

# VAT on Domestic Transactions in the People's Republic of China

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Reprinted from *Tax Notes Int'l*, April 17, 2006, p. 289

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The objective of this article is to analyze the concepts and underlying principles in the People's Republic of China tentative regulations on the value added tax and its detailed implementation rules.<sup>1</sup> The VAT regulations and rules provide the legal framework of VAT in the P.R.C. The scope of analysis covers the issue of the relationship between the VAT rules and other legal rules, including: (1) the administration and levy of import VAT under the P.R.C. customs rules; (2) sales recognition under P.R.C. accounting rules; (3) the sale of goods under P.R.C. contract law; (4) the cash and credit settlement systems; and (5) the dividing lines between a good-faith buyer and a criminal in the use of VAT special invoices in the contexts of the P.R.C. criminal law and the administrative rules. The VAT rules on import and export transactions and VAT and customs rules on export processing are not covered.

## Basic Scope of VAT

The tentative regs on the VAT provide that VAT is imposed on units and individuals for the sale of goods, importation of goods, and the provision of services relating to processing, repairing, and replacement (referred to herein as "taxable services") in the Chinese territories.<sup>2</sup> The provision of services other than processing, repairing, and replacement does not fall into the scope of VAT. The supply of goods and taxable services is exempted in special bonded areas — export processing zones, free trade zones, and logistic parks. A comparison between the scope of VAT and business tax may help explain the difference. The sale of goods is subject to VAT, except for the sale

of immovable properties. The sale of services is subject to business tax, except for the provision of processing, repairing, and replacement services.

## VAT Obligations and Other Legal Relationships

The seller of goods is under a legal obligation to collect VAT from the buyer and pay VAT. The provider of taxable services is also obliged to collect VAT on the service user and pay VAT. On the importation of goods, the consignee is under a legal obligation to pay VAT to Customs.<sup>3</sup> There is a difference between the buyer (or owner) and the consignee. There are two types of legal relationships behind the importation of a particular good, the obligation to deliver the goods under a sales contract and the ownership of the goods. For example, the importer, a wholly foreign-owned enterprise, can purchase goods from a party outside China; alternatively, the importer, a representative office in China, can import the same goods from its head office outside China. The first transaction arises from a buy-sell contractual relationship that results in the change of ownership in the subject goods. The second results in the change in the possession of particular goods without change in ownership. A buyer (or owner) that does not possess a foreign trade right cannot be a consignee. The consignee is a legal or individual person that has duly registered as a foreign trader and completed the customs registration in accordance with legal requirements.<sup>4</sup> The buyer (or owner) that does not have a foreign trade right must appoint an import-export (foreign trade) corporation, which imports the goods in its own name for a service charge.<sup>5</sup>

<sup>3</sup>State Administration of Taxation, *Guo Shui Fa* 155 (1993).

<sup>4</sup>Ministry of Commerce, "The Administrative Measures of Record Filing Registration of Foreign Traders," Order 14, June 19, 2004.

<sup>5</sup>The Chinese government liberalized foreign trade rights in 2004. Import-export corporations lost the monopolistic position of the old days. Foreign investors can set up 100 percent owned foreign invested commercial enterprise (FICE) to carry on trading businesses in the Chinese market beginning December 11, 2004. See document 8 (2004) issued by the Ministry of Commerce on April 16, 2004.

<sup>1</sup>P.R.C. State Council, P.R.C. VAT tentative regulations, Decree 134, Dec. 13, 1993. See also the detailed implementation rules, issued by the Ministry of Finance on Dec. 25, 1993.

<sup>2</sup>P.R.C. State Council, article 1 of the P.R.C. VAT tentative regs, Decree 134, Dec. 13, 1993.

The consignee may appoint a professional declaration agent to handle the customs formality.<sup>6</sup> The agent, which possesses the qualification for import and export declaration, has no foreign trade right, but is permitted to act for the consignee who has the import-export rights. The VAT regulations provide that Chinese Customs collects the duty and import-stage VAT from the consignee.<sup>7</sup> The P.R.C. customs law also provides that Customs has authority to administer the levy of duty and VAT at the import stage.<sup>8</sup> Multiple legal relationships may coexist in the importation of goods: (1) the contractual relationship for the sale of goods; (2) the legal right of the owner over the goods; (3) the hire of the carrier under the contract of carriage; (4) the relationship between the principal and the Customs declaration agent; and (5) the legal authority of Customs over the consignee and agent in the administration and levy of taxes on the imported goods.<sup>9</sup> Because of the special nature of customs practices, Customs may issue the tax payment certificate either to the consignee or the declaration agent.<sup>10</sup> The parties to collect and pay VAT are listed in the table below:

	Sale of goods	Importation of goods	Provision of taxable services
Who bears VAT?	Buyer	Consignee	Service user
Who collects and pays it?	Seller	Customs	Service provider

### Sale of Goods

Goods covered by the VAT regulations include tangible movable goods, central heating, gas, and electricity. "Sales" means the transfer of ownership

of goods for consideration, including the receipt of money, goods, and other economic benefits.<sup>11</sup> The VAT regulations and rules do not expressly mention what constitutes economic benefit. Economic benefits can take the form of acquisition of an equity interest in a company or discharge of one's liability or obligation by giving up the ownership in goods.<sup>12</sup>

### Deemed Sales

The VAT rules contain a deemed sale provision,<sup>13</sup> which makes transactions without a transfer of ownership or payment taxable under some circumstances. Typically, deemed sales occur under the following circumstances: a change in possession (for example, delivery of goods from one location to another); a change in the use of goods for purposes other than sales (for example, the use of goods to settle one's liability or for owner's consumption); and the transfer of goods for no consideration (a gift). The VAT rules list the following examples of deemed sales below:

- delivery of goods from the principle to the agent for on-sale to third parties;
- sales of goods by the agent on behalf of the principal;
- transfer of goods from the head office to branches in other cities;
- self-produced goods, goods processed under contract, or purchased goods used for nontaxable items (say, goods used in the construction of own assets);
- providing self-produced goods, goods processed under contract, or purchased goods to other companies or individuals as investment;

<sup>11</sup>Ministry of Finance, "Article 3 of the Detailed Implementation Rules of the P.R.C. VAT Tentative Regulations," *Cai Fa Zi* 38, Dec. 25, 1993.

<sup>12</sup>An equity interest in a company is a legal right. However, there are exceptions. A person who receives the new shares in a business acquisition that involves the transfer of the net assets from the target company to the acquiring company is not subject to VAT. The transfer of goods in connection with the transfer of all the assets and liabilities goes beyond the scope of a sale of goods in the VAT regulations. See *Guo Shui Han* 420 (2002) issued by the State Administration of Taxation. Similarly, the transfer of goods to a company as capital contribution will not attract VAT because the act of giving up goods is in the nature of undertaking risk in a business venture, which goes beyond the scope for the supply of goods and taxable services in the VAT regulations.

<sup>13</sup>P.R.C. State Council, "Article 4 of the Detailed Implementation Rules of the P.R.C. VAT Tentative Regulations," Dec. 26, 1993.

<sup>6</sup>National People's Congress, P.R.C. Customs Law, article 9, July 8, 2000.

<sup>7</sup>P.R.C. State Council, P.R.C. VAT tentative regs, article 22, Dec. 13, 1993.

<sup>8</sup>National People's Congress, P.R.C. Customs Law, article 65, July 8, 2000.

<sup>9</sup>An understanding of the legal relationship is important. The innocent owner of the goods cannot claim back the goods detained by Customs if the consignee is an import-export corporation the owner has appointed previously. Chinese Customs will only release the goods to the consignee in accordance with customs laws and regulations. Legal ownership over the goods may be lost permanently and the goods will never be returned to the owner if the consignee cannot rectify the wrongful acts.

<sup>10</sup>State Administration of Taxation, *Guo Shui Han Fa* 288 (1995).

- distribution of self-produced goods, goods processed under contract, or purchased goods to the investors or owners;
- self-produced goods or goods processed under contract used for collective welfare or personal consumption; and
- transfer of self-produced goods, goods processed under contract, or purchased goods to others as gifts.

The scope of the deemed sale includes the refundable deposit for a packing case or packaging material under some circumstances. Refundable deposits, if kept by the seller over 12 months, are deemed sales.<sup>14</sup> If a deposit of 100 is received and treated as other payables for more than 12 months, then the amount of deemed sales shall be 85.47 ( $= 100/1.17$ ) and VAT payable shall be 14.53 ( $= 100/1.17 \times 0.17$ ). The amount of deposit is added to the sales amount for VAT computation purposes.<sup>15</sup>

### Accounting Rules vs. VAT Rules

It is useful to make a comparison on the scope of sale between the accounting rules and VAT rules. The terms for the sale of goods can be very sophisticated or very simple, but a contract inevitably includes the terms for the delivery of goods and the payment. The P.R.C. accounting rules provide that a sale is recognized when the following criteria are met:<sup>16</sup>

- risks and rewards associated with the goods pass from the seller to the buyer;
- the seller no longer exercises management and control over the goods;
- the economic benefit of the sale transaction will probably flow to the enterprise; and
- the amount of sale is measurable.

The P.R.C. contract law provides that ownership (or the legal title) of goods passes from the seller to the buyer at the time of delivery unless the law provides otherwise or the parties to the contract stipulate otherwise.<sup>17</sup> Delivery or change in possession may occur with a transfer of ownership. Delivery may also occur without a transfer of ownership, which usually takes the form of a deemed sale. A few examples help illustrate the relevant points. First, a head office may send goods to a branch for sale to a

third party. Second, a principal may deliver goods to its agent for sale to third parties. Third, a company may use self-produced goods in the construction of its own assets. Fourth, the company may give up some finished goods in exchange for raw materials. In the first three cases, the accounting rules do not recognize sales in the absence of a change in ownership for the goods. There is no buyer and seller. In the fourth case, the sale is recognized under the accounting rules, except that the goods received are valued at the cost of the goods given up.<sup>18</sup> The accounting rule here is consistent with principles for the transfer of ownership in the contract law, which does not necessarily occur with a physical transfer of goods. The accounting rules do not depart from the legal rules on the scope of the sale of goods. The VAT rules recognize all of the examples as sales. They provide that a sale is recognized on delivery, which includes delivery with a transfer of the ownership in the goods to a third party and a change in possession in a deemed sale. One can conclude that the scope for the sale of goods is wider under the VAT rules than the accounting rules. The transfer of goods from a head office to branches in other cities or the transfer of goods between branches in different cities does not fall into the scope of deemed sale, subject to the two conditions being satisfied, that is, no VAT special invoice has been issued and no payment has been made.<sup>19</sup>

### Computation of VAT Payable

The amount of VAT payable may be computed in two ways, the simplified computation method and the general computation method, as listed below.

Method	Amount of VAT payable
Simplified computation method	Sales amount x rate of levy
General computation method	Output VAT - input VAT

There is no input credit under the simplified computation method. Those classified as small-scale taxpayers use the simplified computation method to pay the VAT at the levy rate. The general VAT taxpayer pays VAT at the standard rate of 17 percent. The general taxpayer may also adopt the

<sup>14</sup>State Administration of Taxation, *Guo Shui Han Fa* 288 (1995).

<sup>15</sup>State Administration of Taxation, *Guo Shui Fa* 155 (1996).

<sup>16</sup>Ministry of Finance, *Cai Hui Zi* 23 (1998).

<sup>17</sup>National People's Congress, article 133 of P.R.C. Contract Law, Mar. 15, 1999.

<sup>18</sup>Ministry of Finance, *Cai Hui* 7 (2001).

<sup>19</sup>State Administration of Taxation, *Guo Shui Fa* 137 (1998).



simplified computation method to compute VAT payable for the supply of specified goods if it is advantageous to do so.<sup>20</sup> Also, Sino-foreign co-operative joint venture enterprises engaged in the exploitation of crude oil and natural gas pay VAT at a 5 percent levy rate.<sup>21</sup> The disposal of fixed assets is subject to tax at a 4 percent levy rate if the selling price exceeds the original costs. There is a difference between the VAT rate and the VAT burden. VAT rates (standard rate is 17 percent) are constant, but the VAT burden can be higher or lower than the VAT rates, depending on the percentage of value added. An illustration could help explain the different tax positions.

The VAT standard rate and the levy rate are 17 percent and 6 percent (4 percent for nonproduction enterprise), respectively. If a sale is 100 and the purchase is 80, the value added is 20. VAT payable is  $20 \times 17 \text{ percent} = 3.4$ . If the purchase is reduced to 40 in the same example, the value added is 60 ( $= 100 - 40$ ). VAT payable is  $60 \times 17 \text{ percent} = 10.2$ . In both cases, the VAT payable is 6 ( $= 100 \times 6 \text{ percent}$ ) using the simplified computation method. Therefore, one can conclude that the general taxpayer could be better off by choosing the general computation method if the value added is relatively low. The general taxpayer will be better off by choosing the simplified computation if the value added is relatively high. The taxpayer will be indifferent if the VAT payable under the two computations is the same. That can be verified if the purchase is changed to 64.71, then the VAT payable will be  $35.29 \times 17 \text{ percent} = 6$ .<sup>22</sup>

## Computation of Import VAT

Goods imported for sale in the domestic market are subject to import VAT using the following formula:  $\text{Input VAT} = (\text{dutyable value} + \text{customs duty} +$

consumption tax)  $\times 17 \text{ percent}$ .<sup>23</sup> 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 CNY 8:

Duty = CIF value x duty rate (a)	(US \$100 x 8) x 14.2% = CNY 113.60
VAT = (CIF value + duty + CT) x VAT rate (b)	(800 + 113.60 + 391.54) x 17% = CNY 221.87
Total duty, VAT, and CT	113.60 + 221.87 + 391.54 = CNY 727.01

### Notes:

(a) Goods imported from WTO member countries (Japan) are subject to preferential tariff rate. The applicable rate is 14.2% for HS code 33041000.

(b) Computation of CT is based on the following formula:

Composite dutiable value =  $(\text{CIF value} + \text{duty}) / (1 - \text{CT rate})$

Consumption tax = composite dutiable value x CT rate  $(800 + 113.60) / (1 - 30 \text{ percent}) = 1,305.14$

$1,305.14 \times 30 \text{ percent} = 391.54$

The taxable base for computing import VAT includes a duty and CT. A reduction in duty rate also reduces the amount of VAT payable and CT payable, and vice versa.

## Duty Rate and Exchange Rates

The applicable rate for the import (export) tariff refers to that in force on the date Customs accepts the declaration for the import (export) goods. If Customs accepts the 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 import the 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

<sup>20</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui Zi* (2004). The types of prescribed goods taxable at levy rate include: electricity supplied by small thermal electricity generating or hydroelectricity generating plants at or below the county level; sand, soil, and quarry for construction use and manufacture of construction materials; the supply of bricks, soil, and lime made of self-excavated sand, soil, and quarry; building materials that are made of coal ash and boiler slag; biological products that are made of microorganism, animal toxins, or human or animal blood; and the supply of water.

<sup>21</sup>P.R.C. State Council, *Guo Fa* 10 (1994).

<sup>22</sup>35.29 is the percentage of value added that is arrived as follows:  $(\text{selling price} - \text{purchase price}) / \text{selling price}$ . That is  $((100 - 64.71) / 100) \times 100 \text{ percent}$ . If 35.29 is denoted by letter R, then at break even, the VAT standard rate will be the same as the levy rate:  $\text{sale} \times R \times 17 \text{ percent} = \text{sale} \times 6 \text{ percent}$ . Therefore, we get 35.29 percent for R ( $= 6 \text{ percent} / 17 \text{ percent} \times 100 \text{ percent}$ ).

<sup>23</sup>P.R.C. State Council, P.R.C. VAT tentative regs, article 15, Dec. 26, 1993.

week of the preceding month.<sup>24</sup> If the Wednesday in the third week falls on a public holiday, the Wednesday in the fourth week shall be used as the reference.<sup>25</sup>

The import duty of goods subject to ad valorem tariff is affected by the following factors: (1) the applicable tariff schedule; (2) the tariff code (the classification within a tariff schedule); (3) the tariff rate; (4) the exchange rate; and (5) the dutiable base. The country of origin certificate 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 by the value of import; and
- import quantity x rate per unit = specific duty, which is levied by the quantity of import.

### Time to Pay Import Duty and VAT

Import tariff, VAT, and CT are payable 15 days after receiving the Customs' payment notice on the importation of goods into China.<sup>26</sup> There is a daily surcharge of 0.05 percent on the amount of overdue taxes for late payment.<sup>27</sup> After the payment of the import VAT, the importer is entitled to claim an input deduction from the output VAT collected. The right to claim the input deduction is established whether the goods have been paid for or not.<sup>28</sup>

### VAT-Exempt Goods

The VAT regulations provide an exemption from the VAT imposed on the sale of goods in the domestic market and the VAT imposed at the importation of goods, respectively:<sup>29</sup>

- self-produced agricultural products sold by agricultural producers;
- contraceptive medicines and devices;
- antique books;
- importation of instruments and equipment directly used in scientific research, experiment, and education;
- importation of materials and equipment from foreign governments and international organizations as assistance free of charge;
- equipment and machinery required to be imported under contract processing, contract assembly, and compensation trade;
- articles imported directly by organizations for the disabled for the exclusive use by the disabled; and
- sale of goods that have been used by the sellers.

Except as stipulated above, the VAT exemption and reduction items shall be regulated by the State Council. Local governments or departments may not promulgate any regulations on tax exemption or reduction items.

### Goods Subject to Tax Reduction

The VAT regulations provide a rate reduction from the VAT imposed on the sale of goods and the VAT imposed at the importation of goods, as follows:

- A statutory tax reduction is granted on some goods.<sup>30</sup>
- Tax reduction from 17 percent to 4 percent is granted on airliners in the civil aviation cargo transportation business that import cargo aircraft with a loading capacity exceeding 25 tons.<sup>31</sup>
- General taxpayers that sell some prescribed goods are taxed at the levy rate under the simplified computation method.<sup>32</sup>
- Taxpayers that dispose of used yachts, motorcycles, and vehicles subject to CTs are taxed at a 6 percent levy rate.<sup>33</sup>

<sup>24</sup>General Administration of Customs, article 16 of Levy and Administration Measures by the P.R.C. Customs on Import-Export Goods, Decree 124, Jan. 4, 2005.

<sup>25</sup>General Administration of Customs, Decree 53 (2005).

<sup>26</sup>National People's Congress, articles 60 and 65 of P.R.C. Customs Law, July 8, 2000. 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 as per a provision of the P.R.C. Legislation Law.

<sup>27</sup>P.R.C. State Council, article 37 of P.R.C. import and export duty regulations, Oct. 29, 2003.

<sup>28</sup>State Administration of Taxation, *Guo Shui Fa* 148 (2004).

<sup>29</sup>P.R.C. State Council, P.R.C. VAT tentative regs, article 16, Dec. 26, 1993.

<sup>30</sup>P.R.C. State Council, P.R.C. VAT tentative regs, article 2, Dec. 26, 1993. Goods subject to the reduction in VAT rates are listed under the heading of "VAT Rates" in this article.

<sup>31</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui Zi* 78 (1995) and 43 (2004), and General Administration of Customs, *Shu Shui Fa* 352 (2004).

<sup>32</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui Zi* 004 (1994). The list of prescribed goods subject to reduction in VAT rate is included in note 20.

<sup>33</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui Zi* 26 (1994).

- Beginning January 1, 2002, general and small taxpayers that dispose of used fixed assets other than yachts, motorcycles, and goods subject to CTs are granted a reduction in the levy rate from 4 percent to 2 percent. There is no VAT if the asset is sold at below the original cost.<sup>34</sup>
- Agricultural goods can enjoy either exemption or reduction. Agricultural goods produced by producers are exempted from VAT. Sales of agricultural products are subject to VAT at a reduced rate of 13 percent. Importation of agricultural products is also eligible for the same tax reduction.<sup>35</sup>
- Beginning July 1, 1998, the levy rate for commercial enterprises that are small taxpayers with annual turnover not exceeding CNY 1.8 million is reduced from 6 percent to 4 percent.<sup>36</sup>
- Beginning January 1, 2000, general taxpayers engaged in the manufacture and sale of concrete are eligible for paying VAT at a levy rate of 6 percent.<sup>37</sup>

## Determining the VAT Sale Amount

The amount of VAT sale can be determined as follows: the sales amount as ascertained under the P.R.C. accounting rules + deemed sales + additional charges - amount of VAT-exempt goods.

### Additional Charges to the Selling Price

The term "additional charges" refers to all the charges additional to the selling price receivable from the purchaser, such as handling fees, subsidies, funds, fundraising fees, rebates, bonuses, monetary penalties for nonperformance of contractual obligations, packaging fees, rent for packing cases, storage fees, quality fees, loading and unloading charges, sums collected on behalf of the buyer, sums advanced, and other charges of various kinds.

There are exceptions for the following:

- the output VAT collected from the purchaser;

- the CT collected from the service user on the consumable goods under a processing agreement; and
- transportation charges paid on behalf of the buyer if the freight invoice is issued by the transportation company to the buyer and the invoice is handed over to the buyer.<sup>38</sup>

The tax on additional charges is a specific anti-avoidance provision. If the seller fixes a lower selling price and recovers the price reduction by additional charges from the buyer, the seller can legitimately pay less VAT because the taxable base has been reduced in the absence of the antiavoidance provision. To stop the erosion of the tax base, the VAT regulations include all additional charges in the taxable amount even if some are either classified as other income or as the amount creditable against expenses in the income statement under the P.R.C. accounting rules. Some additional charges, like loading and unloading charges, do not actually fall into the scope of the VAT. Instead, they represent the supply of taxable services and would fall into the scope of the business tax but for the provision to the contrary in the VAT regulations and rules.

### Special Rules on Selling Price

The tax base of VAT is computed as: sales amount x tax rate. The sales amount, which consists of a price and quantity component, is the tax base. There are special rules for the determination of the amount of sale if the selling price is exceptionally low without a justification or the VAT special invoice has not been issued in a deemed sale. In the absence of a benchmark selling price, the amount of VAT sale is arrived at by reference to the average selling price for the same type of goods in the month, the average selling price for the same type of goods in recent three-month period, and the composite selling price ( $= \text{cost} \times (1 + 10 \text{ percent deemed profit rate})$ ), in that order.<sup>39</sup>

The VAT sales amount is also adjusted for a refundable deposit for packing cases or packing materials and allowed sales discount. Deposits not refunded to the buyer for a period exceeding 12 months are deemed to be sales inclusive of VAT. If a deposit of 100 is received and treated as other payables, then the amount of deemed sales shall be  $85.47 (= 100/1.17)$  and VAT payable shall be  $14.53 (= 100/1.17 \times 0.17)$ . The amount of deposit is transferred to the sales amount. As a tip, the taxpayer

<sup>34</sup>Ministry of Finance and State Administration of Taxation, document *Cai Shui* 29 (2002).

<sup>35</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui Zi* 004 (1994) and 52 (1995). The scope of agricultural products as defined under the VAT rules includes grains, vegetables, tobacco leaves, tea leaves, plant products, forestry, edible horticultural plants, plants for medical use, vegetable oil, forestry products, fishery and aquatic products, animals and animal products, including eggs, milk, skins, furs, and other animal tissues.

<sup>36</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui Zi* 113 (1998).

<sup>37</sup>State Administration of Taxation, *Guo Shui Fa* 37 (2000).

<sup>38</sup>Ministry of Finance, article 12 of the detailed implementation rules of P.R.C. VAT tentative regs, Dec. 25, 1993.

<sup>39</sup>Ministry of Finance, article 16 of the detailed implementation rules, and the State Administration of Taxation, document *Guo Shui Fa* 154 (1993).



could avoid paying the VAT on the deposit kept for over 12 months by canceling the original agreement and entering a new deposit agreement with the buyer before the due date. However, a discount is deductible from the amount of gross sales if the information for the discount is included in the same VAT special invoice as the sale of goods. Separate invoices are not acceptable for reducing the sales amount under the VAT rules.<sup>40</sup> The VAT rules refer to a price discount, not a quantity discount. Goods supplied under a quantity discount are not treated as sales under the accounting rules, but are deemed sales (gifts) under the VAT rules.

### Extended Scope of VAT

The scope of the VAT can be summarized in three broad categories, excluding the provision on VAT-exempt goods. First, there is a basic provision including the importation of goods, the supply of goods, and taxable services. Second, the deemed sale rule provides that transactions without a change of ownership, a change in the use of goods, or goods given up for no consideration also fall into the scope of the VAT. Third is the mixed sale provision under which nontaxable services are brought into the charging scope of the VAT regulations.

### Mixed Sale vs. Supplementary Sale

Mixed sale transactions are regarded as the supply of goods and nontaxable services to the same buyer or user, with the provider of goods and services paying only one type of tax on the combined sales amount.<sup>41</sup> Nontaxable services refer to the following activities on the list of taxable items subject to business tax: communication and transportation, construction, finance and insurance, posts and telecommunications, culture and sports, entertainment, and provision of services.<sup>42</sup> The VAT regulations provide that taxpayers engaged in the production, wholesale, or retail activities that derive more than 50 percent of the revenue from the supply of goods and taxable services pay the VAT and not the business tax.<sup>43</sup> The VAT rules also provide that the tax authority will determine whether a sale transaction is a mixed sale.<sup>44</sup> There is a planning oppor-

tunity here. If the VAT tax burden for the sale of goods, as mentioned earlier in the comparison between the standard rate and levy rate, is lower than the tax burden for the supply of nontaxable services, the taxpayer can exploit its position because the sale revenue from the supply of nontaxable services, which should be subject to a 5 percent business tax, are now taxed at a rate lower than the 5 percent business tax.

A supplementary sale refers to when the taxpayer either supplies goods and nontaxable services to different buyers (paying different types of taxes) or supplies goods and taxable services (paying same types of taxes, but at different rates) to different buyers. If the taxpayer can separately account for different types of activities, the taxpayer pays different taxes at different rates. Otherwise, the taxpayer must pay VAT if it supplies both goods and nontaxable services, or pay VAT at 17 percent if it supplies goods and taxable services subject to different VAT rates.<sup>45</sup>

### When VAT Obligations Arise

The VAT rules provide that the timing for the VAT obligation to arise for the sale of goods or the provision of taxable services is specified as follows in line with the methods of settlement for sales as shown in the table on the next page.<sup>46</sup>

The seller and buyer may agree on the following terms of payment: payment at the time of delivery, before delivery, or after delivery of the goods; a lump sum payment or payment by installments; and the place of payment. The VAT rules provide that the VAT obligation for the sale of goods arises at the time of payment, and if payment is made before delivery or there is no payment (in a deemed sale), at the day of delivery. In some cases, the VAT obligations for the sale of goods lag behind the sales recognition as determined under the accounting rules. There is a distinction between payment and settlement. Settlement serves to discharge the buyer's obligation and bring the contractual relationship to an end. Payment is a means of cash settlement, but settlement includes noncash payment.<sup>47</sup> On settlement, the seller receives payment or acquires the legal right to receive the sale amount that

<sup>40</sup>State Administration of Taxation, *Guo Shui Fa* 154 (1993).

<sup>41</sup>Ministry of Finance, article 13 of the detailed implementation rules of P.R.C. VAT tentative regs, Dec. 26, 1993.

<sup>42</sup>See the appendix to the P.R.C. business tax tentative regulations.

<sup>43</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui Zi* 26 (1994).

<sup>44</sup>Ministry of Finance, article 5 of the detailed implementation rules, Dec. 25, 1993.

<sup>45</sup>Ministry of Finance, article 6 of the detailed implementation rules, Dec. 25, 1993.

<sup>46</sup>Ministry of Finance, article 33 of the detailed implementation rules of P.R.C. VAT tentative regs, Dec. 25, 1993. State Administration of Taxation, *Guo Shui Fa* 150 (1993).

<sup>47</sup>People's Bank of China, article 3 of the payment and settlement methods, *Yin Fa* 393 (1997). Methods of settlement in the P.R.C. can take the following forms: bills of exchange, bank checks, credit cards, and remittances.



## Special Reports

	Obligation under VAT rules	Recognition of sales under the accounting rules
Sale on cash-and-carry basis	On receipt of sales amount or documentary right to receive sales amount	Same
Credit sale	Payment date per sales agreement	Different (a)
Sales on collection terms	Delivery and completion of collection formalities	Same
Sale by installment	Payment date per sales agreement	Different (b)
Deemed sales (with or without ownership change)	On delivery of goods or change in use	Different (c); see also comparison for accounting rules vs. VAT rules
Advance deposit	On delivery of goods	Same
Goods sold on consignment	On receipt of the "statement of consignment sale" from the agent	Different (d)
Provision of services	On receipt of sales amount or documentary right to receive sales amount	Different (e)

### Notes:

(a) The accounting rules differ from the VAT rules because sales are not recognized on an "as-paid" basis. Rather, they are recognized when the title to the goods passes from the seller to the buyer.

(b) The accounting rules recognize the installment sales on an accrual basis. If the sale agreement provides that the payment of sales amount is by installments and tax invoice is to be issued on delivery of the goods, the VAT rule shall only recognize the sales after the last installment has been settled. (State Administration of Taxation, *Guo Shui Fa* 192 (1995).) It recognizes the sale at a later point of time than the accounting rule does.

(c) Deemed sales consist of a change in possession of the goods without involving a change in ownership, a change in the use of the goods, and giving up of goods as gifts. Taxpayers often fail to report deemed sales and get punished. It is partly because there is no requirement to issue VAT special invoices on most occasions.

(d) The P.R.C. accounting rules provide for two alternative treatments. The agent may record the transaction as a sale in its book of accounts. It may also report commission income and exclude the consignment sale from revenue. Commission income is recognized on the completion of services under the accounting rules. That may occur at a time earlier than the receipt of the statement of consignment sales by the principle.

(e) For the provision of services, the VAT obligation for the supply of taxable service arises on receipt of payment. The accounting rules recognize the revenue on the completion basis for short-term jobs and on the percentage of completion basis for jobs lasting for over one year; the VAT rules provide that the obligation arises on the receipt of sales amount or obtaining the right to receive the sales amount.

may take the form of a postdated check or a bill of exchange following the buyer's acceptance. The seller's VAT obligations arise on obtaining that entitlement in accordance with the P.R.C. law for negotiable instruments, even if he will only get the cash in future months. Likewise, the purchaser will get a legitimate deduction against the output VAT without paying cash in the month of accepting a bill or issuing a postdated check.<sup>48</sup>

### Sale Recognition on Mixed Sales

In a mixed sale involving the sale of goods and the provision of nontaxable services, the taxpayer may, for instance, charge the buyer a sum for the sale of

an elevator and the maintenance fee for a period of one year. The VAT rule requires that the tax must be paid on the whole sum at the month of sale. The accounting rule does not work like that. The matching principle in accounting requires that the sale of goods is recognized in the current month, while the maintenance fee is reported as deferred income recognized evenly over the period of maintenance in future months.

### Types of VAT Taxpayers

There are two types of VAT taxpayers, general (ordinary) taxpayers and small-scale taxpayers. General or ordinary taxpayers differ from small taxpayers in several aspects. First, the business scale between the two types of taxpayers is different. To be recognized as an ordinary taxpayer, the annual turnover must exceed CNY 1 million if the taxpayer is engaged in production activities or CNY

<sup>48</sup>State Administration of Taxation, *Guo Shui Fa* 015 (1995).

1.8 million if the taxpayer is engaged in wholesaling and retailing activities. Second, the rights and obligations of the ordinary taxpayer are different from those of the small-scale taxpayer. The ordinary taxpayer can claim input credit on goods for domestic sales while the small-scale taxpayer cannot. Instead, small-scale taxpayers are taxed at levy rate under the simplified method. The ordinary taxpayer must hire accounting staff holding a valid license and keep books of accounts in sufficient detail so that the tax authority can ascertain the amount of output VAT and the input VAT. The small-scale taxpayer cannot use the VAT special invoice. If the small-scale taxpayer wishes to sell goods to ordinary taxpayers, it must request that the governing tax authority issue a VAT special invoice to be provided to the buyer. The small taxpayer pays 6 percent VAT at the tax office if it is engaged in production activities and pays 4 percent VAT if it is engaged in nonproduction activities.<sup>49</sup> Third, the ordinary taxpayer can claim rebates for VAT paid on the goods either bought for export or used in the manufacture of export goods. The small taxpayer does not have the right to claim export rebates. Fourth, ordinary taxpayers are eligible for VAT incentives, while small taxpayers are not as a general rule.

## Tax Invoices

### Purchase and Use of VAT Special Invoices

All types of taxpayers must purchase tax invoices at the government tax branch or office. A general taxpayer can issue both VAT special invoices and ordinary tax invoices, while the small taxpayer cannot purchase VAT special invoices from the tax offices and issue them. The small taxpayer may ask the tax office to issue a VAT special invoice on its behalf. The production-type small taxpayer obtains VAT special invoices after paying a 6 percent VAT at the tax office. The small taxpayer classified as a commercial enterprise pays a 4 percent VAT at the tax office. The VAT regulations do not permit the use of VAT special invoices in some types of transactions. Instead, ordinary invoices should be used in the following situations even if the seller is a general VAT taxpayer:<sup>50</sup>

- a small taxpayer supplying goods and taxable services;
- the sale of VAT-exempt goods;
- the sale of goods to consumers; and

- the sale of specific types of goods (like cigarettes, wine, food, clothing, shoes, hats, cosmetics, and vehicles).

	General taxpayer	Small-scale taxpayer
VAT special invoice	Yes	No
Ordinary invoice	Yes	Yes

### Tax Invoices and VAT Liability

An ordinary invoice is issued in the sale of goods to consumers in the retail sector. The use of ordinary tax invoices does not mean that the retailer has no output VAT liability. The two issues are independent of each other. The general taxpayer computes the output VAT as follows: sales amount = invoiced value/(1 + standard rate 17 percent). If invoiced value inclusive of VAT is 100, then the sales amount and the output VAT are 85.47 and 14.53, respectively. If the ordinary taxpayer pays VAT at a levy rate using the simplified computation method or the small taxpayer requests the tax authority to issue a VAT special invoice, the sale amount is: invoiced amount/(1 + levy rate).<sup>51</sup>

### Input Credit

The amount of VAT paid by the general taxpayer on the purchase of goods and taxable services is the input VAT. The scope of deduction of input VAT from output VAT is restricted to the following two situations:<sup>52</sup>

- 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 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, which may either be a seller of VAT-exempt goods or a provider

<sup>49</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui Zi* 113 (1998).

<sup>50</sup>P.R.C. State Council, article 21 of P.R.C. VAT tentative regs, and State Administration of Taxation, *Guo Shui Fa* 088 (1995).

<sup>51</sup>Ministry of Finance, article 25 of the detailed implementation rules of P.R.C. VAT tentative regs, Dec. 25, 1993. State Administration of Taxation, *Guo Shui Fa* 122 (1994).

<sup>52</sup>P.R.C. State Council, P.R.C. VAT tentative regs, article 8, Dec. 26, 1993.

of nontaxable services. Ordinary tax invoices cannot be used to claim input credit as a general rule. However, the regulations and rules provide some exceptions:

- If the ordinary taxpayer purchases VAT-exempt agricultural produce, it can get a 10 percent notional input credit.<sup>53</sup>
- If the ordinary taxpayer pays inward and outward transportation charges (excluding the loading and unloading charges), it can claim an input credit at 7 percent on the amount of invoice issued by companies in the transportation business.<sup>54</sup> That special deduction is subject to two exceptions: the freight charges are not paid for the purchase of nontaxable items (like fixed assets) and the freight charges are not incurred in connection with the purchase and sale of VAT-exempt goods.
- The purchase by the ordinary taxpayer from companies in the business of collecting second-hand articles and waste items. The taxpayer gets a 10 percent input credit on the invoiced value.<sup>55</sup>

### Disallowed Input VAT

To obtain a deduction against output VAT, the taxpayer should submit the VAT special invoice to the tax authority for statutory certification within 90 days.<sup>56</sup> The input VAT is not allowed to offset the output VAT under the following situations:<sup>57</sup>

- VAT paid on purchase of fixed assets;
- VAT paid on goods or taxable services used for nontaxable 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;

<sup>53</sup>P.R.C. State Council, P.R.C. VAT tentative regs, article 8, Dec. 26, 1993. If the ordinary taxpayer purchases goods from the small taxpayer, the input credit increases from 6 percent to 13 percent. See *Cai Shui* 105 (2002), jointly issued by the Ministry of Finance and State Administration of Taxation.

<sup>54</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui Zi* 012 (1994) and 114 (1998).

<sup>55</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui* 78 (2001).

<sup>56</sup>State Administration of Taxation, *Guo Shui Fa* 017 (2003).

<sup>57</sup>P.R.C. State Council, P.R.C. VAT tentative regs, article 10, Dec. 26, 1993.

- abnormal loss suffered for purchased goods or taxable services consumed in the manufacture of finished goods and semifinished goods; or
- in an export refund case, the amount of disallowed input VAT.

There is an exception. The purchase of some capital goods in eight prescribed industry sectors located in northeastern China is eligible for deduction against the increase in output VAT of current year over that for the preceding year.<sup>58</sup>

### Timing to Claim Input Credit

For a manufacturing business, the recognition of an input deduction is the receipt of VAT invoices and the entry of goods in the warehouse following inspections. For a commercial business, the time to recognize an input deduction is 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.<sup>59</sup> For the purchase of taxable services, the time to book the input deduction is when the invoice is received and the service fees have been paid.

### Determining Input VAT

The amount of input VAT is computed as follows: the amount of input VAT on purchase as ascertained under the accounting rules + the amount of special deduction (such as the notional input credit for VAT-exempt goods and transportation charges) - the input VAT disallowed for offset against the output VAT.

### Buyer in Good Faith

By having a larger amount of input VAT, a taxpayer can get a smaller amount of VAT payable or a larger export refund. 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 legally required that: (1) the taxpayer have a genuine underlying transaction for each incoming and outgoing VAT special invoice; (2) the information of the seller's name, corporate stamp, quantity, value, and the VAT amount in the VAT special invoice matches the particulars of the actual purchase; (3) 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 (4) there is no evidence suggesting that the buyer knows that the seller obtained the VAT special invoice in any unlawful way. The taxpayer will be excused for cheating the tax authority if the VAT

<sup>58</sup>State Administration of Taxation, *Guo Shui Han* 143 (2004).

<sup>59</sup>State Administration of Taxation, *Guo Shui Fa* 15 (1995) and 192 (1995).

special invoice turns out to be a fake or has been obtained unlawfully. The tax authority will only revoke the input credit if it is already granted and shall not impose any administrative penalty.<sup>60</sup>

Even if there has been a genuine transaction and the quantity and value stated in the VAT special invoice is consistent with the particulars of the actual purchase, the buyer will be punished if input credits or export rebates have been claimed in any one of the following ways:

- the purchase invoice is issued by a party other than the seller;
- the purchase invoice is stamped by a party other than the seller; or
- there is evidence that the buyer knew the seller obtained the VAT special invoice in any unlawful way.

If unlawful acts come to light, the legal consequences will be twofold; the tax authority will revoke the input credit or rebates and will impose fines and administrative punishment on the taxpayer. The taxpayer should not have knowledge that the seller obtained the VAT special invoices unlawfully.<sup>61</sup> The following would be evidence that a taxpayer not only knew about the unlawful practice, but acted in collusion with the seller to profit from it: the VAT special invoice is not matched by underlying sale and purchase of goods, a third-party VAT special invoice was accepted, or the VAT special invoice was 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). Because the invoice was used improperly, the taxpayer and its legal representative will either face administrative punishment or, in a serious case, criminal consequences.<sup>62</sup> Therefore, as a matter of good housekeeping, a buyer should obtain copies of a seller's business license and tax registrations and the invoice purchase book issued by the tax bureau for its own verification and record before entering into a contract with the seller. When a general taxpayer receives any supplier's VAT special invoices, it should check whether the supplier's name is matched against

the issuer's name and the payee's name, as printed on the VAT special invoice. When a general taxpayer issues checks to settle important financial obligations, it could issue the check on nonnegotiable terms.

## Point of Collecting the VAT

VAT is collected at each stage of the value added process for the taxable activities taking place within the P.R.C.; it is also collected at importation. The VAT chain starts from manufacturing stage, through wholesaling stage, to the retailing stage. A comparison of the collecting point between VAT and CT may help illustrate where they lie.

	VAT	Consumption tax
Manufacturing	Yes	Yes
Processing	Yes	Yes
Wholesaling	Yes	No
Retailing	Yes	No
Importation	Yes	Yes

Goods subject to CT fall into the scope of VAT, but not the other way around. There are differences between goods subject to VAT and goods subject to CT. First, CT is borne by the seller of goods or the provider of processing service, while VAT is borne by the buyer and the users of taxable services, as defined. Second, CT is not payable at the wholesale and retail stage except in the retail sector when sellers of gold, silver, diamonds, jade, and precious stones are liable for CT. Those goods are not subject to CT at other stages, including the import-stage CT.<sup>63</sup>

## Tax Period

The tax period for VAT is 1 day, 3 days, 5 days, 10 days, 15 days, or one month. The assessable period of a taxpayer is determined by the tax authority according to the volume of the VAT to be paid. If payment cannot be made on a periodic basis, the tax can be paid on a transaction-by-transaction basis. If VAT is payable monthly, the taxpayer must submit a return and pay the tax within 10 days after the end of the assessable period. If assessable periods other than one month are adopted, the provisional tax shall be prepaid within five days following the end of the assessable period. A monthly tax return shall be filed and a final payment shall be made within 10

<sup>60</sup>State Administration of Taxation, document 187 (2000). The taxpayer can get the input credit if it can obtain a valid replacement VAT special invoice from the seller, against whom the tax authority has taken action.

<sup>61</sup>State Administration of Taxation, *Guo Shui Fa* 182 (2000).

<sup>62</sup>State Administration of Taxation, *Guo Shui Fa* 134 (1997). The threshold amount of tax evasion to trigger criminal liabilities is CNY 5,000 if the input credit has been claimed. See *Guo Shui Fa* 210 (1996), which reproduces the judicial interpretation by the People's Supreme Court on the issue of fictitious VAT special invoices.

<sup>63</sup>Ministry of Finance and State Administration of Taxation, *Cai Shui Zi* 095 (1994).



days from the first day of the following month.<sup>64</sup> Taxpayers importing goods shall pay tax within 15 days after the issue of tax payment certificates by Customs.<sup>65</sup>

### VAT Rates

There are two sets of tax rates under the VAT regulations. One set is the levy rate of 6 percent, 4 percent, and 2 percent under the simplified computation method. The other set of rates is 17 percent, 13 percent, and 0 percent under the general computation method. There is no input credit if VAT is imposed at levy rates.

Tax Under the General Computation Method		
I	17%	For taxpayers selling and importing goods other than those listed in row II below
II	13%	For taxpayers selling and importing the following goods: 1. grain, edible vegetable oil 2. water, air conditioning, hot water, coal gas, LP gas, natural gas, methane gas 3. books, newspaper, magazines 4. animal feed, fertilizer, agrochemicals, agricultural machinery, plastic covering film for farming 5. other goods as specifically regulated by the State Council
III	0%	For taxpayers that export goods
IV	17%	For taxpayers that supply services relating to processing, repairing, and replacement (taxable services)

Tax Under the Simplified Computation Method		
I	6%	Small-scale taxpayer classified as manufacturing enterprise
II	4%	Small-scale taxpayer classified as commercial enterprise
III	2%	Disposal of used fixed assets at above the cost by both the general taxpayer and the small taxpayer

<sup>64</sup>P.R.C. State Council, P.R.C. VAT tentative regs, article 23, Dec. 26, 1993.

<sup>65</sup>National People's Congress, article 60 of P.R.C. Customs Law, July 8, 2000.

### Tax Exemption and Zero-Rated Tax

It is useful to make a comparison between tax exemption and zero-rated tax. Neither seller is required to collect VAT from the buyer. However, the difference is that tax exemption may occur in transactions between the parties in China or between the parties within and outside China, but zero-rated tax only occurs in export transactions between the parties within and outside China. The other difference is that the seller that is exempted from VAT bears the input VAT except for the purchase of VAT-exempt goods, but the seller that is subject to zero-rated tax does not bear the input VAT.

### Types of VAT Liabilities

In broad terms, VAT liabilities in a manufacturing firm can be grouped under four categories:

VAT Obligations Under Domestic Sales vs. Export Sales		
Type I	Domestic sales using imported inputs	Taxed with input credits
Type II	Domestic sales using domestically manufactured inputs	Taxed with input credits
Type III	Export processing using imported inputs, including the input transferred from upstream manufacturing units	Exempted from VAT
Type IV	Export processing using domestically purchased inputs	Entitled to export rebates

In reality, the liabilities are not limited to those four groups. For instance, a production-type foreign investment enterprise may be engaged in export processing using both imported and domestically purchased inputs. In that case, Type III and Type IV occur at the same time. Likewise, an FIE may use both imported and domestically purchased inputs to make goods for sales in the domestic market, so Type I and Type II apply to that case. An FIE may export using both imported and domestically purchased inputs and, at the same time, do domestic sales using both imported and domestically purchased inputs. ♦