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CHINA'S NEW VAT SYSTEM

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INTRODUCTION

On November 26, 1993, the 12th Executive Session of the State Council1 of the People's Republic of China (China) promulgated the Interim Regulations of the Value-Added Tax of the People's Republic of China (VAT Regs), the Interim Regulations of the Business Operation Tax of the People's Republic of China (BOT Regs), and the Interim Regulations of the Consumption Tax of the People's Republic of China (COT Regs).2 These three new tax laws took effect as of January 1, 1994.3 On December 25, 1993, China's Ministry of Treasury promulgated the Implementing Rules of the Interim Regulations of the Value-Added Tax of People's Republic of China (VAT Rules) under Article 28 of the VAT Regs.4 This combined set of tax legislation, heavily patterned after the European VAT systems,5 forms the new and comprehensive turnover tax system currently in place in China (new VAT system).

This Article discusses China's new VAT system in an attempt to assist not only the legal practitioner, but also the concerned

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1. The State Council is the highest executive branch of the government of the People's Republic of China.
2. JIANG RONG ET AL., NEW VERSION OF TAXATION GUIDE (Xianbian Nashui Zhinan), 177, 184, 188 (1994) (providing the text of China's current tax laws).
5. The VAT system used by the majority of Western European countries has two primary characteristics: 1) it calculates the amount of VAT for sales by deducting Input VAT; and 2) the base of calculating VAT is a VAT-excluded sale price rather than a VAT-included sale price. RONG ET AL., supra note 2, at 26-27.
business person through the maze of this complicated new tax scheme. Part I provides background into the two systems that existed prior to the new VAT system, and examines how their problems led to VAT reform. Part II details the intricacies of calculating and applying the new VAT system and underlying laws. Finally, Part III points out some of the more significant problems of the new VAT system, and proposes possible solutions to these problems.

I. HISTORICAL OVERVIEW OF CHINA'S TAX STRUCTURE

Since 1984 and prior to the new VAT system, two turnover taxes coexisted in China, the Old VAT Drafts system and the CICT system. The Old VAT Drafts system was composed of the Rules of Value-Added Tax of the People's Republic of China, the Rules of Products Tax, the Rules of Business Operations Tax, and a number of regulations regarding consumption tax. The Old VAT Drafts system applied only to Chinese enterprises with 100% domestically-sourced capital (Chinese Enterprises). These Chinese Enterprises primarily consisted of Chinese state-owned enterprises.

The Rules of Consolidated Industrial and Commercial Tax (CICT) applied to most non-industrial Chinese Enterprises as well as foreign-Chinese joint ventures, foreign wholly-owned enterprises and other foreign businesses either in China or conducting business with Chinese companies (collectively referred to as foreign-invested businesses or FIBs).

6. Id.

7. Prior to 1983, Chinese state-owned enterprises submitted all of their profits or retained earnings to the State rather than pay any taxes. In June of 1983, the State Council initiated the first stage of tax reform by introducing the Co-existing Profit Submission and Tax Payment, aimed at gradually turning the total profit submission system for the state-owned enterprises into a pure tax payment system. Under that new system, media and large state-owned enterprises became subject to an income tax of 55% of profits. In 1984, the second stage of tax reform came about, and the concept of value-added tax was introduced as a means of fair taxation, i.e., the amount of tax was based on profitability, not on what products an enterprise happened to produce. As a result of the second stage of tax reform, the PRC adopted the Old VAT Drafts and other turnover tax drafts and regulations. Id. at 11-25.


9. See Circular of the Ministry of Treasury Regarding Levying CICT on Chinese-Foreign Equity Joint Ventures and Foreign Wholly-Owned Enterprises (83), Treasury Tax Number 88. The Standing Committee of the National People's Congress (the national legislature of the PRC) adopted the original version of the CICT in principle in 1958. Id. Of course, at that time, the legislature intended that it ap-
The Old VAT Drafts and CICT systems were clouded by their complexity and inconsistencies. Under the Old VAT Drafts system, VAT was levied only on industrial products and service products that related to industrial operations such as equipment installation, industrial engineering, and capital construction. The Old VAT Drafts system had 12 different tax rates and 31 taxable items covering 139 industrial products and related services. Unlike the Old VAT Drafts, the CICT system took the form of a sales tax, based on a product's sale price rather than its added value. The scope of the CICT system was much broader than that of the Old VAT Drafts, ranging from commodities from the agriculture, husbandry, fishery, forestry and machinery industries to the service products of real estate development and agency, wholesale and retail business, tourism, advertising, hotel, restaurant and entertainment. The CICT was levied on 104 types of products, with 38 different tax rates ranging from 1.5% on rough cotton cloth to 69% on luxury cigarettes. These different rates as well as the overlap between the two systems resulted in mounting public outcry against an unfair and complicated tax burden.

Since state-owned enterprises manufactured the vast majority of industrial products subject to both the Old VAT Drafts and CICT, these enterprises, especially the large- and medium-sized ones, were most vocal in complaining about repetitive turnover taxation on their products. The state-owned enterprises argued that under the different tax rates of the Old VAT Drafts system, they paid much more tax than township-owned enterprises, private enterprises, and FIBs under the CICT system. The fundamental differences between VAT and CICT further complicated

ply to Chinese Enterprises only because there were not any FIBs in China until the late 1970s. However, new tax items and technical provisions were subsequently added to the CICT so that by the early 1980s it had become the first comprehensive turnover tax in China, covering more than 100 categories of commodities with 42 different tax rates. Id. In 1983, the PRC Ministry of Treasury issued a circular providing that it would levy the CICT on FIBs in China as of May 1, 1983. Id. The Chinese text appears in MA PEI RONG ET AL., 1 A GUIDE TO THE UTILIZATION OF FOREIGN INVESTMENT & FOREIGN TRADE OF P.R. CHINA 485 (1993).

10. Industrial products include chemicals, textiles, garments, carpet, enamel ware, glass ware, drugs, generic machinery, electrical machines, electronic appliances, steel products, hats footwear, ceramic ware, paper, office equipment, sports products, foodstuffs, leather products, mineral commodities, etc. The vast majority of such products were manufactured by media and large state-owned enterprises in China. RONG ET AL., supra note 2, at 30.

11. Id.
12. Id.
15. Id.
the calculation of the total amount of turnover tax for an industrial product which was subject to both systems. VAT was calculated as sales price less input cost multiplied by the VAT rate, while CICT was calculated as sales price multiplied by the CICT rate. Moreover, the Old VAT Drafts system was so full of flaws that it was not uncommon for the amount of VAT in the same transaction to be calculated differently by different accountants.

In an effort to attract foreign investment and business, the Chinese government at different levels enacted many regulations, circulars, provisions, and rulings during the past decade, granting various CICT concessions to FIBs. For example, in 1984, the State Council announced that the Chinese government would exempt FIBs from CICT on a vast majority of imports within the Special Economic Zones (SEZs) and the Economic and Technological Development Zones (ETDZs) in fourteen coastal cities. The Chinese government also announced that it would reduce CICT on sales of domestic goods sourced within SEZs. Following the example of the central government, the municipal governments of Beihai, Dalian, Guangzhou, Shanghai, Tianjin, and Shenzhen promulgated their own rules exempting FIBs from paying CICT under certain circumstances. They agreed to exempt FIBs from paying CICT on domestic sales, or on purchases of exportable goods in China with Renminbi (RMB), China's official currency, in order to balance the FIB's foreign exchange accounts.

16. Id. at 26.
17. Under the Old VAT Drafts system, the amount of Input VAT was calculated according to the different rates set up by the regulations rather than the actual payment. However, the regulations were so general and vague that a particular industrial product could fall under more than five different input VAT rates. Id. at 31.
18. The SEZs refer to the economic development zones designated by the State Council in the cities of Shenzhen, Zhuhai, Shentou and Xiamen. The ETDZs refer to zones designated by the State Council in the 14 coastal cities of Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wuzhou, Fuzhou, Guangzhou, Zhanjiang and Behai. Because the enterprises established in the SEZs and ETDZs receive a preferential treatment in tax, land use, infrastructure supply, loans, import and export, etc., the vast majority of FIBs in China are established in either SEZs or ETDs.

For SEZs, the CICT on imports of mineral oil, tobacco and alcohol is not exempted, and the CICT on the sale of goods produced in SEZs is reduced by half. For ETDZs, the exemption of CICT is limited to building materials, raw materials, spare parts, components, transportation vehicles and office supplies imported by enterprises in the ETDZs for their own use. Id.
20. Provisional Regulations on the Implementation of Preferential Treatment
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Differential treatment for FIBs really raised the ire of Chinese enterprises.\(^{21}\)

In an effort to improve and unify its VAT system, the Chinese legislature repealed the Old VAT Drafts and CICT in their entirety and replaced them with the new VAT system.\(^{22}\) Both Chinese Enterprises and FIBs became subject to the new VAT system in place in China as of January 1, 1994.\(^{22}\) Also, in an effort to internationalize Chinese tax and accounting standards, the new VAT system adopted many attributes from European VAT systems.\(^{24}\) Although the new system addresses many of the problems associated with the previous tax structure, as Part III of this Article explains, the new VAT system is not flawless. It has caused great concern among FIBs in China and new foreign investors regarding the increase of tax burdens and difficulty of accounting compliance. This is especially true with investors from the United States, who are not familiar with European VAT systems.

II. UNDERSTANDING THE NEW VAT SYSTEM

Of all the new laws making up the new VAT system, none is as broad in scope and application as the body of VAT Regs and underlying Rules, collectively the new VAT law.

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\(^{21}\) RONG ET AL., supra note 2, at 26-27.

\(^{22}\) Article 29 of the VAT Regs provides that the Old VAT Drafts and Product Tax Draft be abolished as of January 1, 1994. Article 20 of the BOT Regs provides that the old Business Operation Tax system be abolished as of January 1, 1994. RONG ET AL., supra note 2, at 183, 191. Article 19 of COT Regs provides that any old Consumption Tax regulations be abolished as of January 1, 1994. Id. at 187. On December 29, 1993, the 5th Session of the Standing Committee of the 8th National People's Congress adopted the resolution that the CICT be abolished and the new VAT system be applied to Chinese Enterprises and FIBs equally. NINGBO DAILY, Dec. 30, 1993, at 3.

\(^{23}\) NINGBO DAILY, supra note 22, at 2.

\(^{24}\) RONG ET AL., supra note 2, at 14-15.
A. The New VAT Law

Some of the fundamental provisions covered by the new VAT law include those provisions which address VAT taxpayers, products and services subject to VAT, VAT rates and exemptions, Special VAT Receipts, and the calculation of VAT, and VAT periods.

1. VAT Taxpayers

The new VAT Regs designate three general categories of VAT taxpayers. They are: (1) sellers of goods, including individuals or units, i.e., organizations for profit; (2) individuals or units that provide processing, fixing, or repairing services; and (3) individuals or units that import goods into China.

2. Scope of VAT Application

The new VAT law applies to the following goods and services: (1) all industrial products; (2) wholesale and retail commodities, mortgaging, pawnbroking, publishing and public utilities such as water, heating, gas, and electricity; (3) all kinds of service products arising from or related to processing, fixing, or repairing, including both industrial and non-industrial services (VAT Services); and (4) imported goods which are declared as imports.

3. VAT Rates

There are four VAT rates under the VAT Regs: seventeen percent, thirteen percent, zero percent, and six percent. The first three rates generally are based on the purpose or use of the goods, and the last one is based on the taxpayer's status.

The seventeen percent rate is the broadest and highest VAT rate applicable across-the-board to sales or imports of goods and

25. Article 1 of the VAT Regs. Id. at 177.
26. The term “fixing” in China traditionally referred to fixing mechanical problems in a machine or mechanical device to make it work again. The term “repairing” usually meant that a shop or factory engaged not only in fixing mechanical problems but also re-equipping or refitting machines or mechanical devices, e.g., refitting a truck into a bus. Today the two terms “fixing” and “repairing” are more or less interchangeable, reflecting the fact that the vast majority of fixing or repairing shops or factories in China are very flexible with respect to their business. Most can perform fixing, repairing or re-equipping services depending on customers’ needs.
27. This paragraph did not appear in the Old VAT Drafts.
28. Paragraphs (c) and (d) represent a substantial expansion of similar categories in the Old VAT Drafts.
29. RONG ET AL., supra note 2, at 42.
30. Articles 2, 3, and 12 of the VAT Regs. Id. at 177-79.
VAT Services not eligible for a lower rate. The thirteen percent rate applies to sales or imports of certain necessities such as grains, edible vegetable oils, public utility products (except electricity), publications, and means of agricultural production.\(^{31}\) The zero percent rate applies only to exports, or as otherwise provided by the State Council.\(^{32}\) Although Article 25 of the VAT Regs implies that taxpayers should receive refunds for any VAT paid in purchasing input goods which are used in making their exports, FIBs still face an uphill battle in trying to obtain VAT refunds with respect to exports made of domestically sourced raw materials.\(^{33}\)

The six percent rate applies only to Small-Scale Taxpayers (SSTs). An SST is a taxpayer whose annual sales subject to VAT is either one million RMB (approximately $120,000, assuming an exchange rate of $1 = 8.5 RMB) or less, or 1.8 million RMB (equivalent to $210,000) where the taxpayer engages in wholesale or retail business. In calculating the sale amount of an SST, the amount of VAT payable is not included. Additionally, for purposes of VAT, the status of an SST is subject to the approval of the State General Administration of Taxation, China's highest tax authority.\(^{34}\)

If a taxpayer sells goods and/or VAT Services which are subject to different VAT rates, the sales of such goods and/or VAT Services must be allocated to different ledgers and accounted for separately. If a taxpayer fails to do so, the highest rate applicable to any of the taxpayer's goods shall indiscriminately apply to all goods and/or VAT Services which the taxpayer sold during the VAT period.\(^{35}\)

\(^{31}\) Section 2 of Article 2 of the VAT Regs provides that the 13% rate shall be levied on sales or imports of the following goods:

1. grains, edible vegetable oils;
2. tap water, heating, air conditioning, hot water, coal gas, liquified petroleum gas, natural gas, biogas, and coal products for residential use;
3. books, newspapers, and magazines;
4. forage, fertilizer, pesticides, agricultural mechanisms, and agricultural films; and
5. other goods as provided for by the State Council.

\(^{32}\) Section 3 of Article 2 of the VAT Regs. \(^{31}\) at 177.

\(^{33}\) The issue of whether to extend export VAT refunds to FIBs was hotly contested by FIBs and foreign investors during the period from August, 1994 through November, 1994. \(^{34}\) See supra notes 70-74 and accompanying text.

\(^{34}\) Article 11 of the VAT Regs and Article 24 of the VAT Rules. \(^{35}\) at 179.

\(^{35}\) Id. at 42-43.
4. VAT Exemptions

The VAT Regs specify eight circumstances under which a taxpayer may not have to pay VAT. They include sales of self-produced agricultural products, contraceptive devices, old and used books, imports for scientific research, foreign aid, equipment imported for processing raw materials or assembling components, imports for disabled persons, and secondhand consumer goods.\[^{36}\] However, in order to close loopholes which have been, or could be created by local governments, the VAT Regs prohibit any local government from making any VAT concessions. The State Council of China possesses the sole power to exempt enterprises from having to pay the tax.\[^{37}\]

5. Special VAT Receipts

According to Chinese tax experts, the new VAT law's foremost characteristic is the requirement that businesses apply for Special VAT Receipts (SVRs) in all commercial transactions in China.\[^{38}\] Under the new VAT law, the amount of input or purchase VAT (Input VAT) which the taxpayer pays for the purchase of input goods can be used as a tax credit for offsetting the sales VAT (Sales VAT). However, this credit is available only to the extent that Input VAT payments can be verified by SVRs received by the taxpayer from the input seller. An exception exists regarding the purchase of agricultural products which are exempt from VAT.\[^{39}\] Therefore, to qualify for Input VAT credits for purchased goods, the taxpayer must provide SVRs from the input seller which can be verified by theSVR.\[^{40}\]

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\[^{36}\] Article 16 of the VAT Regs provides the following exemptions from the VAT: (1) Agricultural producers' sale of their own agricultural products; (2) contraceptive drugs and devices; (3) old and used books; (4) imports of instruments and equipment for direct scientific research, experiments or teaching purposes; (5) imports of materials and equipment of gratuitous aid from foreign governments or international organizations; (6) imports of equipment for the purpose of processing an investor's raw materials, assembling an investor's components, or compensation trade; (7) imports of special goods for use by disabled persons; and (8) sales of secondhand goods used by individuals. *Id.* at 180.

\[^{37}\] Article 16 of the VAT Reg provides that except for cases falling under one of the eight designated exemptions, no local governments or departments of the central government shall be allowed to grant any VAT exemption or reduction. *Id.*

\[^{38}\] RONG ET AL., *supra* note 2, at 48-49.

\[^{39}\] Article 8 of the VAT Regs provides that the amount of VAT paid by a taxpayer for purchasing goods or VAT Services is referred to as Input VAT. The amount of the Input VAT which is allowed to be deducted from Sales VAT is limited, except with respect to VAT-exempted agricultural products, only to:
goods or services, the purchaser must always ask the seller to issue an SVR as opposed to an ordinary commercial invoice. However, sellers cannot always issue SVRs. In some transactions where the subject matter is either a consumer good or a non-VAT item, sellers must issue ordinary commercial receipts instead of SVRs.\(^{40}\)

For transactions in which intermediate goods or non-consumer goods are involved, SVRs serve both as evidence of VAT payment and as the ordinary commercial invoice. The form of an SVR is only slightly different from an ordinary Chinese commercial invoice. Generally, an SVR contains items not found on an ordinary commercial invoice, namely the amount of VAT payment and the registered tax number of the VAT taxpayer.\(^{41}\) Furthermore, the unit price and total price indicated on an SVR are VAT-excluded prices, while those on an ordinary commercial invoice are VAT-included prices.\(^{42}\)

It seems somewhat inconvenient for FIBs or foreign businesses to keep up with the mandatory requirements and formalities with respect to SVRs. However, given the current substandard record-keeping practices of Chinese businesses, these SVR requirements and formalities are actually more burdensome on Chinese Enterprises than on FIBs. In fact, one of the main purposes for making SVRs mandatory is to bring the chaotic record-keeping practices of Chinese businesses under the control of the authority.\(^{43}\)

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\(^{1}\) the amount of VAT payment indicated by SVRs received from the seller; and

\(^{2}\) the amount of VAT payment indicated by Tax Payment Certificates received from the Customs Services.

VAT credits for purchases of VAT-exempted agricultural products are calculated at a rate of 10% of the purchase price:

\[
\text{Input VAT} = \text{purchase price} \times 10\% 
\]

\(^{40}\) Article 21 of the VAT Regs provides that under any of the following circumstances, if an invoice is required, the ordinary commercial invoice rather than an SVR must be issued:

(1) the sale of goods or VAT Services to consumers;

(2) the sale of VAT-exempted goods; and

(3) the sale of goods or VAT Services by SSTs.

\(^{41}\) Id. at 181.

\(^{42}\) Id. at 53.

\(^{43}\) Id. at 49.

Chinese domestic enterprises have traditionally been very sloppy with accounting records and issuing invoices. Under the new VAT system, however, the third missing SRV constitutes a prionable crime for the responsible accountant. Such harsh punishment definitely enhances local respect for the new VAT law with respect to book- and record-keeping practices by Chinese Enterprises.
6. **Basis for Calculating VAT Liability**

According to the new VAT Regs, a taxpayer's VAT liability equals Sales VAT less Input VAT.\(^{44}\)

a. Sales VAT

Sales VAT refers to the amount of VAT which the seller taxpayer collects from the purchaser based on the doctrine of withholding at the source as required by the new VAT law.\(^{45}\) The basic formula for calculating Sales VAT is as follows:

\[
\text{Sales VAT} = \text{Sales Income} \times \text{Applicable Rate.}
\]

Chinese tax experts define the term "sale" for purposes of VAT as the act of transferring goods or VAT Services for any consideration, including money, goods or any other economic benefit received from the transferee as compensation for the transferor's provision of goods or services.\(^{46}\) The sale of goods also includes a broad spectrum of activities involving goods changing hands.\(^{47}\) Article 5 of the VAT Rules refers to sales involving both the transfer of goods and the provision of labor services, which are subject to BOT rather than VAT, as "mixed sales." If a taxpayer is involved in mixed sales while engaged in producing or selling wholesale or retail goods, the whole amount of mixed sales will be subject to VAT. However, if a taxpayer with mixed sales engages in any other business, no part of the mixed sales will be subject to VAT.\(^{48}\) Article 6 of the VAT Rules provides, however, that taxpayers must maintain separate accounts for sales of

\(^{44}\) Article 4 of the VAT Regs. RONG ET AL., supra note 2, at 178.

\(^{45}\) Id. at 43.

\(^{46}\) Id.

\(^{47}\) Article 4 of the VAT Rules extends the meaning of the sale of goods to:

1. entrusting another person to sell one's own goods on commission;
2. selling commissioned goods;
3. purchasing goods on someone's behalf and delivering the goods to a co-signer;
4. transporting goods for the purpose of sales between affiliate or subsidiary units;
5. using self-made goods or entrusted goods for processing for non-VAT projects;
6. using self-made goods or entrusted goods for processing for collective welfare programs or individual consumption;
7. using self-made goods or entrusted goods for processing as gifts;
8. making a capital contribution with self-made goods, entrusted goods for processing or goods purchased for someone else; and
9. making a dividend distribution with self-made goods, entrusted goods for processing or goods purchased for someone else.

\(^{48}\) Implementing Rules Add Detail, supra note 4.
goods, VAT Services, and sales of non-VAT services. Otherwise, their sales of non-VAT services also will be subject to VAT.  

i. Sales Income

"Sales Income" is defined as the total amount which the seller taxpayer receives from a purchaser for selling goods or VAT Services less Sales VAT. The form of the income is not determinative. As long as the income derives from the purchase and is a consequence of the transaction, it will be deemed Sales Income subject to VAT. Based on a derivation of the formula and definitions above, the formula for calculating Sales Income can be expressed as:

\[ \text{Sales Income} = \text{Total Sales Amount Received} - \text{Sales VAT}. \]

However, if the amount of Sales VAT is unknown:

\[ \text{Sales Income} = \frac{\text{Total Sales Amount Received}}{1 + \text{VAT rate}}. \]

ii. Transactions Involving SSTs

For transactions involving SSTs or where SVRs cannot be issued, a formula for calculating Sales Income can be expressed as:

\[ \text{Sales Income} = \frac{\text{Total Sales Amount Received (VAT included income)}}{1 + \text{VAT rate}}. \]

iii. Importing Taxpayers

For importing taxpayers, the constituent price, which like Sales Income in purchase transactions serves as the basis for calculating VAT, can be calculated using the following formula:

\[ \text{Constituent Price} = \text{Tariff Price} + \text{Tariff} + \text{COT Amount (if any)}. \]

b. Input VAT

Input VAT refers to the amount of VAT paid for purchases of input goods or VAT Services which are used in producing other goods. Proof of the Input VAT payment is limited to the following sources or methods: (1) SRVs which are prepared properly and

49. Id.
50. See RONG ET AL., supra note 2, at 44-45.
indicate the amount of VAT paid by the taxpayer for purchases of input goods or VAT Services; (2) Tax Payment Certificates which the taxpayer received from the Customs Services in charge and which indicate how much VAT was paid by the taxpayer for the import of input goods; and (3) for purchases of VAT-exempted agricultural products, Input VAT is calculated using the following formula:

\[
\text{Input VAT} = \text{Purchase Price} \times 10\% \]

i. Proof of Input VAT

Under certain circumstances, the taxpayer's payment of Input VAT may not qualify for a VAT credit to offset Sales VAT payable. This occurs when: (1) no relevant SVRs can be produced, (2) SVRs are not properly prepared, and (3) the underlying assets are used for non-input purposes such as fixed assets, VAT-exempted projects, collective welfare programs and individual consumption.

In addition, if the input goods are lost in the course of transportation, processing or production, the amount of the Input VAT cannot be used as a VAT credit to offset Sales VAT because the sold goods must be made from the input goods.

ii. VAT-exempted and Non-VAT Sales

VAT-exempted and non-VAT Sales do not qualify for the VAT credit. The following formula can be used to calculate the portion of Input VAT paid which may not be used in calculating the VAT credit:

\[
\text{Noncreditable Input VAT} = \text{Total Amount of Input VAT Paid} \times \left( \frac{\text{VAT-exempted or non-VAT Sales}}{\text{Total Sales of the VAT period}} \right)
\]

7. VAT Periods

Under the new VAT law, the period of time during which a taxpayer's VAT liability becomes due may be one, three, five, ten, or fifteen days, or one month (the VAT Periods). The local tax authorities in charge will designate one of the VAT Periods for

51. See id. at 43.
52. See id. at 45-46.
53. Total sales for the VAT period refers to the taxpayer's VAT payment period which for the majority of FIBs in China is one month. See infra, notes 52-53 and accompanying text; see also, RONG ET AL., supra, note 2, at 46-47.
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Each taxpayer based on the taxpayer's potential VAT liability. The vast majority of FIBs receive a one month VAT Period because their average annual sales typically exceed fifty million RMB (approximately $5.88 million at the rate of $1 = 8.5 RMB). A taxpayer with a one month VAT Period must pay its VAT liability no later than ten days after the first day of the following month.

8. Illustrations of Calculating VAT

Illustration A: Calculating the VAT Liability of a Foreign-Chinese Joint Venture Company (JV Co.)

In March, 1994, JV Co., a widget manufacturer, sold its products to wholesalers for ten million RMB, to consumers for 1.5 million RMB, and used some products in conjunction with the provision of 500,000 RMB in technical services subject to BOT. During March, it also purchased China-sourced raw materials for which it paid two million RMB in VAT, as evidenced by a properly prepared Tax Payment Certificate issued by the Customs Service in charge. A portion of the purchased raw materials attributable to 200,000 RMB in VAT payments went towards capital construction, and another portion of raw materials also attributable to 200,000 RMB in VAT payments was converted into JV Co.'s fixed assets. Based on these facts, JV Co.'s VAT liability for March, 1994, (assuming JV Co. was a general taxpayer and the applicable VAT rate was seventeen percent for all items), can be calculated as follows:

\[
\text{VAT} = \text{Sales VAT} - \text{Input VAT}
\]

Calculating Sales VAT

\[
\text{Sales VAT} = \text{Sales Income} \times 17\%
\]

\[
\text{Sales Income} = \frac{\text{Total Income Received}}{(1 + 17\%)}
\]

\[
= \frac{(10,000,000 + 1,500,000)}{1.17}
\]

\[
= 9,829,059.83
\]

\[
\text{Sales VAT} = 9,829,059.83 \times 17\%
\]

\[
= 1,670,940.17
\]

54. Article 23 of the VAT Regs. RONG ET AL., supra note 2, at 182.
55. Id.
56. This illustration is based on an example which appears in RONG ET AL., supra note 2, at 51-52.
Calculating Input VAT

Input VAT = Total Input VAT - Noncreditable Input VAT

Total Input VAT = 2,000,000 + 400,000 - 200,000 - 200,000
= 2,000,000

Noncreditable Input VAT = Total Input VAT x (VAT-Exempted and Non-VAT Sales / Total Sales for March)

Vat-Exempted and Non-VAT sales = 500,000

Total Sales for March = Sales Income + VAT-Exempted and Non-VAT sales

= 9,829,059.83 + 500,000
= 10,329,059.83
= 10,329,060

Noncreditable Input VAT = 2,000,000 x (500,000/10,329,060)

= 2,000,000 x 0.05
= 100,000

Input VAT = 2,000,000 - 100,000
= 1,900,000

Calculating VAT Liability for March

VAT = 1,670,940 - 1,900,000
= (229,060)

Therefore, JV Co.'s VAT liability for March was zero. The 229,060 RMB credit can be carried over to offset JV Co.'s VAT liability for April, 1994.

Illustration B: Calculating VAT Liability in a Mixed Sales Transaction\(^5\)

In May, 1994, Coldair, an air conditioner store, sold air conditioners valued at 1,000,000 RMB and received 50,000 RMB in installation fees. Also, Coldair purchased some air conditioner units in May for which it paid 100,000 RMB in VAT as evidenced by properly prepared SVRs.

57. This illustration is based on an example which appears in Rong et al., supra note 2, at 62.
This is a case of mixed sales of goods and labor services. Since Coldair's primary business is selling air-conditioners, Coldair's total gross sales for May, including the 500,000 RMB in installation fees, will be subject to VAT at the rate of seventeen percent BOT will not apply to this transaction. Therefore, Coldair's VAT liability for May is equal to Sales VAT less Input VAT:

\[
\text{Sales VAT} = \frac{\text{Total Sales for May}}{(1 + 17\%)} \times 17\% = \frac{(1,000,000 + 50,000)}{(1 + 17\%)} \times 17\% = 152,564
\]

\[
\text{Input VAT} = 100,000
\]

\[
\text{VAT} = 152,564 - 100,000 = 52,564 \text{ RMB}
\]

**B. Summary of China's New Business Operation Tax (BOT)**

1. **Introduction**

The new BOT Regs specify two types of BOT taxpayers: (1) individuals or units that are located in China and provide certain specified services, and (2) individuals or units that are located in China and transfer intangible or fixed assets. Services subject to BOT fall under seven broad categories: (1) transportation; (2) construction; (3) finance and insurance; (4) post and telecommunications; (5) culture and sports; (6) entertainment; and (7) other services. The BOT rates for these services range from three percent for categories (1), (2), (4), and (5), five percent for categories (5) and (7), to five to twenty percent for category (6). The BOT rates for transferring both intangible and fixed assets are set at five percent. The BOT Regs exempt from BOT liability service products such as day-care services, kindergartens, nursing homes, cemetery services, services provided by handicapped, medical care, part-time work programs for students, agricultural-related services, cultural education services and religious services.

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58. Article 1 of the BOT Regs. Id. at 188.
59. Rate Table for BOT Items. Id. at 58, 192. The 5%-20% rate for entertainment is intended to provide some flexibility to local municipal or provincial governments which are authorized only to fix rates for the entertainment industries in their respective localities.
60. Article 6 of the BOT Regs provides that the following items are exempted from BOT:
- (1) daycares, kindergartens, nursing homes, care-takers, match-makers and cemetery services provided by the disabled;
- (2) labor services provided by the disabled;
2. Illustration of Calculating BOT Liability

In April, 1994, JV Co., a construction firm, completed a construction project. It received one million RMB for the provision of engineering services and 100,000 RMB for the provision of building materials.

Because JV Co.'s primary business is construction, which is subject to BOT, and supplying building materials is a secondary business, its total sales for April are subject to BOT (at three percent) rather than the VAT (at 17%), including the 100,000 RMB income attributable to supplying building materials. Construction services are not subject to any BOT exemption or reduction. Therefore, JV Co.'s BOT liability for April is calculated as follows:

\[
\text{BOT Liability} = \text{Total Sales for April} \times 3\% \\
= (1,000,000 + 100,000) \times 3\% \\
= 33,000 \text{ RMB}
\]

C. Summary of China's New Consumption Tax (COT)

Under the new COT Regs, taxpayers subject to COT generally fall into two categories: (1) individuals or units who located in China and engaged in producing or processing the commodities which are subject to COT; or (2) individuals and units that import into China the goods subject to COT.\textsuperscript{61} COT applies only to eleven categories of luxury consumer goods, including luxury cigarettes, cigars, alcohol, beer, cosmetic products, skin-care and hair-care products, gold, silver, jewels, fireworks, gasoline, diesel, luxury motorcycles and luxury cars. COT rates vary from three percent on luxury cars to forty-five percent on luxury cigarettes.\textsuperscript{62}

The basic formula for calculating COT liability is:

\[(3) \text{ medical services provided by hospitals, clinics and other medical services providers;}
\]
\[(4) \text{ part-time services provided by students in education-work programs provided by schools and other educational organs;}
\]
\[(5) \text{ tractor-plowing, irrigation and drainage, plant disease and insect pest prevention, vegetation conservancy, farming and stockbreeding insurance, poultry, livestock, aquatic animal breeding and disease prevention and other related technical training;}
\]
\[(6) \text{ admission fees for museums, libraries, galleries, exhibition facilities, other memorial facilities, culturally-protected facilities, religious facilities.}
\]

Any additional exemptions or reductions from BOT are subject to the determination of the State Council. No other localities or departments are permitted to make BOT exemptions or reductions.

\textit{Id.} at 189, 190.

\textsuperscript{61} Article 1 of the COT Regs. \textit{Id.} at 184.

\textsuperscript{62} \textit{Id.}
The concept of Sales Income under the COT Regs, like Sales Income under the VAT Regs, refers to the total income derived from sales excluding VAT. Therefore, Sales Income for COT can be calculated using the same formula used in calculating Sales Income for VAT:

\[ \text{Sales Income} = \frac{\text{Total Sales}}{1 + \text{VAT Rate}}. \]

### III. PROBLEMS AND SOLUTIONS

Many problems have arisen since the introduction of the new turnover tax system in 1994, especially with respect to the tax's application to FIBs and new foreign investors in China. As the following section explains, the majority of problems arise in implementing the new VAT system vis-a-vis the grandfather clause and VAT export refunds for pre-1994 FIBs. The Chinese government has begun to address some of these issues. Nevertheless, further fine-tuning is necessary.

#### A. Six to Seven Percent Real VAT Costs

As of January 1, 1994, nearly all foreign investors in China must face the issue of how much the new VAT system will affect their internal rates of return when calculating profits derived on their Chinese investments. Based on the authors' experience, most FIBs can expect VAT to account for an average of six to seven percent of gross sales. Foreign investors, therefore, should take into account the deduction of six to seven percent of gross sales in order to make reasonably accurate calculations of profit margins.

Some tax experts propose that foreign investors should consider merging their supply sources and manufacturing facilities in China in order to reduce their VAT burden. This proposition is advisable for FIBs and foreign investors to the extent that their raw material suppliers in China are open to foreign investment. Except for manufactured products, raw materials such as mineral products, wood, petroleum and coal primarily remain under the exclusive state ownership system. Foreign investors still may not hold a property interest in these areas of the country's natural resource sector. This restriction is a result of the policy of protection

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63. Id. at 55.
64. Counting the Cost, CHINA ECON. REV., Aug., 1994, at 13; see also Tax Rebate Delay a Threat to Investment, S. CHINA MORNING POST, Sept. 9, 1994, at B1.
65. See, e.g., infra notes 69-73 and accompanying text.
of both the direct result of the government's desire to protect the country's natural resources, a sector of the economy which has been growing slowly in recent years. At this point, it remains to be seen how long it will take the Chinese government to change its laws and policies so as to allow FIBs and foreigners to invest in the country's natural resource sector.

B. Opening Inventory for 1994

In early 1994, the State Tax Bureau, the highest tax authority in China, clarified that it would deem fourteen percent of the cost for industrial products and ten percent of the cost for agricultural products, VAT paid. The bureau would transfer these figures to a sub-ledger of the VAT accounts, entitled "Expense Pending Amortization—Opening Input Tax Credit."\(^7\) The Chinese tax authorities intended to allow at least some FIBs to claim all or part of opening input VAT as a credit to offset their VAT payable. However, in view of the enormous amount of VAT credit involved, as of the end of November, 1994, only retailers could utilize these input credits.\(^6\) The authors are not aware of any expansion of its application since that date.

C. VAT Refunds for Domestic Raw Materials Used for Exports

In August, 1994, The Ministry of Finance of China and the State Tax Bureau issued a joint circular entitled, "Several Measures Regarding VAT Refund," ruling that FIBs would not receive a refund for a seventeen percent VAT charge on their domestically-purchased raw materials used in manufacturing exports, while Chinese Enterprises would receive the refund.\(^6\) Of course, this ruling caused quite a bit of commotion among FIBs and foreign investors.\(^7\) Foreign investors pressed for equal treatment from the tax authorities of the central and local Chinese governments for more than three months.\(^7\)

In November, 1994, the Chinese tax authorities seemed to be backing down from their August ruling. Through China's state news agency, a deputy director of the State Tax Bureau announced that the August ruling had been revised so that FIBs set up after 1993 would receive refunds for their VAT paid on domestically-purchased raw materials used in making their exports.\(^7\)

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\(^7\) Counting the Cost, supra note 64, at 12.
\(^6\) Id.
\(^6\) Tax Rebate, supra note 64; see also VAT Move Slammed, E. EXPRESS, Oct. 19, 1994, at 40.
\(^7\) VAT Move Slammed, supra note 69.
\(^7\) Id.
\(^7\) China Revises Tax Policy That Hurt Foreign Firms, WALL ST. J., Nov. 22,
There has not, however, been any justification for this reversal. The absence of any reason underlying the reversal may explain why, as of the end of 1994, there were no reports of FIB exporters actually receiving these refunds.\textsuperscript{73}

\textit{D. Five Year Grandfather Benefit}

When the enactment of the new VAT, China's government announced that FIBs established before December 31, 1993 would be entitled to refunds if their tax burden increased due to the implementation of the new VAT system. Subject to governmental approval, FIBs may enjoy these refunds for a maximum of five years if the remaining term of the FIB's contract exceeds five years.\textsuperscript{74} In August, 1994, the State Tax Bureau issued a circular regarding the application procedures and formula for calculating any increased tax burden.\textsuperscript{75} However, many FIBs are dissatisfied with the procedure because it takes too long to obtain approval. Many have experienced cash flow problems because the refunds for increased tax burden come only once a year, while VAT payable is due every month. Furthermore, the tax authorities do not take into account the increased tax burden if a FIB previously paid a five percent CICT on its imports, but now pays a higher VAT rate on the same imports.\textsuperscript{76}

Because a satisfactory resolution to the above issue might threaten to remove the fundamental purpose of the new VAT system, i.e., unifying the two previously coexisting systems and replacing CICT, there is no easy solution. However, if a FIB's tax burden increases because the new VAT eliminates a previous CICT exemption, a FIB should be able to convince the local tax authority to agree to refund by presenting its case in a convincing manner. The key is that any such presentation be prepared in accordance with Chinese law and Chinese common sense. Although there may not be a satisfactory resolution to every case involving an increased tax burden, refunds in a majority of these cases may be possible provided that the increased burden is not the result of policies which lie at the heart of the new VAT law.

In addition to the four major issues which this Article has discussed, other problems are inherent in China's new system of taxation. For example, issues have arisen regarding SVRs and utility consumption, apartment renting, and mixed sales involving both VAT and BOT.\textsuperscript{77} Yet notwithstanding these troubling areas,

\textsuperscript{73} \textit{Beijing's Changing Tax Continues to Confuse}, E. EXPRESS, Jan. 5, 1995.
\textsuperscript{74} NINGBO DAILY, supra note 22.
\textsuperscript{75} \textit{Counting the Cost}, supra note 64.
\textsuperscript{76} \textit{Id.}
\textsuperscript{77} \textit{Id.} at 13.
the fact remains that this Chinese new turnover tax system has only been in effect for one year, and it is natural to expect problems to arise as investors become more familiar with the new structure. Once China's government has had an opportunity to analyze the impact of its new taxing scheme, it should make certain adjustments so as to increase transparency, remove existing inconsistencies, and render the system generally more reasonable to the taxpayer. These adjustments would help solve many of the issues which have been causing FIBs and foreign investors considerable concern during recent months as they prepare to file their tax returns.

78. *Beijing's Changing Tax*, supra note 73.