

China Tax Alert

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China VAT Law enactment advances VAT system to a new era

Summary:

The Chinese National People's Congress (NPC) passed the long-awaited Value Added Tax Law ("VAT Law") on 25 December 2024, marking a significant development in Chinese tax history. Given that VAT has been the top contributor towards China's tax revenue, the enactment of the VAT Law is seen as a measure to formalise tax collection.

This issue of China Tax Alert will provide a brief introduction to the VAT Law enactment journey, outline key changes introduced by the law, and discuss potential implications for taxpayers in the future development of China's VAT system.

A brief introduction: the VAT Law enactment journey

China first started to adopt VAT way back in 1994. During this introductory phase, VAT was only applicable mainly to the supply of goods while the supply of services was subject to Business Tax. This "old VAT" regime was often referred to as a manufacturing type system where input VAT incurred on fixed assets was not recoverable and this irrecoverable would pass on to the later part of the supply chain.

This dual indirect tax system created a significant inefficiency and in 2008, the Chinese authorities introduced the first major upgrade to its Chinese VAT system. Input VAT incurred on the purchase of fixed assets was allowed to be recovered and it was reported as China's first move to advance its VAT system to a consumption type VAT system. Not long after this significant development, the Chinese authorities decided to embark on their multi-year journey to convert its VAT system to the internationally adopted model by introducing the Business Tax Convergence to VAT (B2V) pilot reform. The B2V pilot reform was first started in Shanghai on 1 January 2012 for selected industries and was gradually rolled out to cover all geographic areas and to include all industry sectors (e.g., financial services was added as the last sector on 1 May 2016).

The first discussion on VAT Law commenced shortly after the completion of the B2V reform in 2016, but it was only in 2018 that the Chinese authorities decided the observation period on the B2V reform changes was sufficient before the country's VAT system was ready for its final upgrade. The First Draft of the VAT Law was brought to the public for consultation in 2019 and since then, changes to the provisions in the VAT Law have been made over the law enactment process and after 5 years of incubation, the Third Draft VAT Law was passed in the latest NPC meeting.

As a landmark event, China would have its VAT Law coming into effect from 1 January 2026. It is anticipated that further changes to the VAT rules would be based on the VAT Law principles and would be included in the Detailed Implementation Regulations of the VAT Law ("Detailed Implementation Regulations").

Key changes observed from the VAT Law

The VAT Law aims to retain the same basic tax regime framework and not create 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 observed in the VAT Law.

The VAT Law comprises six Chapters (with a total of thirty-eight 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 and input credit carry-forward and refund. These changes will have a substantial impact on taxpayers and we have summarized some of the key ones below:

| Current VAT Treatment | VAT Law changes |
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| <p>Scope of taxable activities</p> <p>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.</p> | <p>Article 4 of the VAT Law</p> <p>The taxable transactions under the VAT Law 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 VAT Law does not seek to deal with it separately.</p> <p>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. The VAT Law treats the sale of financial products as a specific type of taxable transaction separately from other services in general.</p> <p>Considering that the classification and definition of taxable transactions in the VAT Law will affect how the subsequent Detailed Implementation Regulations will further regulate and determine VAT taxability, it is expected that there will be ongoing discussions on this issue before the final adoption of the Detailed Implementation Regulations.</p> |
| <p>Place of supply</p> <p>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.</p> | <p>Article 4 of the VAT Law</p> <p>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.</p> <p>The expression of "Consume" in the VAT Law (comparing to "occur" in Circular 36) 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.</p> |

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| <p>Deemed taxable transactions</p> <p>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.</p> | <p>Article 5 of the VAT Law</p> <p>The scope of deemed taxable transactions in the VAT Law 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 VAT Law. It is important to note that that free-of-charge provision of "financial products" is subject to deemed sales.</p> |
| <p>Non-taxable items</p> <p>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.</p> | <p>Article 6 of the VAT Law</p> <p>The non-taxable items in the VAT Law 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 VAT Law.</p> <p>At the same time, the VAT Law 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, which apparently means that the circumstances under which VAT is not levied may be limited to those listed in the VAT Law.</p> |
| <p>Application of the levy rate under simplified taxation method</p> <p>Under the current VAT legislation, the rates applicable under the simplified taxation method include 3% and 5%.</p> | <p>Article 11 of the VAT Law</p> <p>The VAT Law suggests a VAT levy rate at 3% only. 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 Detailed Implementation Regulation.</p> |

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| <p>Withholding agents</p> <p>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.</p> <p>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.</p> | <p>Article 15 of the VAT Law</p> <p>Under the VAT Law, the purchaser or its appointed agent 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.</p> <p>Practically, having the purchaser acting as the withholding agent may be problematic in some 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.</p> <p>Overseas businesses can now appoint China based withholding agent to fulfil the withholding obligation under the VAT Law.</p> |
| <p>Non-creditable input taxes</p> <p>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.</p> | <p>Article 22 of the VAT Law</p> <p>The VAT Law is restricting the non-credibility 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.</p> <p>The VAT Law 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. It is commented that the Detailed Implementation Regulation would set out whether and how input VAT is going to work in practice.</p> |
| <p>Mixed sales</p> <p>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.</p> | <p>Article 13 of the VAT Law</p> <p>The VAT Law 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.</p> <p>The expression in the VAT Law 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. It is expected that the Detailed Implementation Regulations would set out the principal activity of taxable transaction.</p> |

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| <p>Excess input VAT credits</p> <p>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</p> | <p>Article 21 of the VAT Law</p> <p>According to the VAT Law, 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.</p> <p>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.</p> <p>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 mechanisms could be combined in a similar way as international practice, say at the stage of releasing the Detailed Implementation Regulation.</p> |
| <p>Tax periods</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 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.</p> | <p>Article 30 of the VAT Law</p> <p>The 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.</p> <p>The current tax regulations do not specify the period for filing tax declarations for the importation of goods while the VAT Law specifies that the filing for importation of goods should follow the timeline set by Customs.</p> |

What to expect in the next round of VAT policy development

We have set out below some of the VAT policy areas where suggestions and recommendations are expected to be made towards the Detailed Implementation Regulations enactment process.

Further guidance on VAT recovery

There are many areas where clarifications on input VAT recovery is needed. For instance, loan interest income is generally subject to output VAT but the current VAT rule is disallowing the purchaser of loan services to recover the VAT paid to the lender. This blocked VAT costs would create irrecoverable VAT cost to businesses and the business community has been advocating for changes to enable input VAT recovery for loan interest in light for the VAT Law.

Clearance of obsolete VAT preferential treatments

The Chinese VAT rule has been evolving to fit the country's economic growth and some VAT treatments, specially VAT exemption, were introduced to steer the growth of certain economic activities. For instance, the sale of birth control products is VAT exempt but the current VAT Law has removed this VAT exemption treatment. We understand that the Chinese authorities have already embarked studies on the VAT preferential treatments and would make changes to them. One of the areas where changes would be introduced is the deemed input VAT credit for the purchase of VAT exempt agricultural products. This has been an area where abuses of the VAT preferential treatment are observed thus could be subject to further policy changes.

Enabling a level playing field between international and domestic businesses

In principle, the supply of services from overseas to the Chinese consumers should be subject to Chinese VAT based on the current Chinese VAT place of supply rules (i.e., the place of supply would be China if the supplier or the service recipient is in China). However, in practice, the administrative procedures for non-China established businesses to be Chinese VAT registered are yet to be set up and as a consequence, the local Chinese businesses making the same B2C supplies would need to pay Chinese VAT while their overseas competitors are not. It has been commented that the future Chinese VAT policy should be adopted in a way that a level playing field would be set up to facilitate fair competition.

The international and China tax communities are excited by the VAT Law enactment. As mentioned above, it is anticipated that there will be further VAT policy development to happen in the coming years as the country's economy evolves. It is expected that the Detailed Implementation Regulations would be promulgated in the second half of 2025.

Businesses are recommended to not only pay particular attention to the substantial changes proposed under the VAT Law as compared to the current VAT regulations, but also to be more proactive in providing comments towards the Detailed Implementation Regulations enactment process.

We also anticipate that some practical issues and challenges may surface during the implementation of the VAT Law and its regulations. It is advisable that businesses dedicate resources in order to face the changes and be prepared for any challenges. 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 Chinese Ministry of Finance as well as the State Taxation Administration. 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 VAT Law as well as our suggestions on the details to be added to the Detailed Implementation Regulations. Please stay tune for further update.

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