

Introduction to PRC VAT rules for domestic transactions (Part II)

Scope of VAT and Business Tax

Type of tax	Scope of Tax			
	Goods	Services	Intangibles	Immovable property
VAT	Sale of goods; Importation of goods	Provision of processing, repairing and replacement services		
Business Tax		Supply of services;	Transfer of intangible assets	Sale of immovable property

Tax invoices and VAT liability

The general VAT payer in the retail sector must issue to consumers ordinary invoices. The invoiced value includes the amount of sales and VAT. But unlike the VAT special invoice, those two amounts are not separately shown in the ordinary invoice. Note that the use of ordinary tax invoices does not mean that the retailer has no output VAT liability. The two issues are independent from each other. For example, a large retailer is a general taxpayer but it is not allowed to issue VAT special invoices to the consumer. The general taxpayer shall compute the output VAT in the following way: $VAT = \text{invoiced value} / (1 + \text{standard rate } 17\%) \times 17\%$. If invoiced value inclusive of VAT is CNY100, then the sales amount and the output VAT shall be $CNY85.47 = (100/1.17)$ and $CNY14.53 = (100/1.17 \times 17\%)$ respectively.

VAT on service charges

Note that for some service fee charged in connection with a trading transaction, the taxpayer is not required to issue and use VAT special invoices, which show the sales amount and VAT separately. One example is the refundable deposit received for containers or packing cases. However the PRC VAT rule provides that if the deposits are not refunded to the buyer within a period of 12 months, they are deemed to be sales. In that case, the taxpayer is required to convert the deposit into the sales amount and VAT separately. If a deposit of CNY100 is received for a period exceeding 12 months, then the amount of deemed sales shall be $CNY85.47 (=100/1.17)$ and VAT payable shall be $CNY14.53 (=100/1.17 \times 17\%)$ respectively. Where the ordinary taxpayer pays VAT at levy rate using the simple computation method or the small taxpayer issue ordinary invoice, the sale amount also needs to be converted from the invoiced amount as follows: $\text{sales amount} = \text{invoiced amount} / (1 + \text{levy rate})$.¹

Where the selling price includes the transport charges, the general taxpayer has to pay VAT at 17% in spite of the fact that the provision of delivery services falls under the scope of business tax and is subject to tax at 3%. If the transport charge is CNY100, the output VAT for the seller shall be computed as: $100 / (1 + 17\%) \times 17\% = 14.53$.

¹ The Ministry of Finance, Article 25 of the Detailed Implementation Rules of the PRC VAT Tentative Regulations, December 25, 1993. The State Administration of Taxation, document Guo Shui Fa 122 (1994), 1994.

The amount of input VAT will be computed at 17% on the sum of the following: fuel costs, the repairing and maintenance costs of the vehicles used for the delivery of the goods. If the seller's price does not include the transport charge, the seller can forward to the buyer the freight tax invoices issued to the buyer by the transportation company.²

Input VAT

General provisions

The amount of VAT paid by the general taxpayer on the purchase of goods and taxable services is the input VAT. Small-scale taxpayer is subject to VAT at levy rate and not allowed to deduct input VAT from output VAT. The scope of deduction of input VAT from output VAT is restricted to the following two situations:³

- The VAT amount as stated in the VAT special invoices issued by the seller; and
- The VAT amount as stated in the tax payment certificate issued by the customs for the importation of goods.

Special deductions against output VAT

In view of the limited scope of deduction, circumstances may arise under which the taxpayer cannot get the deduction because the taxpayer receives an ordinary tax invoice from the supplier, who may either be a seller of VAT-exempt goods or a provider of non-taxable services. Ordinary tax invoices cannot be used to claim input credit as a general rule. However, the PRC VAT regulations and rules specifically provide for some exceptions:

1. If the ordinary taxpayer purchases VAT-exempt agricultural produce, it can get a 10% notional input credit;⁴
2. If the ordinary taxpayer pays inward and outward transportation charge (excluding the loading and unloading charges), it can claim an input credit at 7% on the amount of invoice issued by companies in the transportation business.⁵ Note that this special deduction is permitted if: (a) the freight charges are not paid for the purchase of non-taxable items (like fixed assets); and (b) the freight charges are not incurred in connection with the purchase and sale of VAT-exempt goods;
3. The purchase by the ordinary taxpayer from companies in the business of collecting second hand articles and waste items. The taxpayer gets a 10% input credit on the invoiced value.⁶

Disallowed input VAT

The input VAT is not allowed to offset the output VAT under the following situations:⁷

- VAT paid on purchase of fixed assets;

² See Article 12 of the Detailed Implementation Rules of the PRC VAT Tentative Regulations, promulgated by the State Council on 13th December 1993.

³ The PRC State Council, Article 8 of the PRC VAT Tentative Regulations, December 26, 1993.

⁴ The PRC State Council, Article 8 of the PRC VAT Tentative Regulations, December 26, 1993. If the ordinary taxpayer purchases goods from small taxpayer, the input credit increases from 6% to 13%. See Cai Shui 105 (2002), jointly issued by Ministry of Finance and the State Administration of Taxation.

⁵ The Ministry of Finance and State Administration of Taxation, documents Cai Shui Zi 012(94) and 114(1998).

⁶ The Ministry of Finance and State Administration of Taxation, document Cai Shui 78 (2001), 2001.

⁷ The PRC State Council, Article 10 of the PRC VAT Tentative Regulations, December 26, 1993.

- VAT paid on goods or taxable services used for non-taxable items (say in the construction of fixed assets);
- VAT paid on goods or taxable services for VAT-exempt items;
- VAT paid on goods or taxable services used for staff welfare or personal consumption;
- Abnormal loss suffered for purchased goods;
- Abnormal loss suffered for purchased goods or taxable services consumed in the manufacture of finished goods and semi-finished goods;
- In export refund case, the amount of disallowed input VAT.

There is an exception. The purchase of certain capital goods in eight prescribed industry sectors located in Northeastern part of China is eligible for deduction against the increase in output VAT of current year over that for the preceding year.⁸

Ascertainment of input VAT

We can arrive at the amount of input VAT in the following way: the amount of input VAT on purchase invoices for which the certification procedure has been completed, plus the amount of special deduction (such as the notional input credit for agricultural produce and transportation charges), minus the input VAT disallowed for offset against the output VAT. Note that the input VAT is ascertained on a period basis, rather than on the matching basis as one follows under the accounting rules.

Certification of suppliers tax invoices

To obtain deduction against output VAT, the taxpayer who receives the VAT special invoice from the supplier should submit the invoice to the tax authority for statutory certification within 90 days from the issuing date. The amount of input credit is deductible from the amount of output VAT in the month where the taxpayer has completed the certification procedure at the tax bureau. If the taxpayer fails to submit the incoming VAT special invoices to the tax authority within 90 days or the taxpayer does not include the input VAT amount into the VAT returns for the month in which the VAT special invoices have passed the certification, the taxpayer is not entitled to claim input credit.⁹ The taxpayer can legitimately claim input credit irrespective of whether it has paid the seller or has accepted the bill of exchange drawn on it by the seller. Previously the input credit was granted either on the goods received basis or on the payment received basis.¹⁰ As from 1st March 2003, the taxpayer who receives VAT special invoices from the supplier for domestic purchases must complete the certification at the tax bureau within 90 days from the issuing date, and include the certified amounts into the monthly VAT returns. As from 1st February 2004, the taxpayer who imports goods from outside the PRC must submit the customs tax payment certificate to the tax authority for certification within 90 days from the issuing date, and include the certified amount into the monthly VAT returns. A comparison between the old rules and the new rules may help illustrate the different time for the taxpayer to claim the input credit.

⁸ The State Administration of Taxation, document Guo Shui Han 143 (2004), 2004.

⁹ The State Administration of Taxation, document Guo Shui Fa 017 (2003).

¹⁰ The State Administration of Taxation, documents Guo Shui Fa 15 (1995) and 192 (1995).

	Time for claiming input deduction under old rules	Time for claiming input deduction under new rules
Purchase of goods by manufacturing enterprise	The receipt of VAT invoices and the receipt of goods in the warehouse following the inspections	The month following the completion of the certification procedure ¹¹
Purchase of goods by commercial enterprise	The receipt of VAT invoices and the payment, and if the payment has not been made, the acceptance of the seller's bill of exchange.	The month following the completion of the certification procedure ¹²
Purchase of taxable services	The taxpayer received invoice and the service fees have been paid.	The month following the completion of the certification procedure ¹³
Importation of goods	The date of import declaration	The month following the submission of information to the tax authorities for verification ¹⁴

It is possible that buyer may fail to complete the certification within the 90 days for some reason or other. When this occurs, the buyer is not entitled to deduct the amount of input VAT from the output VAT amount. It is noted that the PRC VAT rules on the deduction of input credit operate on a period basis. The PRC VAT rules do not follow the matching principle, as one has to follow under the PRC accounting rules.

Buyer in good faith

It is understood that by having a bigger amount of input VAT, the taxpayer can get a smaller amount of VAT payable, or the taxpayer can obtain a larger amount of export refunds. However, the taxpayer should be aware of the dividing line between a lawful claim for input credit (or export rebate) and an unlawful one. It is a legal requirement that (i) the taxpayer should have a genuine underlying transaction for each incoming and outgoing VAT special invoice; (ii) the information of the seller's name, corporate stamp, quantity, value, and the VAT amount in the VAT special invoice should match with the particulars of the actual purchase; (iii) the VAT special invoice the buyer receives has been purchased from the tax bureau at the province or municipality where the seller is located; and that (iv) there is no evidence suggesting that the buyer knows that the seller has obtained the VAT special invoice in any unlawful way. The taxpayer will be excused for cheating the tax authority if the VAT special invoice turns out to be a fake or to have been obtained in an unlawful way. The tax authority will only revoke the input credit if it is already granted and shall not impose any administrative penalty.¹⁵

¹¹ See document Guo Shui Fa (2003) No. 17 issued by the State Administration of Taxation on 1st March 2003.

¹² See document Guo Shui Fa (2003) No. 17 issued by the State Administration of Taxation on 1st March 2003.

¹³ See document Guo Shui Fa (2003) No. 17 issued by the State Administration of Taxation on 1st March 2003.

¹⁴ See document Guo Shui Fa (2004) No. 128 issued by the State Administration of Taxation on 1st February 2004.

¹⁵ The State Administration of Taxation, document 187 (2000). Note that the taxpayer can get the input credit if it can obtain a valid replacement VAT special invoice from the seller, against whom the tax

In spite of the fact that there has been a genuine transaction, and that the quantity and value stated in the VAT special invoice is consistent with the particulars of the actual purchase, the buyer cannot get away from it and will get punished if input credits or export rebates have been claimed in any one of the following ways:

- (i) The purchase invoice is issued by a party other than the seller;
- (ii) The purchase invoice is stamped by a party other than the seller;
- (iii) There is evidence showing that the buyer has the knowledge of the seller obtaining the VAT special invoice in any unlawful way.

If the unlawful acts come to light, the legal consequences will be two folds: the tax authority shall revoke the input credit or rebates, and impose fines as well as administrative punishment on the taxpayer. The taxpayer is not supposed to have the knowledge that the seller obtains the VAT special invoices in an unlawful way.¹⁶ The following self-explanatory evidence shows that the taxpayer not only knows about the unlawful practice but has acted in collusion with the seller in order to profit from it: (i) the VAT special invoice not matched by underlying sale and purchase of goods; (ii) the acceptance of a third party VAT special invoice; and (iii) the VAT special invoice purchased from a location outside the seller's province (or autonomous regions, municipalities directly administered by the State Council, and cities with independent development plans). Since the invoice has been used improperly, the taxpayer together with the legal representative will either face administrative punishment or in serious case the criminal consequences.¹⁷ Therefore, as a matter of good house keeping, the buyer should obtain copies of the seller's business license, the tax registrations, and the invoice purchase book as issued by the tax bureau for its own verification and record before contemplating entering into a contract with the seller. When the general taxpayer receives any supplier's VAT special invoices, check whether the supplier's name, the issuer's name on the VAT special invoices, and the name of the payee all match together. When the general taxpayer issues any checks to settle any important financial obligations, they could consider issuing non-negotiable checks.

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authority has taken action.

¹⁶ The State Administration of Taxation, documents Guo Shui Fa 182 (2000).

¹⁷ The State Administration of Taxation, document Guo Shui Fa 134 (1997). The threshold amount of tax evasion to trigger criminal liabilities is RMB5,000 if the input credit has been claimed. See document Guo Shui Fa 210 (1996), which reproduces the judicial interpretation by the People's Supreme Court on the issue of fictitious VAT special invoices.