

# China Tax Alert

Issue 36, November 2019

## Release of the draft PRC VAT Law consultation paper

### Regulations discussed in this issue:

- The draft PRC VAT Law consultation paper released by MoF and STA on 27 November 2019

On 27 November 2019, China's Ministry of Finance (MoF) and State Taxation Administration (STA) jointly issued the draft PRC VAT Law consultation paper ("the draft VAT Law"). The issuance of the draft VAT Law marks the first step in the process of both elevating the status of the VAT rules in China to a legislative form, and in harmonizing the rules for both goods and services. The draft VAT Law will be warmly welcomed by businesses and tax advisers given its use of a coherent and cohesive drafting style which should help to considerably reduce uncertainties in the current rules.

The draft VAT Law also goes a long way towards implementing more of the OECD's International VAT/GST Guidelines, in particular, in ensuring that VAT only applies where consumption takes place in China, and in allowing for refunds of excess input VAT credits. While it had been hoped that non-resident entities would be able to register for VAT purposes, and that the rules may have been adapted to cater for the digital economy, perhaps these changes are still yet to come.

The consultation process for the VAT Law is open until 26 December 2019, after which time it is expected that the draft VAT Law will ultimately be considered and approved by the National People's Congress (NPC). The commencement date for the VAT Law is not stated, though it is expected to be submitted to the NPC in early 2020, following which the draft implementation laws may also be prepared.

### Background and context

Since 1994, China has had regulations and implementing regulations in place to govern the application of VAT to the sale and importation of goods (and limited services). At the time, China had a separate Business Tax system applicable to most services. However, as a result of the VAT pilot program, from 2012 through to 2016 the Business Tax system was progressively replaced by VAT. The mechanism by which this was done was through a series of circulars jointly issued by the MoF and STA, including Circular Caishui [2016] No. 36. This bifurcated approach of having one set of regulations applicable to the goods sector, and

separate circulars applicable to the services sector has led to many challenges in practice. For example, uncertainties as to the scope of each set of rules, occasional inconsistencies, and a general lack of harmonization.

The introduction of the VAT Law aims to overcome this bifurcation, as well as elevating the status to a legislative instrument. Its elevation to a legislative instrument serves to provide a more robust system of rule of law; it is intended to be more comprehensive; and should serve as a better foundation upon which to interact with other legislative instruments such as those that governing taxation administration and collection.

### Draft VAT Law

The draft VAT Law adopts principles based drafting, and by international standards, is relatively high level in its approach. That is because the structure for tax laws generally in China is to apply high level principles in the law itself, with the detail typically set out in various implementation rules.

The structure of the draft VAT Law is broadly designed in the following sections:

1. Introduction
2. Taxpayer and withholding agent
3. Taxable transactions
4. Tax rates and levy rates
5. Taxable amounts
6. Tax incentives (e.g. exemptions)
7. Time of supply and place of tax payment
8. Tax collection and administration
9. Supplementary notes

### Key changes

A key issue in considering the draft VAT Law is the extent to which it makes substantive changes as compared with the previous regulations (mainly for goods) and circulars (for goods and services). While significant changes are unlikely to occur until such time as the implementing laws are issued, we have identified the following high level variations to existing approaches:

Current VAT treatment	Key changes observed
<p><u>Small scale VAT taxpayers</u></p> <p>Under the existing VAT rules, taxpayers below the registration threshold as a general VAT taxpayer are required to account for output VAT at the rate of 3% (unless voluntarily electing to register as a general VAT taxpayer), though without any entitlement to claim input VAT credits.</p>	<p>The draft VAT Law notably omits any reference to small scale VAT taxpayers. However, the draft VAT Law does include reference to the 3% VAT levy rate, which may suggest it will be covered later. It also revokes the 5% levy rate.</p>

<p><u>Scope of taxable activities</u></p> <p>Under the existing VAT rules, taxable activities refer to the sale and importation of goods, sales of services, sales of immoveable properties and intangible assets. The sale or trading of financial products is not separately referred to and is generally considered as a type of service.</p>	<p>The draft VAT Law defines those taxable activities (which are potentially subject to VAT) so as to specifically refer to the sale and importation of goods, sales of services, sales of immoveable properties, sales of intangible assets, and sales of financial products.</p> <p>‘Sales of financial products’ only fall within scope of VAT when the seller is a domestic entity, or the financial products are listed in China. This goes a long way to clarifying the scope of application of VAT to financial products in a way which has been contentious and uncertain for foreign investors.</p>
<p><u>Mixed sales</u></p> <p>Based on the existing VAT regulations, a taxpayer will need to pay VAT based on its main business for mixed sales which involve both services and goods in a supply.</p>	<p>The draft VAT Law abolishes the relevant requirement to have both goods and services in a supply as a prerequisite to the mixed sales rules applying. It simplifies the principle for mixed sales by saying that the rules may apply where there are different tax rates or levy rates in a supply.</p>
<p><u>Jurisdictional nexus</u></p> <p>According to Circular Caishui [2016] No. 36, the provision of services is subject to VAT if either the service provider <u>or</u> service recipient is in China, but with an exclusion where the service wholly occurs outside of China. The concept of whether a service ‘occurs’ outside of China has been uncertain and contentious.</p>	<p>The draft VAT Law seeks to define the scope of services which are potentially subject to VAT in China as applying where either the supplier is a domestic entity or individual, or the service is consumed in China. This is a notable change from the previous position in Circular [2016] No. 36. The proposed approach in the draft VAT Law better aligns the Chinese VAT system with the OECD International VAT/GST Guidelines. In particular, where a service is provided by a foreign entity to a domestic entity, VAT should only apply (on a withholding basis) where that service is consumed in China. The mere fact that the recipient is a Chinese entity is insufficient to bring it within scope.</p>

<p><u>Deemed sales</u></p> <p>The existing Chinese VAT rules require output VAT to be paid where there is a 'deemed sale'. Specifically, according to the Implementation Rules of the PRC VAT provisional rules, and Circular Caishui [2016] No. 36, any goods and services provided free of charge to other entities and individuals is considered as a 'deemed sale' of goods and services.</p>	<p>The scope of deemed sales has always been unclear and a source of contention between taxpayers and tax officials in practice. However, the draft VAT Law seeks to define the specific circumstances under which a deemed sale may arise. It comprises: (1) the use of own manufactured goods for personal welfare or self-consumption; (2) the provision of goods free of charge (except for charitable purposes); (3) the provision of intangible assets, immovable assets and financial products free of charge (except for charitable purposes); and (4) other circumstances to be defined by the MoF and STA.</p> <p>It would appear that the provision of services generally should no longer be subject to the deemed sales rule.</p>
<p><u>Excess input VAT credits</u></p> <p>Refunds of excess input VAT credits have not generally been available in China (except for exporters and a few specific types of businesses). However when STA Announcement [2019] No. 39 was released, a new pilot VAT refund mechanism was introduced from 1 April 2019, allowing VAT refunds of excess input VAT credits for a broad range of businesses in China. Such a refund mechanism was neither explicitly referred to in the VAT provisional rules, nor Circular Caishui [2016] No. 36.</p>	<p>The draft VAT Law will, when enacted into law, give effect to the recent trial program of allowing refunds of excess input VAT credits on a more permanent basis. In effect, under the draft VAT law, excess input VAT credits may either be carried forward, or refunded, and the circumstances and criteria governing such refunds will be set out in separate implementation rules.</p>
<p><u>Tax periods</u></p> <p>Under the existing VAT rules, taxpayers are required to file VAT returns based on tax periods of either 1 day, 3 days, 5 days, 10 days, 15 days, or on a monthly or quarterly basis. The applicable tax period mainly depends on the type of taxpayer (whether it is a general VAT taxpayer or a small-scale VAT taxpayer), and the nature of the taxpayer's business.</p>	<p>The draft VAT Law reduces the number of tax periods as compared with the existing rules by eliminating the 1 day, 3 day and 5 day tax periods. In essence, most taxpayers can expect to account for VAT on a monthly or quarterly basis, though now seemingly with the additional option of six-monthly reporting. The circumstances under which this may be used have not been clarified, though it is not applicable to taxpayers who use the general method of accounting for VAT.</p>



<p><u>VAT consolidation</u></p> <p>Based on Circular 36, two or more taxpayers can apply for VAT consolidation and be regarded as one taxpayer if they have the approval of the MoF and the STA. However, the relevant regulation was abolished by Caishui [2017] No.58.</p>	<p>The draft VAT Law has brought back this VAT consolidation principle and will be welcomed by businesses since it will reduce VAT compliance costs for taxpayers. The scope and requirements to apply consolidation will be awaited with interest in the implementation rules.</p>
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The draft VAT Law also says that any previous circulars which operated before the VAT law where there is a need to continue such tax circulars, shall remain effective for up to 5 years. It is inevitable that this clause will be the subject of considerable debate, given there are many previous circulars which may be either more beneficial to taxpayers or to tax authorities, or inconsistent with the draft VAT Law.

**Your comments**

KPMG is proposing to gather input from key industry participants and provide timely feedback to the MoF and STA as part of the consultation process. We welcome any feedback through your regular KPMG contact.

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