Chinese Sales Contracts: How to Set Favourable Tax Terms for Your Business

TAGS Legal and Tax Series

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The terms of sales contract are important when it comes to operating a business. Here are our suggestions on how to set favourable terms.

INTEGRA GROUP

This is the second of a set of articles on legal and tax-related aspects for operating a business in China, mainly through a legal entity in the country. Click here to read the first article on registered capital in China. This article was written by Integra Group, a service provider partner of the EU SME Centre.

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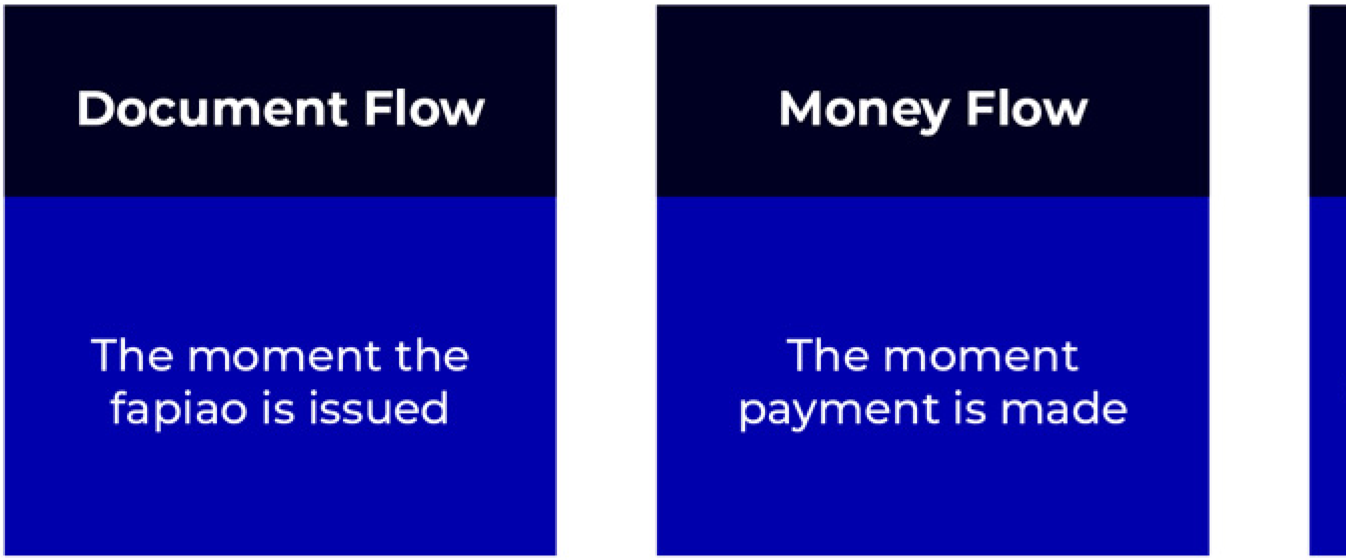
When negotiating sales contracts with clients, terms surrounding the "three flows" have a significant impact on the tax liability and cash flow of your businesses. It's important to know how these "three flows" work, and the cash flow implications that arise when negotiating these terms as part of your Chinese sales contracts.

The "three flows" refer to:

1. "Document flow" i.e. fapiao;
2. "Money flow" i.e. payment;
3. "Goods flow" i.e. transfer of goods/services.



How to make Chinese sales contracts favourable to your business

The three flows are the key events which you need to look out for in order to know when your business' tax liability is realised. We will show you when would be most ideal for your business to schedule these events. We can't advise you on when to deliver goods, or how to structure your payment terms because these vary significantly between businesses. Instead, we focus on how you can manage *fapiao* [official invoices] so as to avoid paying tax early and maximising your business' available cash at any given time.

Fapiaos are often overlooked and are often thought of as minor details in a Chinese sales contract. After reading this article, you will know how fapiao terms can be seen as a negotiating chip to negotiate larger deals with your clients and favourable tax terms for your business.

China is different from the rest of the world. We have said in past articles that fapiaos are the gold standard as far as the tax authorities are concerned. There is one rule that is always true: **if you issue**

a fapiao, your VAT liability stated on the fapiao will be due in the same period. This means that once the transaction has been recorded on a fapiao, it's official, your VAT is due.

It is important that you don't issue fapiaos early. Doing so not only forces you to recognise your tax liabilities early; it is also one of the indicators to the tax bureau that a business is engaging in fraudulent tax manipulation activity. If the total fapiao revenue is higher than the revenue declared on your tax filing within a single period, you may be rejected online by risks reminder, and further explanation may be requested.

Below is our advice to you on how to structure your Chinese sales contracts to plan your fapiaos in a way which is favourable to your business.

Scenario 1: Direct Sales

The most common scenario that businesses face is when the flow of goods and the flow of payment occurs in the same accounting period. Chinese tax law states that if these two events have occurred, VAT liability must be recognised in the same period. It is not allowed to delay VAT liability arising from the transaction if both the ownership of good has been transferred and money received. Not declaring your VAT liability would be considered unlawful manipulation of tax liability.

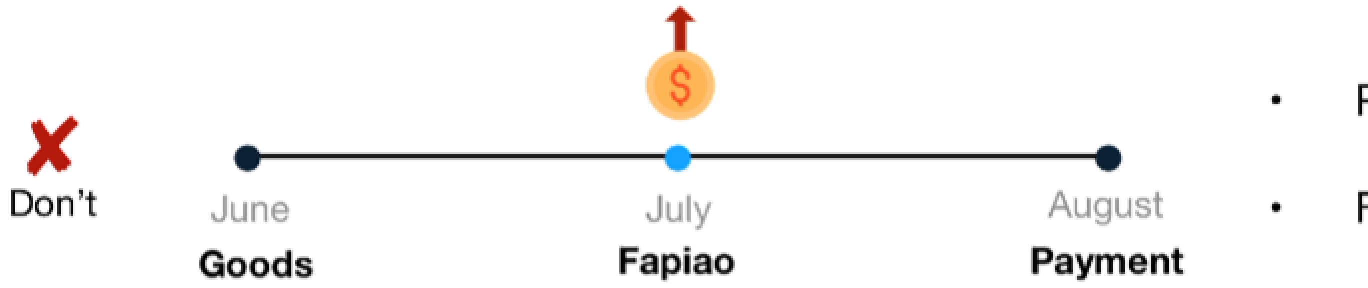
A common mistake we see is when a business' accountant performs bookkeeping on the basis of fapiao; it is very common that accountants are not aware of transactions for which a fapiao has not been issued or issued late. You could unknowingly be manipulating your tax liability, which carries a financial penalty to the business.

China Tax Regulations: Timing of VAT Liability

General principle: Tax liability should be recognised u
date, whichever occurs earlier.

Scenario 2: Credit sales

Let's say that you allow your customers favourable payment terms in order to win a contract. The terms in your Chinese sales contracts might allow the customer to pay 30 days after goods or service have been delivered. In this scenario, you don't want to pay tax on top of the line of credit you give to your clients before receiving payment yourself. Recognising your VAT liability after receiving payment for goods sold on credit is much better for a business cash flow.



Below are some common contract terms resulting in you paying tax early:

- Payment within X number of days of issuing fapiao;
- Issuing fapiao along with goods or service.

Instead, we recommend you use the following contract terms for sales on credit:

- Fapiao will be issued within 3 days of payment.

The contract must explicitly state that the delivery of goods is on the basis of credit along with specific payment terms to allow the business to recognise its VAT upon receiving payment. This will ensure that you are not required to pay the tax on goods for which you have not received payment for. If you do agree to your client's request to issue fapiao early, be aware that this will cause you to pay 6 to 13% (VAT) of the contract value in advance.

It is also worth noting that if the input fapiao was not issued by your supplier, it is not possible to deduct the input VAT. Issuing the fapiao ("output fapiao") before the input fapiao is received causes you to pay the full VAT amount, resulting in a higher total tax payment.

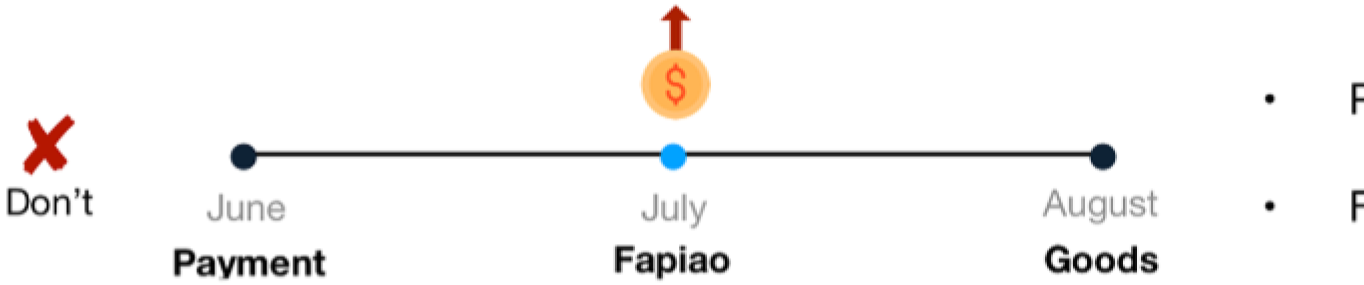
China Tax Regulations: Timing of VAT Liability

Credit sales: Tax liability should be recognised as per p
you to pay tax later as long as Fapiao has not been issu

Scenario 3: Pre-payments or deposits

If you receive payments in advance for future delivery of goods or service, you might be tempted to issue a fapiao because you feel certain that you will do so in the future. Doing so would be paying VAT on liabilities (prepayments & deposits) which have not actually become revenue for your business yet.

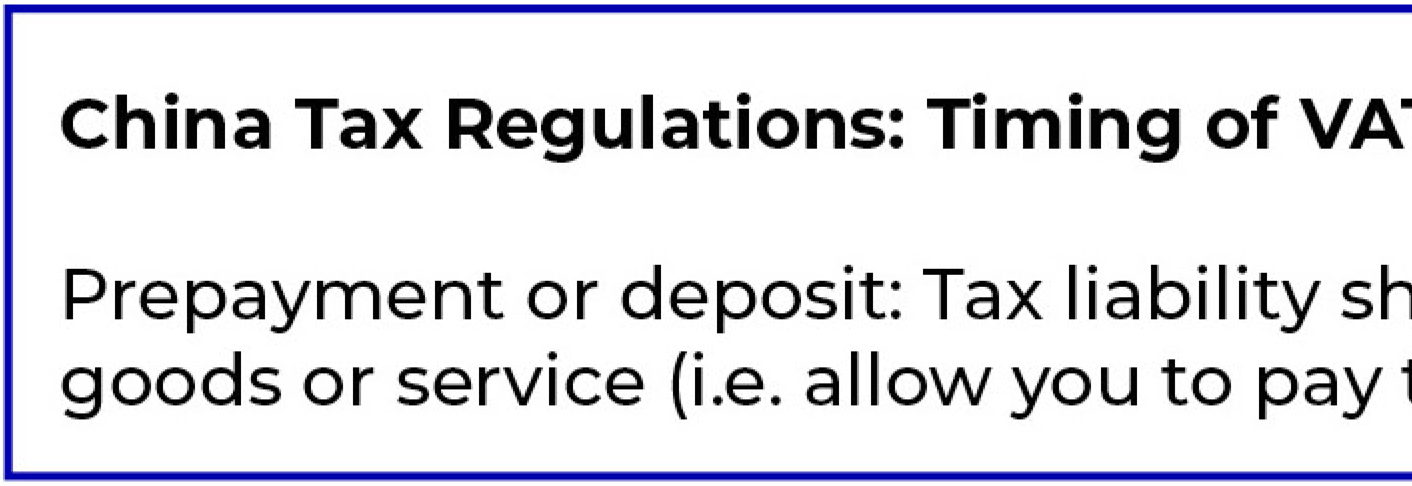
Technically speaking, a fapiao is not supposed to be issued at this stage because no transaction has been completed. Included in PRC Tax law are guidelines allowing the fapiao to be issued along with the good or service being delivered for this reason.



In the prepayment scenario, we recommend negotiating with your clients to try to agree on issuing a fapiao along with goods or service, instead of upon payment.

There are however many scenarios in which a client might request a fapiao before goods are delivered. Agreeing to these terms has several benefits to your client. By issuing a fapiao early, your client is able to deduct the costs from their revenue early and potentially avoid some large corporate income tax payments on their side. They are also able to reduce their VAT payable by deducting the input VAT.

It is very common for clients to ask for fapiao in advance. Know that by agreeing to issue fapiao before goods are delivered, you are making concessions in exchange for benefits to your clients. This knowledge can be useful to negotiate larger deals or favourable contract terms for your business in the future.



No funny business when it comes to fapiaos

Business in China requires flexibility. However, when it comes to whom you issue a fapiao to, there is very little flexibility. A fapiao must be consistent with the real transaction and the supporting documents in order to be a qualified business expense. An unqualified fapiao might come back to cause you trouble if you discover that your client was engaging in fraudulent behaviour.

Avoid the most common scenarios that could cause trouble for your business;

- Issuing a fapiao to a different legal entity than on the contract;
- Receiving money from a personal bank account and issuing fapiao to a business.

A checklist for Chinese sales contracts

Here is a simple checklist to follow when creating new contracts or revising old contracts to help managers manage their tax liability in China. Revisit this list, along with any other important terms to your business, each time a client sends you back a contract.

1. Fapiao information

It's important that you specify on sales contracts the details of the fapiao. This should include whether you will issue a **Special** VAT fapiao or **General** VAT fapiao to your client. A **Special** VAT fapiao saves your client 6–13% of the total amount in the form of tax deductions. This is not only important to your client but also to you, to avoid price-matching a competitor who is a "small-scale" taxpayer, who is subject to 3% VAT tax, which in most cases is non-deductible for VAT purposes.

Secondly, make sure to include complete and accurate fapiao information including: legal name, tax ID, bank account information, registered address and telephone number of the client. This will ensure your client's deductions are qualified. Void or fapiao to reissue will be time-consuming for your accountant, especially for the Special VAT fapiao which are strictly controlled by the tax authorities.

2. Is the price tax inclusive, or tax exclusive?

This might seem simple, but if any dispute arises with one of your clients, not specifically stating in your contracts whether the price is tax inclusive or exclusive can create problems for your business.

3. Does the price include all surcharges? (Insurance, freight fee, packaging, etc.)

Make sure that your contracts detail ownership of all surcharges, including insurance, customs and duty, freight, and packaging.

4. Make sure to separate goods & services

In China, goods are most often taxed at 13% and services at 6%. This means that if the transaction is a mixture of goods and services, combining this into a single product would force you to pay the highest VAT tax rate. Make sure to clearly separate the cost of goods and cost of services.

5. Timing of 3 flows

Make sure to specify in the sales contract the timing of the three flows; goods, fapiao and payments. This helps ensure that when your VAT liability will be recognized is clear in advance.

Conclusion

Clients often ask for special terms and businesses have to make concessions on contracts sometimes. However, knowing how these terms affect your business is critical. It's important that tax planning be included in your finance manager's scope of responsibilities.

Alternatively, a virtual CFO serves as your financial professional and tax planning specialist when setting terms for your Chinese sales contracts. When everything is on the negotiating table, make sure you do not forget to negotiate favourable tax terms for your business.

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