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China Alert

Impacts of Letter Investigation System of Export Goods on Enterprises in China

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The State Administration of Taxation ("SAT") issued a tax notice [2010] No. 11 "Administrative Measures for Tax Collection of Export Goods through Letters of Investigation" ("the Measures") in August of last year in order to strengthen the administration on export tax refund, and has come into effect from 1 September 2010. Meanwhile, Notice (2006) No. 165 "Measures on Tax Collection of Export Goods through Letters of Investigation" ("Notice 165"), which dealt with the same issue, has been repealed.

In China, an early warning evaluation system has been adopted by the SAT since the implementation of export VAT refund. This system has been implemented mainly based on analyses of tax refund (exemption) data on export goods together with the tax collection and administration data. Once abnormality is found, the SAT will send the alerting information regarding the exporters, suppliers and/or exported goods to the tax authority in charge and request it to follow up and inspect. An in-depth understanding on the letter investigation system of export tax refund would greatly benefit foreign investors in their taxation management on doing business in China.

Compared with the Notice 165, the Measures further clarify the administrative procedures for the responsible export tax refund authority ("Tax Refund Authority") to investigate and issue the Letter of Investigation for the exporting enterprises ("Letter Investigation System"). At the same time, the administrative procedures for response and review have also been clarified. The issuance of the Measures indicates that the Chinese tax authorities have taken a further step to strengthen the management on export VAT refund with an aim at preventing tax revenue losses as a result of fraudulent actions undertaken by suppliers and exporting enterprises. The Measures will have considerable impacts on Foreign Investment Enterprises ("FIE") engaged in production and export business and their related suppliers. Enterprises which are affected by the Measures should strengthen their tax compliance management in order to minimise any unnecessary tax disputes and risks.

This article summarises the major points of the Measures, our views and suggestions.

1. Key Points of the Measures

1.1 Enterprises covered

Enterprises covered by the Measures include foreign trading enterprises and manufacturers with export business (collectively called "Exporting Enterprises"), suppliers and the upstream enterprises of the suppliers. In other words, enterprises within the entire supply chain for exports in China are covered.

1.2 Procedures of the Letter Investigation System

1.2.1 Self-Inspection

The Measures specify that where any one of the following conditions is met when an Exporting Enterprise applies for export VAT refund, the Tax Refund Authority may request the Exporting Enterprise to complete the "Export Business Self Inspection Form for Foreign Trading Enterprise" or "Export Business Self Inspection Form for Manufacturing Enterprise" for further analysis:

- 1) The export businesses are included in alerting information of the SAT including those related to Exporting Enterprises, supplying enterprises, export commodities or other information on the alert-list of SAT;
- 2) There are clues of suspected fraudulent activities for export tax refunds reported internally within the tax system;
- 3) There are clues of suspected fraudulent activities for export tax refunds reported by outsiders;
- 4) Both the subject Exporting Enterprise and the subject supplying enterprise are on the concern list ("Concerned Enterprises");
- 5) The Concerned Enterprise exports the goods on the concern list ("Concerned Goods") for the first time;
- 6) The Exporting Enterprise purchases the Concerned Goods from the Concerned Enterprises for the first time;
- 7) Where one of the following circumstances are met and the written explanation provided by the Exporting Enterprise is considered as unsatisfactory:
 - a) Foreign exchange rate used for export is higher than the reasonable limit;
 - b) Exporting the Concerned Goods of which the monthly increasing rate on quantity is over 20% or the unit price is 10% higher as opposed to that of the last reporting;
 - c) Exporting the Concerned Goods of which the unit price of purchase is 10% higher as opposed to that of the last reporting;
 - d) The RMB settlement operation for cross-border trade is considered as abnormal.
- 8) Any other circumstances that the Tax Refund Authority considers an initiation of investigation is necessary.

1.2.2 Letter of Investigation

On receipt of the self-inspection form provided by an Exporting Enterprise, the Tax Refund Authority will proceed to review and analyse. However, if there are still suspicious points after the review, the Tax Refund Authority will issue a Letter of Investigation to the tax authority in charge of the supplying enterprise that supplied goods to the Exporting Enterprise. The export refund approval procedures will be suspended pending reply from the receiving tax authority.

Under the Measures, the tax authorities have certain discretionary powers to hold up initiation of the self inspection procedures or initiation of the Letter Investigation System when the following circumstances occur:

- 1) No violation has been identified during the previous letter investigation process and that the Exporting Enterprise purchases the same goods from the same supplier within one year after the last investigation;
- 2) Exporting Enterprise purchases goods from the same supplier and the monthly amount of application for export VAT refund does not exceed RMB100,000. However, it does not include cases where the Exporting Enterprise purchases from a number of suppliers and any suspicious point as stated in the above section 1.2.1 is found;
- 3) The goods are exported to countries / regions ("Exempted Countries/Regions") excluding Hong Kong, Macau, Taiwan, South-East Asia and other neighbouring countries and areas under the special supervision of Customs (transits through the Exempted Countries/Regions are also excluded), and the export goods do not have the characteristics of high value, high tax refund rates, small size or light weight. There is also no evidence indicating a higher and incorrect VAT refund rate may be used;
- 4) Application for tax refund is made by using tax invoice(s) issued by a tax authority on behalf of the supplier(s);
- 5) Exports under import processing arrangement;
- 6) The Exporting Enterprise voluntarily withdraws its export tax refund claim during the letter investigation process.

Tax authorities have free hands to initiate investigations if special abnormalities are found during the inspection process.



1.2.3 *Response to Letter of Investigation*

The tax authority in charge of suppliers of the Exporting Enterprise ("Responding Tax Authority") would request the suppliers concerned to complete the "Self Inspection Form for Supplying Enterprise" after receiving the Letter of Investigation from the Tax Refund Authority. The Responding Tax Authority is required to send two or more officials to perform onsite inspection on the supplier concerned.

If the goods of a supplier are sourced from third parties or produced under a consignment arrangement, the Responding Tax Authority can issue Letters of Investigation to their upstream enterprises through the Letter Investigation System. In addition, the Responding Tax Authority should reply to the Tax Refund Authority within a prescribed timeline.

1.2.4 *Processing of replies*

Upon receipt of a reply from the Responding Tax Authority, the Tax Refund Authority will approve the export VAT refund if it considers the reply as normal. However, if the reply indicates that the supplying enterprise has irregularities or suspicious activities, the Tax Refund Authority may terminate or suspend the approval procedures on the export VAT refund application, recover the refunds paid to an Exporting Enterprise or withhold temporarily other refundables, or even transfer the case to the Inspection Division for further investigations.

Please refer to Attachment 1 (Diagram of the Letter Investigation System of Export Goods in China) for further details.

2. Impacts of the Measures

- 1) The Chinese tax authority is establishing and fine-tuning a multi-functional system for tax collection and administration with various functional units including collection and administration, assessment, inspection and processing. The system has been reinforced by the joint efforts of the local tax authorities via electronic data analysis and onsite inspection. It aims at counteracting and combating irregularities and / or abnormal tax reporting practices and to reinforce supervisions.
- 2) The Chinese tax authority utilizes large quantities of taxpayers' information to perform data processing and analyses for screening out suspicious enterprises as inspection targets regarding export VAT refunds. The practice is consistent with screening of other inspection targets (such as inspection targets in transfer pricing audit cases).
- 3) Enterprise along the same supply chain as the Exporting Enterprise will be subject to investigations if any one of the enterprises is found being violating the regulations, no matter they are in the upstream or the downstream.
- 4) Tax authorities would request the selected enterprises for self inspection to disclose comprehensive information, including negotiation process for export, annual production capacity, fixed assets details, major suppliers of raw materials, genuineness of existence of suppliers, relationships between suppliers and their invoices issued, customs declarations. Exporting Enterprises should maintain adequate information for the purpose of proving and justifying the genuineness of exporting business including information on purchases, production and exports.

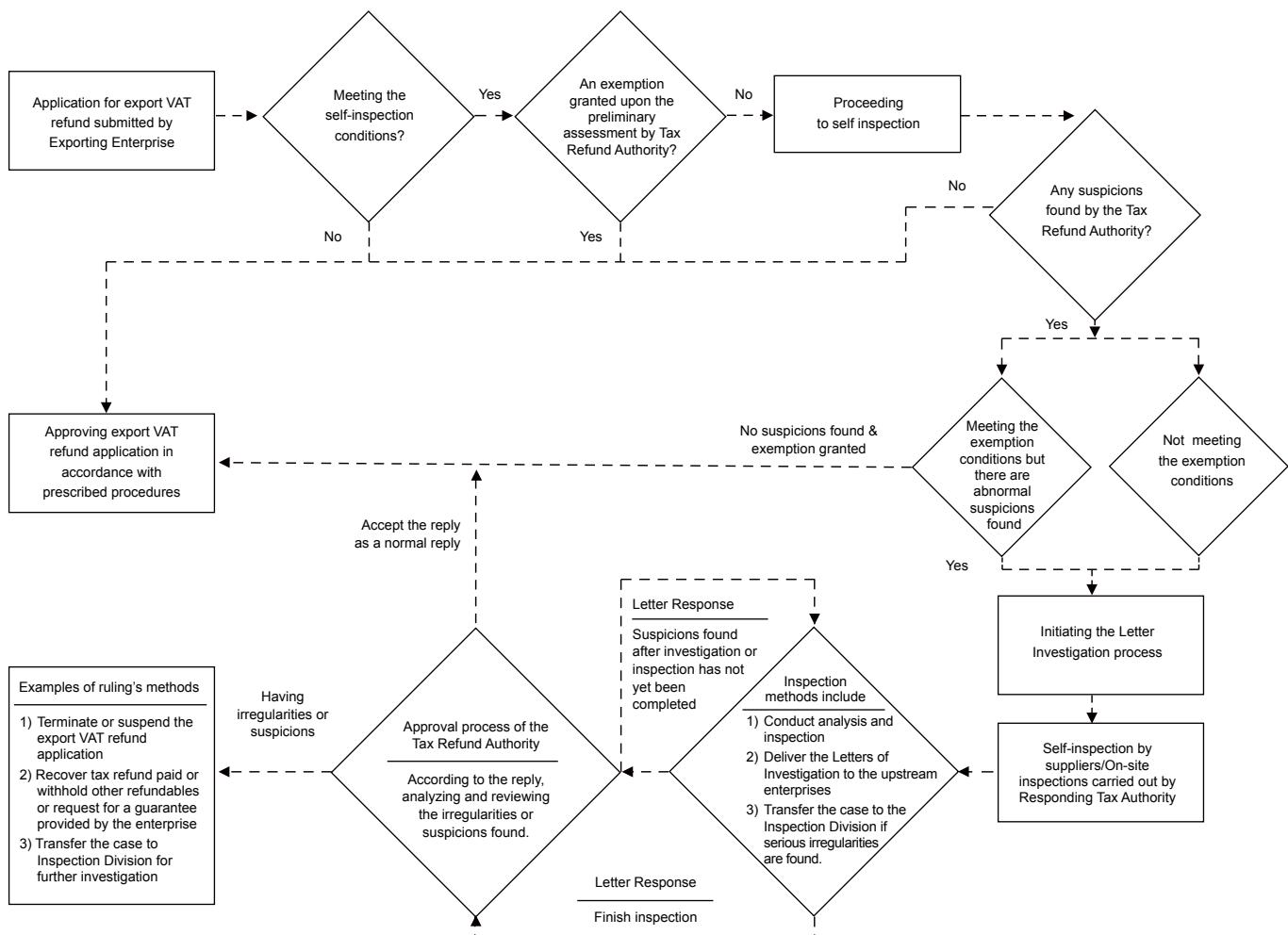
3. Our Views and Suggestions

The Letter Investigation System covers the entire supply chain of Exporting Enterprises. It will have positive impact on those law-abiding Exporting Enterprises. It encourages them to comply with the Measures on the one hand, and requests them to strengthen the administration of export VAT refunds so as to avoid delaying refund application process on the other.

For the foreign companies which have established FIEs with exporting business in China, they should request the enterprises to strengthen the administration of export VAT refund. A FIE should keep eyes on the compliance not only of itself but also of the supply chain including the supplying enterprises that sell goods to the FIE in order to mitigate the potential tax exposures of the group due to the possible violations of the supplying enterprises.

The tax environment in China is getting more stringent. The SAT has constantly issued new tax laws / regulations or renewed existing tax laws / regulations. Foreign companies which have investments or businesses in China should periodically review their tax compliance status in China, recruit more in-house tax staff members and consult tax professionals in order to strengthen the tax risk management and reduce their operational risks in China.

Diagram of Letter Investigation System of Export Goods in China



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