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Following on from his previous article, "Tax compliance and planning for trading business in the PRC", published in *Asia-Pacific Focus* in May 2007, Alfred K.K. Chan continues his examination of VAT in the PRC.

Pricing decisions for the general taxpayer

It is understood that there is a break-even point at which the VAT burden of general taxpayer is the same as that for a small taxpayer. This can be proved using the concept of percentage of value added. At break even:

VAT payable (general taxpayer) = VAT payable (small-scale taxpayer)

Sales amount x 17 x percentage of value added = sales amount x 6 (or 4) (see Example 1).

Example 1

VAT payable (general taxpayer)

= current period output VAT – current period input VAT

= Sales amount x 17% - sales amount x 17% x (1 – percentage of value added)

= Sales amount x 17% x percentage of value added (R);

VAT payable (small taxpayer) = sales amount x 6% (4% for non-production enterprise)

Let R be the percentage of value added. To solve R, we get R = 6/17 x 100 = 35.29 (or 4/17 x 100 = 23.53 for the small-scale taxpayer). 35.29 percent (or 23.53 percent) is the break-even percentage of value added (R). If the actual R is higher than 35.29 percent (or 23.53 percent), the VAT burden for the general taxpayer will be higher than that for the small taxpayer. If the actual R is smaller than 35.29 percent (or 23.53 percent), the VAT burden for the general taxpayer will be lower.

Example

The cost of a good is 200 excluding VAT. The marketing department has to compare the VAT burden before it can decide on the selling price. From past experiences, the particular good can be priced at 250, 310 or 370 respectively with different marketing tactics. The general taxpayer pays VAT at 17 percent while small taxpayer pays the VAT at a levy rate of six percent.

The percentage of value added is: (Sales amount – purchase amount) / sales amount x 100 = (250 – 200) / 250 x 100 = 20. It is advantageous to pay VAT as general taxpayer. One can check for this:

VAT payable (general taxpayer) = output VAT – input VAT = 250 x 17 - 200 x 17 = 8.5[1]

VAT payable (small taxpayer) = sales amount x levy rate = 250 x 6 = 15.

To pay VAT as a general taxpayer can save tax in the amount of 6.5 (= 15-8.5).

Similarly, one can perform the price analysis as shown in Figure 1. It is found that if the price is set anyway above 310, the VAT burden will be higher than the break-even point at 35.29 percent, meaning that the general taxpayer will have a higher VAT burden than small taxpayers.

Figure 1

	Output VAT	Input VAT	Percentage of value added
I	250 x 17% = 42.5	200 x 17% = 34	(250 – 200) / 250 x 100% = 20%
II	310 x 17% = 52.7	200 x 17% = 34	(310 – 200) / 310 x 100% = 35.48%
III	370 x 17% = 62.9	200 x 17% = 34	(370 – 200) / 370 x 100% = 45.94%

It is a fallacy that big companies need not study the VAT positions for the small-scale taxpayer. In a perfect market, there are numerous buyers and sellers and no single company is in a position to set the price. Small and big companies are all price takers. Big companies have to face competition from small companies. A study of the tax break-even point will enable big ones to make a price decision in a sensible way. Otherwise, it may lose business to the small taxpayer.

Break-even percentage of value added (R) exclusive of VAT is shown in Figure 2.

Figure 2

VAT rate (general taxpayer)	Levy rate (small taxpayer)	Break-even R excluding VAT
17%	6%	35.29%
17%	4%	23.53%
13%	6%	46.15%
13%	4%	30.77%

Mixed sale vs. sideline business (supplementary sale)

A mixed sale is defined as the supply of goods and non-taxable services to the same buyer or user. Mixed sales made by enterprises that carry on production, wholesale and retail businesses are deemed to be selling goods and subject to VAT on the combined sales amount. Mixed sales made by other types of enterprise are deemed to be the supply of non-taxable services, and subject to business tax.[2] The enterprises that carry out production, wholesale and retail activities include those that derive more than 50 percent of the revenue in production, wholesale and retail activities, with the provision of non-taxable services as their sideline business.[3]

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Sideline or supplementary sale is defined as the provision of goods and non-taxable services by the taxpayer to different buyers, or the supplies of goods and taxable services to different buyers.

To save tax in supplement sales, the taxpayer should account for the sale of goods and the provision of non-taxable services separately. Otherwise, the taxpayer shall pay VAT. If the supply of goods and taxable services are subject to different VAT rates, the taxpayer shall pay VAT at the highest rate if he does not separately account for different line of activities. Note that the tax authorities will check whether the supply of goods and non-taxable services is to different buyers or to the same buyer. The use of separate accounting or split contract will not reduce tax if the transaction is considered to be a mixed sale.

Examples of mixed sale involving the elements of sale and provision of services:

- Sale of elevator and the provision of installation services;
- Sale of domestic appliances and the provision of delivery services;
- Undertaking decoration work and the sale of construction materials;
- Provision of hotel services and the sale of foods and beverage, or sale of coffee beans and running cafe shop;
- Provision of car beauty services and the sale of lubricants or vehicle accessories;
- Provision of paging services and the sale of pagers;
- Design of plastic or metal moulds and the making of moulds;
- Provision of beauty salon services and the sale of cosmetic products.

A comparison between mixed and supplementary sales is shown in Figure 3:

Figure 3

	Mixed sale	Supplementary sale
1	Same buyer	Different buyers
2	Paying one type of tax on different business activities	Paying different taxes, or same type of tax at different rates on different business activities
3	Set up an entity, or branch reporting operating results separately;	Accounting for sale of different goods; (or sale of goods and non-taxable services) separately
4	Determination by tax authority	Determination by tax authority

The transfer of the business for non-taxable services to another company, or setting up a new branch that maintains an independent accounting system showing its operating results separately, is the only solution to reduce the VAT burden in a mixed sale. Split contract and separate accounting are incorrect solutions. If used improperly, the taxpayer will be exposed to tax risks. The solutions to reducing the tax burden in supplementary (sideline) sales is to split the contract and / or to account for different line of business separately. It is important to ascertain what constitutes mixed sales and what constitutes sideline sales. The play safe, the written determination by the tax authority in-charge on the type of tax the taxpayer has to pay should be kept for future reference.

Tax planning options in mixed sale are demonstrated in Figure 4:

Figure 4

	Solutions	Mixed sales	Sideline sales
1	Spin off different business activities	Yes	Yes
2	Split contract	No	Yes
3	Separate accounting	No	Yes

Example 1:

An elevator company also provides installation services to customers. In the year, the total combined sales amount to 130 million. The cost of elevators is 100 million inclusive of VAT. The sale of elevators is subject to VAT at 17 percent and the provision of installation service is subject to business tax at five percent.

First of all, we check:

1. whether the supply of the goods and services constitutes a single activity, and
2. whether the taxpayer supplies both goods and the services to the same buyer.

Secondly, we should refer to the business scope of the taxpayer and check whether the taxpayer is engaged in production, wholesale or retail business.

Thirdly, check whether the sale of goods accounts for more than 50 percent of the taxpayer's total revenue.

Given that the answers to the above three questions are positive, the taxpayer should pay VAT, subject to the determination by the governing tax authority. A simple computation can show whether the taxpayer is better off by paying VAT instead of business tax. The percentage of value added including VAT, as denoted by (R) is:

(130-100) / 130 x 100 = 23.08.

At break-even point,

R / 1.17 x 17 = 5;

R = 34.41.

Since the actual percentage of value added is less than the break-even value added, it is advantageous for the elevator company to pay the VAT. We can perform checks below:

VAT payable = (130 / 1.17) x 17 – (100 / 1.17) x 17 x 17 = 4.36

If the taxpayer pays BT 130 x 5 = 6.5, it will be worse off by 2.14 = 6.5 – 4.36.

Example 2:

Same information as in above example but the total combined sale amount is 160 million

The percentage of value added including VAT (R) is:

(160-100) / 160 x 100 = 37.5.

At break-even point, R / 1.17 x 17 = 5; R = 34.41.

Since the actual percentage of value added is higher than the break-even value added, it is advantageous for the elevator company to pay the business tax at five percent. We can perform checks shown in Comparison 1 overleaf:

Comparison 1

R is < 34.41% <Example 1>	VAT sales > 50% of total revenue; Taxpayer should try to pay VAT.	VAT payable = [(130 / 1.17) x 17% – (100 / 1.17) x 17%] x 17% = 4.36 If the taxpayer pays BT (130 x 5% = 6.5), it will be worse off by 2.14 = 6.5 – 4.36.
R is > 34.41% <Example 2>	VAT sales < 50% of total revenue; Taxpayer should try to pay BT	VAT payable = [(160 / 1.17) x 17% – (100 / 1.17) x 17%] x 17% = 8.72 If it pays BT 160 x 5% = 8, it will be better off by 0.72 = 8.72 – 8.

If a company's business falls into the scope of mixed sale and the actual percentage of value added is lower than the break-even percentage of value added, it should try to keep the amount for the sale of goods more than 50 percent of the total combined sale amount. Example one shows that to pay VAT would be advantageous to the taxpayer. If the scale of installation business increases, the taxpayer may consider acquiring another business that is a VAT payer. If a company's business falls into the scope of mixed sale and the actual percentage of value added is bigger than the break-even percentage of value added, it should try to keep the amount for the sale of goods less than 50 percent of the total combined sale amount. Example 2 shows that if the taxpayer cannot keep the sale of goods at less than 50 percent of the combined sale revenue, it should consider transferring the installation business to a separate company and pay business tax at five percent by way of a spin-off or the creation of a new company.

Structuring the sales contract

The PRC Contract Law provides that ownership (or the legal title) of goods shall pass from the seller to the buyer at the time of delivery unless the law provides otherwise or the parties to the contract stipulate otherwise.[4] The obligations under a sale contract will inevitably include the delivery of goods and payment. The terms of payment in the contract will have impact on the VAT obligations for the seller. The taxpayer should clearly state the payment date in the credit sales contract. If the credit term is missing or not clearly stated, the VAT obligation will arise upon delivery of the goods to the buyer. The seller has to pay VAT immediately in the following month before receiving any payment from the buyer. The payment term can serve a dual purpose:

- it can postpone the seller's VAT obligation to later tax periods; and
- it can protect the seller from tax risks.

If the seller has not clearly stated that the sale is on credit and provides a fixed payment date in the contract, the tax authority may consider the sales to be on cash terms, in respect of which the VAT obligation should have arisen on the delivery day of goods. The seller's failure to declare VAT on time is an act of tax evasion, and that is subject to fines and penalties.

In addition to the payment terms, the type of contract will also have an impact on the VAT obligations for the seller. In the case of a credit sale, the seller can effectively put off the VAT obligation if he signs a consignment contract rather than a normal buy-sell contract. In the case of consignment contract, the VAT obligation only arises upon the day the principal receives the statement of consigned sales from the agent.[5] There is a loophole in the VAT rules whereby the taxpayer can fix the date when the he should receive the statement of consigned sales at his absolute freedom.[6] In a credit sale contract, the VAT obligation arises on the payment date whether or not the seller has actually received the payment from the buyer. Therefore it makes sense to write up a consignment contract if the seller and buyer are under common control of an ultimate owner or one legally controls the other. Alternatively, if the goods have been sold to a creditworthy third party who cannot settle the payment on the due date, the seller can postpone its VAT obligation by signing a consignment contract to replace the credit contract.

Timing for VAT obligations

The VAT obligation arises depending on the type of contract and the way of settlement, as provided in the sales contract. It may arise before the receipt of payment, on the same date as the payment or after the payment. It may also arise in the absence of any payment:

- on the agreed upon payment date irrespective of whether the buyer has made the payment;
- on the change of possession, a change in use or being given up as gift, as in the case of a deemed sale.

The timing for issuing VAT special invoice occurs on the same day as the VAT obligation does, as demonstrated in Figure 5:

Figure 5

	Obligation under VAT rules	Recognition of sales under the accounting rules
(a) Cash sale	Upon receipt of sales amount, or document that establishes the right to receive sales money	Sale recognized upon delivery and receipt of payment.
(b) Credit sale	Payment date per sales agreement; VAT obligation arises on payment date	Sale recognized upon delivery
(c) Sales on collection terms	Completion of collection formalities; VAT obligation arises before payment	Sale recognized upon delivery
(d) Sale by instalment	Payment date per sales agreement; VAT obligation arises on payment date	Sale recognized upon delivery
(e) Advance deposit	Upon delivery of goods; VAT obligation arises after the day of payment.	At day of delivery;
(f) Goods sold on consignment	Upon receipt of the "Statement of consignment sale" from the agent	On day of receiving statement of consigned sales

a. In respect of cash sales, the recognition of sales for accounting purposes, VAT obligation, and time for issuing tax invoice all occurs on the same day.

b. In respect of credit sales, the PRC accounting rules differ from the VAT rules. Sale is recognised under the accounting rules when the title to the goods passes from the seller to the buyer. The VAT obligation arises on the

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stipulated payment date and it occurs at a date later than that for accounting purposes.

c. The VAT obligation arises before payment.
d. The PRC accounting rules recognise the instalment sales upon the delivery of goods. If the sale agreement provides that the payment of sales amount is by instalments, the VAT rule shall only recognise the sales on the stipulated payment date.[7] The VAT rule recognises the sale at a later point in time than the accounting rule does.
e. The VAT obligation and the time for issuing invoices occurs at a later date than receipt of deposit.
f. The PRC accounting rules provide for two alternative treatments. The agent may record the transaction as if it was a sale in its books of accounts as a buy-sell agent. Alternatively, it may report a commission income and exclude the consignment sale from revenue as a commission agent. The VAT obligation arises when the principal receives the statement of consigned sales from the agent. It occurs at a point of time independently from the payment date.

Sales promotion

Price vs. quantity discount

Sales discount is deductible from the amount of gross sales if the information for the sales discount is included in the same VAT special invoice for the sale of goods. Separate invoices will not be acceptable for purpose of reducing the sales amount under the VAT rules.[8] Note that the VAT rules refer to the price discount not quantity discount. Goods supplied under quantity discount are not treated as sales under the PRC accounting rules, but are deemed to be sales (gifts) under the PRC VAT rules. In the case of sales promotion, the buyer is indifferent if he gets a buy-three-get-one-free offer or a 25 percent discount. However, the VAT impact on the seller is significantly different. Take a numerous example: if a certain good has a selling price of RMB100, the taxable base in the buy-three-get-one-free is RMB400 because the quantity discount is deemed to be a sale; the taxable base in a 25 percent price discount is only RMB300 (=400X75).[9] Therefore, the seller can save a lot in the price discount option.

Income tax incentives for transportation charges

The PRC government does not give any tax concession for foreign invested commercial enterprises (the FICE) that carry out wholesale or retail business because an FICE is not considered to be a production-type enterprise. However, a cargo transportation company is eligible for the two-plus-three income tax concession commencing from the first profit-making year because it is accepted as a production-type enterprise.[10] Therefore, it is worthwhile to set up a cargo transportation company if the carriage and flight charges accounts for a considerable portion of the operating costs. The income earned in the FICE can be shifted to the transportation company, which is entitled to the two-plus-three income tax concession. In addition, the domicile of the transportation company is not subject to any geographic restrictions in the PRC. It can be set up in areas subject to 15 percent income tax. If the retail business has to set up in cities where the income tax is imposed at 33 percent, then the transportation charges can be shifted to the transportation company in cities where the income tax is imposed at 15 percent. Note that the PRC Unified Enterprises Income Tax Law (the UEIT Law) will come into force as from January 1, 2008. The two-plus-three income tax concession will not be available thereafter. In addition, special economic zones will no longer enjoy the concessionary tax rate at 15 percent. Instead, the rate concession will only be granted to the industries and projects that receive principle supports from, and are encouraged by, the state. See Article 25 of the UEIT Law.

Transportation charges

The PRC VAT rules allow the deduction from the output VAT of freight costs relating to the purchase and sale of goods, subject to the following conditions being met:

- goods fall under the scope of VAT;
- the freight invoice must be issued by the company in the transportation business, or issued by the tax authorities in charge of the city where the transportation company is located, or issued by billing agency as approved by the local tax authorities at the provincial level.[11]

The input VAT is seven percent on the face amount of the freight invoice.[12] The seller has to examine three options relating to transportation charges from a VAT planning perspective:

- Suppose the seller can collect the transportation charges from the buyer, the VAT cost will be different in the following cases:
  - the seller who is not a transportation company does not issue an officially recognised freight tax invoice;
  - the seller obtains an officially recognised freight tax invoice from the transportation company and claim input credit;
  - the seller hands over the freight tax invoice to the buyer and does not claim the input credit.
- Who shoulders the tax burden of the transportation charges, or how the tax is to be shared by the buyer and seller respectively.
- Whether it is tax effective for the seller to operate a fleet of vehicles on its own or to establish a separate transportation company.

Collecting transportation charges from buyer

The seller can deliver the goods to the buyer in two ways: it can use its own fleet of vehicle to deliver the goods and collect the charges from the buyer; alternatively it can hire a third party transportation company to do so. There are three possible tax consequences for the seller collecting the transportation charges from the buyer:

- if the seller delivers the goods on its own but it cannot issue a recognised freight invoice, it has to pay VAT on the transportation charges collected from the buyer. Assuming that the transportation charge is RMB10,000, the VAT payable will be RMB1,452.99 (=10,000/1.17 x 17). Such charges fall into the scope of "charges additional to the selling price" provision and should be included in the VAT tax base;

- if the seller hires a transportation company, the seller can keep the freight invoice, and recover the charges from the buyer by including the charges into the sales amount. Given the same amount of RMB10,000 for transportation charges, the tax cost to the seller will be RMB752.99, which equals to (10,000/1.17 x 17) – (10,000 x 7). Note that the seller can get a deduction at seven percent on the face amount of the freight invoice. The seller cannot fully recover the tax costs and he is giving subsidies to the buyer in this case; and
- if the seller does not keep the officially recognised freight invoice and hands it over to the buyer, he can avoid the VAT on all the transportation charges. The seller will not bear any VAT. The PRC VAT rules provide that the transportation charges should be excluded from the selling price, subject to the following conditions to be satisfied:
  - the freight invoice is issued by the transportation company to the buyer and
  - the seller hands over the freight invoice to the buyer.[12]

  A comparison is provided in Figure 6:

Figure 6

Tax position assuming that the freight charge is RMB10,000

	Options	VAT payable = output VAT – input VAT
1	Using own vehicles to deliver the goods	(10,000/1.17) x 17% - 2,941x17% = 1,452.99 -500 = 952.99 (Assuming the amount for fuels, spare parts and repairs is 2,941.)
2	Hiring a transportation company to deliver the goods but keep the freight invoice	10,000/1.17 x 17% – 10,000 x 7% = RMB752.99
3	Hiring a transportation company to deliver the goods and handing over the freight invoice to the buyer	None

Option 3 incurs the lowest VAT cost. Option 2 incurs the moderate cost. It appears that Option 1 incurs the highest VAT cost if the assumption on the amount of input VAT holds. However, the seller earns a profit of approximately RMB5,605 = (10,000/1.17) – 2,941 on the provision of transportation services. Option 2 is simple for administration purposes. Option 3 may not work for two reasons:

- the seller is effectively trying to shift the VAT burden on the freight cost to the buyer since the buyer is to bear the transportation costs;
- the buyer wants to pick the transportation company on its own.

Who shoulders the VAT burden on transportation charges?

The seller sells goods for RMB100,000 including an inland transportation charge of RMB11,700. The seller pays VAT of 1700 (=11700/1.17 X 17) on the transportation fee collected from the buyer. The seller also pays the charges to the transportation company and receives the freight invoice from the transportation company. Therefore, the seller gets an input credit of 819 (=11700 X 7). The VAT burden for the seller is 1700 – 819 = 881. Suppose the seller is free to negotiate the VAT cost with the buyer. The following will be the possible outcomes:

- if the buyer is to bear all the VAT for the freight charges, the seller will receive 90,000 (=100,000 – 10,000) in cash after deducting the payment of freight charges net of the VAT;
- if the seller is to bear all the VAT on freight charge, he will receive only 89,119 (=100,000 – 10,000 – 881). The seller not only bears the freight charges but has to bear the VAT as well;
- if each party has some bargaining power over each other, the final selling price will not be settled on 90,000 or 89,119, but settled at anywhere between 90,000 and 89,119 instead.

Whether to set up a transportation company

Since the supply of non-taxable services and goods constitutes a mixed sale, the question is for the seller to evaluate whether it is advantageous to transfer the transportation activities to a separate company, or a branch, which is a profit centre with an independent accounting system.

If the seller owns a fleet of vehicles for the delivery of goods to the buyer, the seller has to recover the transportation charge in the sales amount. The seller will incur expenses of fuel, spare parts, repairs and maintenance, the VAT of which are deductible from the output VAT. If the seller spins off the transportation activities, it will get a subsidy or deduction at four percent on the freight charge. That is, the seller pays a three percent business tax on the freight income and gets a deduction at seven percent on the freight charge against the output VAT. It is worthwhile examining the difference so that the seller can make a decision on whether to spin off the transportation services. Assuming that the ratio for the fuel, parts, repairs and maintenance (called the consumables hereafter) to the full amount of freight charge is R, then the input VAT rate equals 17 x R. At break-even, 17 x R = 4 (*i.e.,* 7-3). Or alternatively R = 4 / 17 = 23.53 approximately. It means that the amount of input deduction as computed at 4 percent (*i.e.,* 7-3) on the full amount of transportation charges equals to the amount of input deduction as computed at 17 percent on the amount of consumables. An example will help illustrate the equation:

Example

The delivery section in company Y receives a transportation fee of RMB1,000 from the sales department in a given period. It is assumed that R equals to 23.53 percent, meaning that the amount of consumables for the goods vehicle of the delivery section is just about RMB235.30, and that the amount of input VAT will be RMB40 (=235.30 x 17) approximately. If company Y spins off the delivery section into a separate transportation company Z, the transportation company can issue a freight invoice to company Y, which can legitimately claim an input credit of RMB70 (=1,000 x 7). At the same time, the transportation company pays business tax of RMB30 at 3 percent (=1,000 x 3). Taken together, company Y and the transportation company Z get a deduction of 70-30=40.

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The same reasoning applies to the buyer with its own fleet of vehicle for use in buying goods. A company owns a fleet of vehicle for buying goods. It needs to pay RMB1,000,000 for transportation charges in a given period if it hires a transportation company to do so at the market rate. The accounting department reports that R is equal to 10 percent. That means the input VAT is 17,000 = 1,000,000 x 10 x 17. If the vehicle fleet is spun off to become a separate entity, the company can get freight invoices from the transportation company and get an input VAT of 70,000 = 1,000,000 x 7. The transportation company has to pay RMB30,000 business tax at three percent. Taken together, the company gets a 40,000 deduction. That is, 70,000 input credit for VAT purposes and 30,000 for business tax. The group as a whole will be better off by the amount of 23,000 = 40,000 - 17,000. It is advantageous to transfer the transportation business to a new company or set up a branch to deliver the transportation business. The spinning-off however is without limitations. It works only if the buyer is not subject to VAT (property development company, or a construction company for example), or if the buyer pays VAT, it only pays VAT for the purchase of non-taxable items like fixed assets. Otherwise, the buyer will become worse off by the same amount.

Planning for packing charges

VAT is imposed on the manufacturing, wholesaling, importing and retailing of goods within China. Consumption tax is imposed on the manufacturing, processing and importation of goods within China. Goods are not subject to consumption tax at the retail sector, with the exception for the sale of expensive jewellery including gold, silver, diamond, gems.[14] The difference in tax rules provides business enterprises tax planning opportunity. Let's examine the following examples:

A type of cosmetic goods, for which consumption tax is imposed at 30 percent, is quoted at different prices excluding VAT: ex-factory 100, wholesale 200 and retail 500. The wholesale and retail company performs the bulk-breaking and packing function. The factory has the option of:

1. selling the goods direct to the buyer at 500, or
2. selling the goods to wholesale and retail companies it creates for distribution to the consumers.

Option 1 – If the factory sells the goods direct, the VAT and CT payable will be:

VAT = 500 x 17 = 85; CT = 500 x 30 = 150

Total taxes will be 85 + 150 = 235.

Option 2 – If the factory sells the goods to the sales company for re-sales to buyer, the VAT and CT payable will be:

VAT = (500-200) x 17 = 51; (200-100) x 17 = 17, (100-0) x 17 = 17 (assuming no input VAT)

VAT = 51+17 + 17 = 85; CT = 100 x 30 = 30

Total taxes will be 85+30 = 115

The reason for the tax saving in Option 2 is that cosmetic products are not subject to consumption tax at the wholesale and retail sector. If the sales company breaks the bulk, packs and distributes the goods to the consumers, it will not attract consumption tax.

The point of collecting VAT and CT is shown in Figure 7:

Figure 7

	VAT	Consumption Tax (CT)
Manufacturing	Yes	Yes
Contracted processing	Yes	Yes
Wholesaling	Yes	No
Retailing	Yes	No, except for expensive jewellery, diamonds and gems
Importation	Yes	Yes

Planning for taxable items

A factory sells lipsticks for 200, lotion 200, skin care cream 150, and packing 150. Those items are packed in a complete set for sales. To sell the whole set for 700, the factory can:

- do it on its own, or
- set up a FICE trading company to sell the sets.

VAT is imposed at 17 percent and CT is imposed at 30 percent on cosmetic products. The VAT and CT are imposed as follows:

Option 1 – Output VAT = (700 x 17) = 119 (ignoring input VAT)

CT = 700 x 30 = 210;

Total taxes = 119 + 210 = 329

Option 2 – Set up a trading company to buy each item from factory separately and do the packing, turning the purchased items into a whole set of beauty products.

Output VAT = 700 x 17 = 119; CT = 200 x 30 + 200 x 30 = 120

Total taxes = 119 + 120 = 239

There is a tax saving of 329-239=90. The reason is two fold: (i) there is no imposition of consumption tax at the retail level, (ii) skin care product are no longer subject to consumption tax with effect from 1st April 2006.[1]

1 If the seller footnotereferenceunderstands the points of imposing the taxes and the scope for taxable and non-taxable items, it can avoid paying more taxes than it could have been.

Since skin care cream and packing materials do not fall into the scope of consumption tax (CT), separating the businesses can save CT by 90. That is, 329-239=90 or (150+150) x 30.

Use of sales company or agent

VAT

A foreign investment enterprise (the FIE) can choose whether the subsidiary FICE acts as a "sales company" or a commission agent. The VAT consequences are different for different way of distributing the goods. An example is used as illustration:

Option A: The selling price of a product is RMB1,000. For each product sold, the subsidiary receives a commission of RMB200.

Option B: the subsidiary buys the products from the FIE at RMB800 each piece of product. The following illustrates that the "sale company" option is more tax efficient. Remember that VAT is not double tax in nature since the VAT rules provide for input credit, but business tax is double tax since it does not have input credit, in the absence of specific provisions.

These are illustrated in Figure 8:

Figure 8

	Sales Company (Option A)	**Commission agent** (Option B)
1	VAT (FIE) = 800 x 17% = 136 VAT (Subsidiary) = (1000 – 800) x 17% = 34	VAT (FIE) = 1000 x 17% = 170. VAT (FICE) = 1000 x 17% - 1000 x 17% = 0
2	Nil	Commission is subject to business tax (200/1000) / 100% = 20% = 1000 x 20% * 5% = 10
3	Total taxes 136 + 34 = 170	Total taxes 170 + 10 = 180

There is a difference between the PRC accounting rule and the VAT rules. Under option B, the FIE (principal) has to issue VAT special invoice to the FICE (agent). In turn, the FICE has to issue VAT special invoices to the buyer. The deemed sale provision in the VAT rules provides that the both the principle and the agent has to issue tax invoice even if there is no transfer of legal ownership.[15] The PRC VAT rules treat the branch to be an entity on its own.Where the transaction is structured as a consignment contract, the PRC accounting rules provide for two alternative treatments. The agent (FICE) may record the transaction as a sale in its book of accounts. It may also report a commission income and exclude the consignment sales from revenue.[16] If the FICE records the transaction as a sale in the income statement, the form of the accounting treatment departs from the substance of the transactions even though there only exists a principle-agent relationship between the two parties. That is typical case in the wholesale business in China.

Income tax

The existing FIE may establish a subsidiary to carry out the wholesale or retail business in other cities. The source of the goods for sales in the foreign invested commercial enterprises (the FICE) may have different income tax implications. It may be produced by the FIE its self; it may also be purchased from third party for re-sale by the FICE.[17] A production type FIE can set up the sale company (the FICE) in other cities. If the production type FIE produces the goods and then sells the same goods through its subsidiary sales company created in other provinces or cities, the income tax of the sales company will be imposed at the same rate as the production type FIE irrespective of where the sale company is located.[18] For example, a production type FIE located in Shenzhen where income tax is imposed at 15 percent sets up a sales company in Guangzhou where income tax is imposed at 33 percent. The sales company can pay income tax at 15 percent. If the Shenzhen production FIE purchases the goods from a third party and re-sells them to the FICE in Guangzhou, the FICE is not entitled to make use of the tax concession and has to pay income tax at 33 percent. Note that the location tax incentive for special economic zones will be revoked upon the commencement of the UEIT Law on January 1, 2008. Production type FIE created after December 31, 2007 will be affected.

Goods transferred from FICE to branch

Legal and tax definition on entity

The PRC legal rules provide that a branch is not a legal entity. The head office, which is a legal entity on its own, shall assume the civil debts for the branch.[19] However, the PRC tax rules, as part of the administrative law, have different definitions about what an entity is, as defined under the PRC civil law. One example is the provision of a deemed sale in the PRC VAT rules, which provides that the transfer of goods from head office (a legal person) to the branch (a non-legal person) is considered to be a sale.[20] The VAT obligations can arise only from a change in possession of the goods without a change in the legal ownership. A second example is that where the FIE/FICE file a consolidated income tax return, the head office and the branch shall compute the income tax at rates applicable in their respective locations.[21] A third example is that the taxpayer who supplies taxable services under the PRC business tax rules includes a branch whether or not it is operating as independent accounting unit.[22] A branch located in another city should apply for a branch business llicence in accordance with the company law and regulations,[23] and apply for the national and local tax registrations respectively within 30 days of obtaining the branch business llicence.[24]

Contractual capacity

The branch has the capacity to enter into contracts. A branch, classified as "other organisations" under the PRC Contract Law, can enter into trading contracts with a party inside the PRC, but the PRC legal rules impose limitations on the contractual capacity of the branch. First, the business scope of the branch must not exceed that of the head office.[25] In addition, the contractual capacity of a branch is limited to domestic trading transactions. Chinese customs do not accept a branch as the consignor or the consignee for purpose of customs registrations. Instead, the Chinese customs rules require the head office to handle the declaration for its branch.[26] This is so even if the branch can carry on foreign trade in its own name under the provision of the PRC Foreign Trade Law.[27]

VAT

If the goods are physically transferred from the head office to the branch for sales to third parties later, there are several compliance issues:

- whether or not a VAT obligation will arise.
- if there is VAT liability, which tax authority has the jurisdiction to collect the VAT;
- if the branch sells the goods in another city, at what price the goods are to be transferred from the head office to branch; and
- if the head office is to pay the VAT because it either issues VAT invoices or receives payment from the branch, whether it can defer the VAT liabilities.

It is worthwhile analysing these issues below.Whether there is any VAT laibility

The change in possession of the goods between the head office and the branch will attract VAT liabilities if either one of the following situations occurs:

- the head office receives payment from the branch; or

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- the head office issues the VAT special invoice to the branch.

VAT liabilities arise even though there is no change in the ownership for the goods from a legal point of view. In view of this, some taxpayers find it more tax-efficient to maintain storage facilities or distribution hubs in cities throughout China without doing any branch registrations.

Jurisdiction over the VAT taxpayer

The taxpayer shall submit VAT returns and pay the VAT to the tax authority having jurisdiction over the city where its office is located. If the FICE sets up a branch in other cities or counties, both the head office and the branch should collect the VAT from the buyer and pay VAT respectively to the tax authorities in the cities where their offices are located.[28] This is because if the head office and the branches are established in different cities, they come under the jurisdictions of different tax authorities. When goods are dispatched from the head office to the branch for sales, or from one branch to another, the following legal issues will arise: it may trigger the deemed sale provision under the PRC VAT rules. If it does, the head office owes a duty to pay VAT. When the branch later sells the goods, it is required to pay VAT as well. If not, the branch has no VAT obligations, subject to certain conditions being satisfied. This point will be discussed when we deal with the income tax issues below. Note that no VAT obligation will arise where the goods are dispatched to a branch located within the same city as the head office.[29]

Transfer pricing

If the branch has the obligation to pay VAT in the city where it is located, the head office shall issue a VAT special invoice to the branch for the transfer of goods and pay the VAT as well. The PRC VAT rule provides that in the absence of information on the selling price, the transfer price shall use the following prescribed methods in descending order:

the average price for goods of similar category in the current month;

the average price for goods of similar category during the recent three-months; and

cost x (1 +10 deemed profit).[30]

Where the head office is subject to income tax at 15 percent while the branch is subject to income tax at 33 percent, it pays for the head office to set a higher selling price than the 10 percent deemed profit rate.

When the VAT obligation arises

Assuming that there is no difference in income tax rate between the head office and the branch, if the branch has to sign the sales contract, the branch collects the VAT from the buyer and pays the VAT in the city where it is located. The head office needs to collect the VAT from the branch and pay the VAT accordingly. However, the computation method of VAT payable will have significant impact on the cash flow, depending whether or not the goods are shipped to the branch under a consignment contract.

An example may serve to illustrate the issues:

Goods amounting to CNY99,000 (excluding VAT) are transferred from the head office to the branch for re-sale at a mark up of 10 percent. The branch sells some of the goods for CNY 50,000 at the end of the current month. The head office has paid 40,000 for the purchase of the goods.

If the head office and branch report the VAT on normal terms, the overall VAT payable for the head office and branch will be as shown in Figure 9:

Figure 9

Head office	VAT payable = (99,000 – 40,000) x 17% = 10,030
Branch	VAT payable = (50,000 – 99,000) x 17% = - 8,330 (debit balance)
Total VAT	10,030+0 = 10,030 (debit balance shall be carried over to next month)

The branch has no VAT liability and the debit balance is carried over to next month for offsetting output VAT. But the head office has to pay 10,030 to settle its VAT obligations for the current month.

Deferral of VAT liability

If the head office and branch report the VAT to be consigned sales, the overall VAT payable for the head office and branch will be as shown in Figure 10:

Figure 10

Head office	[50,000 /(1+10%) – 40,000] x 17% = 927.27
Branch	[50,000 – 50,000/(1+10%)] x 17% = 772.73
Total VAT	927.27+772.73 = 1,700

The use of consigned sales contract brings along two benefits to the taxpayer. One can see that if the transaction is conducted under normal sales terms, the VAT payable is computed on the whole amount of goods transferred to the branch irrespective of whether the goods have been sold or not. If the transaction is structured under a consignment contract, the head office shall compute the VAT payable on the amount shown on the “statement of consigned sales”. The amount of VAT payable on the consigned sales will be less than the amount of VAT on the goods dispatched to the branch since the amount is computed on sales in respect of which profits have been realised, but not on the total amount of goods dispatched to the branch. The head office retains the legal title to the unsold goods kept at the branch without incurring VAT liabilities. The other benefit is that the taxpayer can effectively postpone its VAT liability to the future. If the transaction is conducted without specific payment terms, the VAT liability shall arise upon the day the goods are delivered to the branch. If the goods are delivered to the branch as consigned goods, the head office need not pay VAT until it receives the statement of consigned sales. It is entirely at the taxpayer’s discretion to fix a date on which the branch should provide the head office with the statement of consigned sales. This has been a loophole in the PRC VAT rules since they came into force in 1994. Note that the tactics for the deferral of VAT liability has now been challenged. The State Administration of Taxation has specifically issued a notice that the VAT obligation shall arise upon the receipt of sales proceeds or the receipt of statement of consigned sales from the branch, whichever is earlier. Where the head office has not received the statement of consigned sales or the sales money within 180 days from the date on which the goods are delivered from the head office to the branch, the goods are deemed to have been sold and the VAT obligation arises on the 180th day.[31]

Income tax plan

It makes no difference where VAT is paid since the PRC VAT rules apply uniformly throughout the country, but there are differences in income tax since the income tax rates are not the same in different locations within the PRC. If the head office pays income tax at 15 percent and the branch pays income tax at 33 percent, then there is a good reason for the business to be structured in a way that the branch should avoid paying the VAT. It is particularly relevant for the FIE/FICE to carry on the wholesale business. However, the branch must pay VAT on its own at its place of business if it is doing retail business.

The VAT may be payable at the city the branch is located or at the city where the head office is located, depending on how the taxpayer structures the transfer transaction. If the head office transfers the goods to the branch, there is no obligation for VAT, subject to two conditions being met:

- the branch does not issue tax invoices to the buyer, and
- the branch does not receive the payment from the buyer.[32]

Whether the head office or the branch shall pay the VAT, in turn, depends on who signs the sales contract with the buyer. If the branch later signs the sales contract for the sale of goods under its own name, the branch shall issue the tax invoice and pay the VAT. In this case, the head office shall also issue a tax invoice to the branch. If the head office signs the contract and sells the goods to the buyer in the city where the branch is located, there is no VAT liability for the branch. Instead, the head office shall issue the tax invoice to the buyer and pay the VAT. Where the head office reports all the sales, it only pays income tax at 15 percent. This arrangement works until the end of 2007 when the PRC Unified Enterprises Income Tax Law comes into force.

Rules on the use of tax invoices

When there is a need for the branch to issue a VAT special invoice or an ordinary tax invoices (tax invoices), the FIE/FICE must comply with the PRC legal rules on the use of tax invoices, whether they are engaged in wholesale or retail business activities. The PRC legal rules do not allow blank tax invoices to be carried by hand or delivered by any means of transportation from one province to another, or from one municipality directly administered by the State Council to another directly administered municipality.[33] The use of tax invoices purchased from the tax authorities located at the cities of other province or municipality will invite administrative punishment.[34] If the branch is located in a different city but within the same province or municipality as the head office, it must obtain administrative approval from the tax authority such that the blank tax invoices can be hand-carried or delivered from the head office to the branch for its use.[35] In the absence of such approval, the branch is required to purchase tax invoices from the tax authority where the branch is located. In this connection, one must check with the tax authorities whether the transportation of tax invoices across cities within the same province is lawful or not.[36]

Where there is a need for the branch to issue VAT special invoice, the branch has to purchase the VAT special invoices from the tax authority in charge and issue the invoice to the buyer on its own. Otherwise, the head office shall sign the sale contract and issue the VAT special invoice. Note that if the branch signs the contract and the head office issues the VAT special invoice, it is in violation of the VAT rules and the branch will get punished for "inviting other parties to issue VAT special invoice on its behalf", which comes under the charge of the improper use of a tax invoice.[38] The taxpayer must follow the legal rules on the use of tax invoices.[37]

Centralised accounting and billing function

The document Guo Shui Fa 137 (1998) issued by the State Administration of Taxation provides for two conditions under which the deemed sales provision does not operate regarding the transfer of goods between the head office and branches situated in different cities:

- the branch does not issue tax invoices to the buyer, and
- the branch does not receive the payment from the buyer.

Note that the PRC VAT rules prohibit the taxpayer from using tax invoices across provinces or municipalities directly administered by the State Council. If the branch receives payment from the buyer, it must purchase the VAT invoice from the tax authority and issue it to the buyer. Where the head office signs sales contract with the buyer, the Chinese tax rules do not prohibit the head office from collecting payment from the buyer in other provinces or municipality. The buyer, located anywhere in the country, can make payment to the bank account held under the name of the head office. Note that the head office can transfer the sales money received to other bank accounts but it is not allowed to draw cash from the bank account opened for that particular purpose. This arrangement for billing and settlement across cities and provinces does not give rise to VAT liability. The jurisdiction over the levy and collection of VAT is divided between the tax authorities in charge of the head office and the branch respectively. The head office shall pay VAT to the tax authority at its place of business.[39] The conditions set out in SAT document 137 (1998) do not apply. Note that the centralisation of the accounting and billing (issuing tax invoices) function only works well for wholesale business. It does not work for retail business since the retail branches are required to issue tax invoice at the place of business.

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1 In the numerical example, sale is 250 and purchase is 200. The percentage of value added is R = (250 – 200)/250 x 100 = 20. Substituting R in the example, VAT = 250 x 17 x 20 = 8.5 for the general taxpayer.

2 See Article 5 of the Detailed Implementation Rules for PRC VAT Tentative Regulations, issued by the Ministry of Finance on December 25, 1993.

3 See Document Cai Shui Zi 26 (1994), jointly issued by the Ministry of Finance and the State Administration of Taxation.

4 The National People's Congress, Article 133 of the PRC Contract Law, March 15, 1999.

5 See Article 33(5) of the Detailed Rules for PRC VAT Tentative Regulations, issued by Ministry of Finance, December 25, 1993.

6 The loophole was plugged by the document Cai Shui 165(2005) issued jointly by the Ministry of Finance and the State Administration of Taxation on November 28, 2005. If the principle has not received the statement of consigned sales within 180 days from the dispatch of goods, the goods are deemed to be sales on the 180th day following the delivery date.

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7 The State Administration of Taxation, document Guo Shui Fa 192 (1995), 1995.

8 The State Administration of Taxation, document Guo Shui Fa 154 (1993).

9 Note that both the amount of RMB400 and RMB300 should have been divided by 1.17 because both of them are quoted inclusive of VAT. The seller in the retail business cannot issue to the consumer a VAT special invoice, which separately record the sales amount and the VAT. See Article 21 of the PRC VAT Tentative Regulations.

10 The State Council, Article 72 of the Detailed Implementation Regulations on the PRC Tax Law for Foreign Investment Enterprises and Foreign Enterprises, June 30, 1991.

11 See Document Guo Shui Fa (2003) 121, issued by the State Administration of Taxation on October 17, 2003.

12 See Document Cai Shui Zi (1998) 114, jointly issued by the Ministry of Finance and State Administration of Taxation on June 15, 1998.

13 Ministry of Finance, article 12 of the detailed implementation rules of the PRC VAT Tentative Regulations, Dec 25, 1993. Note that it is a legal requirement for the buyer to get the freight/carriage invoices for accounting and tax computation purposes.

14 See Circular (94) Cai Shui Zi 095, issued by the Ministry of Finance and State Administration of Taxation on December 24, 1994.

15 The Ministry of Finance, “Article 4 of the Detailed Implementation Rules of the PRC VAT Tentative VAT Regulations”, December 26, 1993.

16 The Ministry of Finance, Cai Hui (2000) 25, December 29, 2000.

17 The Ministry of Commerce, Order 9 (2005). The PRC government allows production type FIE to amend its scope of business to buy and sell third party goods in the wholesale and retail sector. Foreign investor can make a choice between expanding business scope of an FIE or setting up new FICE. The proportion of sale to total combined sales is limited to 30 percent only.

18 See SAT document, Guo Shui Fa 049(1997).

19 The National People’s Congress, the PRC Company Law, article 14, amended on January 1, 2006.

20 Either the issue of VAT special invoices to the branch or the receipt of payments from the branch will suffice. See article 4 of the Detailed Implementation Rules for the PRC VAT Tentative Regulations and document Guo Shui Fa 137 (1998) issued by the State Administration of Taxation.

21 See articles 91, 92 and 93 of the Detailed Implementation Regulations of the PRC Income Tax Law for the Foreign Investment Enterprises and Foreign Enterprises, promulgated by the PRC State Council on June 30, 1991. Note that the Implementation Regulations will be repealed on January 1, 2008 upon the commencement of the PRC Unified Enterprises Income Tax Law on the same date.

22 Ministry of Finance, Detailed Implementation Rules of the PRC Business Tax Tentative Regulations, Article 11, 2December 25, 1993.

23 See article 48 of the PRC Administration Regulations on Companies Registration, promulgated by the PRC State Council on December 18, 2005.

24 See article 15 of the PRC Tax Levy and Administration Law and article 12 of the Detailed Implementation Regulations of the PRC Tax Levy and Administration Law.

25 See article 47 of the PRC Administration Regulations for the Registration of Companies, as amended by the State Council on December 18, 2005.

26 General Administration of Customs, Order 18, 2005.

27 See article 8 of the PRC Foreign Trade Law, promulgated by the National People’s Congress on May 12, 1994 and amended on April 6, 2004.

28 See article 22 of the PRC VAT Tentative Regulations, issued by the State Council on November 26, 1993.

29 See article 4 of the Detailed Implementation Rules for the PRC VAT Tentative Regulations.

30 Note that the VAT rule provides that transfer price between the head office and the branch should not be less than 10 percent on costs. See article 16 of the detailed implementation rules for the PRC VAT Tentative Regulations issued by the Ministry of Finance, and the State Administration of Taxation, document Guo Shui Fa 154 (1993).

31 Please see document Cai Shui 165 (2005), jointly issued by the Ministry of Finance and State Administration of Taxation.

32 See document Guo Shui Fa 137 (1998) issued by the State Administration of Taxation.

33 See article 27 of the Administrative Measures on the Administration of Tax Invoices, as issued by the Ministry of Finance on December 23, 1993.

34 The FIE/FICE will be subject to a fine not exceeding CNY10,000. See article 37 of the Administrative Measures on the Administration of Tax Invoices, as issued by the Ministry of Finance on December 23, 1993.

35 See article 26 of the Administrative Measures on the Administration of Tax Invoices, as issued by the Ministry of Finance on December 23, 1993.

36 The practices vary from province to province. The tax authority at Guangdong province permits the transportation of blank tax invoices across cities within the province subject to administrative approval. The tax authority in Jiangzu province does not permit the transportation of blank tax invoices across cities in the same province.

37 See the discussion on “Legal and Tax Issues on Commodity Trading in the PRC”, *Tax Planning International Asia Pacific Focus*, August 2006.

38 See Article 25, Administrative Measures on the Administration of Tax Invoices, as issued by the Ministry of Finance on December 23, 1993.

39 See document Guo Shui Han 802 (2002) issued by the State Administration of Taxation on September 3, 2002.