A look inside China’s VAT system

Understanding how the regime works to effectively manage VAT risks and opportunities
Warning

China’s VAT is not just a cashflow issue on a company’s balance sheet. Timing differences can become permanent differences that turn into costs which reduce profit levels. Most companies that start exploring China VAT are surprised at the findings and begin to develop an urgent action plan to introduce corrective steps. Unfortunately, these may be too little, too late. Do not let this happen to your business and take charge of your China VAT now ...
Welcome

Many companies do not fully comprehend or appreciate the impact VAT has on their China operations. A majority currently do not proactively or strategically manage their VAT operations; rather the focus is often relegated to processing activities usually performed by staff at the working level. This approach is unwise — China’s VAT system is one of the most complex in the world and requires significant efforts to stay on top of the changing environment. Although companies generally assume that VAT in China is “neutral,” in reality they are often net payers of VAT and can incur significant amounts of VAT related costs. The various VAT processes and accounting entries make it increasingly difficult to identify these cost inefficiencies without a strategic plan and they may remain “hidden” for some time.

China VAT has an impact, both in terms of real costs and tying up precious cash flow, that may result in the company having to fund inefficient VAT processes. By placing added focus on China VAT, we believe companies will be able to improve compliance, enhance cash flow efficiency and reduce costs — all of which can make a difference to a company’s bottom line.

We hope this report will educate and enlighten the reader to a new level of understanding China’s VAT regime and how to more effectively manage VAT within the constraints of the complex system.

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Part I

Introduction

VAT is an important component of the China Government’s entire taxing regime. Based on figures from the Ministry of Finance (MoF) for the year 2011, China collected more than one third of its entire tax revenue in the form of VAT. The China Tax Bureau (CTB) collected over 27% on domestic transactions and approximately another 8–10% is collected by China Customs on imported goods. That means companies and consumers are paying significant amounts of VAT. Do you know how much your company is contributing?
The share of tax revenue coming from VAT is higher than in many developed countries around the world. Consequently, companies and consumers are paying a large amount of this VAT but do not spend much time delving into the transactional details. On top of that, China’s VAT rules differ from many other countries and is in a constant state of change.

In order to understand and validate our insights into China VAT, we conducted a survey of industry professionals and have included relevant survey results throughout this report.

China VAT Survey

Our China Indirect Tax Team frequently host seminars to gather industry experts, Government officials and professionals to present on China’s VAT system and new regulatory developments. In order to understand how companies view China’s VAT and to facilitate gathered learning and knowledge sharing, we conduct surveys covering hot topics and questions of interest. We use the results in discussions with industry players and the Authorities.

Over 550 China professionals interested in VAT responded to over 40 questions in this survey. The respondents came from a number of different industries and over 90% were employed in the tax, accounting, finance or indirect tax role in the organization. This is not a surprise as VAT impacts companies in almost every industry, either directly or indirectly, and a majority of staff responsible for VAT will typically reside in one of these departments. The wide variety of responses from different industries, locations and departments also help to focus on the critical areas that are of greatest interest to our clients.

We have collated certain survey results and included them throughout this report to help educate and elevate the China VAT discussions and findings with practical industry insights.

These were respondents who attended an Ernst & Young China seminar in 2011, covering only China VAT. Thus, most of the respondents were responsible for some portion of the VAT process in their organization.
A look inside China's VAT system
Part II

Do you know enough about your China VAT?

The answer to this question varies from company to company but most stated they lack the desired level of visibility into their VAT accounts and are concerned that important matters are being overlooked. Without visibility, it is not possible to gain a sufficient understanding of the size and magnitude of VAT being managed or whether it is being processed in a compliant, timely and efficient manner.
Based on our experience, it has been quite challenging to fully understand and appreciate how China VAT affects a company. Especially since the governing regulations and VAT accounting treatment vary greatly from other internationally recognized systems. The tendency of many VAT professionals is to assume incorrectly that China’s VAT is similar to their jurisdiction and should function like a “normal” VAT such as in Europe. This is a misconception and individuals need to be ready to have an open mind when talking about China VAT.

The following questions can help to assess your level of understanding regarding whether you know enough about your China VAT:

➤ How much VAT Throughput is being processed by the organization on a monthly or annual basis?
➤ What is the VAT position of the organization on a regular basis (e.g., input VAT carry forward, net VAT payable, pending export VAT refunds, etc.) and do these positions seem reasonable for the business profile?
➤ Are certain non-recoverable VAT costs incurred, either through non-VATable activities, export VAT “leakage,” VAT transfer out, etc? Are these amounts known, managed and possibly reduced?
➤ How do company staff keep up to date with the rapid pace of regulatory change? Is anyone responsible to proactively review new developments for impact to the company or only responding reactively?
➤ How are my VAT accounting transactions conducted in the system and by whom? Is the accounting system linked to the Golden Tax System (GTS)?
➤ Who is managing the VAT return preparation and reporting obligations? Are they able to accumulate the necessary data to accurately complete the returns on a timely basis? Where is the source data gathered from and how is it analyzed prior to finding its way to a VAT return?

2 The combined total of input and output VAT managed by the company; which actually equates to cash handled.
Do staff in the organization conduct a reconciliation between VAT return data and figures in the accounting system to identify variances? If so, what are the root causes of the variances and are they reasonable?

Has the organization conducted a VAT review in recent times and were there any findings to address risk, improve compliance or reduce costs?

Many companies, after contemplating answers to the above questions, have begun to recognize they need to learn more about their China VAT and that the risk levels can no longer be simply tolerated. If your answers to the above questions are unclear, then it may be time to consider delving deeper into China VAT before the company encounters an unwanted surprise. Given the significant size of VAT cashflow managed by a Chinese entity, potential risks and opportunities inherent in VAT processing warrants a closer look.

The remainder of this report discusses how companies can begin the journey to further understand China’s VAT and assess how to identify risks, uncover savings opportunities and improve compliance.

It is difficult to manage what you do not know. Almost 70% of survey respondents answered that they were not aware of the size of VAT under management in their organization. Given the importance of VAT in China, this figure is alarmingly high.
At first glance, many believe VAT should not represent an out of pocket expense to a taxpayer. Some even believe VAT carries inherently lower risk levels because the VAT-related accounts are netted together under the Tax Payable – VAT Payable sub-account and the resulting balance may fall below a materiality threshold. We will show that this type of thinking could be dangerous. In fact, this is far from the truth and we would assert that VAT may be one of a company's largest tax risks with huge unknown costs. On the other hand, it may also be one of your largest unexplored tax opportunities.

Part III

The China VAT myth – not just a low risk “pass through” tax
VAT, in theory, is seen to be a neutral pass through tax that only moves across the balance sheet of a company’s financial statements and does not impact the bottom line. In principle, VAT is passed through by offsetting input VAT, paid by the company to suppliers and/or Customs, against output VAT collected from customers. For export-oriented entities, they would apply for a refund of the input VAT paid since there is little, or no, domestic sales and such transactions do not charge output VAT.

It is a myth to believe that China’s VAT is simply a cashflow item with no P&L impact and a limited risk profile. On closer examination, VAT in China is far from neutral with sticking VAT, blocked input credits, cascading costs and other unique technical matters that can result in significant VAT-related costs hitting the bottom line (although probably not directly visible and rolled into various accounts).

As one would expect, the VAT costs and risks correspondingly rise with the complexity of the legal entity type and the quantity of daily transactional processing. This is exacerbated in China since many companies have “mega-entities” that are part of an intricate global supply chain, which process huge volumes of transactions. Each link in the supply chain may suffer VAT costs or “leakage” that results in a less efficient recovery of VAT. Unfortunately, this is a common, but less known, occurrence in China.

Consider the following types of actual VAT costs incurred by a company operating in China that can impact the bottom line:

- Export VAT “leakage”
- VAT treated as non-creditable and required to be “transferred out”
- Blocked VAT on certain non-creditable expenditures
- VAT directly related to exempt BTable services
- Deemed VAT sales amounts that are not passed on to customers
- Input VAT paid but the invoice not verified prior to expiration (e.g., 180 days)
- Input VAT invoices without proper documentation
- City Construction Tax (CCT) and Education Surcharge (ES) taxes that are assessed on VAT payable amounts
- Input VAT paid by a toll manufacturer
- Cashflow funding costs on pending refunds or extended periods of input credit delays
- Many other such costs
From the above, it is apparent that companies in China incur actual VAT costs and the value is not small. Do you know the value of VAT-related costs being incurred by the company? If not, we would encourage you to attempt extracting and quantifying these cost figures. However, do not be surprised when gathering and analyzing the data proves more difficult than anticipated or should be.

Based on our experience, it will take significant efforts to identify, extract, collate and analyze the VAT data because it resides in many different systems and parts of the organization. This is not an established practice at most companies yet, so it can be time consuming just to locate where the appropriate data resides. Notwithstanding this, the efforts will benefit the company in the long-run but Management is likely to be surprised about the size and magnitude of the unexplored VAT and this reaction could spur a renewed interest in trying to manage this tax.

Now that we have debunked the myth that China VAT is not just a pass through tax but results in actual costs that affect the bottom line, it is time to address the matter of VAT risk.

We asked the survey respondents to rate the level of risk VAT carries as compared to corporate income tax (Figure 4).

Almost 70% said that VAT risks were higher or similar to corporate tax, an area where most companies have dedicated resources.

![Figure 4: In terms of “risk,” how do you compare VAT to corporate income tax in your organization?](image)
Historically, VAT risk in China has been measured by reference only to the net balances in the Tax Payable – VAT Payable accounts. The China VAT accounting approach aggregates numerous individual VAT sub-ledgers together into a single net VAT payable/carry forward/refundable. When viewed in this manner, VAT is rarely considered material in terms of business and accounting risk. However, this approach does not reflect the complete picture and ignores lower/zero rated and exempt activities, which arguably present a greater risk of errors or challenge by the CTB. Historic issues may also be accumulating in the VAT-related accounts due to the China accounting treatment for VAT that clouds visibility into the figures.

Instead of looking only at the net VAT balances, we would suggest a company should consider the risks associated with the quantity and value of individual transactions prior to netting. After all, each of the individual VAT transactions represents either cash paid or cash received and equate to the amount of VAT cash handled by the organization. We would encourage companies to consider their VAT in the following manner:

- **VAT Throughput** = total amount of input VAT paid + total amount of output VAT charged to and collected from Customers.
- **VAT Under Management** = VAT Throughput + the amount of VAT avoided or exempted that is dependent on satisfying certain criteria.

VAT Throughput and VAT Under Management are more accurate measures of VAT risk, compared to net VAT account balances. When viewed in this manner the VAT profile of the entity takes on an entirely different risk profile. When calculating these figures many are shocked to learn that the amount being managed can greatly outweigh other taxes. Let us examine a case study of a typical company fact pattern.

### ABC Chinese company case study

ABC manufactures products in China and has experienced impressive sales growth over the last few years. Originally established as a manufacturing base predominantly for export sales, the company has been experiencing tremendous growth in demand from domestic Chinese customers and is adjusting the business to capture the opportunity. The company has been able to successfully transition a portion of raw material purchases from overseas suppliers to a large domestic supplier base in China. While not wildly profitable, the company is able to generate decent financial returns from the operations:

- **US$100m in sales (80% domestic and 20% export)**
- **US$65m in purchases (80% domestic and 20% import)**
- **US$25m in expenses and overhead (among which US$1m is paid for services)**
- **US$10m in taxable profit**

In order to understand the impact from the above example, the types of taxes under management are as follows:

<table>
<thead>
<tr>
<th>Type of taxes</th>
<th>Base</th>
<th>Tax rate</th>
<th>Tax amount</th>
<th>% of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate income tax</td>
<td>10</td>
<td>25%</td>
<td>2.5</td>
<td>2.5%</td>
</tr>
<tr>
<td>Business tax</td>
<td>1</td>
<td>5%</td>
<td>0.05</td>
<td>0.05%</td>
</tr>
<tr>
<td>VAT</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Input VAT</td>
<td>Domestic purchase</td>
<td>52</td>
<td>17%</td>
<td>8.8</td>
</tr>
<tr>
<td></td>
<td>Bonded imported RM</td>
<td>13</td>
<td>17%</td>
<td>2.2</td>
</tr>
<tr>
<td>Output VAT</td>
<td>Domestic sales</td>
<td>80</td>
<td>17%</td>
<td>13.6</td>
</tr>
<tr>
<td></td>
<td>Export sales (FOB)</td>
<td>20</td>
<td>17%</td>
<td>3.4</td>
</tr>
<tr>
<td><strong>Total VAT under management</strong></td>
<td></td>
<td></td>
<td>28</td>
<td>28%</td>
</tr>
</tbody>
</table>

1. This example does not take into account various taxes levied on the monthly VAT payable such as CCT, ES, etc., which would increase the overall VAT-related tax burden.
2. This is the current corporate tax rate for most companies but in the past many enjoyed significant reductions in tax rates.
3. Due to the VAT pilot, some of these services may or will transition from the BT regime into VAT.
4. In calculating the total VAT Under Management, VAT payable on bonded imported raw materials and export sales has been included. While both of these are theoretically exempt from VAT, it is a requirement that compliance with the Processing Trade program for bonded imported RM and export VAT refund return for export sales in order to enjoy this exemption. Errors in processing of these exempt areas can also lead to VAT costs. Consequently, we include the exempt or “avoided” amounts also to VAT Throughput under Management to give a full picture of possible VAT elements that could be assessed on the company.
It is apparent that the amount of VAT Throughput and VAT Under Management, if reviewed individually, would likely be considered material from a business and accounting risk perspective. In fact, this accounts for almost 30% of sales in the ABC company case study, which is not abnormal. The VAT figures are also much higher than the corporate tax burden, but this is where most companies have allocated their experienced tax staff and resources.

While the risk profile may be higher than anticipated, it usually means that opportunities to increase compliance, enhance cashflow efficiency and reduce costs abound. Over 50% responded that the VAT opportunities were higher or similar to corporate tax while only 32% believed the opportunities were lower – indicating there are benefits waiting to be found (see Figure 6).

Given the large cash dollar values being managed through VAT, we have also seen a steady increase in the attention that internal and external auditors are paying to VAT-related accounts in China. This is resulting from significant issues that stem from the peculiar VAT accounting treatment and accumulated VAT issues that are just now beginning to surface. There are a number of recent examples of both foreign and Chinese companies having to make large provisions, or even restate financial statements, due to VAT related errors or fraud. The abundant risk/opportunity profile means it is critical for companies to clearly understand how China’s VAT system works.

Once you know about the complexities of China’s VAT regime, then it is clear that the “pass through” low risk myth cannot be true. That is, there are high levels of risk and opportunities that should be explored.

![Figure 6: In terms of “saving opportunities,” how do you compare VAT to corporate income tax in your organization?](image)
A look inside China's VAT system
Part IV

Changing VAT regulatory landscape

One thing is constant in modern China – change. The entire landscape can be transformed before your eyes in a very short period of time and the regulatory environment is no different. The rules and regulations governing VAT and BT in China have been under continuous review for years and subject to frequent update and interpretation. This year has seen large and small regulatory changes that need to be understood by companies who wish to be successful in China. Failure to keep on top of the regulatory changes may adversely impact a company’s operations.
Numerous government stakeholders have an interest in overseeing and influencing the VAT developments in China. This seems prudent given over one-third of taxes collected come from VAT. The following have all been, in one way or another, involved in the study, drafting and release of important VAT regulatory developments:

- State Council
- National People’s Congress (NPC)
- Ministry of Finance (MoF)
- State Administration of Taxation (SAT)
- Goods and Services Tax Division (GST)
- Provincial Level Tax Bureaus
- State Tax Bureaus (STB)
- Local Tax Bureaus (LTB)

As one can appreciate, the number of parties interested in VAT policy can make for robust discussions, high-level regulations and differing interpretations on the treatment of technical matters.

While the VAT rules were originally issued in 1993, they were later overhauled in 2009 but still carry, even today, the status of “provisional” rules. The Authorities have been studying for the last few years an overall VAT reform initiative that considers merging the taxation of services, under BT, into the VAT system and possibly upgrading to a law. These policy reform efforts continue but due to various factors has been delayed until possibly 2015, as targeted in the latest 5-year plan. Nevertheless, the future reform will also greatly depend on the outcomes from the VAT Pilot in Shanghai and other areas.

![Figure 7: Summarized changes in VAT regulations](image-url)
China’s VAT-related regulations issued at the central level (MoF and SAT) are typically drafted addressing high-level topics and introducing a framework to address how certain technical matters should be treated. Subsequently, further guidance and interpretative announcements are often released by different levels to provide clarity on the application and interpretation in their jurisdiction. There have been over 500 updates to regulations from different agencies in each of the last few years.

It is easy to see how tax staff may miss an important VAT regulatory development that impacts the business. While over 500 were issued in total, it is interesting to note the increase in circulars issued at the central level and the decline of those issued at the local level. The reduction in local regulations appear to indicate that the rules issued by the MoF and SAT are more comprehensive these days which decreases the need for so many separate local interpretations. This is a promising sign towards improving the consistent application of VAT regulations on a nationwide basis. Companies have frequently raised concerns in the past about inconsistent application of rules on a geographic basis, as they must deal with many different local authority interpretations of the same nationwide rule. Any move towards greater consistency is a positive step in the right direction.

It can be a daunting task to stay on top of these changes and ensure the company is in compliance. In fact, more than 76% of survey respondents said they were not closely monitoring the changes and need more time and assistance to understand how the changes impact the organization.

This statistic is worrying but not entirely unexpected given the pace of regulatory change and the fact that few, if any, company resources are dedicated to strategically managing VAT. It would be advisable to allocate more resources to be responsible for VAT so they can keep up to date and proactively attack issues.
VAT Pilot

We would be remiss not to briefly mention the VAT Pilot which has been called “one of the most important tax developments in China’s history” and hailed as “another landmark in the wave of China tax reform.” The Pilot was designed to test the outcomes arising from the transition of certain BT services to VAT. The Shanghai VAT Pilot was launched from January 2012 and affected over 120,000 new “in-scope” VAT taxpayers. The Pilot starts addressing the challenges stemming from the inefficiencies of China’s indirect taxing system where services, intangibles and other items covered by the BT regime do not interact with the items covered by the VAT regime. Many have asserted that these tax policies resulted in “double taxation” since BT and VAT are not creditable against each other. Unlike other countries with a merged GST regime, China has more cascading tax costs and blockage of VAT that otherwise would be creditable.

The VAT Pilot is a fundamental shift in China’s indirect taxing system and signals the Authorities’ commitment to making this difficult transition. Since VAT and BT comprise approximately 50% of China’s total tax collection, the Authorities are taking a cautious approach to testing the merged system on a smaller scale prior to full implementation. Controversial areas such as: state or local tax bureau jurisdiction; acceptable central and local tax distribution mechanism; appropriate tax rates; and specific industries (e.g., financial services, agriculture, etc.) also add to the daunting task of an overall reform. Surprisingly, 85% of survey respondents thought launching the VAT reform through a Pilot program was necessary but they were split as to the preferred duration, longer vs. shorter, before rolling out on a nationwide basis. This seems to support the Authorities’ idea to roll-out the changes on a Pilot basis.

The VAT Pilot transitioned three categories of BTTable items to the VAT regime and introduced two new rates along with a 0% rate for certain services (see Figure 10). The details of the VAT Pilot are too numerous to be covered in this publication but our other materials discuss this topic at length. On balance we believe the Pilot and the future VAT reforms will benefit a

Over 85% of survey respondents welcomed the expansion of VAT to absorb BTTable services, while 15% did not welcome the expansion because it required them to adapt to the changes.
majority of companies in China under a merged GST regime although some may experience an increase in costs. It will just take some time to reach that point.

The VAT Pilot also sets the scene for future VAT regulatory developments. We expect the Authorities will rapidly expand the Pilot to other locations, a number of whom have already submitted applications, and that other services* will eventually be folded into the GST regime. The Pilot expansion will take place throughout 2012 in eight additional locations. Rapid expansion of the Pilot to new locations may actually accelerate an overall reform due to the difficulties of administering different sets of rules that create cross-border transactions even within China. Those affected by the new Pilot rules need to be prepared for the transition as common feedback from the new VAT taxpayers in the Shanghai Pilot was that they underestimated the amount of financial and operational impact to the company. Many commented that if they were able to do it over again, they would spend more time preparing in advance instead of scrambling after the transition which has proven to be time consuming and more costly.

It is not difficult to see how keeping up with all of these important regulatory developments could be a full time job for one or many staff. Unfortunately, most companies do not have dedicated VAT resources with either the allocated responsibility or sufficient time to monitor, read and comprehend the frequently changing regulations. They are not able to develop insights into the implications for the company or how to respond appropriately. We would advise companies to review their resource model for processing and managing VAT in China and assess whether changes need to be made.

While everyone hopes the volume of VAT regulatory changes will reduce, we anticipate that in the next few years it will actually accelerate; due mainly to the expansion of the Pilot and move towards overall reform. It will be increasingly important to stay ahead of the changes or risk getting left behind. We suggest to proceed with caution as the next round of Pilot expansion and reforms will be on your doorstep sooner than you think. Whatever the case, it looks like we are in for an exciting time of regulatory change over the next few years in the China VAT world.

3 Shanghai Party Secretary Yu Zhengsheng quoted in Shanghai Daily, 6 December 2011.
4 Xiaojie — Head of China’s State Administration of Taxation quoted in the Economic Daily, 10 May 2012.
6 Most likely candidates are construction, entertainment, financial services, telecommunications, etc.
A look inside China’s VAT system
China’s VAT system has its own unique Chinese characteristics and is widely considered to be more complex when compared to most of the VAT/GST regimes around the world. There are many different parts of the company that must be synchronized in order to have a compliant and efficient VAT operation.

Part V
China VAT – how it all links together
The VAT work in China requires more of everything – more transactions, more documentation, more paper, more invoices, more steps in the process, more data, more returns, more involvement of the CTB – which can overwhelm resources and lead to difficulty in maintaining compliance. In order to overcome the additional workload created by all the “more,” it is important to understand how the major components of VAT link together in the organization.

Companies need to explore whether the following major areas are closely aligned to successfully navigate China’s complex VAT regime:

- The Company
- The CTB
- VAT return processes
- Manual “off system” processes or calculations

The following diagram illustrates how each of these major areas interact together (see Figure 11).
Numerous processes and calculations are performed outside of ERP systems with little or no automatic data feeds or links.

At first glance, this picture can be confusing but seeks to clearly illustrate the level of detail involved in China VAT and the need for close coordination. Let us explore each of these areas separately below and then how they must work in synch for the company to improve the VAT operations.
Who manages VAT in your organization? According to survey respondents: 50% finance; 34% tax; 11% accounting; and 5% other.

Company
It is necessary to identify the relevant VAT transactions and the parts of the organization that have ownership of the information and processes if seeking to improve the VAT function. The company typically utilizes three main internal components (people, systems and processes) to perform and manage VAT activities, although they may use various combinations of each to achieve their objectives.

People
Staff in the Finance, Accounting, Tax and Other Departments are typically responsible for invoice processing, accounting entry activities and overall management of VAT. Few companies in China actually employ dedicated in-house staff with responsibility and accountability only for VAT. We find that many departments only partially touch sections of the end-to-end VAT processes and that gaps could arise as a result. It is not uncommon for one department to say they thought the other department was completing a part of the process – when in fact it was not being performed by anyone. This departmental disconnect exponentially increases the chances of errors or inefficiencies and underscores the need for better internal communication and closer coordination of VAT tasks.

Even if staff are assigned to work on VAT, they mostly perform daily processing tasks to issue invoices and submit the VAT returns on time. It is important to understand whom, if anyone, is ultimately accountable for managing the overall VAT results of the company. Without clear accountability and authority to mobilize staff from other departments, we have seen companies take widely different approaches to managing their VAT. In our survey, only 16% answered they have dedicated staff strategically managing the...
VAT function; while almost 25\% said they are in a fire fighting, or reactive, mode only.

As the importance of VAT in China becomes more recognized, we expect that in-house positions to manage VAT will be created; similar to developed VAT/GST countries. Our experience has shown that many companies have already started the journey to building a stronger VAT function in the developing China market. However, it could be argued that the risks in a developing market are higher and this warrants a critical view of how resources are deployed across the organization.

The graph in Figure 13 illustrates that we typically see a mismatch between possible VAT risk levels and allocated resources between developed and developing countries.

For many companies, the first step to improving their VAT performance is to identify a person(s) with deep VAT experience who can deliver results. It can be difficult to find such a resource, because not many exist in China right now, so the company may need to consider alternative resource models. Some would utilize a VAT experienced staff from another country on a short-term basis, although this does not seem to work in all situations, or select a hard worker who is capable of learning the subject matter and let them grow into the role.

We would advise companies to review the current organizational structure for VAT and determine if staffing levels are commensurate with the size and importance of the VAT Under Management. It may be necessary to reallocate resources or to create a VAT function to manage this important part of the business. VAT staff should seek to perform higher value-add activities such as strategic planning while moving away from lower value-add activities such as daily processing and return preparation. Focus on strategic objectives and planning could also yield valuable cashflow and cost saving initiatives.
Systems
We will cover three types of “systems” under this section:
1. The ERP/accounting system
2. The GTS
3. Other systems used by the company for VAT purposes

All companies utilize an ERP or accounting system wherein transactions are booked for purchases, sales and other miscellaneous accounting dealings. Numerous accounting systems may be used in parallel, or cobbled together, at the same legal entity or within the same group. Many of these systems have limited functionality and some struggle to sufficiently capture the VAT aspects of related transactions that could be used to compile the VAT return or perform necessary reconciliations.

Additionally, a system that only copies the VAT processes from another country, such as Europe, will encounter difficulties with VAT processing in China.

Unfortunately in China, the ERP/accounting data usually does not equal VAT data — some even say it cannot due to the paper invoice (“fahpiao”) approach applied by the CTB. This is important but can be confusing for companies who are used to processing VAT/GST in other countries using data directly from the ERP system. While details such as tax coding and transaction tables may help processing VAT transactions in the accounting system, it may not for other VAT processes. There can be material variances in the accounting data vs. VAT data due to timing differences for invoices, quantity of data fields, use of the GTS for VAT data filings and other “off book” VAT transactions such as deemed sales and transfer out requirements. When data cannot be used directly from the accounting system and manual processing must be undertaken to generate VAT return ready data, the chances of errors increases exponentially. In fact, only 31% of survey respondents stated their accounting systems and the GTS are connected to some level (see Figure 14), while the other 69% are not able to directly use their ERP or accounting data directly for VAT return processing. This greatly increases the manual work needed to complete returns and reconciliations.

The gaps from input and output VAT invoices between the accounting system and the GTS can be material and thus a majority of companies have created alternative manual processes in which to gather and organize the data necessary to complete the VAT returns. It is startling to see the amount of manual work performed by these staff who must handle thousands of input and output invoices that the systems are not capable, or cannot perform, without additional configuration efforts. We would advise that a company needs to further understand to what extent the systems are being used, if at all, for VAT operations and whether it is possible to move towards greater automation.

We have recently seen an increased level of interest from companies wanting to improve automated solutions for VAT operations and reduce or remove the level of manual tasks. However, it will require a strong internal supporter to identify the benefits of automation.

7 This system is issued by the CTB but the company must use it frequently to issue invoices and submit VAT returns. The GTS is covered in more detail in the CTB section.
outline the necessary systems and data changes, persuade management to take on this work and push forward the project agenda to completion. This will take some time but our survey respondents are considering utilizing technology and automation in different ways (see Figure 15).

Ernst & Young China has spent countless hours understanding the needs of companies to perform their VAT operations more efficiently and accurately and have worked with CTB and GTS systems developers to come up with unique solutions. This will be more common in the future as companies strive to efficiently streamline processes. We have also developed a software tool, called Discovery, that has been tailored for China to perform VAT data analysis and diagnostics to identify trends, risks and opportunities. The Discovery tool is designed to be used in phases, each with a sequentially higher level of sophistication and cost, and can be helpful in understanding your VAT profile and where to focus your efforts.

We expect the area of systems, automated solutions and the linkages between ERP and GTS will continue to explode in the future as companies understand that potential solutions are either available or can be developed to save them time and money in the long run. We are available to help you explore what is possible.

In China, ERP data does not typically equal VAT data. Some even say it cannot be the same.
Internal controls and processes

VAT processes in China typically concentrate only on the issuance and receipt of VAT invoices and timely submission of VAT returns with limited internal controls built into the process. The VAT work generally falls under what we call “daily processing activities” as compared to “strategic management activities.” This is evidenced by more than 50% of respondents stating their key VAT decision driver was compliance driven with less focus on cost reductions, cashflow efficiency or other noteworthy objectives. However, changes to business processes and the lengthening of the supply chain means that companies should be moving towards strategic management of the entire end-to-end VAT process and introducing appropriate controls.

It is critical for a company to understand and document the step-by-step VAT processes, the roles of each party and critically analyze whether current processes and controls are sufficient to manage VAT risk. This is especially pertinent because many different departments touch parts of the end-to-end VAT processes and rarely work in a coordinated manner. To date we have not seen many companies undertake the task to map out all of their VAT processes, assign responsibility and identify possible compliance gaps. This is evident in our survey results where VAT staff have a surprising low confidence level about the ability of their VAT processes to generate accurate results.

With such a low confidence level companies frequently ask what processes should be reviewed? These are too numerous to put in a comprehensive list but the following provides a good illustration of the “more” VAT processes required in China:

- Accounts receivable (“AR”) and other sales-related transaction processing in the ERP
- Accounts payable (“AP”) and other purchase-related transaction processing in the ERP
- Input VAT invoice printing from the GTS
- Input VAT invoice verification processes (either through GTS or other)
- Output VAT invoice printing from the GTS and issuing to customers
- Red letter issuance process with CTB and through GTS
- Reconciliations between the ERP and the GTS data
- VAT return preparation (gathering data and manual “off system” revisions) and submission process
- Export VAT return preparation and submission process
- Documentation and record keeping processes (remember there is a lot of paper in China)
- Many others

Many of these processes are already conducted in the normal course of business, such as AR and AP, but many times by staff who do not understand the intricacies of China VAT or what is required or helpful for staff preparing the VAT returns. For example, we find many instances of AR/AP staff combining multiple VAT invoices into a single entry into the ERP system. This consolidation approach may appear to simplify data entry for AR/AP purposes but creates significant work and gaps for VAT staff since there is no link between the ERP invoice number details and the
invoice numbers in the GTS. Due to the reliance on the paper VAT invoice, many customers will focus only on the VAT invoice number and not care about the ERP invoice number. Without the simple connection of invoice number, reconciliation of thousands of input and output VAT invoices becomes an almost impossible task. By educating staff in all departments about the impact they have on VAT and looking for synergies can improve efficiencies and reduce errors.

When reviewing these processes, it should be possible to identify compliance gaps and areas for overall improvement of VAT management. For example, VAT rules in China allow a company only 180 days to verify an input VAT invoice with the CTB and place it in the VAT return for credit or refund purposes. If the invoice is not appropriately verified within 180 days, then it cannot be used for credit or refund purposes and becomes a sunk cost. On the other hand, if a company’s processes extend or delay the verification and inclusion process of an input VAT invoice it ties up precious cash flow, since earlier input credits would reduce VAT payable or refunds and risks passing the deadline. VAT process reviews should be able to uncover risks and improvement opportunities and better visibility through formal and documented processes could be achieved.

We have worked with many companies in China on their VAT processes and understand how these complex steps link together. This allows us to add value through leveraging good ideas learned from previous projects that can benefit those companies just starting to look into their VAT processes but do not know where to start or how to proceed.

How confident are you that your VAT processes are generating the correct results? 80% are “not so confident” and only 20% are “very confident.” Therefore, it remains clear that a lot of work remains for companies to improve confidence levels.
China Tax Bureau

The CTB is much more intimately involved in a company’s end-to-end VAT processes than most countries. There are many reasons why this is the case and in this section we explore the following in more detail:

- Various departments within the CTB itself may have jurisdiction
- Frequent regulatory changes
- The GTS
- VAT audits

Within China there are different departments in charge of VAT and BT at both the Central and Local levels and each have jurisdiction on different geographic or technical issues. Companies can encounter obstacles when working on a nationwide basis to understand the application of the regulations to specific circumstances and transactions. There is also clearly overlap on certain issues between the State Tax Bureaus and the Local Tax Bureaus. It can be a confusing endeavor to identify the appropriate Bureau or Department that a company should approach with a question. See the table opposite (Figure 17) for a general idea of some of the different players involved in VAT and BT issues across China.

China continues to issue hundreds of VAT related regulatory updates and many of these rules are drafted at a high-level with implementation details that still remain to be clarified. This creates an inevitable environment where companies are in continuous dialogue with the Authorities to clarify local practices or seek guidance or approval to see if the CTB agrees with the company’s position. At this time in China, there is also little or no legal precedent that companies can research to support their position. Consequently a majority of technical issues must be hashed out with the local in-charge Tax Bureau or Officials through face-to-face contact. It can be difficult to obtain a formal response in writing from these meetings and the company has to rely on what has been agreed. Any contact with the CTB should be made by experienced staff with appropriate tax knowledge and enough seniority to improve the chance of obtaining positive results. Disagreements with the CTB or a local Official are challenging to manage appropriately and finally reach an acceptable resolution.

The GTS is a system developed by the CTB that a VAT taxpayer must use almost on a daily basis. Without the GTS a company cannot issue or print special VAT invoices, is not able to verify input VAT invoices, and would not be able to submit VAT returns. The GTS was originally implemented to combat VAT fraud and invoice counterfeiting since the invoices...
The Golden Tax System is a system developed by the CTB to manage the country’s VAT system where all VAT invoices are issued, processed and verified as well as VAT returns submitted. This is a big difference to other countries, but also places the CTB, who controls the system, squarely in the middle of a company’s VAT processes. Essentially you cannot function in today’s China VAT world without the GTS and the processes can be very time consuming to complete. Companies may employ small “armies” of staff who are responsible for working daily with the GTS to print invoices, submit data through IC cards and transmit/receive data. The GTS seriously increases the number of VAT processes and workload necessary to operate in today’s China VAT world.

One area that the CTB is deeply involved in a company’s VAT process is when they conduct a VAT focused audit. However, this is one area where it appears the CTB is not as involved in a company’s operations as other countries. Over 70% of survey respondents answered that they had not been the subject of a VAT specific audit in the last two years. This is surprising given the complexity of the VAT system in China and the room for errors. Heavy reliance is placed by the Authorities on the ability of the GTS to identify anomalies and highlight potential issues so it appears that actual field audits are not as prevalent. We would expect the CTB to soon begin focusing more closely on a company’s VAT operations and expanding the field audits to a wider group of companies. It will take some time as the CTB and Officials also need deep technical and practical expertise to conduct such audits. Companies should start preparing now for an increase in VAT audits and not get caught off guard when the CTB comes knocking at your door.

Finally, it should be clear from the above points that the CTB is more involved in your VAT operations. Notwithstanding this, we asked the survey respondents how interested they would be in working even closer with their in-charge VAT Authority. Nearly 80% answered they would be very interested to increase the interaction – showing that companies are seeking even more guidance in this complex tax area and are looking for someone to engage with. As companies and the CTB improve communication and interaction, both will benefit through a proactive relationship.

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8 The Golden Tax System is a system developed by the CTB to manage the country’s VAT system where all VAT invoices are issued, processed and verified as well as VAT returns submitted.
VAT returns

Would it surprise you to learn that a typical VAT taxpayer in China may need to file up to two VAT returns and more than 10 appendices, with up to 800 data fields every single month – that equates to 140 forms and almost 10,000 data fields on a yearly basis. When compared to the summarized VAT returns and data fields of most VAT/GST countries, it should be evident that VAT compliance and reporting accuracy in China is a daunting challenge that many companies struggle to achieve. The difficulty increases even further when you consider that most data cannot be extracted directly from the accounting system without first being subjected to manual processing to get the data in the right format for the VAT return. Let’s explore the return and reporting complexities in more detail below.

There are two major types of VAT returns (Main Return and Export VAT Refund Return) that must be completed on a monthly basis by most companies.

The format of the returns can also differ by geography and type of legal entity (e.g., a trading and manufacturing company are different). The returns are periodically updated to address new regulatory developments such as the Shanghai VAT Pilot described earlier where in-scope services must now be included in the Shanghai VAT returns but not the rest of China. The following table provides a quick snapshot of the numerous returns, appendices and types of detail in the main VAT returns (see Figure 18).

The China VAT returns are probably the most complex in the world. There are many versions of VAT returns, numerous data fields, “off-system” manual processes and a high level of dependence on actual paper VAT invoices to complete the VAT return processes.
**Table:** China VAT returns

<table>
<thead>
<tr>
<th>Main VAT Return</th>
<th>Export VAT refund Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>Non-Shanghai</td>
</tr>
<tr>
<td>增值税纳税申报表 (VAT Declaration Form)</td>
<td>增值税纳税申报表 (VAT Declaration Form)</td>
</tr>
<tr>
<td>本期销售收入情况表 (Details of sales in current period)</td>
<td>本期销售收入情况表 (Details of sales in current period)</td>
</tr>
<tr>
<td>本期进项税额明细表 (Details of input VAT in current period)</td>
<td>本期进项税额明细表 (Details of input VAT in current period)</td>
</tr>
<tr>
<td>成品油购销存情况表 (Details of purchase, selling and stock of refined oil)</td>
<td>成品油购销存情况表 (Details of purchase, selling and stock of refined oil)</td>
</tr>
<tr>
<td>纳税申报表 (Illustrative form of VAT return)</td>
<td>纳税申报表 (Illustrative form of VAT return)</td>
</tr>
<tr>
<td>增值税运输发票抵扣清单 (List of transportation VAT invoice for offset and deduction)</td>
<td>增值税运输发票抵扣清单 (List of transportation VAT invoice for offset and deduction)</td>
</tr>
<tr>
<td>海关完税凭证抵扣清单 (Deduction breakdown of import VAT payment certificate)</td>
<td>海关完税凭证抵扣清单 (Deduction breakdown of import VAT payment certificate)</td>
</tr>
<tr>
<td>固定资产进项税额抵扣情况表 (Deduction of fixed assets input VAT)</td>
<td>固定资产进项税额抵扣情况表 (Deduction of fixed assets input VAT)</td>
</tr>
<tr>
<td>损益表 (Income Statement)</td>
<td>损益表 (Income Statement)</td>
</tr>
<tr>
<td>资产负债表 (Balance Sheet)</td>
<td>资产负债表 (Balance Sheet)</td>
</tr>
<tr>
<td><strong>Per month</strong></td>
<td><strong>Form</strong></td>
</tr>
<tr>
<td><strong>Appendices</strong></td>
<td><strong>9</strong></td>
</tr>
</tbody>
</table>

Understanding how the regime works to effectively manage VAT risks and opportunities
**Figure 19: Example of interaction between VAT returns and appendices**

### Main form (Current period)

<table>
<thead>
<tr>
<th>Items</th>
<th>Columns</th>
<th>Current month amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales amount of goods and services which should be taxed</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Sales amount of goods to be taxed simplified calculation method</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Sales amount of VAT-exempt goods and services</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>Output VAT amount</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>VAT due calculated by the simplified calculation method</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>VAT due calculated under simplified calculation method under tax inspection</td>
<td>22</td>
<td></td>
</tr>
<tr>
<td>Reverse of input VAT already recovered</td>
<td>14</td>
<td></td>
</tr>
<tr>
<td>Input VAT amount</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>Export sales amount for which “Exemption, Credit and Refund” method is applicable</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>Export VAT refund amount calculated base on “Exemption, Credit and Refund” method is applicable</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td>Excess VAT amount carried forward from previous period</td>
<td>13</td>
<td></td>
</tr>
</tbody>
</table>

### Appendix 1 Details of sales in current period

<table>
<thead>
<tr>
<th>Columns</th>
<th>Subtotal</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>Sales amount of VATable goods and services</td>
</tr>
<tr>
<td>14</td>
<td>Sales amount on simple approach</td>
</tr>
<tr>
<td>18</td>
<td>Sales amount of VAT exempted products and services</td>
</tr>
<tr>
<td>7</td>
<td>Output VAT of VATable goods and services</td>
</tr>
<tr>
<td>14</td>
<td>Tax payable on simple approach</td>
</tr>
</tbody>
</table>

### Appendix 2 Details of input VAT in current period

<table>
<thead>
<tr>
<th>Columns</th>
<th>Tax amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>13</td>
<td>Input VAT transferred out in current period</td>
</tr>
<tr>
<td>12</td>
<td>Subtotal for the declared input VAT deduction in current period</td>
</tr>
</tbody>
</table>

### Export return (current period)

<table>
<thead>
<tr>
<th>Columns</th>
<th>Tax amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Export amount of products for which “Exemption, Credit and Refund” method is applicable</td>
</tr>
</tbody>
</table>

### Export return (previous period)

<table>
<thead>
<tr>
<th>Columns</th>
<th>Tax amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>VAT refundable in current period</td>
</tr>
</tbody>
</table>

### Main form (previous period)

<table>
<thead>
<tr>
<th>Columns</th>
<th>Tax amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>Excess input VAT amount to be carried forward to next period</td>
</tr>
</tbody>
</table>

### Appendix 3 Details of purchase, stock and selling of refine oil

Only applicable to companies engaged in the retailing of refine oil

### Appendix 4 Illustrative form of VAT return

Only applicable when the sales amount or output VAT is a negative figure

### Appendix 5 List of transportation VAT invoice for offset and deduction

### Appendix 6 Deduction breakdown of import VAT payment certificate

### Appendix 7 Deduction of fix assets input VAT

A look inside China's VAT system
A select number of the hundreds of data fields contained in the appendices are interlinked with the main VAT returns and must flow from one document to the next. Figure 19 illustrates only a part of the data field interactions between the appendices and the Main VAT return.

With the complex nature of China VAT returns, we are continually amazed at how companies go about gathering and processing all the necessary data to complete these returns each and every month. We asked our survey respondents what they thought about the VAT filing process in China and almost 75% agreed it was too complex with an overwhelming 97% commenting it required excessive paperwork to complete each month (see Figure 20).

It is easy to see how simple errors may creep into the VAT returns due to such a complicated filing process. Hopefully, the CTB will begin to simplify and streamline the VAT returns and data requirements in the years to come. This would be a huge undertaking as substantial revisions to VAT returns would also require reprogramming of the GTS to implement any modifications.

Figure 20: The China VAT process is ...
Manual “off system” processes

It has been mentioned numerous times that most companies are not able to directly use data from their internal accounting systems for VAT return filing. Consequently some level of manual “off system” processing is needed. These manual processes currently appear to be a necessary evil and vary from company to company but more often than not are consolidated into an excel spreadsheet(s) or numerous excel files each trying to address a certain section of the VAT return. Tracking the data finally applied in the VAT returns presents a challenge as there is no proscribed format for these “off system” files and many times they are not saved or retained appropriately by the staff who prepared them.

One of the main driving forces behind the need for “off system” processes is related to the high level of dependence on paper VAT invoices when completing the returns. There are many timing differences between the electronic booking of a transaction in the accounting system and receipt of the actual paper VAT invoice – which is a timing difference we refer to as “the paper gap.” For example, a taxpayer is not able to claim an input VAT credit unless they have actually received the VAT fahpiao and have formally verified the authenticity of that invoice through the GTS or directly with the CTB. An unverified input VAT invoice cannot be used in the current month’s VAT return as a credit even though it has mostly likely been booked in the accounting system. This disconnect between the electronic data in the accounting system and the receipt and issuance of the paper VAT fahpiao through the GTS inherently results in variances that need to be manually adjusted. We have seen some companies who have been able to introduce a level of automation into these processes but it usually still requires some level of manual intervention.

9 Not all VAT invoices are verified through the GTS. Some invoices such as import VAT invoices, transportation invoices, oil, etc., have different verification procedures and some may actually require a face to face visit with the CTB before it is authenticated.
Another factor demanding “off system” processes is the need to reconcile data. There are inherent variances between the accounting system data and the VAT return data, from the “paper gap” and other reasons. In theory, these should be reconciled prior to filing the returns, which are due the 15th of the next month. These reconciliations are very complex and require that data is gathered from numerous systems and sources and sorted into a usable format before performing any reconciliation. Identification of variances does not automatically mean a problem exists but signals a need for further exploration. There are types of variances, such as some timing differences, that can be explained and should be acceptable to both the company and the CTB. However, more often the variances represent a gap and potential reporting weakness that needs to be investigated further to ensure the VAT returns are being completed accurately. Our experience with hundreds of companies in China has shown that many are still not able to conduct timely or robust reconciliations prior to the VAT return filing deadline. We have been surprised to see many companies who actually do not complete any data reconciliation work at all and this can be dangerous since it increases the chances of errors and compliance issues. More automation in the reconciliation process is extremely helpful to staff who perform this work. However, most companies do not have a clear idea of what process improvements would be necessary or helpful for reconciliation purposes and have not taken the next step to employ IT resources to develop solutions. We think this should be a priority for companies who want to improve their VAT operations in China.
Part VI

Where to go from here ...

Gaining visibility into, and strategically managing, your VAT in China is a journey ...

The issues and processes are not straightforward and require concentrated efforts to make progress. However, companies will be rewarded with improved cashflow efficiency, reduced risk levels and decreasing costs.
The China Authorities collect more than one-third of their tax revenue through VAT so it is clearly an important tax in this country. The regulations continue to change, such as reforming the taxation of services to transition from BT to VAT, and the pace of regulatory change shows no signs of slowing down in the next few years. Companies must try to maintain compliance in a dynamically changing regulatory environment and that can be challenging.

VAT risk many times is erroneously measured by reviewing only the net account balance between output and input VAT, or net amount payable/refundable, due to China’s VAT accounting treatment. In this context VAT accounts rarely seem material in terms of accounting principles and to the business as a whole. However, this measurement ignores all the VAT cash being handled and doesn’t take into consideration the lower/zero rated and exempt activities which arguably present a greater risk of errors. VAT Throughput and VAT Under Management are more accurate measures of the cash/tax cost the company has to manage and when factored into the equation VAT takes on a very different risk profile. When the total VAT managed or the accumulated balances in each VAT sub-ledger are reviewed in detail, companies frequently conclude they must begin to manage this important tax more strategically and carefully.

As you have seen, it is difficult to put all of the China VAT puzzle pieces together to form a comprehensive view of this challenging tax. The interactions between the Company, the CTB and the VAT returns result in complicated VAT processes that overlap into many different departmental functions. The insertion of the GTS, absence of linkages to the accounting system and reliance on paper VAT invoices create “more” processes that companies must perform to handle VAT in China. Our survey showed almost 80% of companies were not confident that their processes were able to arrive at accurate VAT results. After hearing more above, this diagram may make more sense! See Figure 21.

**Figure 21: Linking China VAT together**

**Company**
- People: Staff focused on VAT usually in finance, tax or accounting department
- Systems: ERP and accounting systems used to track and account for VAT related transactions
- Internal Controls / Processes:
  - AR: Pricing, Sales transaction, Invoice, Collect payment
  - AP: Price quote, Purchase order, Purchase, Make payment

**China Tax Bureau**
- SAT
- GST div
- Regulations, notices, circulars
- Local interpretations and practice
- Different types of VAT invoices / transactions
- Authorized staff to use IC card & GTS
- VAT invoices generated in GTS
- Linkages to ERP/GTS
- Detailed sales lists

**Golden Tax System**
- Computer
- Printer
- GTS Central Database
- Different types of VAT invoices / transactions

**Manual “Off System”**
- Using ERP data to prepare returns?
- Other data sources
- Reconciliation to financial figures

**VAT returns**
- Main VAT return
- Export VAT refund
- Appendices to VAT returns (10+)
- Documents needed for returns
- Input invoices
- Output invoices
- Customs VAT
- Export docs
- SAFE
- Accounting, P&L
- Other
It is not surprising that once a company understands all of these important factors that they decide it is imperative to dive deeper into their China VAT. How should they begin this journey? China is quite unique in that most companies will have numerous legal entities performing different functions and this affects VAT in different ways. A starting point for assessing how to prioritize companies could be based on variations of the types of VAT transactions and VAT complexity of the type of legal entity and processes. It is important to note that this is not the only way to prioritize companies, nor does this equate to VAT risk — even a small legal entity with limited transactions can have high levels of risk. It can even be the smaller companies that have the most issues due to limited staffing levels, less understanding of the regulations and incomplete processes. Most companies can benefit greatly from focused projects that help to bring VAT operations to the surface, such as: VAT process reviews; Discovery data analytics; reconciliations between ERP and VAT data; etc.

Dedicated efforts at each legal entity will usually identify areas of strength, areas for improvement and potential savings opportunities that can set the agenda for future action to be taken by responsible VAT staff.

Notwithstanding this, Figure 22 seeks to provide a high-level idea of how types of legal entities may be plotted along the continuum of variations of transactions and overall complexity to assign a priority of where to start. A company should start developing a plan to begin assessing their China VAT risks and opportunities. The key is to just start the journey.

We expect that as companies become more familiar with their China VAT they will start to improve management of their VAT function in the following ways:

- Strategic (planning and controversy)
- Operational (accounting, finance, GTS, etc.)
- Compliance
- Documentation

By diving into the depths of China VAT, companies will benefit greatly through reduced risks, improved compliance, decreased costs and greater cash flow efficiency which can help both the top and bottom line. We welcome you to start down the China VAT path and we’re glad to bring our valuable insight to supplement your internal efforts. Good luck!

**Figure 22: How to prioritize where to focus on China VAT?**

- **Mega company**
  - Export and domestic manufacturer, large sales volume, trading and distribution activities, R&D, bonded and non-bonded transactions etc.

- **Large scale manufacturer**
  - Mixture of domestic and export sales

- **Export manufacturer**
  - Mostly export-oriented production

- **In-scope service company**
  - R&D, transportation, service company or other providing in-scope Pilot services now subject to VAT

- **Simple manufacturer**
  - Mostly domestic

- **FTZ trade company**

- **FICE trade company**

Understanding how the regime works to effectively manage VAT risks and opportunities
A look inside China’s VAT system
Global indirect tax

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