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Tax Newsflash

# China passed its first law on valued-added tax

China | Tax & Business Advisory | Indirect Tax Services | 31 December 2024

On 25 December 2024, the much-anticipated Value Added Tax (VAT) Law was formally ratified by the Standing Committee of the 14th National People’s Congress (NPC) of China and subsequently promulgated as Order No. 41 by the President of the People’s Republic of China.[1] This new legislation will come into effect on 1 January 2026, thereby replacing the existing provisional VAT regulations that have been in place for three decades.

As a tax generally imposed on sales of goods and services, China’s VAT has contributed the most to the Chinese governments’ tax revenue. The new law basically imports most of the current VAT rules aiming to provide a stable policy environment. However, the law still introduces certain changes that may impact businesses.

This article provides a high-level discussion of certain key changes brought by the new law.

## Cross-border services

### *Determination of VAT-able services “in China”*

Under the current China VAT rules, the place of supply of services is deemed to be in China if the seller or the purchaser is located in China. According to the new VAT law, the supply of services would generally be deemed to be carried out in China where:

- the service supplied is *consumed* in China; or
- the service provider is located in China.

A VAT obligation can be triggered only where 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. It is to be further clarified how to determine whether the service is *consumed* in China, e.g., whether it is determined by

[1] There were two drafts submitted to the Standing Committee of the NPC for review in December 2022 and August 2023 respectively. See Deloitte China’s newsletters for more information about the two previous drafts:
https://www.taxathand.com/article/29466/China-Peoples-Republic-of/2023/Latest-draft-VAT-law-published
https://www.taxathand.com/article/32483/China/2023/Second-draft-of-VAT-law-published-for-public-consultation

where the service recipient is located (aligning with existing regulations), or where the service is actually used and enjoyed according to the OECD guideline.

*Withholding agents*

The VAT 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, *except* where a domestic agent is appointed according to the regulations stipulated by the State Council.

The provision for this exception was initially omitted from the draft but was subsequently reinstated in the final version. It is understood that this exception was introduced to address scenarios where tax authorities might encounter challenges in collecting tax from Chinese buyers (e.g. where the Chinese buyers are multiple private individuals). However, the specific regulations pertaining to this exception are yet to be promulgated by the State Council.

## "Deemed sales" rules

The VAT 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; and
- An entity or individual provides intangible assets, immovable property or financial products free of charge.

Unlike the current rules, the VAT law does not deem the provision of services (other than the sales of financial products[2]) free of charge to be a VAT-able transaction.

Furthermore, the draft law initially granted the State Council the authority to add more situations falling under the “deemed sales” rules; however, the relevant provision is removed in the final version. Consequently, any proposed addition has to be reviewed and approved by the NPC legislators.

## Input VAT from loan interest

The input VAT arising from loan interest has been explicitly listed as a non-creditable item since the financial sector was brought into the scope of VAT in 2016. However, it is no longer appearing on the list of non-creditable input VAT in the VAT law.

Although this removal is welcome by taxpayers, it is worth noting that the legislation grants the State Council to broaden the range of input VAT that cannot be credited against output VAT. It remains to be seen in the forthcoming State Council regulations to what extent the restriction on crediting input VAT arising from loan interest can be liberalized.

[2] The sales of financial products is considered as financial service for VAT purposes under the current VAT rules.

## 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. In the current VAT rules, only one rate (i.e., the "principal rate") would be applied to a mixed sale and the principal rate refers to the applicable VAT rate for the main business of the taxpayer. However, the new law changed that to the VAT rate applicable to 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.

## "Net-off scheme"

Under the current VAT rules, the output VAT is normally computed based on the amount of the gross sales, i.e. the total consideration that is collected by the taxpayer, excluding the output VAT amount. However, in some special situations, certain items may be deducted against the gross sales to account for the output VAT (i.e. "net-off scheme"). The draft law included the provision to grant the State Council the authority to determine where the net-off scheme can be applied. But the provision is removed in the final version of the law.

This change should not be interpreted as an indication that the net-off scheme is to be discontinued under the new VAT law. It is anticipated that the scheme would be provided with more details in the upcoming implementing regulations of the VAT law.

## Preferential policies

The VAT law introduces following key modifications to the current VAT preferential policies:

- Contraceptives and devices are removed from the list of VAT-exempt goods;
- The State Council is granted the authority to develop special preferential policies to support small-/micro-sized businesses, key industries, innovations, entrepreneurship, employment promotion and charitable donations, and also required to assess and modify these policies where appropriate;
- A clarification has been provided regarding the waiting period, which is set at 36 months, for a general VAT payer to apply for a VAT preferential policy after having relinquished their entitlement to the policy.

## Electronic VAT invoices

In light of the promotion of electronic VAT invoices during the last few years, the new VAT law explicitly validates that an electronic VAT invoice should have the same effect as a VAT invoice in paper form. It is also worth noting that, effect from 1 December 2024, the fully-digitalized electronic invoices have been rolled out nationwide.

## Next steps and comments

With the impending implementation of the VAT law on 1 January 2026, it is anticipated that a suite of supplementary documentation, including the Implementing Regulations of the VAT law, may be published within the next year. Certain key issues, such as the limitations on crediting input VAT arising from loan services, are likely to be addressed within these documents. We advise taxpayers to closely monitor regulatory progress in order to evaluate potential implications for their operations and to accordingly formulate strategic responses and action plans.

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