

## VAT Tips – Choice between VAT and Business Tax

### I. Scope of tax

The following is a comparison between the scope of taxable activities taking place in China under VAT and business tax rules respectively.

	Taxable items	Including
VAT	(i) Sales of goods; (ii) Importation of goods	The provision of processing, repairing and replacement services
Business Tax	(i) The provision of services as prescribed under the business tax rules; (ii) The transfer of intangible assets	The sale of immovable property

### II. Mixed sale

A mixed sale is defined as the supply of goods and non-VAT taxable services to the SAME buyer or user. Mixed sales made by the enterprises that carry out production, wholesale and retail activities are deemed to be the supply of goods and therefore subject to VAT on the combined sales amount. Mixed sales made by enterprise that do not carry out production, wholesale and retail activities are deemed to be the supply of non-taxable services, and subject to business tax. <sup>1</sup> The enterprises that carry out production, wholesale and retail activities include those that derive more than 50% of the revenue in production, wholesale and retail activities, and derive the rest of the sales revenue from the provision of non-VAT taxable services as their sideline business. <sup>2</sup>

### III. Separate accounting

A taxpayer can supply goods and non-VAT taxable items, or supply VAT-taxable

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<sup>1</sup> See Article 5 of the Detailed Implementation Rules for PRC VAT Tentative Regulations, issued by the Ministry of Finance on 25<sup>th</sup> December 1993, and amended on 15<sup>th</sup> December 2008.

<sup>2</sup> Same as above.

services and non-VAT taxable items to the buyer. The taxpayer should account for the sale amount for different business activities separately. Otherwise, the tax authority in charge shall the power to determine the sales amount for the supply of goods and the provision of VAT-taxable services. The mandatory requirement for separate accounting for different line of business activities shall also apply to certain mixed sales. The taxpayer who provides both construction services and sells VAT taxable goods to the same buyer is subject to this separate accounting requirement.

Non-VAT taxable services (or services that are not subject to VAT) as mentioned above refer to the services that are subject to business tax, and listed as the taxable items under the following categories including transportation, construction, insurance, postal and telecommunication, culture and sports, entertainment and general services.

Non-VAT taxable items include the following: non-VAT taxable services, the transfer of intangible assets, the sale of immovable properties and the transfer of immovable properties under construction. It is a mandatory requirement that the VAT taxpayer who also deals with non-VAT taxable items should either separately account for the sales amount from the supply of goods and non-VAT taxable items, or separately account for sales amount from the supply of VAT taxable service and non-VAT taxable items. If the taxpayer fails to do so, the tax authority shall the power to determine the sales amount for the supply of goods and the supply of VAT taxable services. Note that the tax authorities will check whether the supply of goods and non-VAT taxable services is to different buyers or to the same buyer.

Example of mixed sale may include the following:

1. Sale of elevator and the provision of installation services;
2. Undertaking decoration work and the sale of construction materials;
3. Provision of hotel accommodation and the sale of foods and beverage,
4. Sale of coffee beans and operating cafe shops;
5. Provision of car beauty services and the sale of lubricants or vehicle tires;
6. Provision of paging services and the sale of pagers;
7. Design of plastic or metal moulds and the making of moulds;
8. Provision of beauty solon services and the sale of cosmetic & beauty products.

#### IV. Comparison between mixed and sideline sales

	Mixed sale	Sideline 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; Planning in sale mix	Accounting for sale of different goods; (or sale of goods and non-taxable services) separately

VAT is imposed on the value added. Where the value added contents in a mixed sale is high, the taxpayer's VAT burden will be very heavy. The transfer of the business of non-VAT 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 for the taxpayer who has mixed sale transactions. Split contract and separate accounting are incorrect solutions. If used improperly, the taxpayer will be exposed to tax risks. The solutions to reduce tax burden in complementary (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.

#### V. Tax planning options in mixed sale

	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% and the provision of installation service is subject to business tax at 5%.

First of all, we check (i) whether the supply of the goods and services constitutes a single activity, and (ii) whether the taxpayer supplies both goods and the services to the same buyer. Secondly, we should refer to the business scope for 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% 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 verification 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:  $(130-100) / 130 \times 100\% = 23.08\%$ . The standard VAT rate for general taxpayer is 17% and the business tax rate is 5%. At break-even point,  $R / 1.17 \times 17\% = 5\%$ ;  $R = 34.41\%$ . 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:

$$\text{VAT payable} = [(130 / 1.17) \times 17\% - (100 / 1.17) \times 17\%] \times 17\% = 4.36$$

If the taxpayer pays BT  $130 \times 5\% = 6.5$ , 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:  $(160-100) / 160 \times 100\% = 37.5\%$ . At break-even point,  $R / 1.17 \times 17\% = 5\%$ ;  $R = 34.41\%$ . 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 5%. We can perform checks below:

R is < 34.41% <Example 1>	VAT sales > 50% of total revenue; Taxpayer should try to pay VAT.	VAT payable = $[(130 / 1.17) \times 17\% - (100 / 1.17) \times 17\%] \times 17\% = 4.36$ If the taxpayer pays BT ( $130 \times 5\% = 6.5$ ), 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 = $[(160 / 1.17) \times 17\% - (100 / 1.17) \times 17\%] \times 17\% = 8.72$ If it pays BT $160 \times 5\% = 8$ , 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% of the total combined sale amount. Example one shows that to pay VAT would be advantageous to the taxpayer. 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% of the total combined sale amount. Example 2 shows that if the taxpayer cannot keep the sale of goods at less than 50% of the combined sale revenue, the taxpayer will pay more tax as the VAT

taxpayer. It should consider setting up another company to deliver the installation services and pay business tax at 5%.