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Tax
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Client Alert

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China's VAT legislation — highlight of draft VAT Law

On November 27, 2019, China released its *Value-added Tax Law of People's Republic of China* (consultation draft) ("**Draft VAT Law**") for the legislation process of the VAT regime. The public comment period for the Draft VAT Law will be open until December 26, 2019.

The Draft VAT Law generally provides an underpinning for the current VAT Interim Regulations while incorporating the VAT reform commenced in 2012. Based on experience with other taxes, it is likely that the VAT Law may be promulgated and submitted for approval by the National People's Congress in 2020.

This alert explains important differences between the current VAT regime and the Draft VAT Law so companies can manage their expectations regarding upcoming changes.

Major Changes

Compared to the current VAT regime, the Draft VAT Law will bring major changes in the following aspects:

Taxation threshold

The Draft VAT Law directly raises the threshold of taxation to CNY 300,000 per quarter of sales, regardless of the taxpayer's taxation period. The amount is the same as that in the current VAT regime, which exempts small-scale taxpayers from VAT if their monthly sales is below CNY 100,000 per month (or CNY 300,000 per quarter). Companies with sales is below the taxable threshold are not taxpayers specified in the VAT Law. However, if a company fails to meet the threshold of taxation, it can voluntarily register and pay VAT.

Meanwhile, the Draft VAT Law omits all references to small-scale taxpayers, which might mean that the concept of small-scale taxpayers has been terminated and will therefore disappear in history.

Taxable activities

The Draft VAT Law defines five categories of taxable activities: sale of goods, services, intangibles, immoveable property and financial products, by including "processing, repair and installation services" in the "services" category and separating "financial products" from "services" as a category.

In determining whether a service or intangibles sale has occurred in China, whether the seller is a company in China, or the service or intangible is ***consumed in China*** is taken into consideration. This definition of taxable activity is narrower than that given by the current regime, where either the buyer or seller of the service or intangibles is in China, when excluding activities totally provided outside China. However, the definition of "consumed in China" is unclear and needs further clarification.

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Deemed sales

One beneficial signal for companies in the Draft VAT Law is that scope of deemed sales does not cover provision of service without consideration and provision of goods without consideration for public welfare.

For the provision of service without consideration, in practice, it is difficult for the tax authority to discover and determine when a company has provided a service to another company without consideration. However, companies still face a risk if they provide a service without consideration, which is now eliminated by the draft VAT Law.

Another piece of good news for companies is that, if it is for public welfare, a company's transfer of goods without consideration will not be deemed as a sale. This will benefit companies when making donations to public welfare funds.

VAT refunds

Unlike the majority of countries, which allow companies to claim VAT refunds for unused input VAT credits during the current period, China generally only allows such unused input VAT credits to be carried forward. Since April 1, 2019, China has allowed qualified taxpayers to obtain 60% refund for their excess accumulated input VAT amount, compared to their accumulated input VAT credit at the end of March 2019.

The draft VAT Law states that when the amount of input VAT is greater than the amount of output VAT in the current tax period, the excess amount can be carried forward or the taxpayers can apply for refunds of the excess amount. Companies may gain cash flow benefits once VAT refunds are allowed for excess input VAT credit.

Calculation of value of import goods

The draft VAT Law specifically states that in calculating the taxable amount of import goods, valuation of non-trade goods is excluded from the custom dutiable value.

Currently, when the Custom calculates the taxable amount of import goods, the customs dutiable value includes royalties, warranties, etc. However, tax authorities require domestic buyers to withhold VAT for such services provided by overseas sellers, which causes double taxation.

The exclusion of the value of non-trade goods when calculating the taxable amount of import goods can eliminate double taxation caused by this practice. Nonetheless, the key to implementing such strategy is coordination between tax bureaus and Customs.

Applicable tax rate of a mixed sale

Under the draft VAT Law, the applicable tax rate in a mixed sale is based on the main tax rate. Compared to the current treatment, where the tax rate of a mixed sale is determined by the seller's main business, the new method is easier to comply with and more accurate. Currently, in practice, if a company engages in multiple categories of business, it is difficult to determine the company's main business. Also, it makes no sense to determine the main business if the company's multiple categories of business are subject to the same VAT rate. Thus, the draft VAT Law allows the applicable tax rate for a mixed sale to be determined by the main tax rate.

Administrative rules

The draft VAT Law provides tax periods of 10 days, 15 days, a month, a quarter or half a year. The original one-day, three-day and five-day tax periods have been replaced. While the tax period of half a year is new, which types of taxpayers can use this tax period remains unclear and will be clarified in the future Implementing Regulations.

Another notable change is that the draft VAT Law allows taxpayers to conduct consolidated tax payment. This policy will be welcomed by companies since it can reduce their VAT compliance costs.

Besides, current VAT regulations will have five-year transitional periods at the most. This transitional period represents that the Chinese government wants to keep current the large picture of VAT regime while possibly making adjustments.

Key Takeaways

The draft VAT Law makes no change to tax rates, which attracts the most attention; the current three brackets VAT rate (i.e., 13%, 9% and 6%) are still applicable. Considering that China has taken multiple steps to reduce tax burdens in the last two years and the guidance of the State Council to simplify the VAT rate brackets from three to two, it is possible that the VAT rate will be changed in the final VAT Law. We will monitor and update companies once the final VAT Law is announced.

The draft VAT Law is commendable with respect to the principles it sets forth to generate a comprehensive law for VAT, the largest tax in China. However, because it lacks many details and contains vague provisions, the final VAT Law will likely be revised. We hope that the final VAT Law and its implementing regulations will provide more details and clarification. Companies should therefore closely track the final VAT Law and the implementation regulations that will follow.

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