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# Peeling the Onion

Peeling the Onion provides an in-depth analysis of the major issues facing multinationals doing business in China in today's environment. It features a regular update of regulations, taxation, business environment and accounting legislation affecting foreign invested enterprises in China.

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## CHINA SEMINAR - LONDON - 28th June "Doing Business in China"

The seminar "Doing Business with China" took place in London, followed by a drinks reception on 28 June 2005. The purpose of the seminar was to examine the issues concerned when conducting business between UK and China and, in particular transfer pricing, a current hot topic of both countries' tax regimes. This seminar placed emphasis on China's business challenges; on how a company can take advantage of opportunities in China; on how to reduce risks; on how to get profits out of the country; and tax optimisation of investment structure.

Speakers at the seminar, Managing Partner of LehmanBrown, Mr. Russell Brown, and Tax Partner at Mercer & Hole, Mrs. Ana Wisdell, were both pleased with the outcome of the event and the interest and enthusiasm shown by the delegates.

**feature article**

## Export VAT Rebates and Exemption under China's Tax System

China's export Value Added Tax (VAT) refund system has been a headache for many Foreign Invested Enterprises (FIEs) in China for years. Due to insufficient financial resources to refund the high demand for VAT rebates that companies engaged in export business had applied for, the Chinese government has tried to ease the problem by

- cutting the tax refund rates,
- implementing a system of granting companies loans on future tax refunds through authorized banks,
- enhancing the complexity of refund application procedures, and
- adjusting refund management solutions.

However, the underlying problem of deficient funds has just recently been dealt with. As a result, refund processes are still slow and due to the delays in refunding the relevant input VAT, banks involved in granting loans on future tax refunds have started to make provisions for bad debt with regard to such loans.

Although in theory quite straightforward, the issue of VAT rebates and exemption is a complex one in practice. Application procedures often turn out to be a major cause of irritations and different tax advisors may even provide you with differing quotes of the tax rebate amounts.

This issue of "Peeling the Onion" is thus meant to bring some light into the dark labyrinth of export VAT application procedures. For those who have just pitched their tents in China and for those on their way to do business in China, we will start with an overview about the current VAT system.

### Current VAT system in China

VAT is a tax levied on goods and taxable services supplied in China and on goods imported to China. The basic principle is that VAT is levied on each stage of value adding processes while the final customer bears the burden of the tax for the whole production process.

All units and individuals engaged in sale of goods, provision of processing, repair and maintenance services (taxable services) and import of goods within China are taxable persons of VAT.

The current VAT system differentiates between "Ordinary taxpayers" and so-called "Small-scale taxpayers". The latter one refers to a taxpayer who can not maintain a proper accounting system to ensure accurate calculations of output VAT, input VAT and thus VAT payable.

Individuals, non-corporate businesses and enterprises with infrequent taxable activities are deemed to be a small-scale taxpayer. While the normal VAT rate is 17% (13% for some goods), the tax rate for businesses categorized as small-scale taxpayer is 4% (for commercial sector, 6% for other sectors).

Small-scale taxpayers may apply for being granted the "Ordinary taxpayer certificate", if either

- their revenue exceeds RMB 1.8 million or RMB 1 million (for taxpayers engaged in wholesale or retail trading and for manufacturing enterprises respectively), or
- the number of employees exceeds 50, or
- the registered capital amounts to at least RMB 5 million.

Until such application has been approved, businesses of this category are not allowed to issue VAT invoices. The VAT payable for the two different VAT payers is calculated in the following way:

#### 1) Ordinary Taxpayer:

Ordinary taxpayers compute their VAT liability as follows:

VAT payable = Output VAT - Input VAT (for the current period)

Output VAT = Sales value in the current period x applicable tax rate

Input VAT = Purchase value in the current period x applicable tax rate (i.e. the tax paid by the taxpayer for receiving taxable services or for purchasing products)

#### 2) Small-scale taxpayer:

As the small-scale taxpayer can not issue VAT invoices, output VAT can not be offset against input VAT. The tax base for small-scale taxpayers is the VAT exclusive sales value. Where the sales value includes VAT, VAT payable can be calculated as follows:

VAT payable = Sales volume incl. VAT x applicable tax rate / (1 - C tax rate)

### **Tax refund on exported goods**

As part of the Chinese government's incentive policy to encourage exportation, there is generally no output VAT levied on export sales and related input VAT may be refunded. Since the amendment of the refund rates, as stipulated by the "Notice on The Adjustment of Export Refund Rate" (Caishui [2003] No. 222), jointly issued by the Ministry of Finance and SAT on 13 October 2003 and effective from 1 January 2004, there are currently five refund rates (13 %, 11%, 8%, 5% and 0%). Export VAT refund rates differ according to the category in which an exported product falls.

The export refund system works by refunding the VAT paid by an exporting company on the input parts and supplies as well as for taxable services provided for the creation of the product exported out of China. In other words, VAT incurred during the process of domestic production or provision of taxable services, may be refunded by the Chinese government after the specific product has been exported if export tax rebate policies and procedures are applied in a proper way.

Eligible for export VAT refund are basically all enterprises with export rights that export products which incur VAT and/or consumption tax. With the exception of goods specifically exempted from refund applicability by the Chinese Government, generally all goods are applicable for export VAT refund purposes.

The VAT exemption and refund policy also applies to goods exported for contracted engineering projects and repair and maintenance services. However, as stipulated by a Circular issued by SAT on 24 March 2005 (Guoshuihan [2005] No. 248), export enterprises exporting products purchased from small-scale taxpayers must present a VAT invoice to obtain a VAT refund. In such cases, the small-scale taxpayer can request the tax authorities to issue a VAT invoice for products sold to export enterprises.

### **Calculation of the tax rebate amount**

Depending on the type of business, there are generally two tax refund computation methods:

#### **1) Exemption-Credit-Refund (ECR) method**

The ECR method is mainly applied to manufacturing enterprises that have the rights to export their self-manufactured products. The term "Exemption" refers to the fact that exported goods are exempted from VAT while "Credit" refers to the setoff of total input VAT against output VAT of domestic sales. "Refund" stands for the refund of input tax provided that the total input VAT exceeds output VAT levied on domestic sales.

The amount of refundable VAT can be calculated as follows:

Step 1:  
Non-creditable or non-repayable input tax for the current period  
= FOB of the exports for the current period x RMB exchange rate x (VAT rate - C tax refund rate for the exports)

Step 2:  
Deductible input tax for the current period  
= Total input tax for the current period - C non-creditable or non-refundable input tax for the current period

Step 3:  
VAT payable or unrelieved input tax for the current period  
= Output tax domestic sales for the current period - C deductible input tax for the current period - C unrelieved deductible input tax brought forward

Step 4:  
If the output tax is smaller than the deductible input tax and the export value of the enterprise is greater than 50% of the total sales value, the input VAT on exports may be refunded as follows:

a) If case FOB of the exports for the current period x RMB exchange rate x tax refund rate for the exports is equal to or greater than the unrelieved deductible input tax,

VAT refundable = Unrelieved deductible input tax

b) If FOB of the exports for the current period x RMB exchange rate x tax refund rate for the exports is smaller than the unrelieved deductible input tax,

VAT refundable = FOB of the exports for the current period x RMB exchange rate x Tax refund rate for the exports

It is important to note that, where the export value of the enterprise is smaller than 50% of the total sales value of the enterprise, no tax refund may be claimed. However, the deductible input tax may be carried forward.

## 2) First-Pay-Then-Refund (FPTR) method

The FPTR method is mainly applied to all trade enterprises that have the right of import and export and that purchase goods for export directly or on consignment of other foreign trade enterprises. Such enterprises need to pay output VAT on export first in order to claim back the VAT according to the following formula:

VAT payable = Output VAT on domestic and export sales - Input VAT

VAT refundable = Sales value of purchased goods x applicable tax refund rate

### Export VAT refund application

In order to obtain the export refund, it is crucial for enterprises to understand the application procedures involved and the documentation to be provided.

In order to qualify for export refund applications, a company must first obtain its VAT refund registration certificate. For this purpose, the following documentation needs to be provided to the relevant tax bureau:

- Entity file registration,
- Foreign trading entity registration file,
- Operating business license,
- Tax registration certificate,
- Entity basic bank account number, and
- Customs import & export company code.

After an enterprise has exported products eligible for export VAT refund an application for refund needs to be filed with the relevant tax bureau in charge. According to a notice (Guoshuifa [2005] No. 68) issued by SAT on 19 April 2005, enterprises must file the application for export VAT refund within 90 days after the export date specified on the export customs declaration form.

The following documentation needs to be provided:

- Customs declaration form
- A verification certificate for export proceeds
- Relevant invoices for exportation
- Special VAT invoices
- Export tax rebate fold of the clearance certificate of received foreign currencies for export commodities
- Subsidiary ledgers for exported items

According to Circular [2005] No. 256 issued by SAT on 1 April 2005, manufacturing enterprises that provide processing and repair services to overseas firms also need to submit relevant processing and repair services contracts to the tax authority in charge.

In the event the enterprise fails to apply for the tax refund in time, the company must accrue output VAT and file the VAT return accordingly. However, if a company can provide reasonable justification for requesting an extension of the 90-days rule, it may apply for extension. Such extension may only be approved by tax authorities at a level higher than the municipal or regional level.

## Conclusion

Businesses in all areas should examine their export strategies and make sure that export VAT refund policies are in place and carried out. Due to the complexity of the topic and the procedures involved companies are encouraged to contact their tax advisor.

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economy

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### Foreign participation in local TV channels banned

The Chinese State Administration of Radio, Film and Television (SARFT) issued Administrative Rules on Local Foreign Affairs of the Radio Film and Television System, Chapter 2, Article 7th on July 6, 2005. This is a new regulation, which further restricted the China media industry. Thereby, the cooperation that has been started early this year between Qinghai Satellite TV station and News Corporation has terminated.

Even if foreign firms can establish a joint venture with domestic TV, film, radio companies, the regulation specifies that they do not have the right to cooperate in channel operation and in live programmes. It also infers that local media cannot rent their channels to foreign firms.

The SARFT will control and approve any other kind of cooperation.

*Source: Xinhua News Agency*

### Zero Tariffs for all made-in-Hong Kong products

The third phase of CEPA, the "Closer Economic Partnership Arrangement" between Hong Kong and China's mainland, is scheduled for January 1, 2006, uncovered Mr. Wang Liaoping, the director of the Taiwan, Hong Kong and Macao Affairs Department of the Ministry of Commerce. This phase will set up tariff free treatment for all made-in Hong Kong products when being exported to China's mainland.

For the manufacturing sector, an additional 300 categories of Hong Kong products would enjoy this zero tariff agreement. For the service sector, Hong Kong services firm would be able to invest in more industries in China's mainland. It will give them an advantage over their foreign rivals.

From the implementation of the CEPA, January 1, 2004, to the first quarter of 2005, investment and trade volume between Hong Kong and mainland have increased.

In the first quarter of 2005, while mainland's import from Hong Kong reached USD 40 billion, mainland's exports to Hong Kong reached USD 33.7 billion.

*Source: Qianlong*

### ACFTA process has started

"Agreement on Trade in Goods of the Framework Agreement on Comprehensive Economic Co-operation between PRC and ASEAN", which was signed by China and Association of Southeast Asian Nations (ASEAN) last November, has entered into force this July 1. Meanwhile, the Most Favored Nation (MFN) tariff lines have been classified into two groups, the Normal Track (about 7,000 sorts and whose tariff rates would be gradually reduced and eliminated) and the Sensitive Track (the rest and whose tariff rates would retain within proper ceilings).

According to the agreement, the two sides should reduce the tariff rates to less than 5% for more than 40% of the tariff lines in the Normal Track by July 1, 2005. For the rest of the tariff lines, the deadline is January 1, 2007. After Jan.1 2007, all the tariffs in the Normal Track should be eliminated by January 1, 2012. From July 1 to July 20, 2005, China and the ASEAN 6 (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand) had a chance to examine the implementation of each other's tariff reductions.

Also, MFN tariffs have been granted to the two sides by each other and ASEAN-China Free-Trade Area (ACFTA) has been

implemented. According to an official from Chinese Ministry of Commerce, the trade volume of ACFTA this year may reach \$100 billion.

Source: *Sinocast*

### WTO Dalian Meeting Considered Failure?

Important WTO members recently concluded an informal meeting in Dalian. WTO Director-General, Mr Supachai Panitchpadki, openly expressed "grave concern" about the state of the negotiations. Supachai said, "WTO members must work harder to reach a consensus on issues having to do with reducing government support for farmers to opening their markets to foreign services such as banking". Too many unresolved issues would almost certainly doom the Hong Kong talks this December to failure, he said. Source: *Business Line*

Ministers gathered at the meeting were optimistic that they could make progress after the European Union and the United States expressed support for the G-20 proposal on market access in agriculture. EU Agricultural Commissioner Marianne Boll Fischer said: "We are willing to develop the structure of an agricultural market access formula using the G-20 proposal as a starting point". And the US, a votary of the Swiss formula, which had been strongly opposed by the G-20 and the developing countries, conceded that the G-20 proposal was a "positive contribution". Adapted from *Asia Pulse*

However, as Supachai said on July 8: "It is true that some progress has been made in certain areas of the negotiations. But let us be clear: this progress is nowhere near sufficient in terms of our critical path to Hong Kong, and it is not being seen in the key issues which would help unblock progress across the board. Overall, there seems to be a renewed sense of blockage and frustration. We are also seeing a resurgence of sterile debate about process, rather than negotiations on substance". Cutting through the haze, he added: "I am afraid we have to face the facts. These negotiations are in trouble".

Adapted from *Business Line*

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legal

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- Direction displayed on extension the business volume with distribution of non-commercial Foreign Investment Enterprises
- Increased Tax Burden on Individuals on Real Estate Investment
- Money Brokers Given Limited Opportunity to Trade on the Foreign Exchange Markets

### China intensifies occupation provisions for Hong Kong, Macau and Taiwan Nationals operating in the PRC

On 14 June 2005 the Chinese authorities amended the administration of employment permits for nationals from all three territories working on the mainland.

The new regulations comprise changes of social security and employment permit and they take effect on 1 October 2005.

#### *Social security changes:*

¡Citizens of the Hong Kong, Macau and Taiwan working in the PRC will now be liable to social security principles. If employees are working for more than three months on a cumulative basis in a calendar year, the new rules apply.

¡Accordant to Chinese guidelines, contributions will be administered by the Ministry of Labor and Social Security.

#### *Employment Permit changes:*

¡Applicants from the three territories now face stricter age limits

¡Definite specification of the documents that have to be presented by an employer to obtain work permits for nationals of the three territories. The demanded documents encompass inter alia health certificates and proof of professional qualifications

These new amendments pose a considerable influence on entrepreneurs operating in the PRC.

### Direction displayed on extension the business volume with distribution of non-commercial Foreign Investment Enterprises

On 2 April 2005 the Ministry of Commerce (MOFCOM) issued a Notice (Shangzihan [2005] No.9) treating the stipulations non-commercial enterprises have to satisfy in order to add distribution activities to their business.

According to the guidance foreign investment enterprises (FIE) have to review the enterprise contract and articles of association and submit several required documents such as the Application Form for Adding Distribution to the Scope of Business Activities of Non-Commercial FIEs or the Application Form for Adding Distribution to the Scope of Business Activities of Investment Enterprises/Regional Headquarters.

These FIEs also have to change the FIEs approval certificate and must indicate the requested form of distribution. Thereby such FIEs have to stick to the precise procedures stated in the relevant rules.

The local branches of MOFCOM will conduct the reviewing process, ensuring the enterprises comply with the regulations.

### **Increased Tax Burden on Individuals on Real Estate Investment**

In May the State Council issued a directive to the relevant authorities regarding an adjustment of the taxation policy of private investment in real property.

Beginning from 1 June 2005, any divestiture of real property by individuals within two years after purchase will affect business tax at 5% on the total sale revenues. In the case the disposal is carried out after two years of purchase a lenient tax treatment will apply.

This means for instance, for ordinary housing is a business tax exemption available.

Moreover, additional criteria have to be fulfilled in order to obtain the business tax exemption, such as the gross floor area of the property should be less than 120 square meters and the selling price should be lower than 120% of the district average selling price of the properties of the same rating.

Due to the variation of the above exemption criteria, it is necessary to check the local demands before ascertaining an exemption opportunity.

### **Money Brokers Given Limited Opportunity to Trade on the Foreign Exchange Markets**

Brokers from financial institutions will now be allowed to work on the currency and foreign exchange experimentally according to the Chinese Banking Regulatory Commission. This will once again prove China's willingness to move toward international financial standards. Although the money brokers merely act as an intermediary for the financial institution, this move by the CBRC will spark further development of the financial markets in China thus enhancing market liquidity and reducing risk. The money brokers will ultimately be allowed to trade foreign exchange products, and loans on tryout basis. *Source: China Business Weekly*

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