Research on the Replacement Business Tax with Value-Added Tax of Chinese Banking Industry

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Abstract: As the heart of China's financial system, the banking industry plays an important role in the nation's economic development. Under Chinese current financial tax system, the main taxes levied to Banks are business tax (BT) and income tax. Shouldering heavy tax burden and being taxed repeatedly, such policies on the Chinese banking industry undermines the integrity of Value-Added Tax (VAT) chain, contrary to the international guiding rule that the financial industry should be lighter taxed. The defect of Chinese financial tax system makes the phenomenon that the capital accumulation rate is lower than business expansion rate. As a result, Chinese banking industry lack a foundation for further development and international competitiveness. This paper, using developed countries' successful experiences in financial tax system for reference, in combination with China's practices, proposes to include the banks into the levying scale of VAT, handling local and central income distribution properly to consummate Chinese financial tax system reform in replacing the business tax with VAT gradually.

Keywords: The Chinese Banking Industry; Business Tax; Value-Added Tax; Tax Reform

I. Introduction

On August 1, 2013, the tax reform to replace the business tax with VAT is extended from the pilot regions to other parts of the country. Though the finance industry is not included in the levying scale of VAT, it is imperative to incorporate the industry in the future to consummate tax reform. Commercial banks, the core component of the financial industry, remain subject to BT at the present time. The tax reform to replace BT with VAT has a far-reaching impacts on commercial banks, such as their tax burden, operating costs, net profit, risk- hedging ability.

In today's global economy, Chinese commercial banks face both opportunities and challenges. As Chinese financial industry is gradually opening up, foreign banks enter continuously into China's domestic market to generate fiercer competition everyday. On the one hand, Chinese commercial banks need to attract more clients and improve competitive ability by innovating products, improving the quality of services and perfecting management mechanisms. On the other hand, they also need a favorable and healthy taxation environment. In accordance with most of the relevant researches, the heavy tax burden of Chinese banks is which not only hamper their development, but also impairs the healthy development of the financial market and national economy. In this paper, we will discuss why we should incorporate the banks into the levying scale of VAT in tax reform, with a focus on commercial banks.

II. Literature Review

2.1 Research on the tax burden of the banking industry

The study of LI Gengyin and ZHANG Zongyong (2005) suggests that the tax burden of Chinese banks is excessive, having a detrimental effect on commercial banks' operating performance. Thus, reducing the burden of taxation could improve performance efficiency and increase the competitiveness of commercial banks.

YANG Jingzhong (2007) points out issues such as an unreasonable business tax basis, unfair tax burden and the high actual tax burden of the Chinese financial tax system. Following an analysis into the experience and operation of OECD countries, he encouraged the establishment of an united income tax system, simplifying the tax system for banks, and improving and unifying regulations for deduction before tax.

The research of ZHANG Jianhua and XIONG Lu (2010) revealed that the taxation upon the banking industry has continued to grow rapidly in recent years and the tax burden of Chinese banks is still heavy despite the drop in its overall actual tax burden rate. Thus, the tax system of Chinese banking industry suffers from dilemmas and problems which undermine the sustained its development, sorely in need of reform.

Starting with uncertainty and information asymmetry, QIN Kai (2012) thoroughly analyzed the internal mechanisms of risk control among the banking industry, the government, and taxation departments. He puts forward opinions about how to use tax policies to lower the financial risk of banks, and that excessively heavy tax burden imposes risks to banking.

2.2 Research on the impact of tax reformation in replacing business tax by value-added tax on commercial banks

The study of ZHANG Furong (2007) suggests that it is necessary to increase tax support for banking innovation and improve the regulation of taxation management, but the decision between reducing the tax burden by lowering business tax rates or covering the financial industry with value-added taxation requires further consideration.

YANG Moru (2010) argues that the design of foreign value-added tax system for the financial industry should serve as references to commence value - added tax reform for the financial industry.

The research of CUI Jun (2013) suggests that since the input tax on the software and hardware purchases of the banking industry could not be credited against the output tax, and that interbank borrowing could not be deducted, the problem of double taxation becomes severe. The reform to replace the business tax with a value-added tax in banking industry could avoid repeated levies and reduce the burden of taxation on commercial banks.

On the other hand, XIONG Rong (2003) has proposed more than a decade ago that adjusting the levying coverage of value-added tax on a large scale would lead to a sharp decline of business tax income and impair the benefits of local government.

III. History of the Chinese Banking Industry Development and Taxation System

3.1 Development History of the Chinese Banking Industry

The bank is a core financial institution, whose origin can be traced back to ancient Babylon. However, it is generally acknowledged that the early bud of banking emerged in Renaissance Italy, and modern banking began in 1694 when the Bank of England was founded.

The first bank in China was the Oriental Bank Corporation set up by the British in 1845. In 1897, the first Chinese-owned bank, Commercial Bank of China, started its operation. During 1977-1986, China's banking system recovered and reconstructed, basically forming a banking system with the central bank as the center, and the four state-owned specialized banks as the backbone. The Chinese Economic Reform provided the impetus for banking reform and development. In 1987, People's Bank of China proposed to establish a socialist financial system with the central bank as the leadership, various banks as the main body, and a variety of financial institutions coexisting and dividing the work; since then China's banking industry began nuanced and extended reform. After the establishment of the Third Plenary Session of the Fourteenth Central Committee proposed policy banks in 1994, policy banks like China Development Bank, Export-Import Bank of China and Agricultural Development provided the gradual transition from specialized state banks to commercial banks. Meanwhile, the joint-stock banks team also began to grow. Examples include Bank of Communications, CITIC Industrial Bank, China Merchants Bank, China Ever bright Bank, Shenzhen Development Bank (now known as Ping An Bank), Fujian Industrial Bank, Guangdong Development Bank, Pudong Development Bank, Hua Xia Bank, Minsheng Bank etc. being established. In 1995, the People's Bank of China set up 16 urban cooperative banks. In the same year, China's first city commercial bank was established in Shenzhen. China's banking industry began to manifest diversely, transparency, and with constant improvement. In 2001, China joined the World Trade

Organization (WTO), thereby reducing restrictions on foreign banks, and allowed them to gradually enjoy the same treatment as Chinese banks.

Table 1: Introduction of the establishment of China's commercial banks

Bank Name	Year Founded	Bank Type	Notes
Agricultural Bank of China	1979	State-owned Commercial Banks	Listed state-owned commercial banks
Bank of China	1979	State-owned Commercial Banks	Listed state-owned commercial banks
China Construction Bank	1979	State-owned Commercial Banks	Listed state-owned commercial banks
Industrial and Commercial Bank of China	1984	State-owned Commercial Banks	Listed state-owned commercial banks
Bank of Communications	1986	Joint-stock commercial banks	China's first joint-stock banks
China Merchants Bank	1986	Joint-stock commercial banks	First created by corporate shares
CITIC Bank	1987	Joint-stock commercial banks	SOE background
Ping An Bank (Shenzhen Development)	1987	Joint-stock commercial banks	The first public offering of shares and listing
Industrial Bank	1988	Joint-stock commercial banks	Fujian Provincial Government Holdings
Guangdong Development Bank	1988	Joint-stock commercial banks	Guangdong Provincial Holdings
China Everbright Bank	1992	Joint-stock commercial banks	SOE background
Pudong Development Bank	1992	Joint-stock commercial banks	Shanghai Municipal Government Holdings
Huaxia Bank	1992	Joint-stock commercial banks	SOE background
Minsheng Bank	1996	Joint-stock commercial banks	First private enterprise owned
City commercial banks	Since 1995	Joint-stock commercial banks	Shenzhen Commercial Bank for the first

Source: Compilation from the official website of major banks and other public market data

3.2 Tax System of the Chinese Banking Industry

3.2.1 Evolution of the tax system

In the early years of the People’s Republic of China, China’s banking was consolidated under the “unification” policy. Subsequently in 1950, the Central People's Government Administration Council issued the “National Tax Implementation Guideline”, which stipulated that taxation for the banking industry mainly consisted of sales tax, income tax and stamp duty. The business tax rate was 4%, and the income tax rate was the full progressive tax rate from 5% to 30%.

In 1958, influenced by the “left-leaning” guiding ideology and the former economic theory and taxation theory of the Soviet Union, China reformed its tax system. That year, “People's Republic of China Industrial and Commercial Consolidated Tax Ordinance (draft)” was issued, which exempted state-owned banks from taxation. During the Cultural Revolution, China’s banking sector lost its integrity and independence. The People's Bank of China was incorporated into the Ministry of Finance, and the tax system was heavily criticized. In 1973, China conducted a large-scale tax reform again, where the re-issued “People's Republic of China Industrial and Commercial Tax Ordinance (draft)” reinstated state-owned bank exemption from taxation.

After the reforms in 1978, the management mechanism as well as taxation of banking in China were adjusted drastically, where sales tax, income tax and stamp duty resumed, alongside taxation of the financial sector being repeatedly modified. In 1994, China's fiscal and financial system reformed again. After these multiple reforms, tax on banking mainly included: Business tax, corporate income tax, stamp duty, urban maintenance and construction tax, vehicle use tax, land use tax, property tax, excise tax, land tax, securities transaction tax and additional tax education etc.. Among them, there was a 55% corporate income tax on commercial banks, which was higher than corporate income tax rate of 33% on other domestic industries, in comparison to the business tax rate of 5%. Sales tax and corporate income tax accounted for about 90% of total bank taxes. In 1997, China raised income tax rate on commercial banks to 33%, the business tax rate was increased to 8%. Since 2001, the state has decided the business tax rate would be reduced to 5% within a three year period. In 2008, after the “tax integration”, bank's income tax rate decreased from 33% to 25%.

3.2.2 The current tax policy and tax burden

China's current bank tax system are sales tax and income tax based, where business tax, which is paid centrally by the Bank Head Office, who is levied and managed by the State Administration of Taxation. The income tax revenue is placed under the central government. The remaining part of sales tax paid by the banks is managed by the local tax bureau, and the income tax revenue is placed under the local government and then shared with the central government. According to statistics, in 2013, the sales tax revenue alone of listed commercial banks amounted to RMB 187.693 billion, accounting for 11.91% of the national sales tax class income that year.

According to China's tax law, the tax basis of banking business tax constitues the taxable services turnover which taxpayers achieved. Taxable operation revenue is as shown in Equation I, where according to the nature and form of business income, determining taxable banking turnover can be divided into three types: the first is the total income for the taxable turnover, such as general loan business, financial brokerage business and other financial services; the second is the spread income, where the taxable turnover equals the balance of interest income minus interest expense, such as foreign exchange lending business; the third is the price-difference income for the taxable turnover, such as financial goods for sale business. Unified business tax rate is 5%. Banking income tax rate is 25%, and its taxable income is as shown in Equation II.

Equation I:

Taxable revenues = loan interest income + foreign currency lending spreads + fee income + Net foreign exchange transfers and other financial products such as securities

Equation II:

Taxable income = gross profit - to make up for losses in previous years - Treasuries exempt interest income + interest expenses exceed the specified + funding exceeding specified for employee education and welfare + exceeds the extraction of allowance for doubtful accounts + prescribed proportion of business promotion expenses and entertainment expenses exceed specified amounts+ philanthropic donations exceed specified amounts + illegal business accruments, fines and penalties for late fees + various taxes, fines and penalties + the sponsorship spending etc.

In addition, urban construction tax and education surcharge within banking is based on the size of business tax, so it should be treated as business-tax-related. By referencing the financial data of the 16 listed banks, we calculated the business tax, additional tax burden and the income tax burden. As Table 2 shows, in 2013, the business income of 16 listed banks is in total RMB2,911.782 billion, paying sales tax and surcharges in a total of RMB187.693 billion, accounting for revenue proportion of 6.45%. Among them, the highest tax rate is Ever Bright Bank at 8.59%, and the lowest is the Bank of China at 5.88% . Therefore, the actual tax burden of banking business tax exceeds its nominal tax of 5.5%. Judging from the burden of income tax in 2013, the 16 listed banks paid income tax in total RMB352.424 billion, thus accounting for 12.1% of revenue. Among them, Shanghai Pudong Development Bank's holds the highest tax rate of 15.11%, the lowest rate was Ping An Bank at 9.21%. The income tax burden of commercial banks far exceeds the 2.5% tax burden corresponding to 10% profit margin the tax administration-approved.

The heavy tax burden has had major consequences in the accumulation of bank capital, causing the mismatch between bank capital expansion and the rapid growth of banking services, thus exacerbating the shortage of capital adequacy ratio in Chinese banks, and leading to a reduced ability of risk aversion and their lack of international competitiveness.

Table 2: Cases of 16 listed banks tax in 2013

Serial number	Bank Name	Operating income (100 million yuan)	Business tax and surcharges (100 million yuan)	Business tax burden ratio	Income tax (100 million yuan)	Income tax ratio
1	Ping An Bank	521.89	40.65	7.79%	48.09	9.21%
2	Bank of Ningbo	127.61	7.71	6.04%	14.41	11.29%

3	Shanghai Pudong Development Bank	1,000.15	68.13	6.81%	151.17	15.11%
4	Huaxia Bank	452.19	32.46	7.18%	51.76	11.45%
5	Minsheng Bank	1,158.86	80.04	6.91%	138.69	11.97%
6	China Merchants Bank	1,326.04	85.79	6.47%	166.83	12.58%
7	Bank of Nanjing	104.78	8.40	8.02%	12.07	11.52%
8	Industrial Bank	1,092.87	78.31	7.17%	127.50	11.67%
9	Bank of Beijing	306.65	22.19	7.24%	33.56	10.94%
10	Agricultural Bank of China	4,626.25	272.26	5.89%	477.19	10.31%
11	Bank of Communications	1,644.35	119.49	7.27%	174.48	10.61%
12	ICBC	5,896.37	374.41	6.35%	755.70	12.82%
13	Everbright Bank	653.06	56.07	8.59%	76.67	11.74%
14	China Construction Bank	5,086.08	316.48	6.22%	677.44	13.32%
15	Bank of China	4,075.08	239.65	5.88%	490.36	12.03%
16	CITIC Bank	1,045.58	74.88	7.16%	128.32	12.27%
-	Total	29,117.82	1,876.93	6.45%	3524.24	12.10%

IV. Problems of the Current Business Tax System implemented on the Chinese Banking Industry

4.1 Heavier Tax Burden Compared with Other Domestic Industries

China’s current business tax system uses different proportions in different tax rates based on industry and categories. The categories of construction, postal services and telecommunications, culture and sports are at the proportional tax rate of 3%, plus 7% for the city maintenance & construction tax and 3% for the education surcharge, thus their overall nominal tax rate of 3.3%. The financial and insurance industry is applicable to the proportional tax rate of 5%, and its overall nominal tax rate is 5.5%. In other words, the overall nominal tax rate of banking industry exceeds the construction industry, post and telecommunications, culture and sports by a proportion of 66.7%.

The reason for the high-tax rate of 5% for the banking sector is that the banking industry is a highly profitable monopoly industry, and requires adjustment by high tax burden. Although the banking sector do profit extensively due to their monopoly, it should be noted that a considerable part of the high profits present in the banking industry is brought by its rapid expansion and increase in the number of outlets in recent years. Currently, the central government has decided to break the bank monopoly, which means that the climate of monopoly that have ensured banks achieve high profits will change.

On the other hand, the regulatory requirements of China's commercial banks' capital adequacy ratio has raised, and it requires a larger amount of additional capital to cover the risk generated by the high profits of the banking sector. The capital gains rate is lowered by high-tax constraints, and it is not conducive to capital accumulation to raise their capital adequacy ratio and thus results in the risk of inadequate coverage. Thus there poses a greater risk in the process of large-scale expansion. Compared with other industries, the higher tax reduces the banking operation incomes, which impairs the capital accumulation and expansion of small and medium scale commercial banks. It is also not conducive to undermine and break up the big banks' oligopoly.

From the design of the taxes, business tax belongs to turnover tax and has distorting effects. Excessive tax burden is not conducive to the development of financial markets. Monopoly profits should be constrained by breaking the monopoly and market profits should be adjusted by income tax.

4.2 Heavier Tax Burden and Lack of International Competitiveness Compared with Foreign Banks

According to the tax law, the business tax policy to domestic banks and foreign banks is consistent. The general lending is of full taxation on its interest income, the taxation on the foreign exchange lending business is levied from the loan interest income minus the loan interest payments, and a tax on the transfer of financial products business is based on the post income. However, since there are significant differences in the revenue structure, domestic banks are loaded with a heavier tax burden than foreign banks on business tax.

Sources of income of domestic banks are mainly loan interest income, accounting for nearly 90% of its revenue, especially prevalent in state-owned commercial banks as their intermediate business income accounts for only about 5% of its total revenue. Foreign bank loans are mainly foreign currency lending business, and intermediate business income generally accounts for about 50% of total revenue. Therefore, nearly 90% of the income in domestic banks is liable for business tax, while nearly half of the income of foreign banks pays only the difference, resulting in a heavier tax burden for domestic banks than foreign banks under the same operating income. In addition, according to Chinese tax law, foreign banks are exempt from China's current urban construction tax and education surcharge, while domestic banks must pay.

Currently, the scope of business for foreign banks is limited within China's domestic territory, and due to the advantages of RMB business, domestic banks are still able to maintain a strong competitive edge. But with the deregulation of foreign banks, domestic banks will be at a disadvantage in competition with foreign banks because of their heavier tax burden. Western countries have generally adopted a lower tax rate on the banking sector to support the development of the financial sector and consequently improve their banking sector's overseas expansion and international competitiveness. In contrast, the high tax burden on China's banking sector restricts its financial innovation and development, resulting in lack of competitiveness in the international arena.

In addition, due to the inability of Chinese business tax to materialize export reimbursement, domestic banks' foreign business cannot truly be at zero tax rate. Despite few countries collecting business tax on banks, many impose a value added tax and achieve export tax reimbursement. This places greater tax constraints at the international level for domestic banks, highly detrimental to their overseas business expansion and competitiveness, leading to more obstacles in the competition against foreign financial giants.

4.3 Double taxation that undermines the integrity of the VAT chain

Firstly, the levy scope of VAT and business tax does not overlap in China, as manufacturing and commercial industries belong in VAT and there is business tax on construction and most of the service industry, with typical industrial characteristics. This double taxation leads to the inability to deduct partial VATs when banks purchase goods such as fixed assets or other investment provided by the services that banks provide. Therefore, the banking industry is paying business tax at the same time as carrying the full burden of the VAT when purchasing goods, bearing double taxation.

Secondly, the business tax is a tax included in price and the tax burden can be passed on to final consumers according to tax theory. However, due to the restrictions upon the floating rate of loans and deposits in China (deposit and loan interest rates as well as savings and loan spreads are stringently restricted), passing on the banking sector's tax burden by changing the prices of its services on the market is impossible. This creates a dilemma of taxation upon taxes.

Thirdly, the business tax that producers carry cannot be deducted when they obtain services from the banking sector, resulting in the breaking of producers' VAT deduction chain. In practice, production enterprises also bear the double burden of VAT and business tax. As VAT and business tax are parallel, it is not conducive to the joint development of the banking sector and the manufacturing sector.

The three points above suggest that there is a deviation of banking sector's current tax goal domestically in China compared to the international norm, alongside the breaking of VAT chain. Thus the current tax system creates a higher tax burden on the banking industry, and restricts its vitality, accumulation and scale expansion. It is also not conducive to maintaining the integrity of the VAT chain.

Therefore, the Chinese banking industry should replace business tax with the VAT, covering the banking industry within the VAT.

V. A comparison between the VAT systems of foreign banking industries

Applying VAT for the banking industry is a common international practice. The application can avoid double taxation and keep the VAT deduction chain integrated, promoting industry amalgamation. It realises the advantage of tax excluded in price. Furthermore, it is beneficial for the tax authority to levy in unison and manage effectively.

5.1 Full levying of VAT for the banking industry

The total amount of tax would be levied, covering the entire banking industry in the scope of VAT tax. Israel levied VAT from 1976 to 1979, and levied a full VAT for the banking industry. In practice, it used the direct addition method because of the difficulty of calculating a tax base. That is, adding up the wage, salary and profit to compute the appreciation value, and then multiplying by the applicable tax rate to calculate the tax payable.

This method is similar to business tax. It can expand the tax base, and increase the fiscal revenue. However, it is detrimental to the complete chain of VAT and tax management.

5.2 Selective levying of VAT for the banking industry

The selective levying of VAT for the banking industry is the most mainstream way of implementation. However there are three models of implementation available in practice.

5.2.1 The EU model

Although different countries have slightly different details of VAT for the banking industry, the general ideas are congruous. The core business of the banking industry takes a non-deductible tax exemption policy. The majority of countries that implement a VAT system choose to give tax exemption to the core business of banking, including general interest on loans and other financial services without direct charge. But alongside giving tax exemption to the main business, the input VAT cannot be deducted. So taxation exemption does not mean untaxed, and it is distinct from a zero tax rate. Some countries such as Germany give financial institutions the right to determine whether these businesses enjoy the duty-free policy or pay taxes in accordance with a standardised criteria.

Banking subsidiary businesses are levied VAT in accordance with a standardised criterion. Those applicable to a banking subsidiary business includes fee and commission income. The VAT rates are different in EU countries contingent to individual situation. The zero-tax rate of VAT is carried out for exports in financial service. With the rapid development of economic and financial globalization, finance as the core of modern economy has increasingly strengthened its prominent position and cannot be replaced, which makes developed financial activities an important symbol of economic power. Therefore, EU countries mostly implement the zero-tax rate policy to domestic export-oriented financial services, in order to lower the transaction costs and to gain more global market share. Because the zero-tax rate policy is more concessional than tax exemption, which applies a simultaneous exemption from VAT for export-oriented financial services, it is allowed to deduct the all input VAT included in products purchased (including fixed asset). This is called deductible tax exemption in short. This way, the cost of the export-oriented financial services can be reduced, boosting competitiveness and promoteing the country's financial sector expansion overseas.

5.2.2 The New Zealand model

The New Zealand model is also termed a zero-tax rate model. All banking is brought into the system of value-added tax, but all intermediary and indirect charge of financial services of banking implement the zero-tax rate policy. And the services of direct charge are levied VAT according to the stipulation. In this way, compared to the EU model, all the input VAT can be deducted. This tax system can lower much more tax burden than the EU model. However, it introduces the problem of different service transfer between direct fee and indirect fee.

5.2.3 The Australia – Singapore model

The Australia – Singapore's model is also called the input tax of fixed percentage deduction, which is similar to the EU model. The core business of banking is exempted from taxes, but deduction of input VAT adopts the way that brings compromise between the EU model and the New Zealand model. That is to say, it sets a fix rate to deduct the input VAT of Duty-free service in banking. Australia sets a 25%deduction of input VAT for banking duty-free service. And the deducted rate in Singapore is determined every year with fluctuation.

Although the developed western countries have adopted three different models on levying VAT for banking, they have all uniformly covered the whole banking industry by the scope of VAT. The practice keeps the integrity of the VAT deduction chain, and lowers tax burden to encourage the development of the banking industry through tax relief. This is the the mainstream international practice and thought for taxing the banking industry.

VI. "Replace BT with VAT" for Chinese commercial banks: Accounting and Impact

China is currently promoting the "replace BT with VAT" tax reform nationwide, where the changes in the tax rate is the addition of two tranches rates of 11% and 6% to the current tax rate of 17% and 13%. Transportation tax which is applicable to a rate of 11%. Other sectors of the modern service industry which includes research and technical services, cultural entrepreneurial services, consulting services and others are applicable to the tax rate of 6%, tangible personal property leasing services is applicable for rate of 17%. The taxation method is divided into general and simple methods. The tax rate for the banking industry after " replace BT with VAT " is still undergoing further design.

6.1 Accounting for "Replace BT with VAT" tax reform

After the business tax reforms to VAT, the tax burden of the banking industry will see differences. Among them, for deposit and lending business, business tax on total interest income will be replaced by VAT levied on net interest income; for intermediate business income and other revenue, they will also change to be levied VAT on its net income. Different levying models is bound to affect the actual calculations of tax burden, due to limiting conditions like how the banking system cannot materialize any deduction when enterprises trade with the banks. In the actual collection process, a number of banks take a simple method of assessment internationally which uses "sales times tax rate" directly, with the following formula:

VAT tax = (net interest income + net income + other business intermediary business net) × levy rate.

Since modern services are applicable to the tax rate of 6%, and as the banking sector belongs to the modern service industry when taking into account its characteristics, we believe that the 6% level of tax is appropriate. According to the bank's currently applicable business tax rate of 5%, plus considerations for the city maintenance and construction tax and education surcharge, the actual tax rate incurred by the banks is 5.6%. On the premise of keeping tax range and tax relief constant, a rough estimate of VAT rates is:

Turnover × 5.6% = [tax sales × r / (1 + r)] × (1+ + city maintenance and construction tax surcharge for education tax rate)

The estimated VAT rate r is 5.26%, close to the modern service tax rate of 6%.

In addition, based on publicly available financial data of the 16 listed banks, we assume that in 2013 the banking officially implemented "Replace BT with VAT ", and use the existing 6%, 11% and 17% tax rate to estimate the impact of "Replace BT with VAT " on banks total profits. Note the calculation results are shown in Table 3. For the 6% VAT tax rate, the total profit of

16 listed banks will increase by RMB15.294 billion; under the 11% tax rate, the total profit will be reduced by RMB128.371 billion; under the rate of 17%, the total profit will be reduced by RMB300.770 billion. These estimates only consider the case of VAT credits under normal circumstances, but cannot take into account the VAT tax incentives rebates, extra credit etc. that commercial banks may enjoy. As is the general case in China, banks tend to be applicable to enjoy some tax benefits, therefore the actual tax situation after the “Replace BT with VAT” policy will more optimistic than the calculation results.

Table 3: 16 listed banks fact after “replace BT with VAT” in 2013, unit: billion

Tax Rate	Net Interest Income Tax	Intermediate Business Net Income Tax	Other Operating Net Income Tax	Total Tax	Impact on Total Profit
6%	134.344	34.196	3.859	172.399	15.294
11%	246.298	62.692	7.074	316.064	-128.371
17%	380.642	96.888	10.933	488.463	-300.77

6.2 Impact of “Replace BT with VAT” tax reform

China’s VAT taxpayers are divided into two kinds: one being general taxpayers, and the other being small scale taxpayers. The general taxpayers’ tax rate are 17%, 13%, 11% and 6%, and the small-scale taxpayers’ tax rate is 3%. Export commodities are applicable to a zero rate. The most important feature of VAT is that in product circulation the tax levied is in a ring of deduction, the tax burden being shared and finally transferred. After concentrating idle funds, commercial banks used them to distribute loans to businesses and people in need, and derive spreads to maintain daily operations. Enterprises obtain funds through issuing of shares and bonds. The current tax policy is taxing interest on loans for business tax. If the switch to VAT is made, every aspect of circulation will be taxed. Then the input tax deduction of commercial bank loan in interest paid to VAT can be carried out, which can reduce the cost of the bank.

In some cases, commercial bank’s lending cannot be recovered in time, which will result in carrying a higher amount of income than the actual income. Under sales tax, commercial banks are required to pay sales tax for interest which they have not received, and this income which cannot be provisioned for bad debts preparation or bad debts losses will be taxed with the interest that has been received, increasing the invisible tax burden and risk of banks. Under value-added tax, the input tax cancels against output tax for each link, and banks can reduce unnecessary taxes and risk of loss.

“Replace BT with VAT” will have a huge impact on the reporting of banks. Sales taxes are the tax inclusive price, which means interest on loans are inclusive of taxes, consequently included in the tax basis of the sales tax. What has not been collected is also counted together, leading to a high tax paid. VAT is the tax exclusive price, then the bank's interest income does not include taxes, and VAT is not accounted for in the income statement. In addition, banks issue relevant VAT invoice of interest and fees, which can be used as deductible input VAT to prevent double taxation.

“Replace BT with VAT” will also affect the business decisions of banks. Banks need to raise prices of goods and services in order to pass on the VAT. In today's heated banking competition, this would lead to a reduction in customer base. However, if the prices are lowered the bank’s revenue may not meet the tax, leading to debt. Therefore, this is both a time of trial and opportunity for bank's future in management and product innovation. Every bank should also improve the quality of the management system, and correspond with reduction to management expenditure in improving the efficiency of operation.

VII. Suggestions for Replacing the Business Tax with A Value-added Tax of Chinese Banking Industry

Judging from the current issues in business taxation of the Chinese banking industry such as heavy tax burden, the chain breakage of VAT, and the inability to carry out the export tax, and considering the impacts of replacing the business tax with a value-added tax on the commercial banks, we hold the opinion that Chinese banking industry should be put into the taxation scope of the VAT system, following the mainstream practice that VAT is levied on banking overseas.

Unlike the income structure of the foreign banking industry, Chinese banking derived most of the revenue (reaching 90%) from the general loan interest income with very small proportion of the fees and commissions. If we completely copy praxis of developed countries, exempting the core business from VAT and only levy VAT on the subsidiary business, the VAT fraction will be small, which will make the tax base of VAT much smaller than the business tax model currently, and greatly reduce the tax burden rapidly as well. Because of the sharply reduction in the tax revenue of the banking, fiscal revenue will be significantly influenced in the short term, bringing a new kind of inequality for different industries as a result.

In the long run, Chinese banking should learn from the business method from international banks; great efforts should be made in financial innovation as well as appropriate adjustment of the income structure. Perhaps then through long-term structural adjustments, the mainstream foreign method of levying tax can be adopted. However, within the immediate future, the practical reality of the Chinese banking industry should be considered holistically. Tax reforms should be implemented gradually, allowing the Chinese banking industry to reach international standards step by step.

Firstly, the banking industry should be included in the scope of VAT taxation as soon as possible. The simple collection method can be adopted first, with applying the method for small-scale taxpayers in paying the VAT, a 3% rate of levy collection to banking without deducting the input tax. The export of the banking services is subject to zero rating in the meanwhile may be considered. Compared to the business tax rate of 5%, the simple collecting method of taxing at the rate of 3% will reduce the tax burden on the bank to some extent, and solve the problem of double taxation on VAT and the business tax currently also, while not affecting the fiscal income substantially.

Secondly, after the income structure of the banking industry has adjusted, the simple collection method can be changed in order to make the VAT system of banking internationally compatible. To do this, the core business of banking, for example, the general loan interest income, should be duty-free, but the input tax should not be allowed to be deducted. As for the subsidiary business, like the foreign currency lending, VAT should be levied according to the rules of the general taxpayers, maybe at the rate of 6%, which is the same as modern services. The export of banking services should still be subject to zero rating as before. All of this will further assuage the tax burden of the banking industry, increasing its operation capacity and sharpening the international competitiveness.

Finally, in the process of reforms that brings banking ultimately into the full scope of VAT, the fiscal relationship between the central and the local governments must be well handled to unify financial and operational authorities. In accordance with the current rules of tax allocation, except head offices of the state-owned commercial banks which pay the business tax to the central government, other branches' business tax belongs to the local fiscal revenue. Business tax is the main tax fund of local fiscal revenue, and the bank sector plays an important part in it. In the light of the regulations of the tax distribution system in China, VAT has become a central and local shared tax, with 75% allocated to the central government and 25% for the local district. If the banking industry is required to pay the VAT, local governments will lose important tax fund, consequently intensifying the conflict and disunity between the financial and operational authorities. Therefore, when replacing the business tax with a VAT in the banking industry, under the condition that the overall social tax burden cannot increase, the distribution ratio should be adjusted. A new local tax, such as the property tax, could also be introduced. Moreover, transfer payment from the central to local governments may also serve a similar purpose of reconciliation. By these means, the unification of the financial and operational authorities of the local governments may be guaranteed.