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### China

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# CHINA

*Wei Cui/Alan Wu*

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## Introduction

The introduction of the VAT to China has been by way of a uniquely gradual process. An early “value-added tax” was adopted for select manufactured goods (ending at the wholesale stage) in 1984,<sup>1</sup> and was so called only because it contrasted with the turnover taxes that had previously applied to such goods. The present Provisional Regulations on value added tax<sup>2</sup> came into effect on 1 January 1994, and apply to the sale of all goods except for intangible and immovable property, as well as to the provision of processing, repair and replacement services. This was still not a comprehensive VAT, because a separate turnover tax, the Business Tax (“BT”), applied to the provision of other services and transfers of intangibles and immovable properties.<sup>3</sup> Nor was the VAT (even where it was applicable) a “value-added tax” in the normal sense of the term, because input tax on fixed asset purchases was not creditable against tax on output. A major reform of the VAT was launched at the end of 2008, and, beginning in 2009, input tax on fixed asset purchases became creditable. At the present, therefore, the bifurcation of the normal VAT into VAT and the BT is the foremost difference between the current Chinese VAT and the VAT/GST as commonly found in other countries. The integration of the VAT and the BT is currently on the government’s legislative agenda, and could happen as soon as in the next three years. By the time it does happen, China will probably have set a world record for the length of time—roughly 30 years—it has taken to fully introduce the VAT.

In 2009 net VAT collected in China constituted 30.48% of total tax revenue collected, and 5.41% of GDP, making it the largest source of tax revenue for the government.<sup>4</sup>

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<sup>1</sup> Regulations on Value Added Tax (Draft) (State Council 18 September 1984, replaced by the VATPR on 1 January 1994 by the VATPR, note 2 infra).

<sup>2</sup> State Council Order No. 538, 10 November 2008, revising regulations with the same title issued as State Council Order No. 134 on 13 December 1993 (VATPR). See also, Detailed Rules Implementing the Provisional Regulations on the Value Added Tax (Ministry of Finance (MOF) and State Administration of Taxation (SAT) Order No. 50, 15 December 2008, revising regulations with the same title issued by the MOF as Caifa [1993] 40 on 25 December 1993) (VATIR).

<sup>3</sup> Provisional Regulations on the Business Tax (State Council Order No. 540, 10 November 2008, revising regulations with the same title issued as State Council Order No. 136 on 13 December 1993) (BTPR); Detailed Rules Implementing the Provisional Regulations on the Business Tax (MOF and SAT Order No. 52, 15 December 2008, revising regulations with the same title issued by the MOF as Caifa [1993] 42 on 25 December 1993) (BTIR).

<sup>4</sup> The computation of total VAT revenue, and therefore the percentages that revenue represents of both total tax collected and GDP, is not without difficulties. Official VAT statistics are fragmented into three categories: (i) domestic VAT, which is the total VAT collected from domestic taxpayers without taking into refunds for exports, (ii) import VAT, the amount for which is aggregated with Excise Tax (*xiaofeishui*) imposed on imports and therefore is at the present difficult to identify precisely, and (iii) refund for exports. The percentages offered in the text is based on a computation that (a) nets (iii) against (i), and (b) multiplies (ii) by a fraction that represents the ratio of domestic VAT to the sum of domestic VAT and Excise Tax (thus making the assumption that the mix of excisable goods is roughly the same for imported goods as for domestically produced goods). Some Chinese discussions overstate the percentage of VAT to total tax revenue by failing to net (iii) against (i). In 2009 China’s GDP was reported to be CNY 33.5353 trillion (approximately 3.35 trillion Euros); see

The Business Tax generated 15.15% of total tax revenue, indicating that the VAT would become an even more dominant revenue source once it absorbs the BT.<sup>5</sup> However, neither tax has a statutory foundation; both are administered pursuant to “provisional regulations” of the State Council.<sup>6</sup> The desire to provide a statutory basis for the VAT (in order to enhance the rule of law) partially drives current preparations for VAT reform, in addition to the substantive policy goal of integrating the VAT and BT.

The bifurcation of the VAT and the BT has substantially shaped the structure of the Chinese tax administration. This structure is divided into two subsystems—the State Tax Bureau (STB) system and Local Tax Bureau (LTB) system—which division is replicated from the provincial down to the county/district levels. The bulk of the STB system’s resources is devoted to VAT collection, although it is also in charge of collecting the national Excise Tax (a selective commodity tax called, somewhat misleadingly, the “consumption tax” or “*xiaofeishui*”)<sup>7</sup> and the enterprise income tax (EIT) from enterprises subject to the VAT.<sup>8</sup> The BT is the largest source of revenue for the LTB system, which also collects the EIT from most businesses subject to the BT, most of the personal income tax and a wide array of other taxes that contribute exclusively to local government coffers. The VAT, like the enterprise and personal income taxes, is a shared tax, and has its revenue split 25/75 between local governments and the national (central) government, according to where the revenue is collected.<sup>9</sup> The determination of where VAT is payable within China, a subject discussed further in Section IV below, in turn determines which local government gets to take the 25% cut of the VAT revenue collected. By contrast, BT revenue is almost entirely allocated to local governments and does not constitute a significant source of revenue for the central government. VAT on import is collected by the customs authorities and remitted entirely to the central government’s treasury. Local governments, however, are partially responsible for financing VAT export refunds.<sup>10</sup>

The Ministry of Finance (MOF) and the State Administration of Taxation (SAT) are

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[http://news.xinhuanet.com/english2010/business/2010-01/21/c\\_13145167.htm](http://news.xinhuanet.com/english2010/business/2010-01/21/c_13145167.htm). CNY 5.95147 trillion (approximately 595 billion Euros) was collected in taxes; see

[http://szs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/201002/t20100211\\_270552.html](http://szs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/201002/t20100211_270552.html).

<sup>5</sup> At the present, data is not available on the VAT gap, or on collection and compliance costs of the VAT.

<sup>6</sup> Both the VATPR (27 articles) and the BTPR (17 articles) are relatively short documents, and many of the actual rules in these areas are contained in MOF and SAT regulations and circulars.

<sup>7</sup> See Provisional Regulations on the Consumption Tax (State Council Order No. 539, 10 November 2008, revising regulations with the same title issued as State Council Order No. 135, 13 December 1993).

<sup>8</sup> Guoshuifa [2008] 120 (SAT, 6 December 2008) [Notice regarding Changing the Scope of Income Tax Administration for New Enterprises].

<sup>9</sup> This is subject to a further “revenue returned” mechanism, treated as part of the transfer payment system, where some VAT revenue belonging to the central government is returned to local governments. See Ahmad, Lockwood and Singh “Taxation Reforms and Changes in Revenue Assignments in China” IMF Working Paper WP/04/125, International Monetary Fund, Washington DC (2004), Section IV.

<sup>10</sup> Guofa [2005] 25 (State Council, 1 August 2005) [Notice regarding Improving the Mechanism of Central and Local Export Refunds]. At the present, local governments are responsible for 7.5% of VAT refunds.

the two central government agencies making VAT and BT policy and issuing regulations, administrative guidance and rulings for the entire country. Formal ministerial regulations are few in number compared to administrative guidance issued in the form of quasi-legal “circulars”. The choice of what rules to issue in regulation form is largely arbitrary. For example, regulations were used for certain VAT rules for retail gasoline stations and for the sale of electricity, whereas more basic VAT rules were scattered through myriad informal documents. However, a recent SAT regulation that laid out mechanisms for determining qualifications of “regular taxpayers” (discussed in Section II below)<sup>11</sup> and which replaced a number of informal circulars suggests that the SAT may be trying to codify its VAT practice more often in forms that are judicially recognized.<sup>12</sup> From 2005 to 2009 a total of over 400 SAT/MOF notices and rulings specifically devoted to VAT and BT issues were issued, whereas only four SAT ministerial regulations were issued on these subjects. There is a large number of published criminal law cases involving VAT fraud,<sup>13</sup> as well as a growing number of civil litigation cases where the disputes arose originally in connection with VAT or BT matters.<sup>14</sup> However, the authors are not aware of any judicial decision that significantly bears on the issues discussed in this report.

For the remainder of this report, we focus primarily on current Chinese law and practice under the VAT, and touch on BT law and practice only in connection with select conceptual issues such as the exclusion from the VAT/BT base, place of supply, etc. Besides the limitation of space, this decision is also based on the considerations that many of the legal issues arising under the VAT cannot be properly discussed in connection with a cascading tax like the BT (as the economics of a cascading tax would undermine much of the logic of VAT rules), and that, when planning the integration of the BT into the VAT, it is the existing VAT rules examined here that will have to undergo further review and “stress tests”.

## **I: Scope of VAT (and the Business Tax)**

Both the Chinese VAT and BT are indirect taxes in the sense that, without exception, they are remitted by the suppliers of goods and services rather than by final consumers. While the VAT and BT govern mutually exclusive tax bases, together they cover a consumption tax base typically subject to the VAT/GST in other countries. In fact, the collective base of the VAT/BT is probably more expansive than the existing

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<sup>11</sup> See Guoshuihan [2010] 138 (SAT, 7 April 2010) [Notice on the Printing and Distribution of Propaganda Materials for “Administrative Measures on the Recognition of Regular VAT Taxpayers”].

<sup>12</sup> Most notices and other circulars issued the SAT and MOF lack independent legal effect. See Wei Cui, ‘What Is ‘Law’ in Chinese Tax Administration?’, *Asia Pacific Law Review* 2011, No. 1, and available at <http://ssrn.com/abstract=1687781>.

<sup>13</sup> Over 400 of such criminal cases are collected in the Chinalawinfo database (<http://www.chinalawinfo.com>).

<sup>14</sup> For a discussion of an impressive set of inter-related administrative law and criminal litigation cases involving issues of the timing of VAT liabilities (in all of which the taxpayers won), see Li and Zhu, “Evidentiary Standards and Applications of Law in Tax Litigation,” in Xiong (ed.) *Tax Law and Case Review* (2010), pp. 169-245.

consumption tax base in any other country. For example, China subjects financial services to the BT,<sup>15</sup> mostly on gross interest received by lenders of loans but also on margins earned in a variety of dealer and brokerage services, such that financial services contributed 18% of total BT revenue in 2008. Both primary and secondary sales of residential housing are also subject to the BT.<sup>16</sup> These and a multitude of other facts underscore the fact that China's indirect tax system is not based on any other country's model: it has displayed its unique inefficiencies (e.g. by previously disallowing input tax credit for equipment purchase and by adopting the VAT/BT bifurcation), but it also has the potential of achieving unique efficiencies by not imitating other flawed systems.

As discussed further below, the VAT applies to all transfers of tangible property for consideration, and the BT applies to the transfer of intangibles and immovable property for consideration.<sup>17</sup> These broad formulations potentially capture transactions that should not be made part of a consumption tax base. For example, the standard VAT is not intended to tax pure financial flows. Consistent with this concern, the MOF and SAT have announced that the transfer of equity interests in subsidiary companies falls outside the scope of the BT (even though such transfers literally constitute the transfer of intangibles under Chinese law).<sup>18</sup> However, given a significant number of other types of transactions excluded from the VAT and BT base for no clearly stated (or easily understood) reasons, this aspect of the scope of the VAT/BT remains unclear.

Unlike other countries that define the supply of services as the supply of anything other than goods, taxable services under both the VAT and BT are specifically defined.<sup>19</sup> The MOF and SAT have interpreted these definitions as having surprising boundaries. So, for example, the following services have been ruled to be non-taxable:

- foreign adoption services;<sup>20</sup>
- waste water processing;<sup>21</sup>

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<sup>15</sup> Guoshuifa [1993] 149 (SAT, 17 December 1993) [Annotations on Business Tax Category (Trial Implementation)] (hereinafter "1993 BT Annotations"), Sec. 3.

<sup>16</sup> The latest policy statement on secondary sales can be found in Caishui [2009] 157 (MOF and SAT, 22 December 2009) [Notice on Change Business Tax Policy on the Transfer of Housing by Individuals].

<sup>17</sup> VATPR, Art. 1; BTPR, Art. 1.

<sup>18</sup> Guoshuihan [2000] 961 (SAT, 28 November 2000) [Notice regarding Non-Applicability of the Business Tax to Equity Transfers] (although the reasoning of this circular seems to imply that equity interests in a company are not intangible property for BT purposes, it is not clear that there is any legal basis for that view); Caishui [2002] 191 (MOF and SAT, 10 December 2002) [Notice regarding Business Tax Issue Relating to Equity Transfers] (categorical statement that the transfer of equity is not subject to the BT).

<sup>19</sup> For services subject to the VAT, see VATIR, Art. 2; for services subject to the BT, see BTIR, Art. 2, and 1993 BT Annotations (listing categories of BT-able transactions).

<sup>20</sup> Guoshuihan [2006] 86 (SAT, 22 January 2006) [Reply regarding the Collection of Business Tax on Fees for Adoption Services Charged by the China Adoption Center].

<sup>21</sup> Guoshuihan [2004] 1366 (SAT, 14 December 2004) [Reply regarding the Non-Applicability of the Business Tax to Waste Water Processing Fees].

- garbage disposal;<sup>22</sup> and
- railway survey and design performed under the order of the government (but for which a fee is charged).<sup>23</sup>

Although whether such exclusions constitute good tax policy is questionable, they indicate that the government does not interpret “services” as an all-encompassing term. Therefore, it should generally be possible to dispute whether certain transactions fall within the categories of taxable services or not. For example, it is unclear as a matter of law whether interest received on debt investments in subsidiary companies is subject to the BT.<sup>24</sup> As a factual matter, however, such investments often do not involve the provision of services. Therefore, it may be argued that since the scope of the BT is not intended to be all-encompassing, any transaction that does not constitute a provision of services or a transfer of intangible or immovable property falls outside the scope of the BT.

Another subject on which the current regulations are not completely clear is the territorial scope of the VAT/BT. The better view is probably that both the VAT and BT are applicable only to transactions connected with China. These include the import and export of goods and services. For example, services rendered for a Chinese recipient located within China is subject to the BT even if performed completely outside of China.<sup>25</sup> However, if a service is performed overseas by Chinese taxpayers for foreign customers, or if Chinese customers, while overseas, consume goods or receive services supplied by foreign suppliers, the transactions should not be subject to the VAT or BT.<sup>26</sup>

## II. Taxpayers and the Role of Permanent Establishments

Under current Chinese law, the concept of a VAT taxpayer presupposes the concept of VATable transactions, rather than the other way around. All “units” and individuals engaged in the sales of goods, the provision of processing, repair and replacement services and the importation of goods—the categories of taxable transactions under the VAT—within China are taxpayers for VAT purposes and are governed by VAT Regulations.<sup>27</sup> The customary (although legally incompletely defined) concept of “units” is very broad, and encompasses business enterprises, government

<sup>22</sup> Guoshuihan [2005] 1128 (SAT, 30 November 2005) [Reply regarding the Non-Applicability of the Business Tax to Garbage Disposal Fees]. The exclusion from the BT under this and the previous circular apply regardless of whom engages in the services.

<sup>23</sup> Guoshuifa [2001] 100 (SAT, 1 September 2001) [Notice regarding Business Tax Issues for Research Units and the Survey and Design Institute of the Railway Ministry].

<sup>24</sup> Caishuizi [2000] 7 (MOF and SAT, 1 February 2000) [Notice on Business Tax Collection on Group Borrowing and Repayment by Non-Financial Institutions]; Guoshuifa [2002] 12 (SAT, 10 February 2002) [Notice on Business Tax Collection on Lending Businesses].

<sup>25</sup> BTIR, Art. 4 (1).

<sup>26</sup> Caishui [2009] 111 (MOF and SAT, 27 September 2009) [Notice on Several Policies concerning the Exemption of Business Tax on Transactions by Individual in Financial Commodities and Other Transactions], secs. 3 and 4. See Section IV below for further discussion.

<sup>27</sup> VATPR, Art. 1.

administrative entities, public institutions, military units, social organizations and others.<sup>28</sup> There should thus be little fear that someone might slip through the VAT net under these definitions: public bodies, charities, etc. are all included in one swoop. Indeed, even though there is a threshold for the application of the VAT (as discussed immediately below), those falling below the threshold are said merely to be exempt from the VAT,<sup>29</sup> but strictly speaking are still VAT taxpayers. Moreover, as long as a person carries out a taxable transaction, there is no fundamental requirement that the person must be engaged in an economic or business activity for that person to be a VAT taxpayer.<sup>30</sup>

## 1. VAT Thresholds

The VAT threshold applies only to individuals and not to other taxpayers (i.e. enterprises and other “units”). Within prescribed ranges, provincial finance and taxation departments determine the threshold for their jurisdictions “in accordance with the actual conditions”. At the present, the prescribed ranges are:

- For sales of goods, monthly sales of CNY 2000 to 5000 (approximately 200 to 500 Euros);
- For sales of taxable services, monthly sales of CNY 1500 to 3000 (approximately 150 to 300 Euros);
- If tax is assessed on a transaction-by-transaction basis, sales per transaction (or per day) of CNY 150 to 200 (approximately 15 to 20 Euros).<sup>31</sup>

Although many local jurisdictions have set their VAT thresholds at the top of the prescribed range, the amount is still low enough that many persons are legally subject to VAT who would not be so subject in other countries. Combining this with the fact that there is no economic or business activity requirement for a transaction to be taxable, one may infer that non-enforcement of legally prescribed VAT obligations is fairly prevalent within a significant range *above* the thresholds.

Indeed, most “VAT taxpayers” in China are, ironically, not subject to VAT but are instead subject to a turnover tax that is provided for in VAT regulations. This is because taxpayers above the VAT thresholds are divided into “regular taxpayers” and “small-scale taxpayers” according to the size of their business operations and the sophistication of their accounting systems. Regular taxpayers apply the normal VAT, and can both claim input credit and issue creditable VAT invoices to other taxpayers. Small-scale taxpayers, by contrast, pay VAT pursuant to a “simplified

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<sup>28</sup> VATPRIR, Art. 9. “Individuals” include both sole proprietors and other individuals. *Id.* See also ‘The Annotation and User’s Guide to the Provisional Regulations and Detailed Implementation Rules for the VAT, BT, and Consumption Tax’, *China Market Press* (2009) (hereinafter “Official Annotations”), pp. 13-14.

<sup>29</sup> VATPR, Art. 17.

<sup>30</sup> These remarks apply equally to taxpayers under the BT. The discussion of thresholds immediately following, however, applies only to the VAT.

<sup>31</sup> VATPRIR, Art. 37. Sales revenue is computed on a tax-exclusive basis.



method”<sup>32</sup>—which means a turnover tax at 3%<sup>33</sup>—without being able to claim input credit or issue VAT invoices themselves to purchasers (although they may request the tax bureau to issue special VAT invoices on their behalf)<sup>34</sup>. The line between the two categories of taxpayers is drawn in part by the volume of annual sales:

- For taxpayers either solely engaged in the production of goods or the provision of taxable services, or engaged principally in the production of goods or provision of taxable services and also partially in the wholesale or retail of goods, annual sales of CNY 500,000 (approximately 50,000 Euros; prior to 2009, the amount was CNY 1 million);
- For other taxpayers, annual sales of CNY 800,000 (approximately 80,000 Euros; prior to 2009, the amount was CNY 1.8 million).<sup>35</sup>

The annual sales amount is computed (i) to include any amount of exempt supplies as well as any amount previously under-reported but found under an audit or an assessment;<sup>36</sup> and (ii) determined for any consecutive 12-month period.<sup>37</sup> Individual persons that are not sole proprietors cannot be regular taxpayers even if their annual sales exceed the above amounts. Taxpayers that are not business enterprises and enterprises that engage in taxable transactions only infrequently may elect to be small-scale taxpayers even if they generate sufficient sales in a year to qualify as regular taxpayers.<sup>38</sup> Moreover, a person with annual sales above the stipulated amounts but who fails to keep a sound accounting system or provide accurate tax information, or who fails to complete the procedures for recognition as a regular taxpayer,<sup>39</sup> would be subject to the punitive measures of (i) an output tax on sale at the regular VAT rates (of up to 17%), (ii) disallowance of input credit, and (iii) prohibition from issuing VAT invoices.<sup>40</sup> Conversely, taxpayers with annual sales below the stipulated amounts may apply to be treated as regular taxpayers (i.e. subject to the regular VAT) if they (i) can demonstrate “a sound accounting system” and provide accurate tax information,<sup>41</sup> and (ii) have a fixed place of business.<sup>42</sup> A

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<sup>32</sup> VATPR, Art. 11.

<sup>33</sup> VATPR, Art. 12; before 2009 rates of either 4% or 6% applied to small-scale taxpayers depending on their activities.

<sup>34</sup> Guoshuifa [2006] 156 (SAT, 17 October 2006) [Measures for Using VAT Special Invoices], Art. 10.

<sup>35</sup> VATIR, Art. 28. Being “principally in the production of goods or provision of taxable services” means that the sales amount of goods produced or taxable services provided by the taxpayers annually accounts for more than 50% of the annual taxable sales amount. *Id.* The sales amount is computed on a tax-exclusive basis. *Id.*, Art. 30.

<sup>36</sup> SAT, Administrative Measures on the Recognition of Regular VAT Taxpayers (SAT Decree No. 22, issued 10 February 2010 and effective 20 March 2010) (hereinafter “Decree 22”), Art. 3.

<sup>37</sup> *Id.* before 2010, annual sales was computed on a calendar year basis.

<sup>38</sup> VATIR, Art. 29. Oddly, a recent SAT notice states, simultaneously, that (i) “engaging in taxable transactions only infrequently” means engaging in such transactions accidentally, and that (ii) “businesses engaging in taxable transactions only infrequently” means businesses that are not VAT taxpayers. SAT, Guoshuihan [2010] 139 (7 April 2010) [Notice Clarifying the Application of Several Provisions under the Administrative Measures on the Recognition of Regular VAT Taxpayers], Art. 5.

<sup>39</sup> Procedures for registering as a regular VAT taxpayer is further discussed in Section VII below.

<sup>40</sup> VATIR, Art. 34.

<sup>41</sup> VATPR, Art. 13. “Sound accounting” means the ability to establish accounting books in compliance with the national uniform accounting system and accurately account in accordance with the lawful and valid ledgers. VAT IR, Art. 32.

person that has been determined to be a regular taxpayer may not be reclassified as a small-scale taxpayer, unless the SAT provides otherwise in the future.<sup>43</sup>

Before 2009, not only was the annual sales requirement for taxpayers to qualify as regular taxpayers set at higher amounts, other conditions also made it difficult for businesses to qualify as regular taxpayers. As a result, it was estimated that, nationally, 84% of VAT taxpayers were small-scale taxpayers, i.e. not subject to the standard VAT.<sup>44</sup> Nonetheless, the amount of “VAT” revenue generated by this large group of taxpayers was small and showed a consistent decline as a percentage of total domestic VAT revenue—from as high as 10% in 2001 to 4.14% in 2007.<sup>45</sup> With the lowering of requirements for qualification as regular taxpayers and the turnover tax rate applicable to small-scale taxpayers in 2009, the revenue contribution of small-scale taxpayers can be expected to experience an even sharper decline. Therefore, questions arise whether the category of small-scale taxpayers should be retained, and whether such taxpayers should simply be excluded from the VAT—in effect, setting the VAT threshold at a level where the line between regular taxpayers and small-scale taxpayers is presently drawn.

## 2. Treatment of branches; group reporting

Besides its breadth, another feature of the concept of “units” used in defining VAT taxpayers is that it has no connotation of possessing legal personality: therefore, different branches of the same legal entity are normally treated as different VAT taxpayers if they are located in different cities or counties.<sup>46</sup> This is the case even if the branches do not constitute independent accounting units and are inseparable from headquarters for accounting purposes. It is only by special permission of the MOF and SAT, or of local authorities to whom the MOF and SAT have delegated authority on the matter, that head offices may file VAT returns and pay tax on a consolidated basis at the places where head offices are located.<sup>47</sup> Since the 1990s, different local tax authorities have approved consolidated VAT branch reporting for select industries such as merchandise retail and gasoline station operators.<sup>48</sup> Invariably, the grant of consolidated reporting rights is made only to branches that are not independent accounting units. And even consolidated reporting may mean that (1) the branches have to separately remit tax in their respective jurisdictions (i.e. on the basis of some

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<sup>42</sup> Decree 22, Art. 4.

<sup>43</sup> VATIR, Art. 33.

<sup>44</sup> Statement of an SAT official during an international conference on VAT legislation, Xining, 22 July 2010.

<sup>45</sup> Computation based on data from the China Tax Statistic Annuals (2002-2008).

<sup>46</sup> VATPR, Art. 22.

<sup>47</sup> Id.

<sup>48</sup> See, e.g. Caishuizi [1997] 97 (MOF and SAT, 11 November 1997) [Notice on Issues Regarding the Place for VAT Payment of Chain-Operated Enterprises]; Decree No. 2 (SAT, 2 April 2002) [Measures for VAT Collection on Retail Gas Stations Selling Refined Oil]; YueGuoshuihan [2004] 4 (State Tax Bureau of Guangdong Province, 5 January 2004) [Notice on VAT Payment on a Consolidated Basis by the Guangdong Branches of PetroChina Co. Ltd.].

apportionment formula applied to total VAT liability computed at the headquarter office), that (2) the branches have to separately apply for recognition as regular VAT taxpayers, and that (3) inter-branch transfers are deemed to be taxable transactions. It is only recently, and only in a few cities such as Shenzhen, that true consolidated reporting (that is, only the headquarters has to file tax returns and pay tax, branches are not independently registered for VAT purposes and inter-branch transactions disregarded) began to be practiced.

Without receiving special approval for consolidated reporting, transactions among different branches are treated as transactions among different taxpayers and subject to the same rules as the latter. A deemed sale rule provides that a transfer of goods, for the purpose of eventual sale, from one branch to another branch that forms part of the same accounting unit is treated as a taxable sale unless the relevant branches are in the same county (or city).<sup>49</sup> That is, when all the transferee branch does is to issue a VAT invoice to, or receive payment from, the ultimate purchaser of the goods,<sup>50</sup> it will be treated as having made a purchase from the transferor branch and as having resold the goods. Entities with independent legal personality are always treated as separate taxpayers for VAT purposes, and there is no known case where group reporting is allowed.

This state of affairs can be contrasted with the enterprise income tax (EIT), under which branches and headquarters generally compute tax liability on a consolidated basis, and certain state-owned corporate groups have been allowed in the past (and some are still allowed) to file consolidated returns. The treatment of different branches as different taxpayers must be understood in light of the background discussed in Section 1, namely that VAT revenue is shared between higher and lower levels of government (i.e. between the central and provincial governments, and between provincial governments and their subdivisions) depending on where revenue is collected. This creates a great incentive for local governments to establish taxing points in their own jurisdictions. The implementation of branch and group consolidation in the EIT area has encountered resistance by local governments for this reason, and the implementation of the same for the VAT in the future is more a political issue than it is a technical one.

Because VAT rates are applied uniformly within China, and because, as discussed below in Section IV, cross-border transactions are taxed on a destination basis, in theory there appear to be few incentives for taxpayers themselves to manipulate pricing in related-party transactions for VAT purposes (even though which branch or subsidiary collects VAT is a matter of importance to local tax authorities). However, the fact that many Chinese businesses are subject to the BT and not VAT means that there may be plenty of room for effective indirect tax rates to differ, and related-party

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<sup>49</sup> VATIR, Art. 22.

<sup>50</sup> Guoshuifa [1998] 137 (SAT, 26 August 1998) [Notice on VAT Collection on the Transfer of Goods Among Branches of the Same Enterprise].

transactions may offer opportunities for tax planning. The VAT regulations provide generally that “where the price used by the taxpayer in the sales of goods or taxable services is obviously low without justification, taxation authorities may independently determine the value of the sales.”<sup>51</sup>

### 3. Permanent Establishments

If a foreign person (either a “unit” or an individual) has an establishment (*jigou*) in China, that establishment, if it engages in taxable transactions under the VAT, will likely constitute a VAT taxpayer.<sup>52</sup> In the most recent relevant regulation,<sup>53</sup> this rule appears to be restated so that it is a “trading establishment” (*jingying jigou*) of a non-resident that engages in activities subject to the VAT or the BT that would be the relevant taxpayer under the VAT or the BT.<sup>54</sup> “Trading establishment” is an undefined term, but it is contrasted with an agent: where there is no trading establishment but there is an agent, the agent must act as the withholding party for VAT and BT purposes.<sup>55</sup> A distinction can thus be made between the VAT concept of an establishment and the (domestic law) income tax concept of an establishment, because the latter encompasses agency types of establishment.<sup>56</sup> And since the concept of permanent establishment under income tax treaties further differs from the domestic law concept of an establishment, there is only limited overlap between the concept of an establishment (of a foreigner) in China for VAT purposes and the PE concept under China’s treaties.

VAT registration rules for “trading establishments” are discussed in Section VII below.

## III. Taxable Transactions

Within the structure of current VAT regulations, a taxable transaction is effectively the most elemental notion, being conceptually prior even to the notion of taxpayers. Taxable transactions include the sales of goods (defined as tangible movable property and inclusive of electricity, heat, and gas<sup>57</sup>), the provision of processing, repair and

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<sup>51</sup> VATPR, Art. 7. For further discussion of VAT valuation rules, see Section VI below.

<sup>52</sup> VATPR, Art. 18.

<sup>53</sup> Decree No. 19 (SAT, 20 January 2009, effective 1 March 2009) [Provisional Administrative Measures on the Tax Administration of Contract Projects and Service Provisions for Non-residents] (hereinafter “Decree 19”). For a summary report of the regulation, see Jiang and Tang, ‘China Issues Guidance on Tax Treatment of Nonresidents on Contract Projects’, *Worldwide Tax Daily* (2009), pp. 34–35.

<sup>54</sup> Decree No. 19, Art. 19.

<sup>55</sup> *Id.*, Art. 20. The VAT obligations of a foreigner where there is no establishment will be discussed in Section IV.

<sup>56</sup> For an overview of the concept of establishment under Chinese income tax law, see Cui, ‘“Establishment”: An Analysis of a Core Concept in Chinese Inbound Income Taxation’, *Columbia Journal of Tax Law* (2010).

<sup>57</sup> VATIR, Art. 2.

replacement services (“taxable services”), and the importation of goods. As discussed in Section I, the BT presently applies to the provision of other services and the transfer of immovable property and intangibles. There is no term that directly corresponds to the term “supply” and that would apply to both goods and services.

The “sales of goods” is defined as the transfer of the ownership of goods for any consideration. Nonetheless, the transfer of possession is sometimes sufficient to give rise to a taxable event. For example, certain purchases of goods on behalf of others are treated as separate taxable events (i) between the seller and the agent and (ii) between the agent and the principal,<sup>58</sup> and a similar treatment may apply to consignment sales and inter-branch transfers. On the other hand, even though financial leases are treated as resulting in the transfer of ownership for income tax purposes,<sup>59</sup> they are not so treated for VAT purposes and are regarded as services subject to the BT instead.<sup>60</sup> Without fully addressing a potential inconsistency with the basic definition of taxable sales, the SAT has ruled that if the transfer of goods forms a part of the transfer by an enterprise of all of its assets, creditor’s rights, obligations and labour force, then the transfer falls outside the scope of the VAT and is not taxable.<sup>61</sup> However, a more recent ruling held that if the transferor company retained the rights and qualifications of a listed company, then its transfer of assets and obligations is incomplete, and therefore the transfer of assets to its parent company in a reorganization, as well as the subsequent transfer of such assets to other subsidiaries of the parent company, are all subject to VAT.<sup>62</sup>

“Consideration” generally includes “money, goods or other economic benefit.”<sup>63</sup> Valuation rules are discussed in Section VI below.

A number of deemed sales rules further expand the definition of the sale of goods to include:

1. Consigning or otherwise delegating to other units or individuals as agents in the sale of goods, and such sale of goods by consignment or other agency

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<sup>58</sup> This treatment applies unless (i) the agent purchasing on behalf of the principal does not advance the purchase price, (ii) the seller issues the invoice addressed to the principal and the agent delivers such invoice to the principal, and (iii) the agent settles with the principal by the actual amount of purchase price (and VAT) paid over to the seller, and charges a handling fee separately. Caishuizi [1994] 26 (MOF and SAT, 5 May 1994) [Notice regarding Certain Policy Provisions on the VAT and Business Tax], Section 5.

<sup>59</sup> See, e.g. Enterprise Income Tax Law (10th Nat’l People’s Cong., 16 March 2007, effective 1 January 2008, hereinafter the “EIT Law”), Art. 11.

<sup>60</sup> Guoshuifa [1993] 154 (SAT, 28 December 1993) [Rules regarding Certain Specific VAT Questions], Art. 1(3).

<sup>61</sup> Guoshuihan [2002] 420 (SAT, 17 May 2002) [Reply Concerning the Non-Imposition of VAT on the Transfer of All Property Rights of an Enterprise]. See also Guoshuihan [2002] 165 (SAT, 21 February 2002) [Reply regarding the Non-Applicability of the Business Tax to Asset Transfers by an Enterprise], which provided that the BT also does not apply to the transfer of intangible and immovable properties under similar circumstances.

<sup>62</sup> Guoshuihan [2009] 585 (SAT, 21 December 2009) [Reply Concerning Issues of VAT Policy on the Reorganization of a Taxpayer’s Assets].

<sup>63</sup> VATIR, Art. 3. Valuation rules are discussed in Section V below.

- arrangements on behalf of others;
2. Certain transfers of goods from one branch to another of a single legal entity;
  3. The use of self-produced goods or goods processed on a commission basis for transactions not subject to the VAT, or for employee benefits or individual consumption;<sup>64</sup> and
  4. The provision of goods purchased, self-produced, processed on a commission basis, to other units or sole proprietors as investments, the distribution of such goods to shareholders or investors, or the giving away of such goods to others for free.<sup>65</sup>

#### 1. Simplified VAT Reporting: Pressure for Reverting to Turnover Taxes

Simplified VAT reporting may seem to be a secondary subject in discussions of the VAT/GST in other countries, but in China it is not only significant but also troubling. As already discussed, large sectors of the economy (e.g. services, finance and real estate) are subject to BT instead of VAT. Moreover, over 80% of all VAT taxpayers are small-scale taxpayers who cannot claim input tax credit but are subject to the “simplified method” VAT—a low-rate turnover tax. All suppliers falling under the BT or small-scale VAT taxpayer categories thus lack incentive to demand VAT invoices from their suppliers, which renders these latter suppliers less motivated to join the VAT network. On top of this, many types of transactions entered into by regular taxpayers are also subject to the “simplified method”, which means a low tax rate on output and no input credit. Unlike its application to small-scale taxpayers, the simplified method as applied to regular taxpayers may sometimes be mandatory—there may be no option of adopting the regular VAT mechanism. Moreover, there is no possibility of having VAT invoices issued to the purchaser.

For example, the simplified method and a 6% rate are available for the sales of certain self-manufactured goods, including electricity produced by small hydraulic power stations, tap water, concrete, lime, brick, and certain biological products.<sup>66</sup> The same treatment is mandatory for tap water sold by tap water companies. A mandatory simplified method and 4% rate apply to sales of goods on a consignment basis by consignment shops, sales of goods by pawnbrokers and retail sales of

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<sup>64</sup> Part of the intention of this rule is clearly to subject consumption that transpires within the workplace and falls outside normal market transactions to the VAT. Taxing final consumption that occurs in the grey area between business and private uses is similarly the aim of a number of rules denying input credit, further discussed in Section V below. Input credit is denied for goods or taxable services purchased and used for employee benefits or individual consumption, and for consumer goods designated by the MOF and SAT intended for the self-consumption of taxpayers.

<sup>65</sup> VATIR, Art. 4. In a case of gratuitous transfer, if the transferor and transferee are both regular taxpayers, a VAT invoice may be issued to the transferee. Guoshuifa [1994] 122 (SAT, 7 May 1994) [Notice regarding Certain Questions of VAT Administration], Art. 3.

<sup>66</sup> Caishui [2009] 9 (SAT, 9 January, 2009) [Notice Regarding Applying Lower VAT Rates and Simplified VAT Collection Methods to Certain Goods]. The election to apply the simplified method to such sales is for a minimum of 36 months.

duty-free goods by approved duty-free shops.<sup>67</sup> A mandatory simplified method and effective VAT rate of 2% apply to the sale of self-used fixed assets sold by small-scale taxpayers (other than individuals), similar assets sold by regular taxpayers where input credit had been denied, and second-hand goods that are not self-used goods.<sup>68</sup> The only type of taxpayer whose sale of self-used goods is exempt from tax is “other individuals,” that is, individual VAT taxpayers that are not sole proprietors.<sup>69</sup>

It is not clear what justifies such an adoption of the simplified method for taxpayers who are otherwise capable of complying with regular VAT mechanisms. In the case of second-hand goods, other countries have deemed unrelieved VAT embedded in purchases from individual consumers to be a problem, in light of the policy goal of putting used goods dealers on the same footing as private sellers. And methods such as notional credits and margin schemes are offered as solutions. It is quite opaque whether, and how, China’s simplified method may accomplish the same goal. Moreover, the wide use of the simplified method for products that use “natural material” for input—presumably without creditable VAT invoices—stands the logic of VAT on its head: whereas in other VAT systems the prevalence of registered suppliers motivates more suppliers to register, in China the prevalence of transactions unaccompanied by special VAT invoices drives the government and even regular taxpayers to take transactions out of the VAT network.

## 2. Imports and Exports

With respect to imports and exports, China nominally practices the destination principle by taxing imports at normal VAT rates and zero-rating exports. For the importation of goods, the time at which the liability of the importer for VAT arises is the date on which the import declaration is made.<sup>70</sup> Importers are required pay tax within fifteen days of the date on which special receipts for import VAT are issued by customs authorities.<sup>71</sup> There appears to be no instance where the payment of VAT due upon importation may be deferred until the filing of a VAT return.

Since the beginning of 2004, it has been possible for certain goods permitted by the customs authority to be brought into China on a temporary basis to be exempt from import VAT (and import excise tax). Such goods must generally leave China within six months of their importation, unless the taxpayer applies for and obtains an extension. The taxpayer must either pay a deposit with the customs authorities in an amount equal to the tax that would have been due on the imported goods or provide

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<sup>67</sup> Id.

<sup>68</sup> Id.

<sup>69</sup> The VAT Provisional Regulations ostensibly exempts the sale of used goods from the VAT. VATIR, Art. 35 (3). However, implementation regulations limit the scope of this exemption to only articles that have been used by “other individuals”. VATIR, Art. 15 (7).

<sup>70</sup> VATIR, Art. 19.

<sup>71</sup> VATPR, Art. 24.

some other guarantee. The goods to which the treatment applies include:

- goods for display or use at exhibitions, trade fairs, conferences or similar events;
- items used in performances or competitions in cultural or athletic events;
- equipment and accessories used in news reporting or the production of film or television, and in scientific research, education, and medical activities;
- special vehicles and transportation devices used in the above activities;
- sample goods;
- devices and tools used in installation, testing, and equipment check-up;
- containers for goods, and
- other goods applied to non-business use.

If the goods fail to be shipped back out of China, the customs authority will collect VAT (and excise tax).<sup>72</sup>

In terms of exports, zero-rating has become a merely aspirational objective,<sup>73</sup> the realization of which is relegated to the indefinite future. Instead, the government frequently adjusts the rates at which input taxes are credited or rebated on exports, making the VAT on exports intentionally non-neutral and an instrument of trade policy. Interestingly, the initial reasons for the government's inability to implement full zero-rating in the mid-1990s were the same that explain the failure of zero-rating in many other countries newly adopting the VAT:<sup>74</sup> the government was fiscally unprepared to return the large amount of revenue to taxpayers, and there was concern about VAT fraud in the claim for rebates. However, improved budgeting and combating VAT fraud appear no longer determinative of whether full zero-rating would come to fruition. Instead, whether exports should receive a full VAT refund has become deeply entangled with China's trade policy. The latest development in this regard is the complete revocation of VAT refund for six categories of products (406 items) effective 15 July 2010.<sup>75</sup> The fact that such policy is adopted when comprehensive VAT reform—by way of absorption of the BT and other measures that attempt to bring the Chinese VAT closer to international norms—is under discussion by legislators is all but breathtaking.

#### **IV. Place of Taxation Rules**

Because the provisions of most services as well as the transfer of immovable property and intangible property are currently subject to BT and not VAT, place of supply issues under the Chinese VAT per se are not as complex and problematic as they are in other jurisdictions. However, place of supply does matter even for domestic

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<sup>72</sup> Caiguanshui [2004] 7 (MOF, General Administration of Customs, SAT, 21 December 2009) [Provisions on Issues of Tax Policy concerning Collection of Taxes by Customs on Imported Goods upon Importation], Art. 1.

<sup>73</sup> VATPR, Art 2 (3) provides that “for taxpayers that export goods, the tax rate shall be zero, except as otherwise provided by the State Council.”

<sup>74</sup> See Ebrill et al., *The Modern VAT* (2001) Chapter 15.

<sup>75</sup> Caishui [2010] 57 (MOF and SAT, published 22 June 2010, effective 15 July 2010) [Notice regarding the Revocation of Tax Refunds on the Export of Certain Goods].



transactions: although VAT rates are largely uniform across the country, the place of supply determines which local jurisdictions collect the VAT revenue.

The sales of goods or provision of taxable services take place within China if (i) the starting place of shipment for, or the location of, the goods to be sold is within China, and if (ii) the performance of taxable services takes place within China.<sup>76</sup> Within China, businesses with fixed establishments generally pay VAT where their establishments are located.<sup>77</sup> If such businesses sell goods or taxable services in another county (or city), they need to apply for a “tax administration certificate of outbound business activities” from the authorities at the place where their establishment is located. Without such a certificate, businesses are required to pay tax to authorities at the places where the sales activities take place or services are provided. However, the tax authorities at the place where the establishment is located retain enforcement jurisdiction if such businesses fail to make a tax return and pay tax at the places of sales or service activities. Taxpayers without a fixed place of business are required to pay tax where a sale is made or service provided, although the authorities at the places of the taxpayers’ domicile may also collect overdue taxes. Finally, for imported goods, taxpayers are to file returns and pay tax to the customs authority at the places where imported goods are declared.<sup>78</sup>

A brief summary of the place of supply rules under the BT is as follows.<sup>79</sup> Unlike services taxed under the VAT, BT-able services are deemed to be performed in China (and thus subject to the BT) if either the provider or the recipient of the service is located in China.<sup>80</sup> That is, for the import of services, China practices the destination principle, while for the export of services, it practices the origin principle. For services provided outside China to recipients within China, the service recipient must withhold the BT payable on the service,<sup>81</sup> even though the foreign service-provider is nominally still a taxpayer and has liability for the tax if unpaid. Not being the taxpayer, the Chinese service recipient also cannot deduct the BT withheld for income tax purposes (unless perhaps it agrees explicitly to gross up for the BT).

A not-insubstantial amount of uncertainty exists as to whether it is the identity of the recipient (a Chinese entity or individual—whatever criteria determine these) or the location of the recipient at the time of service that is relevant for the rule. In a recent

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<sup>76</sup> VATIR, Art. 8. There is no rule under the VAT for taxable services (i.e. processing, repair and replacement services) that is analogous to the BT rule that deems supply to be provided within China if the service recipient is within China.

<sup>77</sup> VATPR, Art. 22. If a business has multiple establishments in different jurisdictions, it either has to pay VAT separately in each of these jurisdictions, or it may seek the government’s approval to pay VAT only in the jurisdiction where the headquarters is located. See discussion of branch rules in text accompanying notes [46-50] supra.

<sup>78</sup> VATPR, Art. 22.

<sup>79</sup> For a more extensive discussion, see Cui, “Taxing Cross-Border Services in China: the (Partial) Switch to Destination-Based Taxation”, in Lang, Melz and Kristoffersson (eds.) *Value Added Tax and Direct Taxation: Similarities and Differences* (2009) pp. 323-338.

<sup>80</sup> BTIR, Art. 4(1).

<sup>81</sup> BTPR, Art. 11.

circular, the MOF and SAT provided that for services in the construction, culture, and sports industries (excluding broadcasting), services performed outside China provided “by Chinese entities or individuals within China” are “temporarily exempted” from BT.<sup>82</sup> Conversely, if a service is entirely provided outside China by an entity or individual outside China (presumably, a foreign entity or individual) for an entity or individual within China (presumably, a Chinese entity or individual), such a service is not deemed to be provided within China—but only if, in addition, the service belongs to a list of services enumerated by the MOF and SAT. Currently, such services include labour services in (i) the culture and sports industries (excluding broadcasting), (ii) entertainment, (iii) hotel, catering and storage, and (iv) bathing, hairdressing, washing and dyeing, picture-mounting, transcription, engraving, duplication and packaging services.<sup>83</sup> In other words, it took a special dispensation of the government to confirm that a restaurant meal purchased and consumed by a Chinese citizen in Vienna is not subject to the Chinese BT.

Finally, the transfer (including license) of intangible property is taxed where the intangible is used; the transfer of real property is taxed where the property is located.<sup>84</sup> Both rules are consistent with the destination principle. International transportation services provided by Chinese enterprises and individuals are exempt from the BT effective from 1 January 2010.<sup>85</sup> And in a gradual transition to the destination principle for the export of services, sales revenue derived from outsourced services performed for foreign customers by enterprises located in selected locations is exempt from the BT until the end of 2013.<sup>86</sup>

## V. Exemptions, Taxable Amount and Tax Rates

### 1. VAT Rules: reduced rates, valuation, exemptions and other preferences

The standard VAT rate is 17%, and has remained unchanged since 1994.<sup>87</sup> A reduced rate of 13% applies to sales and importation of certain types of basic food and utilities; books, newspapers and magazines; forage, chemical fertilizer, pesticides, agricultural machinery and plastic film for agricultural purposes; and other goods as prescribed by the State Council.<sup>88</sup> Apparently, the State Council’s

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<sup>82</sup> Caishui [2009] 111, supra note [26], sec. 3. The identity of the entities or individuals as being “within China” remains undefined.

<sup>83</sup> Id., sec. 4. These categories correspond to categories in the Annotations on Business Tax Category (Trial Implementation), supra note [19].

<sup>84</sup> BTIR Art. 7.

<sup>85</sup> Caishui [2010] 8 (MOF and SAT, 23 April 2010) [Notice Jointly Issued by the MOF and SAT Announcing Business Tax Exemption for International Transportation Services].

<sup>86</sup> Caishui [2010] 64 (MOF, SAT, and the Ministry of Commerce, 28 July 2010) [Notice Regarding BT Exemptions for Foreign Outsourced Services Provided in Certain Demonstration Cities].

<sup>87</sup> This rate had been set in 1993 in order to achieve revenue neutrality when the VAT replaced prior taxes. See Official Annotations, p. 16.

<sup>88</sup> VATPR, Arts. 1 and 2.

power to prescribe reduced rates for other items is regarded as appropriately exercised by the MOF and SAT as well, which had extended the 13% rate to the very broadly defined categories of primary agricultural products (since 1994) and of audio-visual products and electronic publications (since 2006).<sup>89</sup> Even lower rates have also been occasionally been adopted, for example for certain types of imported airplanes.<sup>90</sup> As discussed in Sections II and III, the rate of 3% applies to all supplies by small-scale taxpayers (as opposed to regular taxpayers),<sup>91</sup> and a quite varied set of rates are employed where the simplified reporting method (without input credit) is used for computing VAT liability. These rates are generally applied to the value of sales. Exported goods are zero-rated.<sup>92</sup>

The value of each sales transaction (whether of goods or VAT-able services) is the “total price and all other charges received from the purchaser.”<sup>93</sup> “Other charges” is relatively broadly defined,<sup>94</sup> but excludes, among other things,<sup>95</sup> certain governmental mandatory or administrative charges.<sup>96</sup> The inclusion of advances on behalf of purchasers in transactional valuation is perhaps unusual by international standards; only some specific categories of advances, such as insurance charges collected from the purchaser when the seller purchases insurance for the purchaser, are excluded.<sup>97</sup> Where goods are imported, the VAT rate is applied to a “composite price” which is the sum of customs dutiable price, customs duty and Excise Tax.<sup>98</sup> In computing output VAT, transactional value is to be computed in Renminbi (“RMB”). If a taxpayer accounts for sales amount in currencies other than RMB, the amount is converted into RMB at the middle foreign exchange rate either on the day on which the sales took place or on the first day of the month in which the sales

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<sup>89</sup> These rates were renewed in 2009. See Caishui [2009] 9 (MOF and SAT, 19 January 2009) [Notice Regarding Applying Low VAT Rates and Simplified Collection Methods for Levying VAT to Certain Products].

<sup>90</sup> Caiguanshui [2004] 43 (MOF and SAT, 30 September 2004) [Notice Regarding Adjusting VAT Policy for Airplanes Imported by Domestic Airlines].

<sup>91</sup> VATPR, Art. 12.

<sup>92</sup> VATPR, Art. 2 (3).

<sup>93</sup> VATPR, Art. 6.

<sup>94</sup> They include “service fees, subsidies, government mandatory charges, fund raising fees, returned profits, bonus, liquidated damages, late fees, interest accrued for delayed payments, indemnity payments, amounts collected on behalf of others, amounts advanced for the benefit of others, packaging charges, rentals on packaging materials, storage charges, quality charges, freight and handling charges, and charges of any other nature which is in addition to the price charged to the purchaser.” VATIR, Art. 12.

<sup>95</sup> Examples of such other exclusions are Excise Tax collected on excisable goods produced in commissioned processing, and vehicle purchase tax and vehicle license plate fees collected from and paid on behalf of the purchaser. *Id.*

<sup>96</sup> These must satisfy the following conditions: (i) they are mandatory charges approved by the State Council or MOF, or administrative charges either approved by the State Council or provincial-level governments or such governments’ financial or price regulatory agencies; (ii) fiscal invoices printed by provincial-level departments of finance are issued at the time of collection; and (iii) the amount so collected is turned over in full to the treasury. *Id.*

<sup>97</sup> *Id.* Also specifically excluded are advances for freight charges if the carrier issues an invoice for the charges to the purchaser, which invoice is then furnished by the seller to the purchaser. *Id.*

<sup>98</sup> Art. 14 of the VATPR.

took place. The choice between these two methods by a taxpayer cannot be changed within a year of adoption.<sup>99</sup>

Where the purported price of a transaction subject to the VAT "is obviously low without justified reasons," the sales amount may be adjusted by the competent tax authority.<sup>100</sup> In such a case or in the case of a deemed sale (where there is no sales price), the sales amount is determined in the following order:<sup>101</sup>

1. Based on the average price of similar types of goods sold by the taxpayer during the most recent period; (or if such price is not available,)
2. Based on the average price of similar types of goods sold by other taxpayers during the most recent period; (or if such price is not available,)
3. According to the "composite assessable value," which equals cost multiplied by (1 + profit ratio relative to cost)<sup>102</sup>

"Cost" is the cost of production or purchase, depending on whether the good is produced or purchased. The "profit ratio relative to cost" is set by the SAT, and has generally been 10% since 1993.<sup>103</sup>

If a sales discount is offered, where the sales price and discount amount are both noted on the same invoice, VAT is applied to the after-discount amount. Otherwise the pre-discount price is the basis for determining applicable VAT.<sup>104</sup> If goods are sold through the exchange for older goods, the current price of the new goods is used to determine the sales amount (but special rules apply to the exchange of gold and silver jewellery).<sup>105</sup> Discounts offered in order to encourage earlier payment do not reduce sales price, as for accounting purposes they do not reduce the value of sales but are treated as financial expenses instead. Deposit taken for packaging material rented to purchasers in the sale of goods, if not returned (because the rented packaging is not returned) within a year, is to be included in the sales price of the packaged goods.<sup>106</sup>

A variety of rules apply to purchase price adjustments. For regular VAT taxpayers, VAT refundable to purchasers due to sales returns and discount due to defective quality may be deducted from the output tax for the period in which the sales returns or discount take place, whereas VAT recovered due to returns or discount for purchased goods is to be subtracted from the input tax for the period in which such returns or discount take place.<sup>107</sup> A special procedure for the issuance of a "red-letter VAT invoice" exists for such changes due to the rigid reliance on VAT special invoices

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<sup>99</sup> VATPR, Art. 6 and VATIR, Art. 15.

<sup>100</sup> VATPR, Art. 7.

<sup>101</sup> VATIR Art. 16.

<sup>102</sup> For goods subject to the Excise Tax, the composite assessable value also includes the amount of such tax.

<sup>103</sup> See Guoshuifa [1993] 154 (SAT, 28 December 1993) [Rules regarding Certain Specific VAT Questions].

<sup>104</sup> Guoshuifa [1993] 154, Sec. 2 (2). Certain handling fees paid to distributors may be treated in the same fashion as such discount. Guoshuihanfa [1995] 288 (SAT, 2 June 1995) [Answers to Questions about Value-Added Tax Questions [Part I]].

<sup>105</sup> Id, Sec. 2 (3).

<sup>106</sup> Guoshuihanfa [1995] 288.

<sup>107</sup> VATIR, Art. 11.

for implementing the VAT credit mechanism (discussed in Section VI below). Such a red-letter invoice is required for any reduction of output tax (or input credit) to be feasible. If sales are made through the method of a delayed rebate (*huanben xiaoshou*), the amount rebated is not allowed to be deducted from the sales price.<sup>108</sup>

There is a very formidable array of VAT exemptions and preferences, and it would be mistaken to look just to the VAT Provisional Regulations for them. There, one finds only the following relatively innocuous list:<sup>109</sup> self-produced agricultural products sold by agricultural producers;<sup>110</sup> contraceptive drugs and devices; antique books; imported instruments and equipment used directly in scientific research, experiments and education; materials and equipment imported from foreign governments and international organizations, free of charge, as aid; articles imported directly by organizations for the disabled for specific use by the disabled; and second-hand goods that have been used and sold by the individual user. The truly significant provision, however, is one that states that the State Council may provide for other tax exemptions and reductions.<sup>111</sup> Pursuant to this authorization, the MOF and SAT (again apparently exercising authority on the State Council's behalf), either collectively or individually, have over time prescribed temporary or permanent exemptions for items ranging from material for scientific research, education, and science and technology development, to imported books, imported gold, construction material with recycled elements, supply of blood, agricultural machinery, fertilizers, animal feed, waste water processing, repair of freight trains, maintenance of rural electric grids, food sold at higher education institutions, donations to victims of natural disasters, material used in national defence, material used in building the National Theatre in Beijing, souvenirs sold at the Shanghai 2010 Expo, certain tea consumed by ethnic minorities, and so on.<sup>112</sup> Most of these exemptions do not match the OECD's list of typical exemptions found in other countries.<sup>113</sup>

Just as important as exemptions and reduced rates are a form of preferential policy labelled "collect and return" (*xiangzheng houfan* or *jizheng jitui*): under such an arrangement, VAT would be collected from a regular taxpayer, who would have issued a valid VAT invoice (which the purchaser could use to claim regular input tax deductions), but the tax collected would be returned to the taxpayer either in its entirety or where it exceeds a certain percentage of the taxpayer's value added for a

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<sup>108</sup> Id., Sec. 2 (3).

<sup>109</sup> VATPR Art. 15.

<sup>110</sup> "Agricultural products" are primary products from crop-farming, breeding, forestry, animal husbandry and aquatic products industries; "agricultural producers" include any units or individuals engaged in these agricultural industries. VATIR, Art. 35.

<sup>111</sup> VATPR Art. 15, para. 2.

<sup>112</sup> The relevant MOF and SAT documents are too numerous to cite here.

<sup>113</sup> Many items on the OECD list are services subject to the BT in China instead.

particular period.<sup>114</sup> Such policies have been widely deployed for items such as various products using recycled material, electricity generated from recycled material, mould used in manufacturing, digitally-controlled machine tools, specifically designated magazines and publications, aircraft maintenance, ship-building, and so on.<sup>115</sup> Where such policies are applied to business-to-business transactions and the purchasers have obtained valid tax invoices, they presumably operate simply as subsidies to the suppliers. These subsidies seem rather unconventional by international standards in that they are tied to value added: for example, the use of more employees in production would generate more subsidies. But they do not raise the type of concerns normally raised by exemptions, e.g. creating cascading, encouraging self-supply, etc. Moreover, the fact that, unlike VAT exemptions in Europe, these subsidies do not have a single historical origin but have continuously emerged over time and in different sectors, suggests that they must in many cases result in tangible benefits to the targets of such policies.

Given the explicitly preferential nature of these policies, it should not be surprising there have indeed been geographically-based tax preferences. For example, the supply of heating was made exempt in certain provinces,<sup>116</sup> and the “collect and return” policy was specifically granted for certain book-sellers in the Xinjiang Ethnic Autonomous Region.<sup>117</sup> Exemptions have also been given to particular traders, very often specifically designated.<sup>118</sup> Input VAT incurred for purchases of goods or services used for VAT exempt items generally cannot be credited against the output VAT. However, deemed credit may sometime be available for exempt purchases. A taxpayer who sells exempt goods or provides exempt services may elect to surrender the exemption treatment and pay VAT. No exemption may be applied within 36 months after the election.<sup>119</sup> The election must cover all items supplied by the applicant and not just some supplies.<sup>120</sup>

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<sup>114</sup> See, e.g. Caishui [2000] 25 (MOF, SAT and the General Customs Office, 12 November 2000) [Notice Regarding Certain Tax Policies for Encouraging the Development of the Software and Integrated Circuit Industries] (VAT collected in excess of 3% of value added from software companies returned; VAT collected in excess of 6% of value added from integrated circuit manufacturers returned.).

<sup>115</sup> The relevant MOF and SAT documents are too numerous to cite here.

<sup>116</sup> Caishui [2006] 117 (MOF and SAT, 27 November 2006) [Notice Regarding Continuing to Implement Tax Preferential Policies for Enterprises Supplying Heating].

<sup>117</sup> Caishui [2006] 153 (MOF and SAT, 5 December 2006) [Notice Regarding VAT and BT Preferential Policies for Publicity and Culture].

<sup>118</sup> See, e.g. Caishui [2000] 101 (MOF and SAT, 25 December 2000) [Notice Regarding VAT Collect and Return Policies for Economic Daily and Guangming Daily].

<sup>119</sup> VATIR Art. 36.

<sup>120</sup> Caishui [2007] 127 (MOF and SAT, 5 September 2007) [Notice Regarding Issues in VAT Taxpayers Foregoing Rights of Exemption].

## 2. BT exemptions

The chaotic complexity of reduced rates, exemptions, and other preferential policies in the Chinese VAT is to some extent replicated under the BT, and is certainly beyond the scope of this report. However, because VAT exemptions in other countries often apply to services and other transactions covered by the BT in China, a brief discussion of the scope of the BT with respect to these typical exemptions may be worthwhile. In many respects, the BT base is broader than the corresponding base in other VAT systems. For example, financial services, e.g. lending, dealing and brokerage, currency exchange, insurance and reinsurance services are all subject to the BT.<sup>121</sup> In the case of lending, BT is applied to gross interest.<sup>122</sup> In certain other cases such as the trading of foreign currency, marketable securities and futures, etc., the taxable turnover is the excess of the sales price over the purchase price.<sup>123</sup> Real estate transactions are generally taxed, including the first sale, resale, and rental of residential property. Indeed, the financial, real estate, and construction sectors account for over 60% of BT revenue.<sup>124</sup> The exemptions for education, health, government entities and public institutions are also subject to restrictive conditions not commonly seen in other countries. For example, in order to qualify for the exemption for medical services provided by hospitals, clinics and other medical institutions,<sup>125</sup> the provider must be a non-profit institution.<sup>126</sup> The exemptions for educational services, nursery and kindergarten services, admission fees for cultural activities held by memorial halls, museums, cultural centres, etc.<sup>127</sup> are also all subject to limitations, usually in the form of the requirement that the suppliers have some kind of state-licensed status. Lest one thinks that the status of being state-owned public institutions is sufficient for exemption, research grants received by public universities from the government are also generally subject to the BT, with very narrow exceptions.<sup>128</sup>

Given that the BT is a cascading turnover tax, its exemption removes cascading and distortions on business-to-business transactions. And given that the arbitrariness with which cascading taxes create various degrees of tax burdens—depending on the number of links in the chain of production—even if they are consistently enforced, no

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<sup>121</sup> See BT Annotations, Sec. 3.

<sup>122</sup> Guoshuifa [2002] 9 (SAT, 30 January 2002) [Administrative Measures for BT Reporting by the Financial and Insurance Industries], Art. 11.

<sup>123</sup> BTPR, Art. 5.

<sup>124</sup> For a discussion of the history of, and reform options facing, indirect taxation of the real estate sector, see Cui, “What China Might Learn from the Australian GST?” in Peacock et al (eds.) *The Australian GST: Looking Forward from the First Decade* (2011) (forthcoming).

<sup>125</sup> BTPR, Art. 8 (3).

<sup>126</sup> Guoshuifan [2006] 480 (SAT, 23 May 2006) [Reply Regarding Collecting BT on Medical Services Provided by For-Profit Medical Institutions].

<sup>127</sup> BTPR, Art. 8 (4).

<sup>128</sup> Guoshuifa [2001] 100 (SAT, 1 September 2001) [Notice Regarding BT Issues for Scientific Research Units and the Survey and Design Institute of the Ministry of Railways].

consistent, fair outcome can be guaranteed. From this perspective, BT exemptions may be more supportable than VAT exemptions.

## VI. Deductions

Perhaps the two most important features of the Chinese regime for VAT deductions are, first, the absence, outside the export context, of normal refunds for any excess of input tax paid over output tax, and second, the very strict invoice requirement for input tax credit claims. In terms of the first feature, the VAT payable in a period is the balance of the output VAT of the period after crediting the input VAT of the period. When the amount of output VAT is insufficient to fully offset the input VAT of the period, the excess amount is carried forward to the next period for further set-off.<sup>129</sup> There is no time limitation on such carryover, but unless there is output tax to absorb the input tax deduction at some point, the taxpayer may never recover the input tax paid, not even upon liquidation. Thus, while in one sense, where regular VAT mechanisms operate (i.e. putting aside the cascading created by breaks in the VAT chain, such as transactions to which the BT or "simplified" VAT methods apply), the total tax burden on the final consumer does not depend on the number of intermediaries in the production and distribution process, businesses may often end up bearing the cost of VAT. This renders the Chinese VAT non-neutral (even disregarding extensive breaks in VAT chains), given that businesses will be motivated to minimize such costs.

In terms of the second feature, essentially, only "special invoices" that pass the verification process of the Golden Tax system can be the basis of input credit claims.<sup>130</sup> The nationwide Golden Tax system requires regular VAT taxpayers to report all taxable sales on special IC cards, which incorporate technology that prevents information about such sales from being altered to differ from the information shown on the special VAT invoices issued to purchasers. Except where deemed credit rules (discussed below) apply, in order for input credit to be allowed, a business purchaser must first have the special VAT invoices it has received verified as authentic by the tax authorities, and such invoices must first be matched with information that the STB system has collected from vendors' IC cards.<sup>131</sup> Because the government relies heavily on controlling the use of VAT invoices to secure compliance with VAT law (and performs audits infrequently), form dominates substance in the invoice-credit mechanism. For example, before 1 January 2010, unless a VAT invoice was verified by the tax authorities within 90 days from the date

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<sup>129</sup> VATPR, Art. 4.

<sup>130</sup> Art. 9 of the VATPR states: "Where certificates for the deduction of VAT obtained by taxpayers purchasing goods or taxable services do not comply with laws, administrative regulations or relevant provisions of the competent taxation authority under the State Council, their input tax shall not be credited against the output tax involved." The SAT thus has great deal of discretion over what input taxes may be credited.

<sup>131</sup> See, generally, Guoshuifa [2006] 156 (SAT, 17 October 2006) [Measures for Using VAT Special Invoices].



of its issuance, no input tax credit may be claimed for the purchase to which it relates, no matter how un-controversially one is able to establish the facts of the purchase. Although the time limit has now been extended to 180 days,<sup>132</sup> that very requirement itself demonstrates how the government's decision to secure compliance in a particular fashion can override the substantive logic of the VAT.

Generally, any input tax is creditable only if it has been paid or borne by the taxpayer.<sup>133</sup> Under current rules, creditable types of input VAT include the following:<sup>134</sup>

- a) VAT indicated on special VAT invoices obtained from sellers;
- b) VAT indicated on import VAT memos obtained from customs authorities;
- c) In the case of input purchase of agricultural products, where special VAT invoices or import VAT memos are not available, a deemed input VAT credit is allowed and determined based on the price indicated on the purchase or sales invoice, multiplied by a VAT deduction rate of 13%.
- d) For transportation charges incurred in the purchase or sale of goods as well as during the production process, a deemed input VAT credit is also available, computed based on the amount of such charges as shown on the invoices for transportation services, multiplied by a VAT deduction rate of 7%.

The policy justification offered for the deemed credit for agricultural products is that although self-produced agricultural products sold by farmers are exempt from the VAT, they bear input VAT on the purchases made by these farmers.<sup>135</sup> This provision, however, also covers agricultural products purchased from small-scale taxpayers who do not claim the self-produced agricultural products exemption and who are subject to turnover tax. The deemed credit approach (including its application to non-exempt purchases from small-scale taxpayers) dates back to 1994, when the deemed rate of tax was 10%. In 2002 this was raised to the present 13%. The deemed credit for transportation expenses on the purchase or sale of goods also dates back to 1994. It was initially computed at a 10% deduction rate, which was then lowered to the present 7% in 1998. The deemed credit was expanded in 2009 to cover all transportation charges incurred in business operations.

In the past, other deemed credit policies were practiced. Between 1994 and 2001, for example, regular VAT taxpayers that deal in used and recycled goods were allowed a 10% deemed credit for purchases documented on certain certified invoices. In 2001

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<sup>132</sup> Guoshuihan [2009] No. 617 (SAT, 9 November 2009) [Notice Issued by the SAT Extending the Deadline for Claiming Input VAT Credit].

<sup>133</sup> According to the Official Annotations, p 29, VAT "paid" is the amount reflected on the special VAT invoice received by the purchaser; VAT "borne" may not be reflected on the invoice--presumably, the deemed credits for purchases of agricultural products and transportation services are examples of such credit for VAT "borne".

<sup>134</sup> VATPR, Art. 8. The types of creditable items and the applicable deduction rate may be adjusted by the State Council. Id.

<sup>135</sup> Official Annotations, p. 31.

sales by used goods dealers became exempt, and it was the purchasers from such dealers who were allowed to claim deemed credits (at 10%) based on certain special invoices issued by the dealers. In 2008 this policy was cancelled, so that no deemed credit is now available for used goods (and used goods are subject to simplified reporting and a low turnover tax as opposed to being exempt). However, the VAT treatment of used goods continues to undergo re-thinking, and the revival of some form of deemed credit in the future is possible.

The current VAT system adopts the view that input tax deductions are not available for purchases used for transactions to which the VAT does not apply or a VAT exemption applies.<sup>136</sup> Non-taxable transactions are officially defined essentially as transactions subject to the BT, plus (oddly) immovable property under construction.<sup>137</sup> However, the SAT has also expressed the view that input tax credits are always limited to where taxable output is generated.<sup>138</sup> This would imply that out-of-scope output (output subject to neither the VAT nor the BT) cannot give rise to input credit. Some of the SAT's past rulings are consistent with this view. For example, in 1999, the SAT ruled that where a Chinese enterprise incurred offshore transportation expenses and such expenses were not included in the formal export price of the goods, no input credit would be available for such expenses.<sup>139</sup> Whether such a view would be further articulated in the future is to be closely watched, especially in light of the ongoing debates in other countries about the proper treatment of inputs used for out-of-scope supplies.

Input VAT deduction is specifically denied for some additional categories of input:<sup>140</sup>

- a) Goods purchased, or taxable labour services obtained, for workplace benefits or personal consumption (in addition to those used for non-taxable or exempt transactions);
- b) Goods purchased and related taxable labour services which suffered abnormal loss;
- c) Goods purchased and related taxable labour services consumed in the course of producing finished goods or work-in-progress which suffered abnormal loss.
- d) Consumer goods that are self-used by the taxpayer as prescribed by the MOF and SAT;
- e) Delivery charges paid for the goods specified in foregoing items and for out-of-scope and exempted goods.

”Personal consumption“ as used in item a) includes consumption during business

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<sup>136</sup> VATPR, Art. 10 (1).

<sup>137</sup> VATIR, Art. 23 ("items not subject to the VAT" include "services not subject to value-added tax, the transfer of intangible assets, and the sales of immovable property and immovable property under construction").

<sup>138</sup> Official Annotations, p. 37.

<sup>139</sup> Guoshuihan [1999] 958 (SAT, 3 September 1999) [Replies Regarding the VAT Treatment of Interest on Delayed Payments and Other Issues], sec. 3. Presumably, what was at issue was the deemed input tax credit for transportation expenses.

<sup>140</sup> VATPR, Art. 10.

entertainment.<sup>141</sup> There is also a generous treatment for fixed assets under this rule. As long as such assets (defined as "machinery, means of transport, and other equipment, tools and instruments related to production or business operations and with a useful life of more than 1 year"<sup>142</sup>) are used in part for producing taxable output, input tax credit will be available for the entire purchase even if the assets are also used for non-taxable, exempt, or other purposes that would normally result in the denial of input credits. The government has thus effectively declined to adopt change of use rules for fixed asset acquisitions.<sup>143</sup>

The reasoning implicit in items b) and c) above are also interesting.<sup>144</sup> Presumably, abnormal losses in production due to mismanagement will be borne by the producer and not factored into output price. If input credit is given for purchases that suffered from such loss, the government is made to bear part of the loss, with no benefit for parties further down the production chain. Therefore, the government may choose not to share this loss. Based on considerations of fairness, beginning in 2009, "abnormal losses" include only certain losses from mismanagement, whereas natural disasters and other losses not attributable to mismanagement are excluded.<sup>145</sup>

Where purchases of input cannot be directly attributed to taxable, non-taxed or exempt output items, an apportionment method is to be used.<sup>146</sup> The amount of non-creditable input tax for a given period is the total input tax for the period that cannot be definitely attributed multiplied by a fraction, the numerator of which is the total sales amount from tax-exempt and non-taxable items for the period, and the denominator of which is that total sales amount for the period. While this apportionment is performed for every monthly period, an annual adjustment may be made to as to avoid the disallowance of input credit due to seasonal fluctuations.<sup>147</sup>

## **VII Tax Collection, Compliance, Refunds and Abuse**

### **1. VAT Registration; private taxpayers; reverse charge**

Understood as acquiring the status of a VAT taxpayer capable of claiming input tax credit and issuing VAT invoices, the concept "VAT registration" corresponds to the procedure of applying and obtaining "regular taxpayer" status, and we will refer to such procedure as VAT registration here even though it is not labelled as such in

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<sup>141</sup> VATIR, Art. 22.

<sup>142</sup> VATIR, Art. 21.

<sup>143</sup> Official Annotations, p 129.

<sup>144</sup> See Official Annotations, p 38.

<sup>145</sup> VATIR, Art. 24.

<sup>146</sup> VATIR, Art. 26. Prior to 2009, if a taxpayer engaged in both taxable and non-taxable or exempt transactions, *all* input items (even those that may be clearly attributed to taxable output) must be apportioned among taxable and other types of output. The irrationality of such a rule was eventually recognized and the rule was abolished. See Official Annotations, p. 135.

<sup>147</sup> Guoshuihanfa [1995] 288, sec. 13.

China. Eligibility conditions for being treated as regular taxpayers as well as certain options for choosing not to be so treated were discussed in Section II in connection with “VAT thresholds” above. In terms of procedure, within 40 days after a tax period during which it became required to register, a taxpayer needs to make an application for the determination of its eligibility as a regular taxpayer. The tax agency in receipt of the application must inform the taxpayer of the result of the determination within 20 days. Any taxpayer must also respond to tax agencies’ request for registration either with an explanation of why it believes registration is not required or with an act of registration.<sup>148</sup> Any taxpayer below the registration threshold but opting to register must furnish material proving that it has the accounting capacity and the fixed business premise required for optional registration. The relevant tax agency may conduct on-site inspections to verify eligibility.<sup>149</sup> Any taxpayer determined to be eligible to be a regular VAT taxpayer will have its tax registration certificate stamped to indicate such status,<sup>150</sup> and will be able to purchase and use special VAT invoices and compute tax liabilities according to regular VAT rules starting the ensuing month.<sup>151</sup> These registration procedures are the product of considerable recent simplification and there are no further “simplified” registration rules.

If a non-resident person engages in **contractual construction/engineering** or provision of services within China, it is obligated to complete a tax registration where the project is located or service provided within 30 days after the relevant contract is signed.<sup>152</sup> In theory, it may register as a regular VAT taxpayer if the volume of its transactions exceeds the relevant threshold. However, unless it has a fixed place of business, no optional registration is available.<sup>153</sup>

Individuals are subject to customs duty and import VAT while import personal articles from overseas. Exemptions are allowed for belongings with aggregate value of CNY 5000 for residents (approximately 500 Euros) or less, and CNY 2000 for non-residents or less.<sup>154</sup> As discussed in Section IV, if any unit or individual outside **China** provides VAT taxable services or services subject to the BT in **China** and has no business establishments in China, its agent in **China** will be its VAT/BT withholding agent. If there is no agent in China, the purchaser is its withholding agent.<sup>155</sup>

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<sup>148</sup> Decree 22, Art. 8.

<sup>149</sup> Decree 22, Art. 9.

<sup>150</sup> Decree 22, Art. 10.

<sup>151</sup> Decree 22, Art. 11.

<sup>152</sup> Decree 19, Art. 5.

<sup>153</sup> Decree 22, Art. 4.

<sup>154</sup> See, e.g. Gonggao [2010] 54 (General Administration of Customs, 19 August 2010) [Issues Regarding Standards for Examining and Releasing Items Carried by Incoming Passengers].

<sup>155</sup> VATPR, Art. 18; BTPR, Art. 11.

## 2. Payment and Audit

The period for assessing VAT payable (“tax period”) may be 1, 3, 5, 10 or 15 days or 1 month or 1 quarter. The applicable basis period for a taxpayer is fixed by the tax authorities according to the VAT amount expected to be payable by the taxpayer; and tax that cannot be determined using a fixed period may be paid per transaction basis.<sup>156</sup> When a taxpayer adopts a monthly or quarterly tax period, he must report and pay taxes within 15 days after the expiration of the period. If the tax period is shorter, he must make an advance payment within five days after the expiration of the period and report, pay and settle the tax payable for each month within the first 15 days of the following month.<sup>157</sup> Similar rules apply to BT taxpayers.<sup>158</sup>

Under Chinese laws, enterprises are required to engage a China-registered CPA firm to conduct annual audits.<sup>159</sup> The tax authorities are authorized to inspect the financial, accounting and tax documents of all enterprises<sup>160</sup> The tax authorities usually conduct audits on a random selection basis, and may cover both direct and indirect taxes. It is also possible that tax inspection/audit is carried out on a specific industry or specific target, usually as a result of anonymous letters. Due to the lack of available official information, we are not able to comment on VAT audit targets for past years. We are also not aware of e-audits being conducted in China.

## 3. Procedural and Liability Rules Non-Specific to the VAT or BT

Most basic Chinese tax procedure rules are laid out in the Law on the Administration of Tax Collection and its Implementation Regulations<sup>161</sup>, as opposed to in the statutes and regulations for particular types of taxes such as the VAT and BT. For example, generally speaking, a taxpayer engaged in production and operation must, within 30 days of obtaining its business license, apply for tax registration where its production and operation take place or where its tax liabilities arise.<sup>162</sup> Upon the completion of tax registration, the taxpayer obtains a tax registration code, which serves as its identification number for all its tax filing, including VAT.<sup>163</sup>

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<sup>156</sup> VATPR, Art. 23.

<sup>157</sup> Id.

<sup>158</sup> BTPR, Art. 15.

<sup>159</sup> State Administration of Industry and Commerce Decree No. 23 (24 February 2006) [Measures for the **Annual** Inspection of Enterprises], Art. 7.

<sup>160</sup> Law on the Administration of Tax Collection (7th Nat'l People's Cong., 4 September 1992, effective as amended 1 May 2001) (hereinafter “Tax Administration Law”), Arts. 54 and 57.

<sup>161</sup> Detailed Rules for the Implementation of the Law on the Administration of Tax Collection (State Council Order No. 362, effective 15 October 2002) (hereinafter “Tax Administration Law DIR”)

<sup>162</sup> Tax Administration Law DIR Art. 12.

<sup>163</sup> Tax Administration Law DIR, Art. 10 and Art. 1 of Guoshuifa [2003] No. 47 (SAT, 23 April 2003) [Notice Regarding Certain Specific Questions for Applying the Tax Administration Law and Its Detailed Implementation Rules]. The tax registration code is recorded by banks and other financial institutions when taxpayers open accounts. Tax Administration Law Art. 17.

Similarly, there is a generic group of penalties and interest rules applicable to all taxes.<sup>164</sup> All unpaid taxes are subject to a “default fine”—part interest and part penalty—at the daily rate of 0.05% (equivalent to a rather formidable 18.25% annual rate) on the amount of the tax unpaid commencing on the day of default.<sup>165</sup> There are uniform fines (at CNY 10,000 or approximately 1,000 Euros maximum) for failure to apply for, change or cancel tax registration within prescribed time limits; for failure to establish or maintain accounting books, or maintain supporting documents for accounts as required; failure to submit accounting software to the tax authority as required; failure to install and use tax-control facilities as required or damaging such facilities or altering them without authorization. Failure to make tax registration may also result in revocation of business licenses.<sup>166</sup> The failure to file tax returns or submit information required to accompany such returns will result in penalties of similar magnitudes.<sup>167</sup> Heavier penalties (ranging from 50% to 500% of tax owed) are imposed upon “tax evasion”, defined as where a taxpayer “forges, alters, conceals or destroys without authorization accounting books or supporting vouchers for the accounts, or overstates expenses or omits or understates revenue in accounting books, or refuses to file tax returns after having been notified by the tax authority to do so or files fraudulent tax returns, does not pay or underpays the taxes payable.”<sup>168</sup> If returns are not filed and tax is owed, the same heavy (and heavily discretionary) penalties may apply.<sup>169</sup>

What is striking about the interest and civil penalties applicable to tax-related conduct is that they are not tied to specific provisions of substantive law or procedural rules relating to specific taxes. For example, the VAT Provisional Regulation or other regulations with formal legal effect may prescribe certain VAT compliance procedures, but many further procedures and indeed substantive requirements are contained in circulars of the MOF or SAT that do not have formal legal effect (i.e. they may not be recognized by courts). It is unclear whether interest and penalties may accrue to violation to these informally prescribed rules. On the one hand, the prescription of punishable conduct seems to be a power that should be reserved to higher levels of government. On the other hand, the Tax Administration Law is non-specific about what types of rules taxpayers must comply with in order not to attract interest or penalties. The idea that violations of rules that are prescribed without legal effect can meet with legally prescribed penalties is at once paradoxical and unpalatable.

Finally, according to the General Principles of the Civil Law of China, in cases of concealing facts from tax authorities and practicing fraud, not only does the offending enterprise as legal person bear liability, its legal representative may additionally be

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<sup>164</sup> See, generally, Tax Administration Law, Chapter 5 (Legal Liabilities).

<sup>165</sup> Tax Administration Law, Art. 32.

<sup>166</sup> Tax Administration Law, Art. 60.

<sup>167</sup> Tax Administration Law, Art. 62.

<sup>168</sup> Tax Administration Law, Art. 63. Similar rules apply to withholding agents. Some such acts may also result in criminal liabilities. See generally Criminal Law (amended and adopted by the National People’s Congress, 14 March 1997, effective as last amended in February 2009), Arts. 201-212.

<sup>169</sup> Tax Administration Law, Art. 64.

given administrative sanctions and fined and, if the offence constitutes a crime, criminal liabilities may exist.<sup>170</sup>

#### 4. VAT Criminal Liabilities

There are certain civil penalties that, although applicable to other taxes, are most relevant to the VAT. For example, anyone who fraudulently obtains tax refunds by fraudulently declaring exports is subject to a penalty between 100% and 400% on the refund illegally obtained. The tax authorities may also deny future refunds to such persons as prescribed by relevant rules.<sup>171</sup> But VAT fraud features much more prominently under the Criminal Code. Criminal export refund fraud may, depending on the magnitude, attract life sentences.<sup>172</sup> The fraudulent issue of VAT special invoices in order to obtain illegitimate refunds or input credit, fabrication of such invoices or the sale of fabricated invoices are criminal conduct that may attract sentences from three years of imprisonment to life sentence.<sup>173</sup> Illegal sales of VAT special invoices may not result in the death penalty but may still be met with life imprisonment and confiscation of personal property.<sup>174</sup> Illegal purchases of VAT special invoices or the purchase of fabricated invoices may result in imprisonment of up to five years.<sup>175</sup> The fabrication and illegal production of other invoices that may lead to improper refunds or input credit (and the sale of invoices so fabricated or produced) may also result in lengthy imprisonment.<sup>176</sup> Theft and the fraudulent obtaining of invoices that may be used for export refunds or input credit are treated as theft of public property and may result in penalties up to the life sentence.<sup>177</sup>

#### 5. Double Taxation and Anti-avoidance

In nine of China's income tax treaties, treaty partners obtained exemptions from the Chinese Business Tax on international transport.<sup>178</sup> The agreement with South Korea is illustrative: "it is understood that Korea shall exempt the value added tax on the operation of ships or aircraft in international traffic by an enterprise of China and China shall exempt the business tax on the operation of ships or aircraft in international traffic by an enterprise of Korea."<sup>179</sup>

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<sup>170</sup> General Principles of the Civil Law (promulgated by the 6th Nat'l People's Cong., 12 April 1986, effective 1 January 1987), Art. 49. Legal representative refers to that in accordance with the law or the articles of association of the legal person, the responsible person who acts on behalf of the legal person in exercising its functions and powers shall be its legal representative. Id, Art. 38.

<sup>171</sup> Tax Administration Law, Art. 66.

<sup>172</sup> Criminal Law, Art. 205

<sup>173</sup> Criminal Law, Arts. 205-6. Capital punishment for such crimes was removed in 2011.

<sup>174</sup> Criminal Law, Art. 207.

<sup>175</sup> Criminal Law, Art. 208.

<sup>176</sup> Criminal Law, Art. 209.

<sup>177</sup> Criminal Law, Arts. 210, 264 and 266.

<sup>178</sup> These are the treaties with Singapore, HK, Jamaica, Ukraine, Israel, Slovenia, Mauritius, India, and Korea.

<sup>179</sup> Para. 1 of the First Protocol to the China-South Korea treaty. Compare this with a similar provision in Para. 1 of the First Protocol to the China-Singapore Treaty: "For residents of China carrying on the

We are not aware of instances of China unilaterally refraining from taxation in order to prevent VAT double taxation. Currently, there is neither a general nor a specific anti-avoidance concept underlying the VAT or BT regulations.

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operation of ships or aircraft in international traffic, supplies of international transportation shall be zero-rated in terms of the Goods and Services Tax or any other similar tax and the input tax attributable to such supplies shall be creditable in full amount in Singapore.” In 2010 China abolished the Business Tax with respect to all international transportation provided to entities and individuals inside China. Caishui [2010] 8 (MOF and SAT, 23 April 2010) [Notice Regarding the Exemption from Business Tax for International Transportation Service].