

## Introduction to the VAT rules in China - Part 1

### Computation of VAT payable amount

There are two ways of computing the amount of VAT payable: the simple computation method and the general computation method as listed below.

	Method	Amount of VAT payable
I	Simple computation method	Sales amount x rate of levy <No input credit>
IIA	General computation method	Output VAT – input VAT <Certification of tax invoice for purchase>
IIB	General Computation method	Sales amount x standard rate <No input credit>

There is no input credit under the simple computation method. Taxpayers who are classified as small-scale taxpayers shall use the simple computation method to pay the VAT at the levy rate at 6% (4% for non-production enterprise). The general VAT taxpayer pays the VAT at the standard rate of 17%, and is entitled to offset the input VAT against the output VAT. The general taxpayer may also adopt the simple computation method to compute the VAT payable for the supply of certain specified goods if they find it to be advantageous to do so.<sup>1</sup> It is noted that the PRC VAT rules provides for a variation on the general computation method. Where the taxpayer who can satisfy the conditions for a general taxpayer has not submitted the application for getting recognized as a general taxpayer, the VAT liability is ascertained as per the output VAT without the deduction of the input credit.<sup>2</sup>

### Types of VAT taxpayers

There are two types of VAT taxpayers: general (ordinary) taxpayer and small-scale taxpayer. General or ordinary taxpayer differs from the small taxpayer in several aspects. First, the business scale for these two types of taxpayers is different. Second, the rights and obligations of the general taxpayer are different from that for small-scale taxpayer. The general taxpayer can claim input credit on goods for domestic sales while the small-scale taxpayer cannot. Small-scale taxpayers are taxed at the levy rate under the simple computation method. Third, the general taxpayer can claim refund for the VAT paid on the goods either bought for purpose of export, or used in the manufacture of export goods. The small taxpayer does not have the right to claim export refunds.

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<sup>1</sup> The Ministry of Finance and State Administration of Taxation, document Cai Shui Zi 004 (94), 1994. The type of prescribed goods taxable at levy rate includes: electricity supplied by small thermal electricity generating or hydro-electricity generating plants at or below the county level; the sands, soil, and quarry for construction use and manufacture of construction materials; the supply of bricks, soil and lime that are made of self-excavated sand, soil and quarry, building materials that are made of coal ash and boiler slag; biological products that are made of micro-organism, animal toxins, human or animal bloods; and the supply of water.

<sup>2</sup> See Article 30 of the Detailed Implementation Rules for the PRC VAT Tentative Regulations.

## Example

The following information of a taxpayer for current month is available: The amount of local sales is 2 million; There is no export sale, and local purchase is 1.5 million. Computation of VAT payable for domestic sales is given below:

Case 1 – with input credit	Case 2 – without input credit
= Output VAT – input VAT	= Output VAT x 17%
= 2 m x 17% - 1.5m x 17%	= 2 m x 17%
= 340,000 – 255,000	= 340,000
= 85,000	

In the above example, the VAT payable is 85,000. The taxpayer is eligible for input credit if it has acquired the status as the general taxpayer. If it has not, the taxpayer cannot claim input credit and has to pay VAT of 340,000. This will happen where the taxpayer fails to apply to the tax bureau in charge for getting recognized as VAT general taxpayer.

## Recognition as general taxpayer

To get recognized as a general taxpayer, the taxpayer has to satisfy the following requirements: (i) the annual turnover must exceed 1 million if the taxpayer is engaged in production activities, or exceed 1.8 million if the taxpayer is engaged in wholesaling and retailing activities; (ii) the ordinary taxpayer must hire staff holding a valid accounting license; (iii) and keep books of accounts in sufficient details so that the tax authority can ascertain the amount of output VAT, the input VAT and the amount of VAT payable;<sup>3</sup> (iv) the taxpayer has the facilities (i.e. a safe) for the custody of VAT special invoices; (v) the taxpayer should have signed a lease agreement or own an office premises showing that it has a place of business (flats for residential use are not acceptable); (vi) the taxpayer should submit to the governing tax authority a written application form and other information as required by the governing tax authority.

Note that the taxpayer's annual turnover encompasses the amount of export sales and domestic sales. The following constitutes "a sale within the territories of China" within the context of the PRC VAT rules: (i) the place of dispatching goods is located within the territories of China; (ii) the goods are warehoused within the territories of China.<sup>4</sup> Note also that the tax authority will not grant the status of general or ordinary taxpayer automatically even though its turnover exceeds one million (or 1.8 million) in a year. The amount of turnover is a necessary but not a sufficient condition. The taxpayer has to pay output VAT on sales amount at 17%, and cannot claim input credit in either one of the following situations: (i) the taxpayer whose sales revenue exceeds one million in the year (or 1.8 million for non-production taxpayer) does not submit application for getting recognized as the general taxpayer status, or (ii) the taxpayer has not maintained a sound accounting system or kept books of account in

<sup>3</sup> See Article 27 of the Detailed Implementation Rules for the PRC VAT Tentative Regulations.

<sup>4</sup> See Article 7 of the Detailed Implementation Rules for the PRC VAT Tentative Regulations. Article 1 of the PRC VAT Tentative Regulations provides that "Units and individuals who sell goods, provide processing, repairing and replace services, and import goods into the territories of China owe an obligation to pay VAT and shall pay VAT in accordance with the law."

sufficient details for the output VAT, the input VAT and the amount of VAT payable.

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### **Newly incorporated trading company**

Newly incorporated trading companies are subject to different administration under the tax authorities over the granting of general taxpayer status, depending whether they are classified as large or small commercial enterprises. Large commercial enterprises are defined as those who have a registered capital of no less than CNY5 million, and have a staff of no less than 50. Commercial enterprises that cannot meet the above-mentioned criteria are small commercial enterprises. A large commercial enterprise upon application can acquire the status of the general taxpayer commencing from the date of incorporation. A small commercial enterprise operates as the small-scale taxpayers from the date of incorporation until its turnover reaches CNY1.8 million. After submitting the application for getting recognized as general taxpayer, the small commercial enterprise will enter into a 6-month supervision period. During the supervision period, the small commercial enterprise attains the status of the general taxpayer meaning that they can purchase, install and use the anti-forgery tax control system, including the purchase and issue of VAT special invoices in the same way as the general taxpayers.<sup>6</sup> The small commercial enterprise that operates as general taxpayer during the supervision period is subject to the restrictions imposed by the tax authorities on the following: (i) the quantity of VAT special invoices it can purchase from the tax authority in charge shall not exceed 25 sets, and (ii) the maximum amount of sales that it can print on each VAT special invoice with the anti-forgery tax control system shall not exceed CNY10,000. Where the supervision period is over, the tax authorities in charge will raise the above-mentioned restrictions taking into account the scale of business of the small commercial enterprise.<sup>7</sup>

### **Purchase of VAT special invoices**

All types of taxpayer shall purchase the tax invoices at the tax branch or office in-charge. General VAT taxpayer can purchase from the tax office both VAT special invoices and ordinary tax invoices for own use, depending on the type of goods sold and the tax status of the buyer. The small taxpayer cannot purchase from the tax authorities the VAT special invoice for own use. If the small-scale taxpayer wants to sell goods to general VAT taxpayers, the small-scale taxpayer may request the governing tax office to issue the VAT special invoice on its behalf, which is to be provided to the buyer.<sup>8</sup> The production-type small taxpayer obtains the VAT special invoices after paying a 6% VAT at the tax office. The small taxpayer classified as commercial enterprise pays a 4% VAT at the tax office. Note that the purchase of any type tax invoices from parties other than the tax bureau in charge is in violation of the PRC legal rules.<sup>9</sup>

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<sup>5</sup> See Article 30 of the Detailed Implementation Rules for the PRC VAT Tentative Regulations.

<sup>6</sup> To use the VAT special invoice, the taxpayer must install and operate the “anti-forgery tax control system”. “Use” here is defined as the purchase, issue, cancellation, and authentication of the paper-based VAT special invoice and the corresponding data message. See Article 3 of SAT Circular Guo Shui Fa (2006) 156, issued on 17<sup>th</sup> October 2006.

<sup>7</sup> See Circular Guo Shui Fa Ming Dian (2004) 37, as amended under (2004) 62, issued by the State Administration of Taxation on 1<sup>st</sup> August 2004.

<sup>8</sup> The Ministry of Finance and State Administration of Taxation, document Cai Shui Zi 113 (1998).

<sup>9</sup> See Article 8 of the Administrative Measure for the Use of VAT Special Invoices, issued under

## Use of VAT special invoices

The PRC VAT rules do not permit the use of VAT special invoices for the following transactions: <sup>10</sup>

- Sale of goods or supply of taxable services to Small taxpayer;
- The sale of VAT-exempt goods;
- The sale of goods or taxable services to the final consumer;
- The sale of specific types of goods at the retail sector (such as cigarette, wines, food, clothing, shoes, hats, and cosmetics products).
- The sale of export goods or taxable services for consumption outside the PRC;
- The use of goods for non-taxable items (such as using stock-in-trade for the construction of own assets);
- The use of goods for collective or personal consumption;
- The supply of goods at no consideration (a gift);
- The provision of non-taxable services (except for those subject to VAT in mix sales).

## Taxpayer's status and use of tax invoices

	General taxpayer	Small-scale taxpayer
VAT special invoice	Can it issue VAT special invoice? Yes.	It cannot issue VAT special invoice. But it can request the tax bureau to do so on its behalf.
Ordinary tax invoice	Can it issue ordinary tax invoice? Yes.	Can it issue ordinary tax invoice? Yes.

The application of the legal rules on the use tax invoices is not always straightforward. Take the sales of goods for example. First, one must consider the tax status of the buyer: (i) if the buyer is a small-scale taxpayer, the seller needs to issue ordinary tax invoices; (ii) if the buyer is a supplier of non-taxable services (such as a construction company, a property development company or an advertising company, etc <sup>11</sup>), the seller should issue ordinary invoices. Second, one must consider the type of goods the taxpayer sells. Where the taxpayer is a seller of tax-exempt goods or certain prescribed goods, the taxpayer should issue ordinary tax invoices. <sup>12</sup> Third, one must consider the use of the goods. Where the buyer is a VAT general taxpayer, it depends on whether the goods are to be treated as stock-in-trade or fixed assets. If the goods are treated as stock for re-sale, the seller should issue VAT special invoices. If the goods are to be used as fixed assets, then the seller should issue ordinary tax invoices in general. Fourth, one has to consider whether the buyer is the consumer. If they are

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document Guo Shui Fa (2006) 156 by the State Administration of Taxation on 17<sup>th</sup> October 2006.

<sup>10</sup> The PRC State Council, Article 21 of the PRC VAT Tentative Regulations, the State Administration of Taxation, document Guo Shui Fa (1995) No. 088, and document Guo Shui Fa (2006) No. 156.

<sup>11</sup> The PRC Business Tax Tentative Regulations provide that the following services or businesses are subject to business tax: transportation services, construction work, financial institutions and insurance companies, postal and telecommunication companies, cultural and sports business, entertainment business, services, transfer of intangible goods, and the sale of immovable properties.

<sup>12</sup> The prescribed goods are cigarette, wines, food, clothing, shoes, hats and cosmetic products. See Article 10 of the State Administration of Taxation, document Guo Shui Fa (2006) No. 156.

consumers, the seller cannot issue VAT special invoices. The VAT rules do not allow the use of VAT special invoices if the retailer sells goods to the consumer. However, where the buyer is a corporation, the retailer can either issue an ordinary tax invoices or VAT special invoices. If the corporation is a VAT general taxpayer, the retailer should issue VAT special invoices upon request. Fifth, where the buyer carries on business activities falling under the encouraged category, the buyer is entitled to a refund for the VAT paid on the purchase of domestically manufactured capital equipment. The seller of vehicles, vessels, boilers, machinery and equipment should issue VAT special invoices upon request from the buyer.<sup>13</sup>

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<sup>13</sup> The State Administration of Taxation, document Guo Shui Fa (1995) No. 088 and Guo Shui Fa (2000) No. 075.