

# **P.R.C. VAT and Customs Rules On Import-Export Transactions**

**by Alfred K.K. Chan**

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*Alfred K.K. Chan is with China Tax & Investment Consultants Ltd. in Hong Kong.*

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The People's Republic of China's laws and regulations classify imported goods into four categories: general goods, bonded goods, goods either exempt from duty and taxes or subject to reduced duty and tax rates, and goods temporarily imported.<sup>1</sup> General goods are subject to import taxes and normal customs formalities, which consist of customs document verification, physical inspection, collecting taxes, and granting release. The consignee can take delivery of the goods after Customs' completion of import formalities. In contrast, bonded goods, tax-exempt (or reduced-tax) goods, and temporarily imported goods are exempt from duty and VAT. Those three categories of goods are subject to special customs formalities, including the application for administrative approvals for tax exemption or deferral preceding the importation of goods, as well as the customs supervision that commences immediately after the importation until it is terminated in accordance with the legal rules.

In this article, we focus our discussion on the VAT and customs rules on import and export transactions in the following areas: tax-exempt goods, including a brief review of the duty and VAT exemption policy on the importation of tax-exempt capital goods; temporarily imported goods, including a discussion on the use of the ATA certificates (or merchandise passports); bonded goods, including the VAT and customs rules in designated economic areas; general goods, including the valuation rules for accounting and customs purposes; and VAT rules for export refunds. Finally, the article ends with a brief explanation of the mechanism of the foreign exchange verification system for export collections as well as the scope of its application. The customs procedures governing the bonded goods used in processing exports are excluded from discussion in

<sup>1</sup>See article 100 of the P.R.C. Customs Law.

the article. (For an overview of the P.R.C.'s VAT rules for domestic transactions, see *Tax Notes Int'l*, Apr. 17, 2006, p. 289.)

## Scope of Tax Exemption

The scope of VAT exemption under the P.R.C. VAT regulations and rules includes the exemption on export sales, domestic sales of goods, and the importation of goods. The P.R.C. law also provides that the legal rules on the collection and administration of customs duty apply to the collection and administration of import VAT.<sup>2</sup> For goods imported into the P.R.C., there is a difference between the authority for granting the exemption and the administration of the exemption on import duty and VAT. The P.R.C. General Administration of Customs is vested with legal authority over the administration of import duty and VAT exemption at all the frontier ports throughout the country. The legal authority to grant exemption or reduction on import duty and VAT rests exclusively with the P.R.C. law, or the delegation of the legal authority for granting the exemption and reduction to the P.R.C. State Council in accordance with the laws.<sup>3</sup> In practice, the Ministry of Finance, the State Administration of Taxation, and the General Administration of Customs issue the administrative rules singly or jointly under the authority of the P.R.C. State Council. P.R.C. ministries and the institutions directly under the State Council do not have the authority to grant tax exemptions or reductions that go beyond the scope of the law.

The P.R.C. law on tax-exemption and the reduction on imported goods consists of statutory exemption and specific exemptions. The P.R.C. Customs Law directly provides for the scope of goods receiving the treatment of statutory exemption or reduction.<sup>4</sup> The law does not directly set the scope of goods

<sup>2</sup>See article 65 of the P.R.C. Customs Law.

<sup>3</sup>See article 57 of the P.R.C. Customs Law. See also article 33 of the P.R.C. Tax Levy and Administration Law.

<sup>4</sup>See article 56 of the P.R.C. Customs Law. The following goods are subject to statutory exemption: advertising items and trade samples of no commercial value; materials provided at no consideration by foreign governments or international organizations; goods to which damage or loss was caused before customs release; articles of a quantity or value with

(Footnote continued on next page.)

subject to exemption or reduction. Instead, it delegates the legal authority to the P.R.C. State Council that issues administrative regulations on the scope of the tax exemption and reduction, and the procedures for granting the exemption and reduction. Specific exemption and reduction refers to the exemption or reduction granted to goods entering designated areas (including the free trade zones (FTZs), the export processing zones (EPZs), and the bonded logistic parks (BLPs)) and goods imported by designated enterprise or the exemption on goods imported for designated purposes. Imported goods to which a specific exemption or reduction is granted are used only in designated areas and designated enterprises or for designated purposes. They cannot be used for other purposes unless Customs' approval is obtained and import duties and VAT are paid.<sup>5</sup> The P.R.C. State Council also has the legal authority to grant exemptions or reductions on import goods and articles on an interim basis.<sup>6</sup> The volume of duty and VAT exemptions on imported goods is large; therefore, only major policies are discussed here.

### Tax-Exempt Goods

Tax exemption can be granted to capital and non-capital goods. Self-used capital goods imported into the special economic areas are exempt from duty and VAT. Those capital goods imported into areas outside the special economic areas are taxable, subject to some exceptions. The legal rules for granting the specific exemption on the importation of self-used capital equipment by foreign investment enterprises in the nonspecial economic areas are as follows:

- Circular *Guo Fa* 37 (1997), promulgated by the State Council, provides that as of January 1, 1998, both duty and import VAT will be exempt, subject to the list of the non-tax-exempt import goods in foreign investment project, on the importation of self-used capital equipment, within the approved total investment amount, in domestic and foreign investment projects if the equipment is purchased for projects falling into the encouraged or restricted B categories in the Catalog of Guiding Foreign Investment in Industry and involving the transfer of technology.<sup>7</sup>

fixed limits; other goods and articles specified by law as items for receiving duty exemption or reduction treatments; and goods and articles specified as items for duty reduction or exemption by international conventions to which the P.R.C. is either a contracting party or an acceding party.

<sup>5</sup>See article 57 of the P.R.C. Customs Law.

<sup>6</sup>See article 58 of the P.R.C. Customs Law.

<sup>7</sup>Category B was removed in the revised catalog in 2002 and 2004. If the FIE project was approved after April 1, 2002, one should refer to the encouraged category. See *Guo Shui Fa* 63 (2002), issued by the State Administration of Taxation.

- Circular *Guo Fa* 37 (1997) and circular 383 (1998), which was jointly issued by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) (now the Ministry of Commerce (MOFCOM)) and the General Administration of Customs, provides that beginning January 1, 1998, the self-used equipment that is either financed by loans from foreign governments and international finance institutions or provided at no consideration by foreign investors under export processing agreements is also exempt from import duty and VAT if the equipment is not on the list of the non-tax-exempt import goods in foreign investment projects and the import equipment is located in a separate production facility and is used exclusively for export productions. If the import equipment is not separately located, no less than 70 percent of the goods produced should be for export during the period of the production contract.<sup>8</sup>
- Circular *Shu Shui* 791 (1999), issued by the General Administration of Customs, provides that beginning September 1, 1999, duty and VAT exemption are granted to five prescribed categories of foreign invested enterprises (FIEs) using reserve funds, depreciation, development funds, and retained earnings of the purchase of capital equipment including the technology contained therein, attachments, and spare parts, which does not form any part of the approved total investment amount for the FIE, if there is no substitute supply of the capital equipment in the domestic market or if the performance of the domestically manufactured ones cannot meet with market expectations and the equipment is bought for use in the same business lines and for the replacement and repair of existing equipment or for technical improvement. The five prescribed FIEs are: FIEs engaged in projects classified as encouraged category in the catalog; FIEs engaged in projects classified as restricted category B (now reclassified into encouraged category); FIEs that are research and development centers; FIEs recognized as technologically advanced enterprises; and FIEs recognized as export-oriented enterprises.
- In *Cai Shui* 146 (2002), issued by the Ministry of Finance and State Administration of Taxation, production equipment used in the manufacture of export goods that fall into the permitted category is specifically included under the

<sup>8</sup>Under a decision passed in the first session of the 10th National People's Congress on March 10, 2003, MOFCOM was to be set up to take the place of MOFTEC and the State Economic and Trade Commission.

encouraged category in the catalog and is exempt from duty and VAT if the FIE directly exports all of the finished goods. However, the FIE is still required to pay the full amount of import duty and VAT in the year of purchase. The use of the equipment is under the scrutiny of Customs throughout the supervision period. The duty and VAT will be refunded to the FIE in five equal installments over a period of five years under the pay-first-and-refund-later policy. The Chinese government will revoke the exemption and impose a penalty accordingly if the finished goods are not directly exported on a 100 percent basis.

### Customs Formalities

The foreign investment enterprise will provide the following documents or certificates for exemption of duty and VAT on the importation of production equipment:<sup>9</sup>

- written confirmation from the authority granting approval for the investment projects falling into the encouraged category in the Catalog for Guiding Foreign Investment in Industry;
- written confirmation from the authority granting the approval for the investment projects falling into the restricted category B in the catalog;
- for an R&D center, written confirmation from the National Development and Reform Commission and MOFTEC/MOFCOM, granting the approval to set up the R&D center;
- for an export processing agreement under which the foreign investor is to provide the equipment at no consideration, approval by MOFTEC/MOFCOM on the production contract and the list of equipment provided;
- for an export-oriented enterprise, the certificate of export-oriented enterprise granted by MOFTEC/MOFCOM; and
- for a technologically advanced enterprise, the certificate for technologically advanced enterprise granted by MOFTEC/MOFCOM.

The customs procedures for the importation of tax-exempt capital equipment preceding the arrival of the shipment are as follows:

- First, the FIE that imports capital equipment should apply for exemption from the original approving authorities and obtain the official

<sup>9</sup>See *Shui Shu* 791 (1999), issued by the General Administration of Customs.

confirmation documents or certificates according to the classifications of the enterprise as mentioned above.

- Second, the FIE should submit the application with the document or certificate to the customs in charge for granting the tax exemption certificate before importing the capital equipment.
- Third, in submitting the import declaration following the arrival of the equipment, the FIE should include the tax exemption certificate for examination by P.R.C. Customs.

P.R.C. Customs will release the goods on the strength of the “tax exemption certificate.”<sup>10</sup> The customs supervision during the postimportation stage over the tax-exempt goods commences on the day the foreign investment enterprise takes delivery of the tax-exempt goods and continues until Customs lifts the supervision on the application by the FIE. A grant of the duty and VAT exemption on imported goods does not mean that the FIE need not comply with other nontax requirements. The FIE must obtain the certificate for commodity inspection and quarantine for the importation of goods in accordance with the legal rules in force.

***Some goods temporarily imported into or exported out of China for a period not exceeding six months are exempt from duty and VAT.***

Tax-exempt production equipment for use by an FIE is subject to customs supervision for five years from the date of customs release.<sup>11</sup> During the period of customs supervision, the customs rules do not allow any change in the use of the equipment or any physical or legal transfer of the equipment. Tax-exempt equipment for use in the export processing trade, for example, is not allowed to make goods for sales in the Chinese domestic market. If the owner would like to dispose of the tax-exempt equipment or use it for other purposes before the expiration date of the customs supervision, it must pay duty and taxes and complete the procedure for lifting customs supervision. The FIE buying the tax-exempt equipment would pay import duty and

<sup>10</sup>See article 48 of the P.R.C. Import and Export Duty Regulations and the Public Notice by the General Administration on Approving Tax Exemptions and Reductions, issued under Notice 43 (2005) by the General Administration of Customs.

<sup>11</sup>See article 75 of the Administrative Measure by the P.R.C. Customs for Levy of Taxes on Import and Export Goods, issued by the General Administration of Customs on January 4, 2005.

VAT on the depreciated value of the asset using the following formula: depreciated value = original dutiable value x [1 - the number of months in use / (5 years x 12)]. There is an exception: The FIE may transfer legal ownership of the equipment to another enterprise that has been granted approval to import tax-exempt equipment, subject to Customs' approval.<sup>12</sup> After the expiration of the supervision period, the FIE needs to apply for a certification for lifting the customs supervision to discharge its legal responsibility for the tax-exempt goods. Thereafter, the FIE may dispose of the equipment by returning it to the place of origination outside the P.R.C., continuing to use the equipment, or selling it to a third party. There are no tax implications for returning it or continuing to use it. For disposal to a third party, if the equipment is sold below the original cost, there is no VAT liability; however, if the equipment is sold above the original cost, the seller would pay VAT at a levy rate of 4 percent on the gross sale proceeds.<sup>13</sup>

### Exemption for Designated Purposes

Duty and VAT exemptions are granted on the importation of the following:

- prescribed lists of imported equipment, instruments, parts, components, and special tooling directly used by Sino-foreign cooperative joint venture projects in the exploration of crude oil and natural gas in specific oceanic or land areas within the Chinese territories under the tax policy of the P.R.C. State Council during the period of the 10th five-year plan, as approved by the Chinese National People's Congress;<sup>14</sup>
- donated relief supplies for natural disasters;<sup>15</sup>
- medicines for the treatment of AIDS;<sup>16</sup>
- relief supplies donated by charitable organizations for the relief of poverty;<sup>17</sup>

<sup>12</sup>See article 76 of the Administrative Measure by the P.R.C. Customs for Levy of Taxes on Import and Export Goods, issued by the General Administration of Customs on January 4, 2005.

<sup>13</sup>See *Cai Shui* 029 (2002), jointly promulgated by the Ministry of Finance and the State Administration of Taxation. VAT is reduced by half from 4 percent to 2 percent.

<sup>14</sup>See *Shu Shui Han* 104 (2002) and *Shui Guan Han* 204 (2002), jointly issued by the General Administration of Customs and the State Administration of Taxation.

<sup>15</sup>See *Cai Shui Zi* 98 (1998), jointly issued by the Ministry of Finance and the State Administration of Taxation.

<sup>16</sup>See *Cai Shui* 181 (2003), jointly issued by the Ministry of Finance and the State Administration of Taxation.

<sup>17</sup>See *Cai Shui* 152 (2000), jointly issued by the Ministry of Finance and the State Administration of Taxation.

- some prescribed categories of imported materials and equipment in connection with the 29th Olympic Games to be held in 2008;<sup>18</sup>
- goods used for scientific research and education that cannot be produced domestically and imported by qualified institutions, if those goods are not for commercial use and the quantity of the goods are within reasonable limits;<sup>19</sup>
- articles imported directly by organizations for the disabled for the exclusive use by the disabled;<sup>20</sup> and
- goods exempt from import duty (exempt from import VAT) under article 45 of the P.R.C. Import and Export Duty Regulations.<sup>21</sup>

### Exemption in Designated Regions

Self-used equipment, within the approved total amount of investment and under the projects in the encouraged categories invested by FIEs in the western regions of the P.R.C., is exempt from import duty and VAT, subject to the list of the non-tax-exempt import goods in the foreign investment project.<sup>22</sup>

### Regional Trade Agreements

The following are exempt from import duty only:

- goods originating from the Hong Kong Special Administration Region that are on the list of goods subject to zero tariff under the Closer Economic Partnership Arrangement between

<sup>18</sup>See *Cai Shui* 10 (2003), jointly issued by the Ministry of Finance, the State Administration of Taxation, and the General Administration of Customs.

<sup>19</sup>See *Guo Han* 3 (1997), promulgated by the State Council on Jan. 12, 1997, and issued under Order 61 (1997) by the General Administration of Customs on April 10, 1997.

<sup>20</sup>See *Guo Han* 3 (1997), promulgated by the P.R.C. State Council and issued under Order 61 (1997) by the General Administration of Customs.

<sup>21</sup>See *Cai Guan Shui* 007 (2004), jointly issued by the Ministry of Finance, the General Administration of Customs, and the State Administration of Taxation. Article 45 of the P.R.C. Import and Export Duty Regulations specifically provides the following duty exemptions:

- a consignment of goods, whose customs duty estimates to be less than CNY 50;
- advertising articles and samples of no commercial value or value not exceeding the amount for CNY 400;
- goods damaged before customs releases;
- goods donated by foreign governments or international organizations; and
- fuel, supplies, and drinking water required for consumption by inbound and outbound international transportation means.

<sup>22</sup>See *Cai Shui* 202 (2001), jointly issued by the Ministry of Finance and the State Administration of Taxation.

the Central Government and the Government of the Hong Kong Special Administrative Region;

- goods originating from the Macau Special Administration Region that are on the list of the goods subject to zero tariff under the Closer Economic Partnership Arrangement between the Central Government and the Government of Macau Special Administrative Region;
- some goods originating from the Association of Southeast Asian Nations (ASEAN) countries that are on the list of Early Harvest Tariff Schedule under the Framework Agreement of Free Trade Area between China and the ASEAN countries; and
- goods originating from Cambodia, Laos, Bangladesh, and Myanmar that enjoy a special preferential duty rate.

### Temporarily Imported Goods

P.R.C. law provides that, subject to approval by Customs, some goods temporarily imported into or exported out of China for a period not exceeding six months are exempt from duty and VAT.<sup>23</sup> The scope of temporarily imported goods includes: (1) exhibits, items to be used in exhibitions, trade fairs, conferences, or other similar activities; (2) items to be used for performing or competition in cultural activities and sports events; (3) instruments, equipment, and articles for use in news reporting, film shooting, and television programming; (4) instruments, equipment, and articles for use in activities relating to scientific research, education, and medical services; (5) special-purpose transportation means and vehicles for use in activities listed in items (1) through (4) above; (6) samples of goods; (7) tools and instruments for installation, testing, and setting equipment; (8) containers used for cargo; and (9) goods used for noncommercial purposes.<sup>24</sup>

As a condition for the tax exemption, the consignee is required to deposit at the bank a refundable security deposit equal to the amount of the duty and VAT on the imported goods. P.R.C. Customs may grant an extension of stay for the goods on the application of the taxpayer. If the goods are re-shipped out of China within the time period prescribed by Customs, there will be no tax liability. The consignee can apply to close the customs record filed before the arrival of the temporarily imported goods and get a refund after the goods are reshipped. If the temporarily imported goods remain in the

Chinese territories after the period ends, the importer is liable for the duty and taxes. After the payment of tax, the temporarily imported goods become general goods. The importer can apply to close the record filed with Customs before the arrival of the temporarily imported goods. Temporarily imported goods falling outside the scope as prescribed above receive different tax treatments. P.R.C. Customs imposes tax on the goods with reference to the dutiable value, considering the period of stay in months in proportion to the total number of months for duty and VAT computation purposes; that is,  $\text{dutiable value} \times \text{period of stay in months} / 60 \text{ months} + \text{VAT} \times \text{period of stay in months} / 60 \text{ months}$ .<sup>25</sup> After payment of duty and taxes, the goods can be freely transferred in the Chinese territories. The temporarily imported goods will be reclassified as general goods. P.R.C. Customs will lift its supervision over the goods accordingly. The division of authority to grant the approval preceding the importation of the temporarily imported goods in question is shown in Table 1.

Special tax rules may apply to the importation of exhibits. As an alternative to a refundable deposit or bank guarantee, the holder of an ATA certificate (Admission Temporaire-Temporary Admission) who imports exhibits and related items into the P.R.C. for use in exhibitions or trade fairs is not required to put up deposits or provide any guarantee to P.R.C. Customs. The holder can apply for an ATA certificate from the local chamber of commerce of the International Bureau of Chamber of Commerce (IBCC) in its own country before the exhibits and the related items are shipped to the P.R.C.<sup>26</sup> The ATA certificate serves a dual purpose: It provides a common import/export document for the temporary importation of goods into the P.R.C., and it is an internationally accepted security for goods entitled to temporary admission without payment of duties and taxes. If the temporarily imported goods remain in the P.R.C. after the allowed period is over, P.R.C. Customs will collect the duty and VAT from the China International Chamber of Commerce, the local member of the IBCC.<sup>27</sup> Upon the settlement of the duty and VAT, the local IBCC member in the P.R.C. has a

<sup>25</sup>The total number of months is 60. See article 44 of the Administrative Measure by the P.R.C. Customs for the Levy of Duty on Import-Export Goods, issued by the General Administration of Customs on January 4, 2005.

<sup>26</sup>The P.R.C. government has been a member of the IBCC since 1998.

<sup>27</sup>The IBCC plays an important role in the operation of the ATA Carnet system. The efficient and effective implementation of the terms of the ATA and Istanbul Conventions provides major benefits to international business in the form of expedited and streamlined flow of trade within the Asia-Pacific Economic Cooperation (APEC) region and among

(Footnote continued on next page.)

<sup>23</sup>See article 59 of the P.R.C. Customs Law.

<sup>24</sup>See article 42 of the P.R.C. Duty Regulations for Import and Export Goods.

**Table 1. Division of Authority Regarding Temporarily Imported Goods**

Items and Equipment to Be Used for and in	Local Departments and Offices
News reporting (excluding those for use by reporters from Hong Kong, Macau, and Taiwan)	Ministry of Foreign Affairs <sup>a</sup>
Award-winning film contests and exchange programs	State Administration of Radio, Film, and Television <sup>b</sup>
Entertainment and artistic performances	Ministry of Culture <sup>c</sup>
Science, technology exchange, and seminars	Ministry of Science and Technology <sup>d</sup>
Conventions and exhibitions	Ministry of Commerce <sup>d</sup>

*Notes:*

<sup>a</sup>See the regulations on the Administration of Foreign Correspondents and Resident Foreign News Offices, issued under Decree 47 by the P.R.C. State Council in 1990.

<sup>b</sup>See the Administrative Measure on the Television, Film Festival, and Exchange Programs, issued under Order 38 (2004) by the State Administration of Radio, Film, and Television.

<sup>c</sup>See Order 15 (1999), issued by the Ministry of Culture, and Article 16 of the Regulation on the Administration of Show Business, issued under Decree 439 (2005) by the P.R.C. State Council.

<sup>d</sup>See article 3 of Decree 25 (1997), promulgated by the P.R.C. State Council.

right to claim reimbursement from the chamber that issued the ATA certificate to the holder in their home country.

### Bonded Goods

Bonded goods are defined under the P.R.C. Customs Law as goods entering P.R.C. territories with Customs' approval to defer the payment of duty and VAT to be reshipped out of the P.R.C. territories after being stored, processed, and assembled.<sup>28</sup> Chinese law provides two categories of bonded goods: bonded goods stored for later use and bonded goods used in export processing or assembling.

There are several properties for bonded goods. First, because they are not treated as imports, bonded goods are not subject to the requirement for import licenses.

Second, one can add value to bonded goods by performing processing and assembling work on them, or goods can be kept in storage in their original shape and condition for later use and consumption. If stored bonded goods are later sold for consumption in the P.R.C., Customs collects import duty and VAT on them. Accordingly, the status of the

bonded goods changes from bonded goods to general goods, and the rules for import license apply. If the bonded goods are later sold for consumption outside China, there will be no duty and tax consequences. One example of that tax exemption is the fuel and consumable supplies imported for use by aircraft and ocean-going vessels in international transportation.

Bonded goods can be used in manufacturing export goods under an export processing agreement. When that happens, the goods under the agreement are subject to the special customs rules governing the reporting, use, and movement for those goods.<sup>29</sup> Bonded goods can be used as security for legal charges, pledged as the subject of a lien; however, bonded goods used for export processing are not permitted to have those financing arrangements.<sup>30</sup>

P.R.C. Customs does not collect duty and VAT on the bonded goods imported under export processing contracts on the condition that those goods are reshipped out of China within one year following completion of processing. P.R.C. Customs collects duty and VAT if the bonded goods used in export

ATA/Istanbul signatory trading partners worldwide. The IBCC issues and manages ATA Carnets through affiliated chambers of commerce in many countries. It manages and promotes the ATA Carnet system at the international level in close collaboration with the World Customs Organization.

<sup>28</sup>See article 100 of the P.R.C. Customs Law.

<sup>29</sup>See the Administrative Measures by the P.R.C. Customs Over the Supervision of Bonded Goods Under Export Processing, issued under Order 113 (2004) by the General Administration of Customs.

<sup>30</sup>See article 7 of the Administrative Measures by the P.R.C. Customs Over the Supervision of Bonded Goods Under Export Processing, issued under Order 113 by the General Administration of Customs.

processing stay inside the P.R.C. after the allowed period is over. Also, the requirement for import license applies.<sup>31</sup>

Third, because the export processing enterprise (EPE) can take delivery of the imported goods without payment of duty and taxes, under Chinese law, the EPE must provide security for the importation of the bonded goods.<sup>32</sup>

Fourth, the bonded goods are under customs supervision throughout the allowed period of stay inside the P.R.C., commencing from the date of customs release to the date of lifting customs supervision.

**Because they are not treated as imports, bonded goods are not subject to the requirement for import licenses.**

Fifth, there is a legal requirement for customs verification that takes place before lifting customs supervision over the bonded goods, so that the EPE can discharge the legal liability for the importation of the bonded goods under the production contract.<sup>33</sup> The EPE can redeem the security deposit afterwards.

### Duty and VAT in Designated Areas

Designated areas include FTZs, EPZs, and BLPs. The establishment of FTZs requires approval from the State Council.<sup>34</sup> FTZs are excluded from Chinese customs zones under the Chinese laws. Goods shipped between FTZs and destinations in other countries or regions are exempt from import duty and VAT. Production equipment imported for use by the enterprises in designated FTZs is exempt from duty and VAT. Goods other than self-used production equipment imported from a destination in another country to the FTZ are bonded goods.<sup>35</sup> The duty and VAT treatment of bonded goods varies depending on how they will be used and their final destinations, as shown in Table 2.

Goods delivered by an enterprise in non-FTZ areas (that is, elsewhere in the P.R.C.) to an enterprise inside the FTZ are considered exports. They are eligible for VAT export rebates after the goods physically leave the FTZ for overseas destinations.

The establishment of an EPZ requires approval from the P.R.C. State Council; EPZs must be located within the existing economic and technology development zones.<sup>36</sup> It is useful to compare the differences between an FTZ and an EPZ. First, one can carry on trading, re-export, and exhibition business in an FTZ, but one cannot in an EPZ. Second, one can carry on only simple export processing activities in an FTZ, but one can carry on substantive export processing in an EPZ. Third, the same exemption of duty and VAT treatment applies to the goods shipped between EPZs and the destinations in other countries or regions; however, the duty and VAT treatments for the movement of the goods that take place between an EPZ and elsewhere in the P.R.C. are different. Shipments of goods from an enterprise inside an EPZ to an enterprise outside an EPZ (elsewhere in the P.R.C.) are treated as imports. Goods imported from an EPZ are subject to import duty and VAT on the value of the finished goods, with no distinction between imported and domestically purchased materials. That tax treatment is different from the importation of goods from enterprises situated in an FTZ into the non-FTZ (elsewhere in the P.R.C.) mentioned above. Shipments of goods from an enterprise elsewhere in the P.R.C. to an enterprise inside an EPZ are treated as exports. However, the VAT export refund treatment is different from that in FTZs. Materials and semifinished goods delivered by an enterprise outside an EPZ (elsewhere in the P.R.C.) to an enterprise in an EPZ are eligible for VAT export rebates immediately, without the requirement that those goods leave the Chinese territories. Domestically manufactured production equipment sold by enterprises elsewhere in an P.R.C. to an EPZ enterprise is also eligible for immediate export refunds. Imported equipment sold by a non-EPZ enterprise to an EPZ enterprise does not receive the export refund treatment.<sup>37</sup> The phrase “the enterprise situated outside an EPZ [or an FTZ]” means that the non-EPZ enterprise must be a general VAT taxpayer who has been duly registered as a foreign trader in accordance with

<sup>31</sup>See article 33 of the P.R.C. Customs Law.

<sup>32</sup>See article 59 of the P.R.C. Customs Law.

<sup>33</sup>See article 30 of the Administrative Measure for the Supervision by the P.R.C. Customs Over the Bonded Goods Used in Export Processing, issued under Order 113 (2004) by the General Administration of Customs.

<sup>34</sup>See article 57 of the P.R.C. Customs Law. See also article 2 of the Customs Policies for Free Trade Zones, approved by the State Council and issued by the General Administration of Customs on August 1, 1997.

<sup>35</sup>See article 12 of the Customs Policies on Free Trade Zones, issued by the General Administration of Customs on August 1, 1997.

<sup>36</sup>See article 2 of the Tentative Administrative Measure by the P.R.C. Customs for the Supervision Over the Export Processing Zone, issued by the General Administration of Customs on May 24, 2000.

<sup>37</sup>See article 27 of the Tentative Administrative Measure by the P.R.C. Customs for the Supervision Over the Export Processing Zone, issued by the General Administration of Customs on May 24, 2000.

**Table 2. Duty and VAT Treatment of Banded Goods**

Use and Final Destinations	Duty and VAT Obligations
Bonded goods sold between enterprises within the FTZs	Exempt from duty and VAT.
Bonded goods used exclusively in the manufacture of export products by enterprises within the FTZ	Exempt from duty and VAT if the bonded goods are shipped out of China within one year after processing. <sup>a</sup>
Bonded goods delivered to an enterprise outside the FTZ for exclusive use in the manufacture of export products	Exempt from duty and VAT if the bonded goods are shipped out of China within one year after processing. Security for duty and VAT will be provided under security account system.
Bonded materials, parts, and components sold by an enterprise situated inside the FTZ to an enterprise situated outside the FTZ (elsewhere in the P.R.C.)	Considered as imports and are subject to duty and VAT.
Finished goods, consisting of imported components, sold by an enterprise situated inside the FTZ to an enterprise situated outside the FTZ (elsewhere in the P.R.C.)	Subject to duty and VAT. If the finished goods consist of both imported and locally purchased components, Customs will levy duty and VAT only on the amount of imported components. <sup>b</sup>
Bonded goods sold or returned to destinations in other countries or regions	Exempt from duty and VAT if they are shipped out of the P.R.C. within one year.
Bonded goods stay within the P.R.C. for a period exceeding one year	Without approval for the extension of period of stay, liability for import duty and VAT arises. <sup>c</sup>

*Notes:*

<sup>a</sup>See item 4 in article 61 of the Detailed Implementation Regulations of the P.R.C. Tax Law for Foreign Investment Enterprises and Foreign Enterprises, and the Tentative Measure on the Administration of Export Processing Trade under Order 314 (1999), issued by the Ministry of Foreign Trade and Economic Cooperation on May 27, 1999.

<sup>b</sup>See article 22 of the Customs Policies on Free Trade Zones, issued by the General Administration of Customs on August 1, 1997.

<sup>c</sup>See article 30 of the P.R.C. Customs Law.

Chinese law. Sellers elsewhere in the P.R.C. who are not registered as foreign traders are not eligible for export refund treatments.<sup>38</sup> Goods shipped into and out of the BLPs receive the same duty and VAT treatment as the EPZs. FIEs situated in the FTZs or BLPs can carry on trading activities. Effective July 2005 the Chinese government has granted the wholesale distribution right to FIEs in the BLPs.<sup>39</sup> The FIEs situated in the FTZs have only import-export rights and no distribution rights. It is useful to compare the different scope of business activities that the FIE can perform in the designated economic areas, as shown in Table 3.

<sup>38</sup>See article 2 of the Tentative Administrative Measure for the Levy of Taxes in Export Processing Zones, issued under *Guo Shui Fa* 155 (2000) by the State Administration of Taxation.

<sup>39</sup>See *Shang Zi Zi* 76 (2005), jointly issued by the Ministry of Commerce and the General Administration of Customs on July 13, 2005.

**General Goods****Computation of Import Duty and VAT**

Goods imported for sale in the domestic market are subject to import VAT using the following formula: Input VAT = (dutiabale value + customs duty + consumption tax) x 17 percent. An illustration could help explain the VAT terminology. If the cost, insurance, and foreign (CIF) value of a set of lipsticks (HS code 33041000) from Japan is US \$100, importation of cosmetics is subject to VAT at 17 percent and consumption tax (CT) at 30 percent, the customs duty, import VAT, and CT will be computed as follows assuming an exchange rate of US \$1 to RMB 8, as shown in Table 4.

The taxable base for computing import VAT includes a duty and consumption tax. A reduction in duty rate also reduces the amount of VAT payable and CT payable, and the other way around. The applicable rate for the import tariff refers to that in force on the date Chinese customs accepts the declaration for the import goods. If customs accepts the

**Table 3. Business Activities Available to FIEs**

	Designated Economic Areas (duty- and VAT-free)			Nondesignated Economic Areas
	Free trade zone	Export processing zone	Bonded logistic park	Elsewhere in the P.R.C.
Trading	Yes	No	Yes <sup>a</sup>	Yes <sup>b</sup>
Exhibition	Yes	No	Yes	Yes
Re-exporting	Yes	No	Yes	Yes
Export processing	Yes <sup>c</sup>	Yes <sup>d</sup>	Yes <sup>e</sup>	Yes <sup>f</sup>
Storage	Yes	Yes	Yes	Yes
Transportation	Yes	Yes	Yes	Yes

*Notes:*

<sup>a</sup>Effective July 13, 2005, the foreign invested commercial enterprise located in the BLP can apply for the wholesale distribution right, in addition to the import-export rights. See Order 76 (2005), jointly issued by the Ministry of Commerce and the General Administration of Customs on July 13, 2005.

<sup>b</sup>Effective December 11, 2004, the foreign invested commercial enterprise situated elsewhere in the P.R.C. can apply for both the wholesale and retail distribution rights, in addition to the import-export rights. See Order 8 (2004), issued by the Ministry of Commerce on April 16, 2004.

<sup>c</sup>The FIE can carry on only simple export processing activities.

<sup>d</sup>The FIE can carry on extensive processing activities, and the sellers of the goods to the EPZ enterprises are eligible for immediate export refunds.

<sup>e</sup>The FIE can carry on simple export processing, packing, bulk-breaking, grading, sorting, and labeling activities.

<sup>f</sup>The export processing enterprise must provide P.R.C. Customs with a security deposit for the importation of bonded materials and use the customs diary to import the bonded materials, parts, and components.

submission of declaration before the arrival of the imported goods, the applicable rate is the rate on the declared entry date as stated in the import declaration of the vehicles and vessels that carry the imported goods into the P.R.C. The prices of imported goods are quoted in foreign currency. The applicable exchange rate for tariff computation is adopted by reference to the date of the applicable tariff rate. For that purpose, the applicable exchange rate is the base rate the People's Bank of China announces on the Wednesday in the third week of the preceding month.<sup>40</sup> If the Wednesday in the third week falls on a public holiday, the Wednesday in the fourth week is used as the reference.<sup>41</sup>

The import duty on goods subject to ad valorem tariff is affected by the following factors: the applicable tariff schedule, the tariff code (the classifica-

tions within the tariff schedule), the tariff rate, the exchange rate, and the dutiable base. The country of origin determines the applicable tariff schedule. The commodity classification system determines the applicable tariff code, to which a specific duty is applied. The import declaration date determines the applicable tariff rate and the exchange rate. The customs valuation directly affects the dutiable base.

There are two ways of imposing the import tariff:

- CIF value x duty rate = ad valorem duty, which is levied on the value of import goods.
- Import quantity x rate per unit = specific duty, which is levied on the quantity of import goods.

**Time to Pay Import Duty and VAT**

Import duty and VAT are payable within 15 days after receiving Customs' payment notice on the importation of goods into China.<sup>42</sup> After the payment

<sup>40</sup>See article 16 of the Levy and Administration Measures by the P.R.C. Customs on Import-Export Goods, issued by the General Administration of Customs under Decree 124 on January 4, 2005.

<sup>41</sup>See Decree 53 (2005), issued by the General Administration of Customs.

<sup>42</sup>See article 60 of the P.R.C. Customs Law. Note that article 24 of the VAT regulations provides that the payment time is within seven days, but the P.R.C. Customs Law takes precedence over the VAT regulations.

**Table 4. Computation of Duty, VAT, and Consumption Tax**

Duty = CIF value x duty rate	(US \$100 x 8) x 14.2% = CNY 113.60	The applicable rate is 14.2% for HS code 33041000 (Note 1)
VAT = (CIF value + duty + CT) x VAT rate	(800 + 113.60 + 391.54) x 17% = CNY 221.87	(Note 2)
Total duty, VAT, and CT	113.60 + 221.87 + 391.54 = CNY 727.01	

*Note 1:* Goods imported from World Trade Organization member countries (for example, Japan) are subject to a preferential tariff rate.

*Note 2:* Consumption tax is computed using the following formula: consumption tax = [(CIF value + duty) / (1 - consumption tax rate)] x consumption tax rate = [(800 + 113.60) / (1 - 30 percent)] x 30 percent = 1,305.14 x 30 percent = 391.54

of the import VAT, the importer is entitled to claim an input deduction from the output VAT collected. The right to claim an input deduction is established whether or not the goods have been paid for.<sup>43</sup> There is a daily surcharge of 0.05 percent on the amount of overdue taxes for late payment.<sup>44</sup> If the taxpayer fails to pay the duty and taxes within three months, the director of the in-charge customs can take tax enforcement measures against the taxpayer, including issuing a written notice for the bank to deduct the duty and taxes from the taxpayer's account and selling dutiable goods held by Customs and deducting the duty and taxes from the proceeds.<sup>45</sup> If P.R.C. Customs finds that during the prescribed period for the taxpayer to pay taxes the taxpayer is trying to transfer its assets or hide them so that the assets are placed out of the reach of P.R.C. Customs, P.R.C. Customs can order the taxpayer to put up a third-party guarantee for the duty and taxes. If the taxpayer fails to do so, the director of the customs in charge can take tax preservation measures against the taxpayer.<sup>46</sup>

### Valuation Rules on Importation

To determine the base for the levy of tariff on imported goods, Customs adopts the practices of transaction price. Normally, the transaction price is the CIF price, subject to the following:

- the commission borne by the importer;
- the container considered to be the integrated part of the imported goods;
- packaging charges borne by the importer;

<sup>43</sup>See *Guo Shui Fa* 148 (2004), issued by the State Administration of Taxation.

<sup>44</sup>See article 37 of the P.R.C. Import and Export Duty Regulations.

<sup>45</sup>See article 60 of the P.R.C. Customs Law.

<sup>46</sup>See article 61 of the P.R.C. Customs Law.

- R&D expenses, design fees, and related service charges borne by the importer;
- the royalty paid by the importer to the overseas seller on the sale of goods after importation; and
- the payment made by the importer to the overseas seller for the resale, disposal, or use of the imported goods.

But the price excludes:

- the cost of installation, testing, maintenance, and technical service fees for imported machinery and equipment;
- inland freight charges and insurance premiums from port of import to final inland destination; and
- import duty and taxes.

If Customs determines that the declared price of an imported good is lower than that for the identical or similar product without any credible evidence in support of the low price, or that the normal price is manipulated by arrangements between the consignee and the consignor, Customs may substitute the following valuation for the imported goods in the following order:

- the transaction price of identical goods in the exporting country or region;
- the transaction price of similar goods in the exporting country or region;
- the cost of goods in the country of export plus profit, transportation, and insurance expenses;
- the wholesale price for the same goods in the domestic market after deducting taxes, transport charges, and insurance; and
- other reasonable valuations for the imported goods.

### Accounting and Customs Rules

Here is an example for capital movement. The holding company in Singapore pays US \$100,000 to

the supplier for a piece of production equipment to be used by a wholly foreign owned enterprise (WFOE) in the P.R.C. But the Singaporean holding company of the enterprise chooses to use a lower declared value (for example, US \$80,000 purchase from supplier) as capital contribution to the WFOE, and the loss should be taken up in the income statement by the holding company. The holding company has to declare a value and issue an invoice (US \$80,000) to the WFOE for the goods to be shipped to China. Customs can make an official valuation on the importation of the equipment, regardless of the declared value. The customs valuation (for example, US \$90,000) may not be the same as the declared value (invoiced value) (US \$80,000). The difference of US \$10,000 should be recorded in the capital reserve in the enterprise. It is assumed that there is no exchange difference, the equipment is imported as general goods, and the amount of duty and VAT is US \$25,000.

In the WFOE's books of account	In the holding company's books of account
Equipment (costs) (US \$80,000)	Investment (US \$80,000)
Equipment (up-valuation) (US \$10,000)	Loss in investment (US \$20,000) (to income statement)
Capital reserve US \$10,000	Bank US \$100,000
Capital US \$80,000	
Fixed asset (equipment) (US \$25,000)	No entry required
VAT payable US \$25,000	

The accounting rule should be used to match the amount of capital with the equipment cost in the WFOE. The price difference, including the exchange difference, should be taken to the capital reserve account to keep the amount of capital stated in the books of the WFOE in line with the amount of investment stated in the books of the Singapore holding company. Note that the local currency, yuan renminbi (CNY), should be used for local reporting purposes; U.S. dollars are used here for simplicity's sake.

Here is another example of a trading transaction. A WFOE in Shenzhen imports materials for use in production. The invoiced value for the purchase contract is US \$50,000 (CIF Shenzhen) at a contract rate of US \$1 to CNY 8. On arrival, the customs valuation is US \$51,000 at an exchange rate of 8.1 for import duty and VAT computation purposes. The WFOE accepts the valuation and does not lodge an application for administrative review. The original

purchase in U.S. dollars is converted to CNY 400,000. The accounting treatment for the import transaction should be recorded as follows:

Purchase of import materials (CNY 400,000)	= 8 x 50,000
Other expenses (CNY 8,000)	The difference arising from customs valuation
Other expenses (CNY 5,100)	The difference arising from exchange rate movements
Accounts payable (or bank) CNY 413,100	= 400,000 + 8,000 + 5,100

*Notes:*

- Note that the accounting cost is used with appropriate accounting adjustments to bring the financial ledger balance in line with the customs valuation. The differences arising from customs valuation and exchange movements should be charged to the income statement.
- If the import duty and VAT is CNY 120,000, the WFOE should record a debit of CNY 120,000 to VAT payable and a credit to the bank for the same amount. The import VAT paid can be used later to offset the output VAT collected on sales from the buyer.
- If the imported materials are subject to consumption tax, there will be a debit to the cost of sale and a corresponding credit to the bank. The amount of consumption tax paid is charged to costs and cannot be passed on to the buyer later.

## How Accounting and Customs Rules Differ

Valuation on imported goods under the P.R.C. accounting rules differs from that under the customs rules because the components forming the bases of the valuation for the P.R.C. accounting rules and customs rules are different. For example, the charges of installation and testing for imported equipment are included in the cost of equipment under P.R.C. accounting rules but are not included under the VAT and customs rules in that installation. Testing fees are related to the provision of services, which does not fall within the scope of VAT and customs duty. P.R.C. accounting rules do not include in the cost of sales the royalty paid by the importer to the overseas seller on the sale of goods after importation, but P.R.C. customs rules include the payment for the use of intangible rights inside the P.R.C. into the dutiable base. Also, exchange rate changes affect the value of goods imported. The exchange rate agreed under the contract is not the same as the rate used for customs valuation purposes.

## VAT Export Refunds

### Scope of Goods

VAT paid for the purchase of export goods in the Chinese market can be refunded in whole or in part to the exporter if the following conditions are met:<sup>47</sup>

- the goods are subject to VAT under the Chinese tax regulations;
- the nature of the export transaction is treated as a sale in the books of accounts for the exporter (as evidenced by bill of lading or airway bills);
- the goods have physically left the country (except for those shipped to export processing zones or entering the BLPs); and
- the exporter provides evidence showing that the foreign exchange verification procedure governing the export collections has been completed.

In general, goods not wholly satisfying the above four conditions are ineligible for export refunds. There are two important exceptions under which the production enterprise can claim export refund on purchased goods as opposed to self-manufactured goods. The first exception applies if the production enterprise can satisfy the following conditions: the purchased goods carry the same description or perform the same function; the purchased goods use the same trademark; and the goods are purchased for sale to the overseas buyer who imports the goods manufactured by the production enterprise.

The second exception applies to goods purchased under a subcontracting agreement by the production enterprise that are subject to the following conditions: the goods purchased from the subcontractor carry the same description or perform the same function; the goods are purchased for sale to the overseas buyer who imports the goods manufactured by the production enterprise; the production enterprise has a cost accounting system in place; and the production enterprise provides materials to the subcontractor under the agreement and the subcontractor issues a VAT special invoice to the production enterprise for the processing fee.<sup>48</sup> The production enterprise that buys goods for export and VAT refunds should amend the scope of its business by adding to its business scope the purchase of goods for re-export. The exporter should also acquire general taxpayer status in accordance with the P.R.C.'s VAT tentative regulations and rules. Further, the

exporter who submits an application for export refunds must be a foreign trader with a business license and must have duly completed customs registration. For that purpose, the foreign trader can be a legal person, a partnership, or an individual.<sup>49</sup>

### Refund Rates

Effective January 1, 2004, tax refund rates are 17 percent, 13 percent, 11 percent, 6 percent, and 5 percent, depending on the categories of goods. If the VAT rate is lower than the refund rate, the lower rate will be adopted for refund computation purposes.<sup>50</sup>

### Export Refund Rules

Chinese tax rules provide three export refund methods: the tax-exempt method; the pay first, refund later method; and the exempt offset refund method. The tax-exempt method has two variations. In the first, the exporter has paid input VAT on the export goods, but the exporter is not entitled to any export refund. In the second tax-exempt method, the exporter has not previously paid any input VAT on the export goods and therefore is not entitled to export refund. Under the pay first, refund later method and the exempt offset refund method, the exporter has no tax burden if the refund rate is equal to the standard rate. The exporter has a tax burden if the refund rate is less than the standard rate. The exporter will have a higher working capital requirement if the pay first, refund later method is adopted. As of January 1, 2002, all production enterprises must use the exempt offset refund method for export refund purposes. Commercial enterprises must adopt the pay first, refund later method for export refund purposes.

#### 1. Tax-Exempt Method: No Credit for Input VAT

Under the tax-exempt method, the buyer who exports his goods is not eligible for refund of the VAT paid on purchases; therefore, the buyer bears the cost of the input VAT. The following goods on which VAT has been paid for local purchases receive exemption treatment but are not eligible for export refunds: goods that are banned from export under Chinese law; goods purchased by the exporter from a small-scale taxpayer who cannot provide a VAT special invoice to the exporter; goods purchased locally for use in export processing with supplied materials; and goods on which the general taxpayer pays VAT at the levy rate, not at standard rate.

<sup>47</sup>See *Guo Shui Fa* 031 (1994), issued by the State Administration of Taxation.

<sup>48</sup>See *Guo Shui Fa* 165 (2000), issued by the State Administration of Taxation.

<sup>49</sup>See *Guo Shui Fa* 51 (2005), issued by the State Administration of Taxation.

<sup>50</sup>See *Guo Shui Fa* 222 (2003), issued by the State Administration of Taxation.

First, some goods prohibited from export — such as musk, bezoars (cow's gallstones), copper, platinum, crude oil, and diesel fuel — fall into this category.

Second, goods purchased from small-scale taxpayers are not eligible for export refunds even if they are shipped out of the P.R.C. as export. The VAT rules specifically provide that if the exporter receives an ordinary tax invoice from the small-scale taxpayer, the goods are ineligible for export refunds. However, if the small-scale taxpayer pays the VAT, obtains a VAT invoice from the tax office, and passes the invoice to the exporter, the goods are eligible for an export refund.<sup>51</sup>

Third, goods purchased locally for use in export processing with supplied materials are not entitled to export refunds. Export processing with supplied materials (*lai liao jia gong*) differs from export processing with purchased materials (*jin liao jia gong*) in that the former is only a contractual arrangement under which a Chinese party, situated inside the Chinese territories, undertakes processing or assembling work on materials provided by a foreign party and is paid a processing fee. The title to the goods being processed for export using supplied materials remains with the foreign party throughout the period they stay inside the P.R.C.; therefore, no export sales take place. In contrast, legal title to the goods being processed for export using purchased materials passes from the foreign party to the Chinese party under a purchase contract. After processing and assemblage, the legal title passes back to the foreign party under a contract of export sales.

Fourth, the goods on which VAT is paid at levy rate are exempt from export VAT because the goods subject to VAT at levy rate are not entitled to input VAT credit in domestic sales. The exempt-offset-refund method applies to goods that are taxed at the standard rate (17 percent).<sup>52</sup>

### 2. Tax-Exempt Method: No Payment of Input VAT

If the export enterprise previously has not paid any VAT on the purchase, those goods are not entitled to any export refunds. There are three origins of those goods: tax-exempt goods purchased locally for purpose of export, such as the agricultural produce directly purchased from local farmers and fishermen, or tax-exempt goods purchased for use in the manufacture of export goods; bonded materials directly imported for use in export processing, indirectly imported from a bonded warehouse or an FTZ;

and semifinished bonded goods transferred from other export processing enterprises for substantive processing.

### 3. Exempt Offset Refund Method

The exempt offset refund method applies in the computation of export refunds for exports of self-produced goods. For export sales from January 1, 2002, all production enterprises exporting products made from local materials or bonded materials will adopt the exempt offset refund method in computing the disallowed credit, VAT payable, VAT offsettable, and VAT refundable. Here, "exempt" refers to the exemption of VAT for the export sales. "Offset" means the input VAT paid on purchase in the manufacture of export sales will be used to offset the output VAT collected on local sales. "Refund" means that if the amount of input VAT is larger than the VAT payable for the current period, the excess is refundable.<sup>53</sup>

**Under the tax-exempt method, the buyer who exports his goods is not eligible for refund of the VAT paid on purchases.**

According to the origination of the input materials, the export goods may be made from bonded materials (BM), local materials (LM), or a combination. There will be a disallowed credit to be deducted from the input VAT paid on local materials, and the VAT payable and VAT refundable needs to be adjusted accordingly:

- disallowed credit = (export sale - BM) x (standard rate - refund rate)
- VAT payable for current period = output VAT on local sales - (input VAT on LM - disallowed credit)
- VAT refundable = (export sale - BM) x (refund rate)

The amount of purchased bonded materials may consist of the amount of tax-exempt materials bought in the domestic market and the amount of bonded materials imported under an export processing agreement. Tax-exempt materials are those goods that are specifically exempt from VAT under the P.R.C. Tentative VAT Regulations and Implementation Rules.<sup>54</sup> Bonded materials are those directly imported under export processing contracts, obtained from a bonded warehouse or imported from

<sup>51</sup>See *Guo Shui Han* 248 (2005), issued by the State Administration of Taxation.

<sup>52</sup>See article 10 in *Guo Shui Fa* 139 (2003), issued by the State Administration of Taxation.

<sup>53</sup>See article 2 of *Cai Shui* 7 (2002), jointly issued by the Ministry of Finance and the State Administration of Taxation.

<sup>54</sup>See article 16 of the P.R.C. Tentative VAT Regulations and article 31 of the Implementation Rules.

an FTZ, and transferred from other export processing enterprises for substantive or extensive processing. Purchased bonded materials are given a notional input VAT on the dutiable value of the imported materials for purposes of computing VAT export refunds and disallowed credits.<sup>55</sup> The notional input credit is not granted automatically. The taxpayer must submit an application for a tax-exemption certificate for the inclusion of bonded materials into the VAT refund computation. Otherwise, the amount of purchased bonded materials is excluded from the computation.

**Example 1:** Assume that the EPE exports all the finished goods made 100 percent of local materials. There are no local sales. For simplicity, the following example excludes the computation of VAT export refunds on the purchase and consumption of water and electricity in the manufacture of the export goods:

Local materials	70,000	VAT paid	11,900
Bonded materials	0	VAT paid	0
Local sales	0	VAT collected	0
Export sales	100,000	VAT collected	0

Disallowed credit = (export sales - bonded materials) x (standard rate - refund rate) = (100,000 - 0) x (17 percent - 13 percent) = 4,000

VAT payable = VAT on local sale - (VAT on LM - disallowed credit) = 0 - (11,900 - 4,000) = -7,900

VAT refundable = (export sales x refund rate) - (BM x refund rate) = (100,000 x 13 percent) - (0 x 13 percent) = 13,000.

Because VAT payable is negative and shown as a debit balance in the accounting ledger, the FIE is eligible for an export refund. The amount of refundable VAT is restricted to the lesser of VAT refundable and the absolute amount of VAT payable. Because the maximum amount of VAT refund (13,000) is larger than the absolute amount of VAT payable (7,900), the amount of final refundable VAT for the current period is 7,900. The amount of offsettable VAT is 5,100 (= 13,000 - 7,900).<sup>56</sup>

<sup>55</sup>See *Guo Shui Fa* 11 (2002), issued by the State Administration of Taxation.

<sup>56</sup>See the computation in clause 3 of *Cai Shui* 7 (2002), issued jointly by the Ministry of Finance and the State Administration of Taxation.

**Example 2:** The export processing enterprise exports goods made from both local materials and bonded materials. There is no local sale.

Local materials	40,000	VAT paid	6,800
Bonded materials	30,000	VAT paid	0
Local sales	0	VAT collected	0
Export sales	100,000	VAT collected	0

Disallowed credit = (export sales - BM) x (standard rate - refund rate) = (100,000 - 30,000) x (17 percent - 13 percent) = 2,800<sup>57</sup>

VAT payable = VAT on local sale - (VAT on LM - disallowed credit) = 0 - (6,800 - 2,800) = -4,000

Bonded materials are eligible for a notional input VAT on the dutiable value of the imported materials, according to document *Guo Shui Fa* 11 (2002), issued by the State Administration of Taxation. Because the VAT payable is negative, the FIE is eligible for an export refund. The amount of refundable VAT is restricted to the lesser of the refundable VAT amount and the absolute amount of VAT payable. VAT refundable = (export sales x refund rate) - (BM x refund rate) = (100,000 x 13 percent) - (30,000 x 13 percent) = 9,100. Because the maximum amount of VAT refund (9,100) is larger than the absolute amount of VAT payable (4,000), the amount of final refundable VAT for the current period is 4,000. The amount of offsettable VAT is 5,100 (= 9,100 - 4,000).<sup>58</sup>

There is a difference between general import and export trading versus the export processing trade. An enterprise engaged in export trading might produce export goods from domestically purchased materials, imported materials, or both. The export enterprise is eligible for the export refund of VAT paid on domestically purchased materials used in the manufacture of export goods. If the export goods are produced from both domestically purchased and imported materials, the amount of imported materials will be ineligible for export refunds if they are exempt from VAT. The export processing enterprise exporting finished goods using bonded materials is

<sup>57</sup>VAT cost = VAT paid on LM + VAT payable - VAT collected = 6,800 - 4,000 = 2,800.

<sup>58</sup>See the computation in clause 3 of *Cai Shui* 7 (2002), issued jointly by the Ministry of Finance and the State Administration of Taxation.

not entitled to export refund treatment because the bonded materials are imported tax-exempt.

**Example 3A:** The export processing enterprise sells in both the domestic and the overseas market using both bonded materials and local materials in the final products.

Local materials	40,000	VAT paid	6,800
Bonded materials	30,000	VAT paid	0
Local sales	60,000	VAT collected	10,200
Export sales	40,000	VAT collected	0

We first determine the amount of disallowed credit — the portion of input VAT that is neither creditable nor exemptable. Disallowed credit, VAT payable, and VAT cost are computed as follows:

Disallowed credit = (export sales - BM) x (standard rate - refund rate) = (40,000 - 30,000) x (17 percent - 13 percent) = 400<sup>59</sup>

VAT payable = VAT on local sale - (VAT on LM - disallowed credit) = 10,200 - (6,800 - 400) = 3,800

**Example 3B:** There is no refund in example 3A because the VAT payable is positive. Let us see how a negative VAT payable case works. Suppose that the sale mix and the purchase mix have been changed.

Local materials	50,000	VAT paid	8,500
Bonded materials	20,000	VAT paid	0
Local sales	30,000	VAT collected	5,100
Export sales	70,000	VAT collected	0

Disallowed credit = (export sales - BM) x (standard rate - refund rate) = (70,000 - 20,000) x (17 percent - 13 percent) = 2,000

VAT payable = VAT on local sale - (VAT on LM - disallowed credit) = 5,100 - (8,500 - 2,000) = -1,400

<sup>59</sup>VAT cost = VAT paid on LM + VAT payable - VAT collected = 6,800 + 3,800 - 10,200 = 400, which is the same as the disallowed credit.

VAT refundable = (export sales x refund rate) - (BM x refund rate) = (70,000 x 13 percent) - (20,000 x 13 percent) = 6,500

Because the maximum amount of VAT refund (6,500) is larger than the absolute amount of VAT payable (1,400), the amount of final refundable VAT for the period is 1,400. The amount of VAT offsettable is 5,100 (= 6,500 - 1,400).<sup>60</sup>

### Tax Planning Opportunity

In comparing examples 1 and 2 above, the VAT costs represented by the portion of input VAT that is neither creditable nor exemptable decreases from 4,000 to 2,800. The VAT cost is a function of the input mix. The higher (lower) the contents of local materials in the input mix, the higher (lower) the disallowed credit and the cost of sales will be. The export enterprise can avoid the VAT cost if it is located in the export processing zone where the enterprises engaged in export processing activities are exempt from VAT.

### Rules for Commercial Enterprises

For production enterprises, the amount used to calculate the export refund is the free on board (FOB) value of the export goods. For commercial enterprises, the amount used to compute the export refund is the amount of purchase. The pay first, refund later method is used in export refunds for commercial enterprises. Under that method, the exporter pays VAT on export sales to the VAT collection unit at the tax bureau and applies for a VAT refund from the VAT refund unit at the tax bureau. According to the input VAT paid for the export goods, the amount of VAT refundable is computed as follows:

- VAT refundable amount = amount of purchase x refund rate, if the refund rate is at the same level as the standard rate.
- If the refund rate is less than the standard rate, VAT refundable = amount of purchase x refund rate = input VAT on export - amount not refundable. Amount not refundable = purchase amount x (standard rate - refund rate).

For those goods that are purchased from small-scale taxpayers that are granted or receive specific export refund treatment, the amount of input VAT for export refund computation is as follows: input VAT = invoiced sales amount inclusive of VAT / (1 + levy rate) x refund rate. Starting in 2005, the ordinary invoice obtained from suppliers who are small-scale taxpayers cannot be used for export

<sup>60</sup>See the computation in clause 3 of *Cai Shui 7* (2002), issued jointly by the Ministry of Finance and the State Administration of Taxation.

refund purposes under any circumstances. Small-scale VAT taxpayers providing goods to the exporter should pay VAT before being issued a VAT special invoice by the tax office to forward to the exporter, who can obtain the export refunds in accordance with the legal rules.<sup>61</sup>

### Required Documents

The exporter needs to submit the application for export rebates within 90 days of the export declaration and produce the following documentary proofs to the tax refund division within the tax authority:<sup>62</sup>

Documents	Commercial Enterprise	Production Enterprise
Export invoices	Yes	Yes
Export declaration forms	Yes	Yes
Foreign exchange verification note for export collection	Yes	Yes
VAT special invoices for purchases	Yes	Not required
VAT payment certificate	Yes	Not required
Appointment letter of export agent (if applicable)	Yes	Yes
Proof of medium- and long-term settlement of export collection	Yes	Yes
Other document required by the tax authority	Yes	Yes
VAT declaration as verified by the collection division of in-charge tax authority	Not applicable	Yes
Tax-exemption certificate on bonded materials	Not applicable	Yes, if under export processing agreement

### Time to Apply Export Refund

The export enterprise should produce all required documents and submit the application for the export refund within 90 days from the date of export declaration. If noncompliance is not rectified before the 15th day in the following month, all the export sales are deemed to be local sales and are subject to

<sup>61</sup>See *Guo Shui Han* 248 (2005), issued by the State Administration of Taxation.

<sup>62</sup>See *Cai Shui* 7 (2002), jointly issued by the Ministry of Finance and the State Administration of Taxation.

VAT liability.<sup>63</sup> The export enterprise must reclassify the export sale into domestic sale in the tax computation and pay the VAT accordingly.

### Direct and Indirect Export

The production-type enterprise can export its self-produced goods directly if it possesses the foreign trade rights and has been duly registered as the foreign trader. Alternatively, it can appoint a foreign trade company to handle the export business and export refunds. Production enterprises without foreign trade rights must appoint a foreign trade company to do the export business. For an indirect export, the production enterprise must sign an agency agreement to appoint the agent to act on its behalf. The production enterprise must also obtain from the tax bureau the tax payment certificate to prove the VAT has been paid. The export agent will apply for and get the refund on behalf of the principal.<sup>64</sup> For direct export, there is no legal requirement to produce the tax payment certificate. The production enterprise should not issue VAT special invoices to the agent. Otherwise, it is treated as a domestic sale.

### Foreign Exchange Verifications

Chinese legal rules do not impose any restriction on the cross-border movement of funds in settlement for the obligations in trading transactions under the current account.<sup>65</sup> However, the cross-border settlement of obligations under export and import transactions are subject to administration of the foreign-exchange verification system. The Chinese government has implemented a foreign exchange verification system under which the information on foreign currency and physical movement of goods across the border is shared between Customs and the local office of the State Administration of Foreign Exchange (SAFE) to keep track of foreign currency movements in each import and export transaction. Chinese law does not allow the exporter to keep the foreign currency from export collections

<sup>63</sup>See *Guo Shui Fa* 113 (2004), issued by the State Administration of Taxation.

<sup>64</sup>See *Cai Shui Zi* 092 (1995), jointly issued by the Ministry of Finance and the State Administration of Taxation.

<sup>65</sup>See article 5 of the P.R.C. Foreign Exchange Administrative Regulations. In 1996 the Chinese government formally accepted the obligation under the IMF to remove exchange restrictions on trade and nontrade transactions under the current account. Since then, yuan renminbi has been fully convertible on transactions of import and export trading. IMF confirms that China does not impose any foreign exchange restrictions on current account transactions.

outside China.<sup>66</sup> Under the foreign exchange verification system, foreign traders inside China are required to comply with verification procedures on export collections for each export transaction.<sup>67</sup> The control by the administrative body begins before the physical shipment of the export. The export enterprise is required to obtain a preprinted and numbered verification note for the export collections from SAFE on the export shipment. The local Customs and SAFE offices share the information on the export collection and the verification notes under the electronic frontier port system. When submitting the export declaration, the export enterprise is required to present the above-mentioned prenumbered verification note to Customs to secure release of the export shipment and to obtain from Customs a copy of the export declaration for completing the verification procedures on export collection at the SAFE's local office later. After the dispatch of the export shipment and the receipt of payment or the confirmation of settlement at a determinable future date, the export enterprise should complete the

verification procedure on the export collection at the SAFE's local office. The export enterprise will then discharge its legal obligation for verification of export collections if the amount of export shipment agrees with the receipt of foreign currency payment or the confirmation to receive foreign currency payment. Customs will not release the next batch of export goods if the export collection procedure for the previous export shipment has not been complied with. Both the enterprise that exports goods and the enterprise that performs export processing, including transferring bonded goods from the upstream factory to the downstream factory, must comply with the requirement for export collection verifications. Noncompliance with foreign exchange verification requirements invites administrative fines and punishments.<sup>68</sup> However, Chinese law does not impose the legal obligation for the verification of export collection on the export processing enterprises situated outside the FTZs, the EPZs, and the BLPs. ♦

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<sup>66</sup>See article 9 of the P.R.C. Foreign Exchange Administrative Regulations, promulgated by the P.R.C. State Council.

<sup>67</sup>See article 11 of the P.R.C. Foreign Exchange Administrative Regulations, promulgated by the P.R.C. State Council.

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<sup>68</sup>The offender will receive warning from the SAFE in charge, be deprived of the illegal profits, and be subject to a fine of not less than CNY 50,000 but not more than CNY 300,000. See article 48 of the P.R.C. Foreign Exchange Administrative Regulations, promulgated by the P.R.C. State Council.