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Draft VAT law consolidates, streamlines existing rules

Authors:

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Email: sachin@deloitte.com.hk

Shanghai
Li Qun Gao
Partner
Tel: +86 21 6141 1053
Email: ligao@deloitte.com.cn

Beijing
Charles Gong
Partner
Tel: +86 10 8520 7527
Email: charlesgong@deloitte.com.cn

Shelley Zheng
Manger
Tel: +86 10 8512 5664
Email: szheng@deloitte.com.cn

Sophie Tian
Assistant Manger
Tel: +86 10 8512 4111
Email: sotian@deloitte.com.cn

On 27 November 2019, China's Ministry of Finance (MoF) and the State Taxation Administration (STA) released a public consultation document, which contains a draft VAT law that would consolidate, streamline and improve existing rules. The draft law basically imports most of the current VAT rules and documents set out in the 1993 "Provisional Regulations on Value-added Tax" (Provisional Regulations), with a few clarifications and modifications (e.g. allowing a refund of excess input VAT, etc.). The consultation period is open until 26 December 2019, after which the draft law will be further reviewed. The effective date of the new VAT law are not yet known.

This article provides a high-level overview of the current VAT rules and the main features of the draft VAT law.

Current VAT rules

In brief, taxpayers currently are categorized as "general taxpayers" or "small-scale taxpayers" for VAT purposes, mainly depending on the amount of their annual taxable sales. The VAT rates that apply to general taxpayers range from 6% to 13% (the most recent rate reduction taking effect as from 1 April 2019), with a 3% rate applying to small-scale taxpayers.

Two methods are used to calculate VAT due: a general method and a simplified method. Under the general method, the VAT payable is the output VAT less the current input VAT, and under the simplified method, the 3% VAT rate applies without any deduction of input VAT. Until 1 April 2019, there was no mechanism for most taxpayers to obtain a refund in cases where the amount of output VAT was less than the input VAT—the only option was to carry the excess forward to offset the output VAT in the following tax period. Refunds now are possible if certain requirements are met.

VAT reform has been a priority in China for several years, starting with the limited pilot replacement of the business tax with VAT in 2012, and expanded to all industries in 2016. Over the past couple years, the Chinese government has issued various new VAT policies (expanding the scope of VAT credits, allowing refunds of excessive input VAT) and implemented rate reductions designed to bring the Chinese system more in line with international trends. These changes are positive steps for both the Chinese economy and businesses, as they should stimulate investment and thus economic growth, provide more clarity and certainty, reduce the tax and administrative burdens on taxpayers, and enhance tax collection efforts. The draft VAT law takes the reform efforts one step further by consolidating the policies into a single legislative document.

Consultation draft law

Taxpayers / taxable threshold

The draft law defines a VAT payer as:

- An entity or individual that carries out VAT-able transaction in China with quarterly sales of at least RMB 300,000; or
- A consignee of imported goods in China.

Entities and individuals that do not reach the RMB 300,000 quarterly sales threshold can voluntarily elect to pay VAT (although it is unclear whether such persons would be allowed to issue VAT invoices).

Currently, under the Provisional Regulations, an entity or individual will become a VAT payer if it carries out a VAT-able transaction in China, regardless of the amount of the transaction. However, the proposed introduction of a monetary threshold to trigger VAT-taxpayer status should not substantially reduce the number of VAT payers, since the existing rules already grant an exemption to VAT payers whose quarterly sales are under RMB 300,000.

It should be noted that the consultation document does not address issues, such as:

- Whether the RMB 300,000 threshold requirement would apply to foreign parties making supplies in China;
- Whether an entity or individual whose VAT-able sales does not reach the threshold, and therefore is not a VAT payer would be allowed to issue a VAT invoice; and
- How the tax authorities would monitor sales amounts to determine whether an entity or individual has become a VAT payer.

Withholding agents

The draft law provides that a domestic purchaser generally would act as a VAT withholding agent for a foreign seller that makes VAT-able supplies in China. The proposed rule is simpler than the rules in the Provisional Regulations, which require a domestic agent to be the withholding agent in the first instance, with the domestic purchaser becoming the withholding agent only when there is no domestic agent.

For more information, please contact:

Indirect Tax Service
National Leader
Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Email: sachin@deloitte.com.hk

Northern China
Beijing
Yi Zhou
Partner
Tel: +86 10 8520 7512
Email: jchow@deloitte.com.cn

Eastern China
Shanghai
Li Qun Gao
Partner
Tel: +86 21 6141 1053
Email: ligao@deloitte.com.cn

Southern China
Guangzhou
Janet Zhang
Partner
Tel: +86 20 2831 1212
Email: jazhang@deloitte.com.cn

Western China
Chongqing
Frank Tang
Partner
Tel: +86 23 8823 1208
Email: ftang@deloitte.com.cn

Scope of taxation

The draft law provides that VAT would apply to the following:

- The supply of goods, services, intangibles, immovable property and financial products; and
- Importation of goods.

The draft would make the following changes to the Provisional Regulations (a simple re-allocation of categories):

- "Processing and repair services" would be incorporated into general "services"; and
- "Financial products" (e.g. notably listed stocks, bonds and other securities) that currently are found under general services would become a separate item.

Determination of VAT-able transaction "in China"

Under the current VAT rules, the place of supply of services, intangibles (other than the right to use natural resources) and financial products is deemed to be in China if the seller or the purchaser is located in China. According to the draft law, the supply of services, intangibles (other than use rights of natural resources) and financial products would be deemed to be carried out in China where:

- The seller is an entity or individual located in China or the service or intangible is used in China; and
- The seller is an entity or individual located in China or the financial products are issued in China.

A VAT obligation can be triggered only when a VAT-able transaction is conducted in China. Therefore, the place where a transaction is carried out could play a vital role in determining the chargeability of VAT. The draft law would modify the current rules to determine the place of supply by taking into account the place of consumption or the place where the financial products are issued, as appropriate. Given the diversified nature of services and intangibles, it may be difficult to develop simple unified guidance to determine the place of consumption for services and intangibles, which could give rise to controversies.

"Deemed sales" rules

The draft law provides that a VAT-able transaction would be deemed to exist in the following situations:

- An entity or individual industrial and commercial household uses self-manufactured goods (including goods consigned to other parties for processing) for personal consumption or employee welfare;
- An entity or individual industrial and commercial household provides goods free of charge, except for goods supplied for the public interest;
- An entity or individual provides intangible assets, immovable property or financial products free of charge, except where the assets/property/products were supplied for the public interest; and
- Any other circumstances stipulated by the MoF/STA.

The above provisions generally would carry over the current deemed sale rules, although a few situations enumerated in the implementing rules of Provisional Regulations have been removed. For example, using goods for capital contribution purposes would be removed from the list (in part, because using goods for these purposes could be interpreted as a sale of goods in exchange for the shares of another company (rather than cash consideration), so it is not necessary to be listed as a situation to which the deemed sale rules would apply).

A supply of goods without consideration would be considered a VAT-able transaction in the draft law, although an exception to the deemed sale rules would apply if the goods were donated for a public purpose. This exception should help relieve the tax burden on those donating goods for the public interest, although the draft is silent on whether the input VAT incurred to acquire or produce the goods would be creditable.

It is worth noting that, unlike the current rules, the draft law does not deem the provision of services free of charge to be a VAT-able transaction. In practice, it has been difficult to determine whether certain services are provided for free or not, so this change in the law should help to eliminate most disputes regarding the application of the deemed sale rules in the services sector.

Non-VAT-able items

The draft law provides that the following supplies are non-VAT-able items and, therefore, no VAT would be charged:

- Services provided by employees to employers for salaries and wages;
- Government funds or administrative fees collected by administrative departments;
- Expropriation or requisition compensation;
- Interest on deposits; and
- Other items stipulated by the MoF/STA.

"Expropriation or requisition compensation" is new and should be welcomed by businesses or individuals who obtain compensation for agreeing to have their property demolished by the government to implement urban development and reconstruction plans. The actual scope of "expropriation or requisition compensation," however, may need to be further clarified.

The list of non-VAT-able items in the draft does not cover all such items under the current VAT rules. It is expected that the MoF and STA may further expand the list.

Gross sales

A general VAT payer must multiply the gross sales amount by the VAT rate to compute the output VAT. The draft law defines "gross sales" to include all consideration acquired, including both cash and non-monetary economic benefits.

Uncertainties may arise in determining whether there are any "non-monetary economic benefits" in certain business arrangements, and if so, how to quantify the benefits.

For deemed VAT-able transactions (see "Deemed sales rules" above) where the gross sales are not reflected in cash, the draft law provides that gross sales should be determined by reference to the fair market value of the goods or services.

According to the current VAT rules, the gross sales amount of such VAT-able transactions is determined by reference to the average selling price of the same or similar goods/services by the same taxpayer (or a similar taxpayer) in the same or similar period. If such a price is not available, a cost-plus method may be used. It is unclear whether the draft law would use the current rules to arrive at the "fair market price."

Input VAT for financial products

Under the general taxing method, VAT liabilities are determined by crediting input VAT against output VAT. Input VAT is defined by the consultation draft as VAT incurred by a taxpayer from purchasing goods, services, intangible assets, immovable property and financial products to the extent such purchases relate to VAT-able transactions. The VAT incurred on the purchase of financial products is newly added to the definition of input VAT.

Under the current VAT rules, the general taxing method is not applied to the sale of financial products. Instead, a simplified taxing method applies, and the VAT liability is computed by multiplying the margin by a VAT collection rate. Therefore, taxpayers that purchase and sell financial products do not have to separately account for the input VAT from purchasing financial products. The new definition of the input VAT could prompt speculation about the possibility of a change to the general taxing method for the sale of financial products. Potentially affected taxpayers should monitor future developments in this area.

Refund of unutilized input VAT

The draft law confirms that, under the general taxing method, any unutilized input VAT (i.e. the excess of input VAT over output VAT) may be carried forward to the next period for credit or refunded to the taxpayer. Administrative measures containing the relevant criteria to obtain refunds of unutilized input VAT will be separately formulated by the MoF/STA.

Unutilized input VAT previously could not be refunded to taxpayers. However, the Chinese government launched a pilot program for input VAT refunds in select industries, and on 1 April 2019 extended the pilot to all industries to allow eligible taxpayers to claim refunds of unutilized input VAT (see Deloitte Tax Analysis on 22 March 2019).

Uncreditable input VAT

The current VAT rules do not allow the credit of input VAT incurred from purchasing catering services, entertainment services and certain other services for personal consumption. The draft law clarifies that such input VAT cannot be credited only if the relevant services were purchased and then directly used for self-consumption purposes by the taxpayer. The clarification is believed to benefit certain online platform businesses, e.g. online food ordering platforms, which may be considered as purchasing catering services from restaurants and then re-selling them to consumers for VAT purposes. Under current rules, some tax authorities may deny an input VAT credit for the purchase of catering services by the platform enterprise.

Despite anticipation that the government would relax the credit of input VAT from loan interest, the draft law is in line with the current rules that disallow the credit of such input VAT.

Consideration in relation to trade in services

The draft law provides that any consideration in relation to trade in services cannot be included in the dutiable price of imported goods to account for import VAT. This provision aims to address the potential "double" imposition of VAT on some outbound payments in cross-border transactions. For example, certain royalties would be considered by the customs authorities as part of the consideration to import goods into China to be subject to import VAT. On the other hand, the tax authorities would impose VAT on the same royalties by regarding them as consideration in relation to trade in services (i.e. licensing intangibles to be used in China). The proposed measure appears to confirm that a single payment cannot be regarded as consideration both for the importation of the goods and in relation to trade in services. It also suggests that a coordination mechanism may be established under the new VAT law between the customs and tax authorities to resolve the issue.

Mixed sales

A mixed sale is a single VAT-able transaction that is comprised of two or more elements, which would be subject to different VAT rates if the elements were provided separately. Although two or more elements are involved, the draft law confirms that only one VAT rate (i.e. the "principal rate") would be applied for a mixed sale. There has been considerable uncertainty as to how to differentiate a mixed sale from multiple VAT-able transactions that are provided simultaneously and subject to different VAT rates. The draft law does not provide any guidance in this respect.

The draft also is silent on whether the "principal rate" refers to the applicable VAT rate for the principal element in the relevant transaction or the applicable VAT rate of the taxpayer's principal business. The Chinese tax authorities currently may tend to apply the VAT rate by reference to a taxpayer's principal business, which was the principle used to determine the indirect tax treatment of a mixed sale before the VAT reform. For example, where a taxpayer carries out mixed sales involving both goods and services, the tax authorities would apply the VAT rate applicable to the goods to the entire transaction if the taxpayer is mainly engaged in goods sales activities in its normal course of business.

VAT exemption for education services

The draft law provides that a VAT exemption would be granted to education services provided by "schools and other educational institutions." According to the current VAT rules, VAT-exempt education services are restricted to those provided by "schools that provide academic education." Therefore, it seems the draft would expand the scope of taxpayers that may be able to enjoy the VAT exemption for education services.

VAT rates

Although the State Council has confirmed that the current three VAT rates (i.e. 13%, 9% and 6%) would be consolidated into two rates, the draft law does not include any change to the three bands, and the 3% rate also would remain applicable to small-scale VAT payers.

As discussed above, "processing and repair services" has been merged into general "services," but the applicable VAT rate remains 13%.

The current rules allow the application of a 5% rate for certain sales and leases of eligible immovable property. This policy is expected to continue for up to five years in accordance with the transitional arrangement (see below).

Tax assessment period

The draft law provides that the VAT assessment period may be 10 days, 15 days, one month, a quarter or half a year. Compared with the Provisional Regulations, the draft would eliminate three currently permitted tax assessment periods: one day, three days and five days, and would add a new half-year period, which may apply only to small-scale VAT payers. These changes are designed to reduce the number of VAT filings for small-scale VAT payers.

Information sharing

The draft law adds new articles to require the customs authorities to share import and export information with the tax authorities and other relevant government departments or entities (e.g. foreign exchange administration, market supervision bureaus, banks, etc.) to provide necessary information for VAT administration purposes. These articles would give the tax authorities more access to taxpayer information, which would enhance tax collection efforts and enforcement of the law.

"VAT deposit" mechanism

The draft law provides that, subject to implementation regulations issued by the State Council, a VAT payer would have to pay and "deposit" its VAT amount. This new article implies that the government is contemplating a new VAT collection mechanism. Although no details have been released, it is anticipated that, under the new mechanism, the VAT portion in each payment may be remitted and deposited in a special bank account after the payment is made by a purchaser.

Transitional arrangement

According to the draft law, any VAT rules that were issued before the promulgation of the new VAT law and that still are necessary can remain in effect for up to five years after the law comes into force, subject to stipulations by the State Council. The introduction of the transitional arrangement may help the tax authorities and taxpayers achieve a smooth transition after the new law becomes effective. However, it is worth noting that not all rules will be covered by the transitional arrangement.

Comments

The release of the consultation draft VAT law marks another significant step forward in VAT legislation in China. The draft carries over most of the Provisional Regulations and sets out the relevant principles but does leave some issues to be clarified. Therefore, businesses should continue to closely monitor the progress of the VAT legislation and begin to prepare for the implementation of the new law.

Taxpayers should consider taking the following actions, in particular:

- ***Assess the potential impact of the draft law and develop an action plan:*** **Taxpayers should begin now to assess the impact of the draft law on revenue, profits and cash flow, and explore opportunities to improve supply chain arrangements. For example, given the relaxation of certain input VAT credits for the purchase of catering services, daily-life services and entertainment services, affected taxpayers may wish to consider whether they should renegotiate certain contract articles. Importers that made service payments to foreign parties should monitor the progress on the coordination mechanism between the customs authorities and the tax authorities. Educational institutions should monitor future guidance about the exemption granted to education services.**

- ***Improve internal controls on VAT management:*** **Based on the assessment of the potential impact, taxpayers should examine their current internal control systems in light of the draft VAT law, identify any weaknesses and make improvements, as needed. Given that the tax authorities will be able to access more information under the new VAT law, taxpayers should ensure they are in compliance with the rules and where necessary, seek professional advice.**

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Beijing
Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 1326
Email: andzhu@deloitte.com.cn

Harbin
Jihou Xu
Partner
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056
Email: jihxu@deloitte.com.cn

Shenyang
Jihou Xu
Partner
Tel: +86 24 6785 4068
Fax: +86 24 6785 4067
Email: jihxu@deloitte.com.cn

Chengdu
Frank Tang / Tony Zhang
Partner
Tel: +86 28 6789 8188 / 8008
Fax: +86 28 6500 5161
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Shenzhen
Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

Chongqing
Frank Tang / Tony Zhang
Partner
Tel: +86 23 8823 1208 / 1216
Fax: +86 23 8859 9188
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Jinan
Beth Jiang
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@deloitte.com.cn

Suzhou
Kelly Guan
Partner
Tel: +86 512 6289 1328 / 1297
Fax: +86 512 6762 3338
Email: kguan@deloitte.com.cn

Dalian
Jihou Xu
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: jihxu@deloitte.com.cn

Macau
Raymond Tang
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: raytang@deloitte.com.hk

Tianjin
Bill Bai
Partner
Tel: +86 22 2320 6699
Fax: +86 22 8312 6099
Email: bilbai@deloitte.com.cn

Guangzhou
Victor Li
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: vicli@deloitte.com.cn

Nanjing
Frank Xu / Rosemary Hu
Partner
Tel: +86 25 5791 5208 / 6129
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn
roshu@deloitte.com.cn

Wuhan
Gary Zhong
Partner
Tel: +86 27 8526 6618
Fax: +86 27 6885 0745
Email: gzhong@deloitte.com.cn

Hangzhou
Qiang Lu / Fei He
Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn
fhe@deloitte.com.cn

Shanghai
Maria Liang
Partner
Tel: +86 21 6141 1059
Fax: +86 21 6335 0003
Email: mliang@deloitte.com.cn

Xiamen
Jim Chung
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: jichung@deloitte.com.cn

Zhengzhou
Charles Gong
Partner
Tel: +86 371 8897 3701
Fax: +86 371 8897 3710
Email: charlesgong@deloitte.com.cn

About the Deloitte China National Tax Technical Centre

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National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader / Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Western China
Tony Zhang
Partner
Tel: +86 28 6789 8008
Fax: +86 28 6317 3500
Email: tonzhang@deloitte.com.cn

Eastern China
Kevin Zhu
Partner
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

Southern China (Mainland)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Southern China (Hong Kong)
Doris Chik
Director
Tel: +852 2852 6608
Fax: +852 2851 8005
Email: dchik@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.