to ship from a designated port (for example, “FOB Shenzhen”).

For buyers new to China, FOB is a much more convenient way to purchase compared to EXW because the supplier is responsible for handling any VAT issues.

EXW with tax receipt

This means the buyer or his representatives will need to organize the VAT rebate and customs clearance out of China on their own. This is not an easy task and not recommended for those who are new to China unless they have a trusted advisor who can walk them through the process.

If you are consolidating orders among multiple suppliers in China, or buying in China for delivery to another location in China, then understanding VAT is an imperative. Failure to do so risks sacrificing a potential rebate.

As a final point, while China VAT is a complex issue, simply asking your supplier to outline their VAT rebate rates and process is a big step in the right direction, and may shed some light on an often opaque part of importing from China.

About the Author

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Recognized as an expert on China sourcing, Mike Bellamy has been a featured presenter for Global Sources China Sourcing Fairs in Hong Kong and Dubai, Boat Tech China, Rotary Foundation, the US Chamber of Commerce, British Chamber of Commerce and State Bar of California among others. A former Rotary Foundation Ambassadorial Scholar, Mike speaks Chinese and Japanese. Based full time in Shenzhen, China.

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