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Tax Analysis

Latest draft VAT law published

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On 27 December 2022, the latest draft of the VAT law was submitted to China's Standing Committee of the National People's Congress for first review and then published on 30 December 2022 for a 30-day public consultation. Similar to an earlier draft[1] that was circulated for public consultation almost three years ago, the new draft basically imports most of the current VAT rules aiming to provide a stable policy environment. However, the new draft still introduces certain changes that may impact businesses, notably the modifications to the creditable input VAT.

This article provides a high-level discussion of the changes brought by the new draft, as compared with the earlier draft released three years ago.

Categories of domestic VAT-able transactions

The earlier draft classified domestic VAT-able transactions into five sales categories: goods, services, intangible assets, real estate, and financial products (e.g., stocks, bonds, etc.).

The new draft consolidates the category of "financial products" into the categories of either "services" or "intangible assets," so that there would be four categories remaining in the new draft.

[1] See our Tax Analysis for more information about the earlier draft: https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2019/deloitte-cn-tax-tap3052019-en-191220.pdf

Taxpayers

According to the earlier draft, an entity or individual that has carried out VAT-able transactions in China would be considered a VAT payer only if the amount of such transactions reaches a threshold.

The new draft removes the threshold requirement when defining VAT payers. In other words, the entity or individual could become a VAT payer regardless of the amount of VAT-able transactions it carried out in China. However, the new draft provides an exemption for such taxpayers if the amount of their VAT-able transactions carried out in China does not reach a threshold (which is RMB 100,000 per month under the current VAT rules). Therefore, there seems to be no substantial changes in the new draft to the scope of VAT payers.

Deemed sales

The earlier draft provided that donations of goods, intangible assets, and real estate would be deemed as VAT-able sales (i.e., "deemed sales"), except where such donations were made for public interest purposes.

The new draft removes the exception in the deemed sales rules, which means the VAT still should be accounted for even if the donations were made for public interest purposes.

Input VAT from loan interest

One of the most significant changes that would be brought by the new draft is to allow the credit of input VAT arising from loan interest. The credit of such input VAT has been disallowed since the financial sector was brought into the scope of VAT in 2016, and the earlier draft did not make any changes in this respect. The change in the new draft should be welcomed by businesses because they could benefit from the credit to reduce their financing cost.

Input VAT from fixed assets, intangible assets, and real estate

The earlier draft, which is consistent with the current rules, would disallow the credit of input VAT arising from acquisition of fixed assets, intangible assets, and real estate, but only if such assets were exclusively used for non-VAT-able purposes (e.g., private consumption) or VAT-able projects that are not subject to the general taxing method (e.g., VAT-exempt projects). Relying on the above rules, a taxpayer may claim credit of the whole amount of the input VAT arising from acquisition of a fixed asset, if the asset was used simultaneously for a non-VAT-able project and a VAT-able project (subject to the general taxing method), without apportioning the input VAT between the two projects.

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However, the new draft seems to tighten up the rules by removing the above "exclusive usage" condition. This being the case, the taxpayer in the above scenario would need to develop a reasonable method to apportion the input VAT from the fixed asset between the two projects, and only the input VAT attributable to the VAT-able project would be creditable.

Mixed sale

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. The earlier draft provided that only one rate (i.e., the "principal rate") would be applied to a mixed sale. However, the earlier draft was silent on whether the principal rate refers to the applicable VAT rate for the principal element in a mixed sale or the applicable VAT rate of the taxpayer's principal business.

The new draft clarifies that the principal rate refers to the applicable VAT rate for the principal element in a mixed sale. Therefore, a taxpayer would need to review the facts of a mixed sale itself rather than the taxpayer's normal business at the entity level to determine the principal rate for a mixed sale transaction.

Electronic VAT invoices

Given the promotion of electronic VAT invoices during the last few years, the new draft specifically confirms that an electronic VAT invoice should have the same effect as a VAT invoice in paper form.

Transitional arrangement

According to the earlier draft, any VAT rules that were issued before the promulgation of the new VAT law and that still are necessary would remain in effect for up to five years after the law comes into force, subject to stipulations by the State Council.

The section relating to the above transitional arrangement is no longer in the new draft. As such, it is uncertain whether a similar transitional arrangement would be provided under the new VAT law.

Next steps

After the expiration of the consultation period, the comments provided by the public will be reviewed and discussed by the legislators. Based on prior experience with tax legislation, many have anticipated that the second and third review of the law would be carried out in the near future so that the law can be passed in 2023. Businesses are advised to closely monitor the legislative development, assess the impact by the potential changes to the current VAT rules, and formulate any action plans accordingly where necessary.

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