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First round review of the draft PRC VAT Law

Abstract:

The first draft of the VAT law was released by the National People's Congress ("the NPC") on 27 December 2022. The aim of the VAT law is not to create an additional tax burden for business. Instead, the aims are to better enhance the adoption of OECD International VAT/GST Guidelines into the draft law, and to upgrade the status of the previously bifurcated VAT pilot program rules (applicable to services) and Regulations (applicable to goods) to become a single substantive VAT law. Importantly, the draft VAT law does contain some important changes as compared with the current VAT rules in areas of simplified taxation, deemed sales, non-creditable input taxes and mixed sales.

Background

Since 1994, China has enacted and implemented the Provisional Regulations of the People's Republic of China on Value Added Tax (the "Provisional Regulations") and the Implementation Rules of the People's Republic of China on Provisional Regulations on Value Added Tax (the "Implementation Rules"), which set out the VAT regime applicable to the import and sale of goods (and some services). At that time, China had a separate business tax regime that applied to most service industries. However, with the implementation of the VAT pilot program from 2012 to 2016 and a series of regulations jointly issued by the Ministry of Finance ("MoF") and the State Administration of Taxation ("STA") (including Cai Shui [2016] No. 36, "Circular 36"), the Business Tax system was progressively replaced by VAT. Alongside the introduction of a series of measures such as adjusting the VAT rates, expanding the scope of VAT creditable items and establishing the mechanism of refunding excess input VAT credits, the Chinese government is seeking to achieve not only the establishment of a modern VAT system, but also the reduction of tax burden for businesses in a wide range of sectors, including but not limited to manufacturing, construction and transportation.

The tax system in the PRC generally adopts the structure of first setting out the key principles in the law, which is then supplemented by implementation guidance or regulations. The adoption of a legislative approach to set out the tax regulation helps to promote a more robust tax system, and allows effective interaction between the VAT tax system and other legal systems (e.g. Tax Collection and Administration Law). In November 2019, the MoF and SAT jointly issued the PRC VAT Law Consultation Paper ("the Consultation Paper") which showed the Chinese government's efforts in seeking to unify the VAT regulations applicable to goods and services. After extensively collecting feedback from various stakeholders, the Draft was prepared and submitted to the 38th Meeting of the Standing Committee of the Thirteenth NPC for the first round review on 27 December 2022.

The Draft is open for comments until 28 January 2023. The proposed commencement date is not yet clear. It is expected that the Draft will be reviewed and approved by the NPC in 2023, with the implementing regulations to be published thereafter.

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KPMG observations

The draft VAT law aims to retain the same basic tax regime framework and not creating any additional tax burden for taxpayers. The government intends to take a significant leap forward in adopting the OECD International VAT/GST Guidelines into the Chinese VAT system, in particular by adopting the place of consumption approach in determining whether a transaction has a place of supply within China, and by allowing refunds of excess input VAT credits. There are also a number of further adjustments and amendments that observed in the Draft.

The Draft comprises six chapters (with a total of thirty-seven articles), namely the General Provisions, Tax Rates, Taxable Amounts, Tax Concessions, Collection and Administration, and Supplementary Notes. Compared with the existing Provisional Regulations and other relevant regulations, there are some noteworthy changes in the areas of taxable acts, tax jurisdiction, deemed sales, non-taxable items, simplified taxation, withholding agents, input taxes, non-creditable input taxes, mixed sales, input credit carry-forward and refund, and consolidated filings. These changes will have a substantial impact on taxpayers when the Draft is officially enacted. We summarise below some of the key changes in the Draft:

Current VAT treatment	Key changes observed
Scope of taxable activities Under the current VAT regulations, taxable activities include the sale of goods or processing, repair and fitting services, the sale of services, intangible assets, immovable property and the import of goods. The sale of financial products is a sale of services and not a separate taxable act.	The taxable transactions under the Draft include sales of goods, services, intangible assets, immovable property and imports of goods. For the sale of financial products, consistent with the prevailing Circular 36 and the Provisional Regulations, the Draft does not seek to deal with it separately. Under the current VAT regulations, financial product transactions refer to the transfer of ownership of financial commodities, which carry different characteristics compared to general services. In 2019, the Consultation Paper introduced the idea of treating the sale of financial products as a specific type of taxable transaction separately from other services in general, but such change was reversed and does not exist in the Draft. Considering that the classification and definition of taxable transactions in the VAT Law will affect how the subsequent Detailed Implementation Regulations of the VAT Law ("Detailed Implementation Regulations") will further regulate and determine VAT taxability, it is expected that there may be ongoing discussions on this issue before the final adoption of the legislation.
Place of supply According to the provisions of Circular 36, when a seller or buyer of the services or intangible assets is located in the PRC, the seller is a VAT taxpayer and shall pay VAT. Exceptions are provided when the services occur or the intangible assets are used completely outside of the country. In practice however, there is controversy and uncertainty as to how to determine when a service "occurs" wholly outside of the country.	According to the Draft, the supply of services and intangible assets within the PRC means that the services or intangible assets are consumed within the PRC or the seller is a domestic entity and individual. The sale of financial products within the PRC means that the financial products are listed or the seller is an entity or individual within the PRC. This is broadly consistent with the definition of "taxable transactions occurring in the territory" in the Consultation Paper. Compared with Circular 36, the expression of "taxable transactions occurring in the PRC" according to the Draft as well as the Consultation Paper is more in line with the concepts used in the OECD International VAT/GST Guidelines regarding the determination of the place of consumption. It should be noted that the definition of "consumption in the territory" will be a key factor in determining whether VAT is required to be levied in China, and given the complexity of the actual transactions, we also welcome further clarification of the term "consumption in the territory" at the implementation stage to reduce any controversy.

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Current VAT treatment	Key changes observed
Deemed taxable transactions Under the current VAT regulations, deemed sales include consignment sales, transfers of goods among branches across provinces for sale, capital injection, distribution-in-kind to shareholders, use for collective welfare or personal consumption, free-of-charge gifts, free-of-charge transfers of intangible assets or real estate and free-of-charge provision of services.	The scope of deemed taxable transactions in the Draft has been narrowed down compared to the current VAT regulations - Consignment sales, inter-province transfers among branches, capital injection, distribution-in-kind to shareholders and the free-of-charge provision of services are no longer included in the deemed taxable transactions listed in the Draft. Meanwhile, both the Draft and the Consultation Paper specifically emphasised that free-of-charge provision of "financial products" is subject to deemed sales. Overall, the coverage of deemed taxable transactions are similar between the Draft and the Consultation Paper, except that the Draft does not exclude circumstances that occur "for public welfare purposes" which was excluded in the earlier Consultation Paper.
Non-taxable items The non-taxable situations in the current VAT regulations include non-business activities, such as administrative fees and government funds, salary services provided by employees, services provided by employers for hiring employees, as well as non-taxable items listed in other tax circulars such as Circular 36. The non-taxable items listed include railway transportation services and air transportation services provided without compensation in accordance with State's directives; interest on deposits; insurance indemnities received by the insured; special residential maintenance funds collected on behalf of the insured and the transfer of goods, real estate and land use rights involved in the process of asset restructuring where the conditions are met.	The non-taxable items in the Draft continue to include the services provided by employees to employers for wages and salaries, the collection of administrative fees and governmental funds, and the receipt of interest income from deposits. "Compensation for expropriation or requisition in accordance with the provisions of the law" is newly added as a non-taxable item. However, some of the non-taxable items listed in the other tax circulars are not covered by the Draft. At the same time, compared to the Consultation Paper, the Draft removes the "fallback clause" of "other circumstances as prescribed by the competent fiscal and taxation authorities of the State Council" from the non-taxable items that was seen in the Consultation Paper, which apparently means that the circumstances under which VAT is not levied may be limited to those listed in the VAT Law. We expect this change to be subject to ongoing discussions before the legislation is finalised.
Application of the levy rate under simplified taxation method Under the current VAT legislation, the rates applicable under the simplified taxation method include 3% and 5%.	Both the Draft and the Consultation Paper suggested a VAT levy rate at 3%. It remains to be seen whether the 5% levy rate that currently applies to circumstances such as the sale and rental of real estate for grandfathered projects will be abolished or amended in the future.
Withholding agents According to the Provisional Regulations, if an entity or individual outside the PRC sells services within the territory and does not have a business establishment, its agent within the territory shall be the withholding agent; if there is no agent within the territory, the purchaser shall be the withholding agent. According to Circular 36, if a taxable act is performed by an overseas unit or individual in the territory and no business establishment is set up in the territory, the purchaser shall be the withholding agent for VAT, unless otherwise stipulated by the MoF and STA.	In the Draft, the clause that "if a person does not have a business establishment in the territory, the agent in the territory shall be the withholding agent" is removed. This means that it is not necessary to determine whether a foreign entity or individual has a business establishment or agent in the PRC, and the purchaser will directly be considered as the withholding agent. Such change is more conducive to the determination of the withholding agent as well as the enforcement of withholding obligations. However, having the purchaser acting as the withholding agent may be problematic in some practical respects. Under the current VAT regulations, foreign organisations cannot register as VAT taxpayers in China. Alongside the development of third party trading platforms such as cross-border e-commerce platforms or digital platforms, cross-border B2C transactions are growing rapidly. However, individual consumers often lack the incentive to take the initiative in fulfilling their VAT withholding obligations and there are difficulties in the collection and administration. Despite high expectations, a system for overseas enterprises to register for VAT in China has not been introduced in the current Draft.

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Current VAT treatment	Key changes observed
Definition of input tax According to the current VAT regulations, input tax is the amount of VAT paid or borne by a taxpayer on the purchase of goods, processing, repair and maintenance services, services, intangible assets or immovable properties.	Input tax is defined in the Draft as the amount of VAT paid or borne by a taxpayer on the purchase of goods, services, intangible assets or immovable property in connection with a taxable transaction. Compared with the existing regulations, the expression "in connection with a taxable transaction" has been added, which is consistent with the expression in the Consultation Paper. The Draft clarifies that only input tax used in connection with taxable transactions is creditable, while purchases for non-taxable items are not creditable. Taxpayers need to pay attention to the differences between the Draft and the current VAT regulations in terms of the definition of creditable input tax items – specifically, the changes corresponding to input credits associated to non-taxable supplies, such as dividend income.
Non-creditable input taxes Under current VAT regulations, input taxes on the purchase of loan services, food and beverage services, residential daily services and entertainment services cannot be credited against output tax.	Unlike the Consultation Paper, the Draft excludes loan services from the list of non-creditable input tax items. Considering that interest on loans is an essential part of businesses' operating costs, allowing the crediting of input taxes on loan services will reduce the tax burden of enterprises and avoid double taxation. This is undoubtedly great news to the taxpayers given it enlarges the scope of VAT creditable items for most of the taxpayers. In addition, the Draft adopts the same position as the Consultation Paper in terms of restricting the non-creditability of input VAT regarding food and beverage services, daily services for residents and entertainment services only to those "purchased and directly used for consumption". This means that businesses need to distinguish between personal consumption and business consumption when purchasing these three types of services, and that input taxes should be creditable as long as they are related to a taxable business.
Mixed sales Under the current VAT regulations, a sale involving both services and goods is a mixed sale and is subject to VAT in accordance with its main business.	The Draft deletes the requirement that a mixed sale must satisfy the condition that the same sale involves both services and goods. As long as a taxable transaction involves supplies that are subject to two or more different tax rates and levy rates, the provisions relating to mixed sales shall apply. In addition, compared to the Consultation Paper, the Draft further clarifies the tax rates/levy rates applicable to the act of mixed sales. In the Consultation Paper, the expression "the tax rate or levy rate applicable to the principal activities", and taxpayers may have different interpretations as to whether "applicable to the principal activities" should be assessed in the context of the taxpayer's principal business, or the principal activity of the particular taxable transaction. The expression in the Draft is further clarified as "the tax rate or levy rate applicable to the principal activity of the taxable transaction", which is more conducive to taxpayers' judgment.

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Current VAT treatment	Key changes observed
Excess input VAT credits A refund policy for exported goods and some cross-border services that can be subject to VAT zero-rating have been allowed in the Provisional Regulations and Cai Shui [2016] No. 36. This can be subject to an exemption, as well as credit or refund of the input credits if certain conditions are met. Starting from 2019, China began to gradually implement the VAT refund mechanism on excess input VAT credits since April 2019. According to the MoF, STA and the General Administration of Customs Announcement [2019] No. 39, a pilot programme was introduced to allow a wide range of taxpayers to apply for a refund of excess input credits when relevant conditions are met. The Ministry of Finance General Administration of Taxation Announcement No. 15 of 2021, No. 14 of 2022 and No. 21 of 2022, on the other hand, increased the extent to which the refund could be claimed by taxpayers in advanced manufacturing industries, as well as expanded the policy from advanced manufacturing industries to covering more industries as well as small and micro enterprises. There was also an expansion to cover the excess input credits carried forward prior to April 2019.	The Draft is consistent with the Consultation Paper in respect of incorporating the mechanism of refunding excess input VAT credits into the law. According to the Draft, when the input tax in a certain period that is greater than output tax, the excess portion may be carried forward for crediting or refund in the next period. The specific mechanism shall be prescribed by the competent departments of finance and taxation under the State Council. Currently, for some businesses that can apply for both the export tax refund and excess input VAT refund policies, a distinction needs to be made between them. Specifically, it should apply for export tax refund first, and only if it still qualifies for a refund of the remaining excess input VAT credits afterwards, it can apply for a refund in respect of the remaining excess input VAT credits. According to our observation of international practice, it is not common to have two separate mechanisms to deal with export VAT refunds and refunds of excess input VAT credits. It remains to be seen as to whether the two refund mechanism could be combined in a similar way as international practice, say at the stage of releasing the Detailed Implementation Rules.
Tax periods 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 specific tax period applicable to the taxpayer usually depends on the type of taxpayer (general or small-scale) and the nature of the taxpayer's business.	Both the Draft and the Consultation Paper reduce the number of tax periods as compared with the existing rules by eliminating the 1-day, 3-day and 5-day tax periods. The half-year tax period included in the Consultation Paper has been removed in the Draft. The current tax regulations do not specify the period for filing tax declarations for the importation of goods, and this remained unclear in the Consultation Paper earlier. The Draft specifies that the filing for importation of goods should follow the timeline set by Customs.
VAT consolidation Based on Circular 36, two or more taxpayers can apply for VAT consolidation and be regarded as one taxpayer if they have the approval granted by the MoF and the STA. However, the relevant regulation was abolished by Cai Shui [2017] No.58.	The Consultation Paper had reintroduced the principle of VAT consolidation, but it does not remain in the Draft. Based on international experience, consolidated filing mechanisms can effectively reduce the compliance costs of VAT taxpayers and address the differences in the level of tax liabilities among taxpayers in the same group. It is expected that this change may be discussed continuously before the legislation is finally passed.

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As part of the legislative process, the Draft is open for comments until 28 January 2023. Based on our discussions with the relevant government officials, we understand the enacting date would depend on whether the Draft would be passed by the NPC over the second (or third) reading and the earliest possible timing could be the end of June 2023 (especially if a third reading is not required). Some of the expected changes to the current VAT treatments were only briefly mentioned without providing much implementational detail. Based on the level of delegation shown in the Draft, it appears that the MoF and the STA would be in a position to set directions for VAT policy and treatments in the future without the need to involve the NPC. This delegation could certainly be perceived as an act to improve efficiency and flexibility, but on the flipside, the arrangement could also mean that, if changes are not introduced in the VAT Law to reinforce some of the fundamental rights for taxpayers, taxpayers could face uncertainties and may need to rely on discretions of the tax authorities when facing tax controversy.

Businesses are recommended to not only pay particular attention to the substantial changes proposed under the Draft as compared to the current VAT regulations, but also to be more proactive in providing comments on the Draft. Businesses are advised to prepare for these possible changes by assessing the potential impact of them in advance too.

KPMG has been actively focusing on the VAT legislative process and has been heavily involved in the process as a key advisor to the policymakers. We are very keen to gather views from key industry players and provide timely feedback to the NPC during the consultation period. We welcome any feedback from your company through your regular KPMG contact. KPMG's Indirect Tax team also plans to organize seminars in multiple cities shortly following the release of this China Tax Alert, with a view to share our thoughts on the Draft as well as our suggestions on the details to be added to the Draft. Please stay tune for further update.

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