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Overview of the value-added tax (VAT) system in China

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I. Introduction

Value-added tax (VAT) issues should not be underestimated when doing business in China as the VAT is not always a "cash neutral pass through" on financial statements of a company. It is far more complex, may be effectively cost-incurring and therefore potentially riskier than one might expect at first glance.

China's VAT law changed a lot in the past two years. The Chinese government replaced the Business Tax (BT) with the VAT system in 2016. Both regulations coexisted alongside each other which led to certain complexity and confusion about the specific application of the different tax rates. The reform simplified China's tax system by abolishing the disproportionate taxation of services and unifying sales of goods, processing, repairs and replacement services, sales services, intangible properties, real estate and import of goods within China etc. under a general VAT regime.

In April 2018, China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) issued new guidelines (Caishui [2018] No. 32 and 33 (Circular 32 and 33)) on the VAT rates as well as the changes to the threshold for small-scale VAT payers (turnover of max. RMB 5,000,000 = approx. EUR 640,000 per annum). The circulars are applicable as of 1 May 2018.

II. VAT rates

All taxable activities that were subject to the 17%/11% VAT rates until 30 April 2018 will be eligible for a **lower rate (16%/10%) as of 1 May 2018. The VAT rate of 6% for certain services did not change.**
Different VAT rates are applied for different taxable activities:

The VAT rate of 16% applies for taxable activities such as:

- Sales and import of general goods
- Provision of processing, repair and replacement services
- Leasing services of tangible and moveable assets

The VAT rate of 10% applies for:

- Sales and import of specified goods such as agricultural products (including grains), tab water, heat, liquefied petroleum gas, natural gas, edible vegetable oil, air conditioning, hot water, coal gas, coal products for residential use, edible salt, agricultural machinery, feed, pesticide, agricultural film, fertilizer, methane, dimethyl ether, **books, newspapers, magazines, audio and visual products and electronic publications**
- Postal and basic telecommunication services
- **Construction services**
- Leasing services of immoveable property
- Sales of land use rights or immovable property

The VAT rate of 6% applies for:

- Value-added telecommunication services
- Financial services
- Modern services (such as research and development services, technology consulting services, information technology services, cultural and creative

services, **logistics support services, tax and legal services**, etc.)
- **Lifestyle services**
- Sales of intangible assets other than land use rights

III. VAT refund mechanism

In general, the Chinese VAT system is comparable to many other VAT systems in the world. In particular, it generally mitigates the burden of VAT on transactions between businesses by applying an input **VAT credit mechanism**.

VAT a company paid when buying or importing goods from a general taxpayer with a proper fapiao is called **input VAT.** The VAT a company adds when selling goods to buyers in China (with a proper invoice, so-called "*Fapiao*") is VAT that the company receives and actually collects on behalf of the government, called the **output VAT**. This does not constitute the company's revenue but must be transferred to the Chinese government.

In most cases, the input VAT can be offset against the output VAT. The surplus of the output VAT over the input VAT is the amount that a company is obliged to declare and transfer to the Revenue Department monthly. If the difference between the output and input VAT is negative, the company may apply for a refund from the Revenue Department.

This can be summarized as follows:

Output VAT – Input VAT < 0
→ VAT refund from the Revenue Department

Output VAT – Input VAT > 0
→ VAT payable to the Revenue Department

IV. Import of goods

The import of goods is subject to VAT which is payable to the Chinese Customs Department. This must not be confused with the obligation to pay **import duty** which represents a different tax at specific rates. So basically, both VAT as well as duty have to be paid on importation of goods into China.

Foreign companies that sell goods to consumers in China via online sales will need to appoint a customs agent/broker to handle the VAT on import.

VAT on importation has to be paid within 15 days of the issuance of a tax payment certificate by the Customs Department.

Import VAT is furthermore subject to the VAT credit/refund mechanism as part of input VAT.

V. Export of goods

1. General

When exporting goods and services, the general rule is that no VAT will apply. There are two categories of exported goods and services: <u>zero-rated</u> (= 0% VAT) or generally <u>VAT-exempt.</u>

2. Export refunds

If a good is considered VAT zero-rated, it is technically subject to VAT, but the VAT rate is set at 0%. Therefore, any input VAT is, in general, refundable.

However, the actual finally accepted refund rate can be lower than the input VAT rate, therefore the actual refund accepted by the Revenue Department can be less than the VAT amount paid when buying goods in China or importing a good into China. In that way, the Chinese government actually intends to somehow restrict or limit the export of goods (such as agricultural products or rare earth) and to rather keep certain products within the Chinese economy. By not refunding the full amount of the paid input VAT, the government indirectly sanctions companies for exporting certain products. Therefore, companies will only get part of the VAT back, whereby the refund rates vary from product/service to product/service and, unfortunately, also sometimes actually from region to region.

The range is between 0% and 15%. A full list of approximately 11,000 (!) refund rates can be found on the State Administration for Taxation website (with easy google translation and HS numbers, respectively the Chinese Commodity Code Numbers).[1]

For example, the refund rate is set to:

- 0% for most agricultural products and many kinds of papers (to rather keep them in China),
- 5% for screws and pins,
- 13% for cartons, cutting pads, styrofoam or silicone pads,
- 15% for blades, blade rollers and heaters or
- 16% for any kind of fabric.

If an exported good or service is considered exempt, the already paid input VAT cannot be refunded at all nor used to deduct the output VAT from domestically sold goods or services. The VAT paid can only be added to the cost of the exported goods. However, this category does not apply to many cases. Exempt goods include e.g. oral contraceptives, ancient books, imported equipment directly used in scientific research, experiments or teaching, imported materials for charitable foreign aid and assistance from foreign governments and international organizations or imported articles for persons with disabilities by supporting organizations.

3. Methods of implementing VAT refunds

In principle, there are two methods of calculating VAT refunds, depending on the business of the company.

For production companies that produce goods that are exported or sold in China, the input VAT on raw materials and machines, either imported or bought in China for the production process, can be fully offset (credited) against the output VAT on sales within China.

After this offset, any excess amount of input VAT is refundable, which means that the surplus amount will be re-paid by the Revenue Department to the local Chinese company.

For trading companies with no producing capabilities, the input VAT (VAT paid when buying goods in China) is directly refundable in cash, as export is not subject to output VAT (and therefore, there is nothing to offset/credit).

It is important to note that authorities require significant documentation in order to treat a supply of goods from China to another country as a zero-rated export for VAT purposes. It is necessary to submit a monthly Declaration form for Tax Refund of Production Enterprises, together with supporting documentation. Different types of exporters have to comply with different specific requirements applicable to their business activity.

VI. Import and Export of Services

In general, VAT applies if either the supplier or the recipient is in China. If the service provider does not have an establishment in China, the recipient is required to pay the VAT on a withholding basis which means that the VAT is withheld from the price and accounted for by the recipient in China. The recipient is also entitled to an input VAT credit if it is registered as general VAT taxpayer.

In general, the export of services is exempt from VAT. This includes services such as:

- Licensed international transportation services by Chinese domestic carriers
- Production and publication of radio, film and television services for foreign entities abroad
- Offshore outsourcing services
- **Research and development services provided to foreign entities abroad**

[1] http://hd.chinatax.gov.cn/fagui/action/InitChukou.do.

- Software services and information systems services provided to foreign entities abroad etc.

Some services may qualify as zero-rated, for example:

- International transportation (foreign airlines or carriers)
- Broadcast of radio for overseas entities
- Technology advisor services
- Advertising services where the advertisement is released outside China
- Leasing of tangible movable property if the property is outside China
- Cultural, education and healthcare and travel services provided outside China
- **Technology advisory services**
- Postage services, delivery services and insurance for exported goods etc.

VII. General Taxpayer and Small-scale VAT payer status

There are two classifications of taxpayers under the new VAT rules: the general taxpayers or small-scale taxpayers. A manufacturing or trading company whose sales reached the threshold of RMB 5,000,000 (approx. EUR 640,000) must register as a general VAT payer. Any business below this threshold pays 3% VAT on its outputs **without the right** to claim input VAT credits. However, these businesses still have the option to register as general VAT payer if they can demonstrate a profound accounting system and therefore provide detailed tax information as well as having a fixed place of business in China and be approved by the tax authorities.

NOTE: Under the old regulations applicable until April 2018, the threshold for small-scale VAT payers was set to RMB 500,000 for manufacturing enterprises, RMB 800,000 for trading enterprises and RMB 5,000,000 for taxpayers under the VAT reform program whose business would have been subject to Business Tax before the reform. As the general threshold is now at RMB 5,000,000, companies that had to register as general VAT payers under the old regulation because their sales reached the threshold of RMB 500,000/800,000 (but not RMB 5,000,000) can now convert back to small-scale VAT payer status. This might have consequences that companies have to be aware of when doing business with such "converted" small-scale VAT taxpayers. The purchaser will not be able to obtain a VAT invoice with a 16%/10%/6% VAT rate anymore but only 3% in the future. Therefore, they will have less creditable input VAT and higher purchase costs, especially if the purchase price remains the same.

VIII. Invoices for VAT (*Fapiao*)

1. General

Chinese authorities require businesses to issue *Fapiaos* (invoices/receipts) to oblige companies to pay tax in advance. *Fapiaos* are official invoices/receipts that validate the purchase of goods and services in China. The Chinese government introduced them to track tax payments and deter tax evasion. *Fapiaos* are printed, distributed and administered by the Chinese Tax Bureau (State Administration of Tax) but provided by the seller of goods or services. They are registered with the relevant tax authority which audits the issuance in order to determine the appropriate amount of tax payable.

There are two types of *Fapiaos*: special VAT *Fapiaos* and general VAT *Fapiaos*.

2. Special VAT *Fapiaos*

Special VAT *Fapiaos* are issued by general taxpayers when goods or services are sold to other businesses or non-consumers. General taxpayers are thereby allowed to credit their input VAT. This does not apply to small-scale VAT payers.

Special VAT *Fapiaos* contain detailed information including the seller's

- tax code,
- address,
- telephone number and

- bank account information.

Fapiaos have to show the detailed components of taxable and non-taxable activities and the exact tax rate and amount. They also need to be stamped with the issuer's special *Fapiao* chop.

When issuing a special VAT *Fapiao*, the following three basic copies have to be provided:

- A copy for accounting purposes of the issuer
- A copy for tax deduction for the customer who made the purchase
- A copy for accounting purposes of the customer

The number of *Fapiaos* that may be printed for a company and the value of each individual Fapiao are subject to quotas determined by the local tax bureau based on the taxpayer's business scope. If the tax bureau approves the quotas, a general taxpayer can print the **invoices using the tax bureau's printers** that are specifically designed for these purposes. One or more company staff have to be trained to use these printers.

3. General *Fapiaos*

General *Fapiaos* are only used as evidence of payment where special VAT *Fapiaos* are not applicable. For example, small-scale taxpayers or general commercial taxpayers who retail cigarettes, alcohol, food, clothing, shoes, makeup and other consumer goods cannot issue special VAT *Fapiaos*.

IX. Foreign companies and VAT

Foreign companies cannot register for VAT purposes in China. If they are aiming to enter the Chinese market, foreign entities have to establish either a Chinese foreign-invested commercial enterprise (FICE), a wholly foreign-owned entity (WFOE) or a Joint Venture. They may also operate within a free trade zone.

X. Risks

Companies have to be careful if there is no proper *Fapiao* issued. In some cases, *Fapiaos* have been faked or *Fapiaos* from other companies were used, which is a straight-forward tax evasion and crime.

When calculating goods, it is very important to make the right comparison, if the competitors are local Chinese companies. Some of these competitors might not be part of the VAT system and simply not charge any VAT (which is obviously not fully compliant). They hope for a pure cash business transaction making prices of lawful and compliant businesses up to 16% more expensive for end users.

We hope that the information provided in this brochure was helpful for you.
If you have any further questions please do not hesitate to contact us.

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