

Title: "What is VAT and why should I worry about it?"

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Value Added Tax (VAT) is one of the most confusing and most often overlooked issues when purchasing from China.

At the risk of oversimplifying, in theory a 17% tax is paid at each step as a given product flows down the supply chain toward the end users. Take the example of a plastic comb. Raw plastic is purchased for injection molding (and tax is paid), then the molded comb is sold to a beauty product distributor (and tax is paid), who in turn sells to a trading company (and tax is paid) for eventual export. When the comb is exported, there may be a VAT rebate of 0-17% (depending on the product classification) against the 17% taxes paid. Without going into the complex tax formulas, let's say the VAT rebate for plastic combs is 10%. So $17-10=7\%$ is the amount that stays in the government coffers, while 10% goes back to the exporting company. In this fashion the VAT rebate amount is a tool which the central government can use to either give more incentive (increase the rebate %) or less incentive (reduce the %) from industry to industry. In July of 2007, thousands of product types had their rebates reduced without notice as 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 "undesirables" such as low end metals and plastics which may pollute the environment and pay out the lowest wages.

While this VAT adjustment has effected the bottom line for a number of suppliers, some suppliers whose products were not effected have used the Summer 2007 VAT shake up as a convenient excuse to ask for a price increase from the buyer. Feel free to contact info@psschina.com if you would like to confirm your VAT rebate rate and find out if your product is or is not effected by the recent VAT changes.

Overlooking the impact of VAT on your sourcing project can lead to major complications such as these:

1. If you don't know the VAT rebate amount, then you don't really know your vendor's true pricing. This can complicate negotiations and vendor comparisons. The vendor 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. So, a vendor may tell you they are only getting a certain % back, when in reality it may be much more.
2. Many vendor's lack import-export rights and proper VAT processing facilities. They are forced to use 3rd party trading companies which inflate the price and complicate the relationship.

3. If the order is small, vendors may find ways to avoid the VAT issue (can't get a rebate if it wasn't paid in the first place!) and offer a "non VAT price". While a "no tax price" may be attractive at first, things get can get ugly when:
 - (a) You buy direct from the factory (ExW) in China, but find out later you can't export out of the country because of a lack of tax documentation.
 - (b) The volume of business grows to a point that the supplier can't avoid putting the tax payment on their books. Just when you are expecting a price discount for a large order, out of the blue you get smacked with an increase for a tax that now all of the sudden has to be paid.

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:

- 1) EXW
- 2) FOB China Port
- 3) EXW with Tax Receipt

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

FOB (freight on board) means the ownership of goods 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 new to China buyers, FOB is a much easier way to purchase than EXW, as the supplier is responsible for handling any VAT issues.

"EXW with Tax Receipt" means that the buyer or his representatives will need to organize the VAT rebate & customs clearance out of China on their own. This is not an easy task and not recommended for new to China buyers unless they have a trusted advisor that can walk them through the process.

If you are consolidating orders among multiple vendors 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.

In summary, while 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 China business.

Editor's note

PassageMaker is in a unique position to help clients avoid VAT pitfalls as, according to our knowledge, they are the only mid-sized, US-owned Contract Assembly/ Inspection facility to be granted full import-export rights and authorized to process VAT rebates by the Chinese government in Shenzhen.

Introduction to the author

For the past decade Mike Bellamy has been based full-time in Asia. Fed up with the inability of middlemen/ trading companies to control quality and tired of having intellectual property (IP) knocked off, he decided to do something about it by forming PassageMaker in 2002. Mike developed a system to extract the best pricing in China and protect IP without compromising quality and service. PassageMaker's 100% US owned and operated Assembly Center in S. China serves as the client's "black box" where inspection, final assembly and branding takes place behind closed doors. In this fashion, Intellectual Property is physically secured and full quality inspection is conducted before product leaves China. Mike has structured sourcing investments in over 150 production classifications for US and European clients during his time in China. He has an International MBA from the University of South Carolina, which included course work in Harbin and Beijing.

Recognized as expert on China sourcing, Mike is has been a featured presenter for Global Sources Asia Expo HK, Global Sources Dubai, Boat Tech China, Rotary Foundation, 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, and is based full time in Shenzhen China.

Learn more about Mike and PassageMaker at www.PSSchina.com. This website includes free educational material such as sourcing seminar videos and tools of the trade.

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