

Tax Planning International Asia-Pacific Focus

International Information for International Businesses

Tax and Business Information for the Asia-Pacific Region

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First published in BNA International's
Tax Planning International Asia-Pacific Focus, May 2007



www.bnai.com

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The Chinese government has fully opened up the foreign trade sector and domestic distribution sector to foreign investment since December 2004. This article aims to provide some guidance for the foreign investor who would like to run a trading business in the PRC. The structure of this article is divided into two parts: compliance and planning. The first part includes a brief introduction of PRC VAT rules including output VAT, input VAT, general taxpayer and small-scale taxpayer. It also covers the scope of VAT and business tax, tax invoices, revenue recognition and measurement. The second part covers some effective tactics of saving VAT as well as other taxes. Finally this article ends with a lengthy discussion on various tax planning techniques on trading goods between the head office and the branches created elsewhere in the country.

The legal and tax rules for conducting trading business in special economic areas have been dealt with in another article.¹

Computation of VAT Payable

There are two ways of computing the amount of VAT payable: the simple computation method and the general computation method as shown in Table 1.

Table 1

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

There is no input credit under the simple computation method. Taxpayers who are classified as small-scale taxpayers shall use the simple computation method to pay the VAT at the levy rate at six percent (four percent for non-production enterprise). The general VAT taxpayer pays the VAT at the standard rate of 17 percent, and is entitled to offset the input VAT against the output VAT. The general taxpayer may also adopt the simple computation method to compute the VAT payable for the supply of certain specified goods if they find it to be advantageous to do so.² It is noted that the PRC VAT rules provides for a variation on the general computation method. Where the taxpayer who can satisfy the conditions for a general

taxpayer has not submitted the application for recognition as a general taxpayer, the VAT liability is ascertained as per the output VAT without the deduction of the input credit.³

Types of VAT Taxpayers

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

Example

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

Table 2

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

In the example in Table 2, the VAT payable is 85,000. The taxpayer is eligible for input credit if it has acquired the status of the general taxpayer. If it has not, the taxpayer has to pay VAT of CNY340,000.

Recognition as General Taxpayer

To get recognition as a general taxpayer, the taxpayer has to satisfy the following requirements:

1. the annual turnover must exceed one million if the taxpayer is engaged in production activities, or exceed 1.8 million if the taxpayer is engaged in wholesaling and retailing activities;
2. the ordinary taxpayer must hire staff holding a valid accounting licence; and
3. keep books of accounts in sufficient details so that the tax authority can ascertain the amount of output VAT, the input VAT and the amount of VAT payable;⁴

- the taxpayer has the facilities (such as a safe) for the custody of tax invoices;
- the taxpayer should have signed a lease agreement or own office premises showing that it has a place of business (flats for residential use are not acceptable);
- the taxpayer should submit to the governing tax authority a written application form and other information as required by the governing tax authority.

Note that the taxpayer's annual turnover encompasses the amount of export sales and domestic sales. The following constitutes 'a sale within the territories of China' within the context of the PRC VAT rules:

- the place of dispatching goods is located within the territories of China;
- the goods are warehoused within the territories of China.⁵

Note also that the tax authority will not grant the status of general or ordinary taxpayer automatically even though turnover exceeds one million (or 1.8 million) in a year. The amount of turnover is a necessary but not a sufficient condition. The taxpayer has to pay output VAT on sales amount at 17 percent, and cannot claim input credit in either one of the following situations:

- the taxpayer whose sales revenue exceeds one million in the year (or 1.8 million for non-production taxpayer) does not submit application for recognition of general taxpayer status, or
- the taxpayer has not maintained a sound accounting system or kept books of account in sufficient details for the output VAT, the input VAT and the amount of VAT payable.⁶

Newly Incorporated Trading Company

Newly incorporated trading companies are subject to different administration under the tax authorities for the grant of general taxpayer status, depending whether they are classified as large or small commercial enterprises. Large commercial enterprises are defined as those who have a registered capital of no less than CNY5 million, and have a staff of no less than 50. Commercial enterprises that cannot meet the above-mentioned criteria are small commercial enterprises. A large commercial enterprise upon application can acquire the status of the general taxpayer commencing from the date of incorporation. A small commercial enterprise operates as the small-scale taxpayers from the date of incorporation until its turnover reaches CNY1.8 million. After submitting the application for getting recognised as general taxpayer, the small commercial enterprise will enter into a six-month supervision period. During the supervision period, the small commercial enterprise attains the status of the general taxpayer meaning that they can purchase, install and use the anti-forgery tax control system, including the purchase and issue of VAT special invoices in the same way as the general taxpayers.⁷ The small commercial enterprise that operates as general taxpayer during the supervision period is subject to the restrictions imposed by the tax authorities on the following:

- the quantity of VAT special invoices it can purchase from the tax authority in charge shall not exceed 25 sets, and
- the maximum amount of sales that it can print on each VAT special invoice with the anti-forgery tax control system shall not exceed CNY10,000.

Where the supervision period is over, the tax authorities in charge will raise the above-mentioned restrictions taking into account the scale of business of the small commercial enterprise.⁸

Purchase of VAT Special Invoices

All types of taxpayer shall purchase the tax invoices at the tax branch or office in-charge. General VAT taxpayer can purchase from the tax office both VAT special invoices and ordinary tax invoices for own use, depending on the type of goods sold and the tax status of the buyer. The small taxpayer cannot purchase from the tax authorities the VAT special invoice for own use. If the small-scale taxpayer wants to sell goods to general VAT taxpayers, the small-scale taxpayer may request the governing tax office to issue the VAT special invoice on its behalf, which is to be provided to the buyer.⁹ The production-type small taxpayer obtains the VAT special invoices after paying six percent VAT at the tax office. The small taxpayer classified as a commercial enterprise pays four percent VAT at the tax office. Note that the purchase of any type tax invoices from parties other than the tax bureau in charge is in violation of the PRC legal rules.¹⁰

Use of VAT Special Invoices

The PRC VAT rules do not permit the use of VAT special invoices for the following transactions:¹¹

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

Taxpayer's status and use of tax invoices is demonstrated in Table 3.

Table 3

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

The application of the legal rules on the use tax invoices is not always straightforward. Take the sales of goods for example. First, one must consider the tax status of the buyer:

- if the buyer is a small-scale taxpayer, the seller needs to issue ordinary tax invoices;
- if the buyer is a supplier of non-taxable services (such as a construction company, a property development

company or an advertising company, etc.),¹² the seller should issue ordinary invoices.

Second, one must consider the type of goods the taxpayer sells. Where the taxpayer is a seller of tax-exempt goods or certain prescribed goods, the taxpayer should issue ordinary tax invoices.¹³ Third, one must consider the use of the goods. Where the buyer is a VAT general taxpayer, it depends on whether the goods are to be treated as stock-in-trade or fixed assets. If the goods are treated as stock for re-sale, the seller should issue VAT special invoices. If the goods are to be used as fixed assets, then the seller should issue ordinary tax invoices in general. Fourth, one has to consider whether the buyer is the consumer. If they are consumers, the seller cannot issue VAT special invoices. The VAT rules do not allow the use of VAT special invoices if the retailer sells goods to the consumer. However, where the buyer is a corporation, the retailer can either issue an ordinary tax invoice or VAT special invoices. If the corporation is a VAT general taxpayer, the retailer should issue VAT special invoices upon request. Fifth, where the buyer carries on business activities falling under the encouraged category, the buyer is entitled to a refund for the VAT paid on the purchase of domestically manufactured capital equipment. The seller of vehicles, vessels, boilers, machinery and equipment should issue VAT special invoices upon request from the buyer.¹⁴

VAT and Business Tax

Table 4 demonstrates the scope of VAT and business tax.

Table 4

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

Tax Invoices and VAT Liability

The general VAT payer in the retail sector must issue to consumers ordinary invoices. The invoiced value includes the amount of sales and VAT. But unlike the VAT special invoice, those two amounts are not separately shown in the ordinary invoice. Note that the use of ordinary tax invoices does not mean that the retailer has no output VAT liability. The two issues are independent from each other. For example, a large retailer is a general taxpayer but it is not allowed to issue VAT special invoices to the consumer. The general taxpayer shall compute the output VAT in the following way:

$$\text{VAT} = \text{invoiced value} / (1 + \text{standard rate } 17 \text{ percent}) \times 17 \text{ percent.}$$

If invoiced value inclusive of VAT is CNY100, then the sales amount and the output VAT shall be:

$$\text{CNY}85.47 = (100/1.17) \text{ and}$$

$$\text{CNY}14.53 = (100/1.17 \times 17 \text{ percent}) \text{ respectively.}$$

VAT on Service Charges

Note that for some service fees charged in connection with a trading transaction, the taxpayer is not required to issue and use VAT special invoices, which show the sales amount and

VAT separately. One example is the refundable deposit received for containers or packing cases. However the PRC VAT rule provides that if the deposits are not refunded to the buyer within a period of 12 months, they are deemed to be sales. In that case, the taxpayer is required to convert the deposit into the sales amount and VAT separately. If a deposit of CNY100 is received for a period exceeding 12 months, then the amount of deemed sales shall be CNY85.47 ($=100/1.17$) and VAT payable shall be CNY14.53 ($=100/1.17 \times 17 \text{ percent}$) respectively. Where the ordinary taxpayer pays VAT at levy rate using the simple computation method or the small taxpayer issue ordinary invoice, the sale amount also needs to be converted from the invoiced amount as follows: sales amount = invoiced amount / (1 + levy rate).¹⁵

Where the selling price includes the transport charges, the general taxpayer has to pay VAT at 17 percent in spite of the fact that the provision of delivery services falls under the scope of business tax and is subject to tax at three percent. If the transport charge is CNY100, the output VAT for the seller shall be computed as: $100 / (1 + 17 \text{ percent}) \times 17 \text{ percent} = 14.53$. The amount of input VAT will be computed at 17 percent on the sum of the following: fuel costs, the repairing and maintenance costs of the vehicles used for the delivery of the goods. If the seller's price does not include the transport charge, the seller can forward to the buyer the freight tax invoices issued to the buyer by the transportation company.¹⁶

Input VAT

General Provisions

The amount of VAT paid by the general taxpayer on the purchase of goods and taxable services is the input VAT. Small-scale taxpayer is subject to VAT at levy rate and not allowed to deduct input VAT from output VAT. The scope of deduction of input VAT from output VAT is restricted to the following two situations:¹⁷

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

Special Deductions Against Output VAT

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

1. If the ordinary taxpayer purchases VAT-exempt agricultural produce, it can get a 10 percent notional input credit;¹⁸
2. If the ordinary taxpayer pays inward and outward transportation charge (excluding the loading and unloading charges), it can claim an input credit at seven percent on the amount of invoice issued by companies in the transportation business.¹⁹ Note that this special deduction is permitted if: (a) the freight charges are not paid for the purchase of non-taxable items (like fixed assets); and (b) the freight charges are not incurred in

connection with the purchase and sale of VAT-exempt goods;

3. The purchase by the ordinary taxpayer from companies in the business of collecting second hand articles and waste items. The taxpayer gets a 10 percent input credit on the invoiced value.²⁰

Disallowed Input VAT

The input VAT is not allowed to offset the output VAT under the following situations:²¹

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

There is an exception. The purchase of certain capital goods in eight prescribed industry sectors located in the North-eastern part of China is eligible for deduction against the increase in output VAT of current year over that for the preceding year.²²

Ascertainment of Input VAT

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

Certification of Suppliers Tax Invoices

To obtain deduction against output VAT, the taxpayer who receives the VAT special invoice from the supplier should submit the invoice to the tax authority for statutory certification within 90 days from the issuing date. The amount of input credit is deductible from the amount of output VAT in the month where the taxpayer has completed the certification procedure at the tax bureau. If the taxpayer fails to submit the incoming VAT special invoices to the tax authority within 90 days or the taxpayer does not include the input VAT amount into the VAT returns for the month in which the VAT special invoices have passed the certification, the taxpayer is not entitled to claim input credit.²³ The taxpayer can legitimately claim input credit irrespective of whether it has paid the seller or has accepted the bill of exchange drawn on it by the seller. Previously the input credit was granted either on the goods received basis or on the payment received basis.²⁴ As from March 1, 2003, the taxpayer who receives VAT special invoices from the supplier for domestic purchases must complete the certification at the tax bureau within 90 days from the issuing date, and include the certified amounts into the monthly VAT returns. As from

February 1, 2004, the taxpayer who imports goods from outside the PRC must submit the customs tax payment certificate to the tax authority for certification within 90 days from the issuing date, and include the certified amount into the monthly VAT returns. The comparison between the old rules and the new rules shown in Table 5 may help illustrate the different time for the taxpayer to claim the input credit.

Table 5

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

It is possible that they buyer may fail to complete the certification within the 90 days for some reason or other. When this occurs, the buyer is not entitled to deduct the amount of input VAT from the output VAT amount. As a tax saving tip, the buyer can make arrangement with the seller by returning the VAT special invoice to the seller, and asking the seller to cancel the old VAT special invoice and issue a new one. By doing so, the buyer can have another 90 days to submit the invoice for certification. It is noted that the PRC VAT rules on the deduction of input credit operate on a period basis. The PRC VAT rules do not follow the matching principle as one has to follow under the PRC accounting rules.

Accounting Treatment for General and Small Taxpayer

The input VAT is offset against the output VAT the seller collects from the buyer. Both the input VAT and output VAT is reported in the balance sheet. The small-scale taxpayer cannot do it in the same way as the general taxpayer. Instead, if it has to pay any VAT, the input VAT has to be charged to the cost of production or sales. The accounting treatment can be illustrated as in Table 6 assuming that the sale is settled in cash:

Table 6

General taxpayer	Small-scale taxpayer		
Purchase of goods	Dr. Purchase 100	Purchase of goods	Dr. Purchase 100
Input VAT	Dr. VAT payable 17	Input VAT	Dr. Cost of Sales 17
Payment	Cr. Bank 117	Payment	Cr. Bank 117

In respect of the purchase of goods and services, the accounting treatments for VAT, business tax and consumption

tax are different. The business tax and consumption tax are charged to the cost of sales in the income statement. The input VAT goes to the balance sheet against the output VAT collected from the buyer.

Tax Burden vs. Tax Rate

There is a difference between the VAT rate and the VAT burden. VAT rates (standard rate is 17 percent) are constant but VAT burden can be higher or lower than the VAT rates, depending upon 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 six percent (four percent for non-production enterprise) respectively. Given that sale is 100 and 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 simple computation method. Therefore one can observe that the general taxpayer could be better off by choosing the general computation method if the value added is lower than six percent (or four percent for non-production enterprises). The general taxpayer will be better off by choosing the simplified computation if the value added is higher than six percent (or four percent for non-production enterprises). The taxpayer will be indifferent if the VAT payable under the two computation methods is the same. This can be verified if the purchase is changed to 64.71, then the VAT payable will be $35.29 \times 17 \text{ percent} = 6$.²⁵ To sum up, the percentage of value added and tax rate are not necessarily the same. For the general taxpayer, VAT is imposed on the amount of value added; for the small-scale taxpayer, VAT is imposed on the sales amount.

VAT Rates

There are two sets of tax rates under the PRC VAT regulations. One set is the levy rate of six percent, four percent and two percent under the simplified computation method.²⁶ The other set of rates is 17 percent, 13 percent, and zero percent respectively under the general computation method.²⁷ There will be no input credit if VAT is imposed at levy rates.

Rates are shown in Table 7.

Table 7

I	17 percent	For taxpayers selling and importing goods other than those listed in row II immediately below
II	13 percent	For taxpayer selling and importing 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 feeds, fertilizer, agrochemicals, agricultural machinery, plastic covering film for farming 5. Other goods as specifically regulated by the State Council
III	0 percent	For taxpayers who export goods
IV	17 percent	For taxpayers who supply services relating to processing, repairing, and replacement (taxable services)

Tax at levy rates is shown in Table 8.

Table 8

I	6 percent	Small scale taxpayer classified as production enterprise
II	4 percent	Small scale taxpayer classified as commercial enterprise
III	2 percent	Only applicable to the disposal of used fixed assets at above the cost by both the general taxpayer and the small taxpayer

Tax Invoices

The issue of tax invoices serves the following purposes among others:

1. recognition of sale;
2. documents for accounting purposes;
3. base for the computation of VAT and business tax;
4. receipt acknowledgement for payment.

The taxpayer must issue tax invoices when the VAT obligation arises. It is noted that the VAT obligations may not occur at the same time as sales are recognised under the PRC accounting rules. In addition, the accounting rules may differ from the tax rules relating to trade discount, sales discount, cash discount and sales concession. One can classify the above differences into two categories: sales recognition and measurement. The following section will illustrate the interaction of the accounting rules, the VAT rules and the rules of using VAT special invoices in a lawful and tax-efficient way.

Sales recognition

The Administrative Provision for the Use of VAT Special Invoices provides for the statutory time for the issue of VAT special invoices relating to different type of transactions,²⁸ as demonstrated in Table 9.

Table 9

	Type of transactions	Obligation to issue invoice
1	Advance deposit, collection by carrier, and collection by the bank	The day of delivery of goods
2	Sales on cash-and-carry-terms	The day of receiving payment from buyer
3	Credit sales or installment sales	The payment day as provided under agreement
4	Sales on consignment	The day of receiving "statement of consigned sales"
5	Transfer of goods from head office to branch or vice versa, which triggers the deemed sales provision	The day of delivery
6	Transfer of goods to other entities or individuals as capital contribution, which is deemed to be sales.	The day of delivery
7	The distribution of goods to shareholders, which is deemed to be sales.	The day of delivery

Deemed sale provision

The taxpayer is under an obligation to issue VAT special invoices for sales transactions. There are some exceptions. The taxpayer is required to pay VAT for certain transactions falling under the scope of deemed sales but there is no

requirement for the taxpayer to issue VAT special invoices.²⁹ A typical example is a change in the use of self-made goods. When the taxpayer uses its inventory to construct its own warehouse (fixed asset), it has to pay VAT and income tax but it is not required to issue tax invoices to itself. The scope of transactions falling under the deemed sales provision includes a physical transfer (a change in possession), a change in use, and the giving out of the goods at no consideration (a gift).³⁰

Sales measurement

The sales amount as measured under the PRC accounting rule is different from the sales amount as measured under the VAT rules. One example is the treatment of discounts and concession. The seller has to give the buyer a sale discount or concession for a number of reasons such as poor quality or off specification. Where the issue of discount or concession arises, the seller should consider the VAT and income tax implication and plan the transaction so that it is conducted in a tax-efficient way. A case study may help illustrate the relevant points.

Case study

1. Company A, a wholesaler, sells goods to Company B, a retailer, for an amount of RMB70,000. According to trade practice, A gives B a trade discount of 10 percent. In the sales agreement, Company A also offers a cash discount of five percent if Company B settles the amount due within one month. After the dispatch of goods, Company A issues a VAT special invoice to Company B in the amount of RMB70,000. At the same time, A also issues a credit note (also called invoices printed in red) to B for a trade discount of RMB7,000. Company records an account receivable of RMB63,000 in the books of accounts.
2. Shortly after the receipt of goods, Company B informs Company A that some of the goods have quality problems. Upon verification, Company A accepts the complaint from B but the goods are still considered to be in a saleable condition. Nonetheless, A offers B a special discount of 10 percent on the full amount of goods sold. A also issues B a credit note for RMB7,000. Company A further reduces the account receivable from RMB63,000 to RMB56,000.
3. Company B issues a check for RMB53,200 to settle the amount due within 20 days. In accordance with the sales agreement, Company B is entitled a five percent discount (RMB2,800) for settlement within one month. Again company A issues a credit note for 2,800 as a supporting document to offset the sales amount against the balance in the account receivable with Company B.
4. Company A also has a separate agreement with Company B that if the year-to-date sale amount exceeds three million at the end of the year, B is entitled a special concession of CNY30,000 on the annual sales amount. At the year-end, B manages to achieve the sales target. Accordingly Company B issues an official receipt to Company A, who issues a check for RMB30,000 in accordance with the agreement. Company A charges the amount to sales expenses.

Tax implications

Company A will have a number of tax issues arising from its sales activities relating to the giving of trade discount, cash discount and sales concessions.

Trade discount

The deduction of 10 percent trade discount of RMB 7,000 from the gross sales amount is incorrect for VAT and income tax computation purposes. According to the VAT rules, the net sales amount can be used for computation of output VAT and income tax (IT) only if the trade discount is printed in the same VAT special invoices.³¹ But Company A has issued a credit note separately. The sales amount, from which the trade discount has been deducted, for accounting purposes is CNY63,000. The sales amount for VAT and income tax computation purposes should be CNY70,000 in this case.

Sales discount (concession)

Since the sales discount is due to quality problems that emerge after delivery of the goods, Company A did not state the sales discount in the same VAT special invoices. There are two possible correct treatments depending on whether or not Company B has already made payment or used the VAT special invoice for accounting records:

1. if Company B can return the unused original copies of the VAT special invoice to A, Company A can reverse the sales amount relating to the quality problem in the following month and issue a revised VAT special invoice to Company B; and
2. if Company B already made payment or used the VAT special invoices for accounting records and cannot return the same to A, Company A needs to obtain from Company B a copy of 'Notification of Issuing VAT Special Credit Notes' issued by the tax bureau in charge of the city where Company B is located.³² On the strength of the Notification, Company A can issue a credit note to Company B, and reduce the sales amount and the account receivable accordingly. Note that in the absence of the said notification, it is unlawful for Company A to issue a credit note and reduce the sales amount for VAT and income tax purposes.

Note also that the sales discount can be a price discount or a quantity discount. The PRC VAT rules allow the deduction of price discount for output VAT computation subject to the condition that the information for sales discount is printed in the same tax invoice issued to Company B for goods sold. Goods supplied under a quantity discount are not treated as sales under the PRC accounting rules, but is subject to VAT under the deemed sales provision of the PRC VAT rules.³³ Therefore, giving price discount is more tax efficient than giving a quantity discount.

Cash discount

It is incorrect for Company A to issue a credit note for cash discount allowed. It is also incorrect for Company A to reduce the sales amount for output VAT computation purposes. The cash discount should have been charged to financial expenses in the income statement.

Previously the income tax treatments regarding the deductibility of cash discount are not consistent among tax authorities in different cities. In a document the State Administration of Taxation released in 2006, it is expressly provided that cash discount is deductible against the taxable income for non-foreign investment enterprise (the non-FIE) taxpayers.³⁴ However, the income tax rules for the FIE is silent whether cash discount is deductible against the taxable income. It is interesting to see how the two different

Box A

Entry (1)	Prior year adjustment – Income statement	-100,000		
	VAT payable	-17,000	A/C receivable	-117,000
Entry (2)	Prior year adjustment – Income statement	+52,000	Inventory	+52,000
Entry (3)	Prior year adjustment – Income statement	+14,400		
	Income tax payable	-14,400 (a)		
Entry (4)	Prior year adjustment	+33,600		
	Retained profits	-33,600 (b)		

Balance Sheet Extracts at December 31, 2003

	Revenue reserve		Inventory	+52,000
	Retained profits	-33,600	Account receivable	-117,000
	Tax payable (VAT and income tax)	-17,000-14,400 = -31,400		
	Total	-65,000	Total	-65,000

practices on cash discount deduction are treated after the unification of the income tax laws for non-FIE taxpayers and for the FIE taxpayers in future. To cope with the tax authorities that disallow the deduction of cash discount for income tax computation, Company A can issue the VAT special invoices net of the five percent cash discount. Where Company A sales goods for RMB56,000, only RMB53,200 is stated in the tax invoice. By doing so, Company A can be better off and pay VAT on the amount of RMB53,200. If Company B makes payment within one month, Company A will not issue the invoice for the balance in accordance with the agreed upon terms in the contract. If Company B does not make payment within one month from the date of tax invoice, Company A issues another invoices in the amount of RMB2,800 for late settlement of amount due.

Sales concession

The official receipt is not a piece of lawful evidence for PRC accounting purpose. The amount of CNY 30,000 cannot be excluded from sales amount both for VAT and income tax purposes. The issue of credit note is not tax efficient either. Company A should have tried to obtain from Company B a 'Notification of Issuing VAT Special Credit Note' issued by the tax authority in charge of the city where Company B is located as a valid document for accounting and tax purposes.

Goods returned after balance sheet date

Where the goods are returned after the balance sheet date, the accounting and tax rules will have different treatments. An example may help illustrate the impact on different areas.

Company A sold goods for RMB100,000 to Company B on credit on December 19, 2003. Assume that VAT rate is 17 percent and income tax rate is 30 percent. We also ignore

the legal requirement for the appropriation of after-tax profits to reserves. The cost of goods is RMB52,000. Suppose Company B returned the goods to Company A on January 9, 2004. The board of directors of Company A does not approve the financial statement until March 1, 2004. The accounting treatments and tax treatments are shown in Box A.

The return of goods will have impact on assets and liabilities. On the asset side, there is a decrease in the account receivable and inventory. On the liability side, the amount of the following items will be reduced: retained profits, VAT payable, income tax payable, and revenue reserve.

- Income tax payable $(100,000 - 52,000) \times 30 = 14,400$;
- Retained profits $(100,000 - 52,000) - 14,400 = 33,600$;
- Prior year adjustment (income statement) is zero;
 $-100,000 + 52,000 + 14,400 + 33,600 = 0$.

The PRC accounting rules require the adjustment to be made to the liabilities and the assets of the preceding year. The accounting adjustment follows the matching principle and the treatment for the post-balance sheet events where the directors have not approved the financial statements. The VAT rules do not allow the return of goods to be adjusted retrospectively. That is a departure from the matching principle as is mentioned earlier. The adjustment to the VAT Return should be made in January 2005 when the return of goods took place. Again it is assumed that the accounting profit and the taxable income report no differences, RMB3,000,000 in 2004 and RMB1,000,000 in 2005 (first quarter) respectively. The accounting reports, income tax returns and VAT returns will show the

adjustments in different periods (for sales revenue only), as shown in Table 10:

Table 10

	Income Statement	Income Tax Return	VAT Returns
Income 2004	3,000,000 –100,000	3,000,000 –100,000	3,000,000
Income 2005	1,000,000	1,000,000	1,000,000-100,000
Both 2004 and 2005	3,900,000	3,900,000	3,900,000

Taxation on returned goods with quality or specification problem in import-export transactions

Where imported goods are returned in original condition within one year from the importation date, the Chinese customs shall not impose export tax, if any; the consignee can apply for the refund of import duty and VAT within one year from the date of duty and VAT payment. Where export goods are returned in original condition within one year from the exportation date, the Chinese customs shall not impose import duty and VAT; the consignor can get a refund for export tax, if any, within one year from the date of making the export tax payment, subject to the return of VAT refund for export goods.³⁵

Note that the consignee is not necessarily the buyer. Under the PRC legal rules, a consignee is one who has duly completed the registration as foreign trader.³⁶ The same registration requirement applies to the consignor. Note also that in the event of short shipment, the consignee can apply for a refund of import duty and VAT, if paid, upon the production of a certification report duly issued by the frontier port office of the China Commodity Inspection and Quarantine.

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- 1 See 'Legal and Tax Issues for Commodity Trading Operations in the PRC' by Alfred KK Chan, *Tax Planning International Asia-Pacific Focus*, August 2006.
- 2 The Ministry of Finance and State Administration of Taxation, document Cai Shui Zi 004 (94), 1994. The type of prescribed goods taxable at levy rate includes: electricity supplied by small thermal electricity generating or hydro-electricity generating plants at or below the county level; the sands, soil, and quarry for construction use and manufacture of construction materials; the supply of bricks, soil and lime that are made of self-excavated sand, soil and quarry, building materials that are made of coal ash and boiler slag; biological products that are made of micro-organism, animal toxins, human or animal bloods; and the supply of water.
- 3 See Article 30 of the Detailed Implementation Rules for the PRC VAT Tentative Regulations.
- 4 See Article 27 of the Detailed Implementation Rules for the PRC VAT Tentative Regulations.
- 5 See Article 7 of the Detailed Implementation Rules for the PRC VAT Tentative Regulations. Article 1 of the PRC VAT Tentative Regulations provides that 'Units and individuals who sell goods, provide processing, repairing and replace services, and import goods into the territories of China owe an obligation to pay VAT and shall pay VAT in accordance with the law.'
- 6 See Article 30 of the Detailed Implementation Rules for the PRC VAT Tentative Regulations.
- 7 To use the VAT special invoice, the taxpayer must install and operate the 'anti-forgery tax control system'. 'Use' here is defined as the purchase, issue, cancellation, and authentication of the paper-based VAT special invoice and the corresponding data message. See Article 3 of SAT Circular Guo Shui Fa (2006) 156, issued on October 17, 2006.
- 8 See Circular Guo Shui Fa Ming Dian (2004) 37, as amended under (2004) 62, issued by the State Administration of Taxation on August 1, 2004.
- 9 The Ministry of Finance and State Administration of Taxation, document Cai Shui Zi 113 (1998).
- 10 See Article 8 of the Administrative Measure for the Use of VAT Special Invoices, issued under document Guo Shui Fa (2006) 156 by the State Administration of Taxation on October 17, 2006.
- 11 The PRC State Council, Article 21 of the PRC VAT Tentative Regulations, the State Administration of Taxation, document Guo Shui Fa (1995) No. 088, and document Guo Shui Fa (2006) No. 156.
- 12 The PRC Business Tax Tentative Regulations provide that the following services or businesses are subject to business tax: transportation services, construction work, financial institutions and insurance companies, postal and telecommunication companies, cultural and sports business, entertainment business, services, transfer of intangible goods, and the sale of immovable properties.
- 13 The prescribed goods are cigarette, wines, food, clothing, shoes, hats and cosmetic products. See Article 10 of the State Administration of Taxation, document Guo Shui Fa (2006) No. 156.
- 14 The State Administration of Taxation, document Guo Shui Fa (1995) No. 088 and Guo Shui Fa (2000) No. 075.
- 15 The Ministry of Finance, Article 25 of the Detailed Implementation Rules of the PRC VAT Tentative Regulations, December 25, 1993. The State Administration of Taxation, document Guo Shui Fa 122 (1994), 1994.
- 16 See Article 12 of the Detailed Implementation Rules of the PRC VAT Tentative Regulations, promulgated by the State Council on December 13, 1993.
- 17 The PRC State Council, Article 8 of the PRC VAT Tentative Regulations, December 26, 1993.
- 18 The PRC State Council, Article 8 of the PRC VAT Tentative Regulations, December 26, 1993. If the ordinary taxpayer purchases goods from small taxpayer, the input credit increases from 6 percent to 13 percent. See Cai Shui 105 (2002), jointly issued by Ministry of Finance and the State Administration of Taxation.
- 19 The Ministry of Finance and State Administration of Taxation, documents Cai Shui Zi 012(94) and 114(1998).
- 20 The Ministry of Finance and State Administration of Taxation, document Cai Shui 78 (2001), 2001.
- 21 The PRC State Council, Article 10 of the PRC VAT Tentative Regulations, December 26, 1993.
- 22 The State Administration of Taxation, document Guo Shui Han 143 (2004), 2004.
- 23 The State Administration of Taxation, document Guo Shui Fa 017 (2003).
- 24 The State Administration of Taxation, documents Guo Shui Fa 15 (1995) and 192 (1995).
- 25 35.29 is the percentage of value added that is arrived as follow: (selling price – purchase price) / selling price. That is ((100-64.71)/100 x 100 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: Sale x R x 17 percent = Sale x 6 percent. Therefore we get 35.29 percent for R (= 6 percent / 17 percent x 100 percent).
- 26 See Article 12 of the PRC VAT Tentative Regulations, and document Cai Shui Zi 113 (1998) jointly issued by the Ministry of Finance and State Administration of Taxation.
- 27 See Article 2 of the PRC VAT Tentative Regulations.

- 28 See SAT document Guo Shui Fa (2006) No. 156.
- 29 See Article 4 of the Detailed Implementation Rules of the PRC VAT Tentative Regulations, issued by the PRC Ministry of Finance on December 25, 1993.
- 30 See Page 295, Tax Notes International, by Alfred KK Chan, on April 17, 2006.
- 31 See document Guo Shui Fa (1997) No. 472, issued by the State Administration of Taxation.
- 32 See document Guo Shui Fa (2006) No. 156, issued by the State Administration of Taxation.
- 33 See Article 4, the Detailed Implementation Rules of the PRC VAT Tentative Regulations.
- 34 See SAT document Guo Shui Fa (2006) No. 56, issued by the State Administration of Taxation on April 18, 2006.
- 35 See Article 57 and 58 of the Administrative Order 124 (2004), issued by the General Administration of Customs on December 15, 2004.
- 36 See Article 2 of the Administrative Order 14 (2004), issued by the Ministry of Commerce on June 25, 2004. See also Article 54 of the PRC Customs Law, promulgated by the National People's Congress on July 8, 2000.