VAT Legislation in Full Swing – Highlights of the Consultation Draft

In brief

The Value-added Tax (VAT) regime has undergone a series of reform, in particular the major Business Tax to VAT reform which commenced in 2012, since its introduction in 1994. The VAT regime is now ready for the legislation process.

In order to follow the principle of legislating tax collection, the Ministry of Finance and the State Taxation Administration jointly incorporated the achievements of the VAT reform and issued *the Consultation Draft of the VAT Law of the People’s Republic of China* (hereinafter referred to as “the Consultation Draft”) on 27 November 2019 to solicit public comments.

Based on the prior experience in legislating other taxes, it is reasonable to anticipate the VAT Law may be promulgated after deliberation and approval by the National People’s Congress in 2020.

We have performed preliminary analysis on the Consultation Draft immediately upon its release and identified the differences compared with the prevailing VAT regulations. We hope our analysis will help enterprises to have a better understanding of the Consultation Draft. Meanwhile we will collect comments from enterprises and formulate and submit these comments to the relevant authorities during the legislation process.

For tax rates which have attracted the most attention, the Consultation Draft has inherited the three rate brackets under the current VAT regulations. Considering the trend of tax reduction in the last couple of years and the guidance of the State Council on simplifying the VAT rate brackets from three to two, it is important to monitor closely whether adjustment and simplification of VAT rate brackets will be included in the final draft VAT Law to be submitted to the Nation People’s Congress for review and discussions.

In detail

In comparing with the prevailing regulations, the Consultation Draft has the following major changes:

1. Revision of taxable threshold

In the Consultation Draft, the taxable threshold for sales turnover is adjusted to RMB300,000 per quarter. Organisations and individuals whose sales turnover is below the taxable threshold are not taxpayers specified in the VAT Law; however, they can still elect to pay VAT in accordance with the VAT Law on a voluntary basis.

In the article, the taxable threshold is the same amount as the VAT exemption - amount of VAT small-scale taxpayer as defined in the prevailing regulations. However, it also specifies that organisations and individuals whose sales turnover is below the taxable threshold are not taxpayers under the VAT Law. Comparing with the prevailing regulations, further clarifications will be required on areas such as: (1) whether existing VAT general taxpayers are eligible for such taxable threshold policy; (2) how to manage organisations and individuals who are not taxpayers under the VAT Law; and (3) whether foreign organisations and individuals are eligible for such taxable threshold policy.
2. Specifying purchaser as the withholding agent

Under the prevailing regulations, for foreign organisations or individuals performing services or conducting taxable activities in China, if they do not have place of business or agent in China, the Purchaser will be the withholding agent. This requirement has been modified in the Consultation Draft as “for foreign organisations or individuals conducting taxable transactions in China, the Purchaser will be the withholding agent”.

The amendments clarify the withholding obligation of the Purchaser and the Purchaser no longer has to assess whether the foreign organisations or individuals have place of business or agent in China, which makes provides more clarity on the tax obligations and the tax withholding implementation procedure which will be more convenient for both parties.

3. Consolidating the taxable scope

The Consultation Draft amended the definition of taxable scope by including “processing, repair and installation services” into “services” scope and listing “trading of financial products” as a separate sub-category in the “services” scope, which is more in line with the substance of the transaction. Since there is no change on the applicable tax rate, there may not be any substantial difference comparing with the prevailing regulations.

It is also important to note that, currently domestic enterprises outside Special Customs Supervision Areas (“SCSA”) which provides processing, repair and installation services to enterprises in SCSA are eligible for VAT refund, while the provision of other services are not eligible for VAT refund. The corresponding policies and practices may need to be further clarified later.

4. Refining the concept of conducting taxable transaction “in China”

The Consultation Draft has modified the concept of conducting taxable transaction in China from “the seller or purchaser of services (excluding leasing of immovable properties) and intangible assets (excluding the right to use natural resources) is domiciled in China” into “sale of services, intangible assets (excluding the right to use natural resources) by domestic organisations and individuals, or the services and intangible assets are consumed in China”. The wording of “purchaser is domiciled in China” has been removed.

Foreign organisations or individuals selling services or intangible assets which are consumed in China to other overseas organisations or individuals should pay attention to the difference with the prevailing policies.

5. Narrowing the scope of deemed sales

The scope of deemed taxable transactions in the Consultation Draft does not cover consignment sales, transfer of goods between organisations under the same taxpayer, investment, distribution to shareholders or investors and provision of service for no consideration.

For consignment sales and goods moving between organisations under the same taxpayer, with the rapid development of the logistics industry in China, deemed sales treatment relating to these items rarely applies nowadays. For investment and distribution to shareholders or investors, the deemed sales treatment is less meaningful now since: (1) the prevailing regulations already allow the transfer of assets under a restructuring transaction where a business is being wholly or partly transferred to be exempt from VAT; (2) even if the transfer of such assets is subject to VAT, the transferee can still claim input VAT credit or refund upon obtaining VAT Special Invoice.

For the provision of services for no consideration, considering the intangible nature of the services, the deemed sales treatment is relatively less being applied in practice. It is also difficult for the tax authorities to determine whether there are services provided for no consideration. Hence, it is reasonable to remove this item from the scope of deemed taxable items.

The Consultation Draft excludes situations of public welfare undertakings from the deemed taxable scope, which conform to the basic direction of encouraging enterprises and individuals to contribute to public welfare undertakings, and also cover some of the prevailing VAT exemption policies. At the same time, the Consultation Draft also removes the item “targeting to the public” from the exclusion scope of deemed sales, which may be due to difficulty in making the assessment.

6. Refining the scope of non-taxable items

Comparing with the prevailing regulations, the Consultation Draft removes a number of non-taxable items such as “provision of services by an organisation or sole proprietor to its employees”, “insurance claims received by insured person”, and “housing special maintenance fund collected by housing authorities or designated organisations, provident fund administration centres, development enterprises and property management organisations”. It also removes the transfer of goods, immovable properties and land use right involved in the assets restructuring, where all or part of a business is transferred as a whole, from the non-taxable items, which is in line with the removal of relevant items in the scope of deemed sales as discussed above.

7. Introducing the “relevance” concept of input VAT

The Consultation Draft introduces a new concept that input VAT should be “related to the taxable transactions”. In practice, the determination of whether the input VAT is related to taxable transactions could be difficult and uncertain. Meanwhile, the Consultation Draft also includes “VAT paid or borne in acquiring financial products” as one of the input VAT items, which indicates there could be a change of the prevailing VAT practice for trading of financial products, from net basis method to gross basis method with input VAT credit.
8. Clarifying the policy of input VAT credit balance refund

Based on the prevailing policy for excess input VAT refund, the Consultation Draft clarifies that, when the amount of input VAT is greater than the amount of output VAT in a tax filing period, the excess amount can be carried forward to the next period or refunded. This will provide a lawful refund mechanism for the refund of input VAT balance and also authorise the finance and tax authorities of the State Council to formulate specific measures.

The mechanism of input VAT balance refund helps enterprises to effectively reduce the cost of capital. China implemented the pilot scheme of input VAT refund in 2018, which benefits 18 designated industries including certain advanced manufacturing industries, modern services industries and power grid enterprises. Effective from 1 April 2019, the mechanism of incremental input VAT refund was also introduced to all industries.

If the principal of input VAT credit balance refund can be confirmed in the new VAT Law, it will be conducive to the implementation of the input VAT refund mechanism gradually and improve cash flow of enterprises.

9. Enhancing the arrangement for non-creditable input VAT items

Under the prevailing regulations, input VAT generated from catering services, resident daily services and entertainment services are not creditable. In the Consultation Draft, the condition of “acquired and consumed directly” was added for determining non-creditable input VAT items, which may imply that the input VAT generated from purchase of catering services, resident daily services and entertainment services which forms a part of the final product of an enterprise can be credited. This may have a significant positive impact to enterprises engaging in catering platform, traveling and exhibition business. Meanwhile, input VAT generated from purchase of loan services is still not creditable.

10. Enhancing the calculation of composite assessable value of import goods

In the Consultation Draft, for the calculation of composite assessable value of import goods, it changes the term “duty paid value” to ‘dutiable value”, and clarifies that consideration related to trade in services should not be included in the dutiable value.

Currently the customs value includes royalties, warranty fees, etc. which is the base for calculating Customs Duty and import VAT payable. At the same time, the tax authorities require the domestic purchasers to withhold VAT for such services provided by overseas vendors, which may create a double taxation issue.

The modification in the Consultation Draft eliminates such problem of double taxation. Meanwhile, in current practice, although the VAT may be levied twice, the tax authorities generally allow enterprises to claim credit for both input VAT.

11. Continuance of the concept of adopting the main business in mixed sale transactions

The Consultation Draft retain the concepts of “concurrent operation” and “mixed sale” in the prevailing regulations, and stipulates that if a single taxable transaction involves two or more tax rates or collection rates, the tax rate or collection rate applicable to the main item of the transaction shall apply.

Under such terms, it may be difficult to define whether a transaction belongs to a “single transaction” or “multiple transactions” under a concurrent operation. At the same time, where a company engages in multiple categories of businesses, it is difficult to determine the “main” business/transaction – whether it refers to the main business of an enterprise with the highest amount of sales turnover, or the taxable item with the highest proportion of sales turnover in the specific transaction which involved different taxable items. The assessment period and other detailed matter should also be clarified in subsequent drafts or regulations.

12. Continuation of VAT exemption for education services

Under the current regulations, there are VAT exemptions for educational services provided by schools engaged in diploma education; and VAT General Taxpayers who provide non-degree education services can choose to apply the simplified tax calculation method and pay VAT at the 3% levy rate. In the consultation draft, the VAT exemption scope is changed to “education services provided by schools and other educational institutions”, which may be good news to other educational institutions which can meet the eligibility requirements.

13. Extension of tax filing period

The Consultation Draft removes three VAT assessment basis periods, i.e. “one-day”, “three-day” and “five-day”, and adds a “half year” basis period, which will further reduce the frequency of tax filing and reduce the taxpayer's compliance burden. It should be noted that the half-year period is not applicable to taxpayers who adopt the general tax calculation method.

14. Information exchange

The Consultation Draft states that Customs should share information of entrusted VAT collection and the export declaration of goods with the tax authorities; tax authorities and banks, Customs, foreign exchange authorities, market supervision authorities and other departments should establish a VAT information exchange and coordination mechanism, to safeguard the further strengthening of VAT collection and administration.

15. Introduce a mechanism of depositing VAT

The Consultation Draft proposes to stipulate a VAT deposit mechanism which will be formulated by the State Council. The mechanism may refer to international experience such as directly splitting the VAT amount of a transaction and transfer the
amount to a separate VAT payment account of the enterprise, which can improve VAT administration and control the behaviour of issuing false invoices.

**The takeaway**

The deadline for soliciting public comments on the Consultation Draft is 26 December 2019. The public can submit their comments through the official website of Ministry of Finance or by mail. The above insight summarises our preliminary analysis of the Consultation Draft, and we shall continue to pay close attention to the development of VAT legislation and timely share our observations with you.
Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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