

China's VAT Law – Risks in Application

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Abstract---China's Value-Added Tax Law of the People's Republic of China (VAT Law) officially came into effect on January 1, 2026, replacing the Interim Value-Added Tax Regulations of the People's Republic of China (Interim Regulations) that have been in effect for 31 years. The VAT Law aims to promote high-quality development, regulate the collection and payment of VAT, and protect the legitimate rights and interests of taxpayers. Its goal is to improve efficiency and neutrality of tax administration, benefiting both taxpayers and tax authorities. The enactment of the VAT Law is considered a measure to formalize tax collection and a significant step forward in China's tax legislation process. This paper introduces some key changes in the VAT Law and discusses the implications of these changes for taxpayers, while pointing out potential pitfalls taxpayers should be aware of. Furthermore, this paper presents a real-world case to illustrate the potentially significant economic losses taxpayers may face if they violate the VAT Law.

Keywords---China's VAT Law, China's Tax Laws, Value-Added Tax Law.

On December 25, 2024, the Standing Committee of the 14th National People's Congress (NPC) in China passed the Value-Added Tax Law of the People's Republic of China (VAT Law), which took effect on January 1, 2026, replacing the Interim Value-Added Tax Regulations of the People's Republic of China (Interim Regulations) that have been in effect for 31 years.

VAT is China's largest tax, accounting for approximately 38% of total national tax revenue in 2023 (Li, Xia & Yu, 2025; Reuters, 2024). It covers almost all sectors and stages of economic activities, playing a crucial role in driving economic growth and optimizing the tax system structure. The VAT Law is formulated to promote high-quality development, regulate the collection and payment of VAT, and

How to Cite:

Shum, C., & Lui, G. (2026). VAT Law-Risks in application. *The International Tax Journal*, 53(4), 1823–1829. Retrieved from <https://internationaltaxjournal.online/index.php/itj/article/view/571>

The International tax journal ISSN: 0097-7314 E-ISSN: 3066-2370 © 2026

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Submitted: 01 March 2026 | Revised: 18 May 2026 | Accepted: 27 June 2026

protect the legitimate rights and interests of taxpayers. Its goal is to improve efficiency and neutrality of tax administration, benefiting both taxpayers and tax authorities. The enactment of the VAT Law is considered a measure to formalize tax collection and a significant step forward in China's tax legislation process.

Background

The VAT system was first implemented in 1994, when the VAT provisional regulations were promulgated. It was based on the Interim Regulations and the Implementing Rules for the Interim Regulations of the People's Republic of China on Value-added Tax (Implementing Rules), as well as the Circular on Comprehensively Promoting the Pilon Program of the Collection of Value-added Tax in Lieu of Business Tax. In the past 31 years, the VAT system has undergone numerous significant reforms and improvements—from shifting to a consumption-based tax system in 2009, to gradually implementing VAT pilot reforms in various service sectors in 2012, and finally being fully implemented in 2016. The system was further streamlined with simplified tax rates in 2017 and enhanced through subsequent reforms in 2018 and 2019.

The first draft of the VAT Law was released for public comment in 2019. Since then, the provisions in the VAT Law have been continuously revised during the legislative process. After five years of preparation, the third draft of the VAT Law was passed in the latest NPC meeting. With the introduction of the VAT Law, 14 out of China's 28 tax categories have their own laws, covering most of the tax revenue, and marking significant progress in the implementation of the principle of statutory taxation.

After the VAT Law went into effect in January 2026, it is expected that further amendments to the VAT rules would be based on the principles of the VAT Law and would be incorporated into the Detail Implementation Regulations of the VAT Law.

Key Changes

The officially-promulgated VAT Law of China consists of six chapters and 38 articles. These articles cover essential aspects such as scope of taxation, tax rates by categories, taxable amounts, tax concessions, collection and administration procedures, and supplementary explanations. Although the existent VAT policies remain largely unchanged, there are some key changes.

1. Definition of VAT taxable transaction

The definition of VAT taxable transactions has been improved. VAT applies to two types of transaction: sale of goods, services, intangible assets, and real estate within Chinese territory; and import of goods. For taxable transactions, the new VAT Law consolidates goods, services, intangibles, and real estate into a unified category of "services," and explicitly states that "sale" refers to "paid" transactions.

2. Definition of domestic taxable transaction

The definition of domestic taxable transaction has been refined. Domestic taxable transaction refers to services rendered or intangible assets provided within China, and that the services or intangible assets are consumed within China or the seller is a domestic entity or individual. The VAT Law focuses on the location of consumption. In defining domestic taxable transaction, this focus in the VAT Law aligns with the destination principle, which is a widely accepted standard in international trade for levying VAT in the place where final consumption occurs.

3. Scope of deemed taxable transaction

The scope of Deemed Taxable Transaction is narrowed with stricter limits. VAT Law defines Deemed Taxable Transaction as follows:

- a. entities and individual businesses using self-produced or commissioned processed goods for collective welfare or personal consumption;
- b. entities and individual businesses transferring goods free of charge; and
- c. entities and individual businesses transferring intangible assets, real estate or financial products free of charge.

Transfer of goods for sale across counties/cities between a head office and its branches within the same legal entity, or transfer of goods for investment or distribution to shareholders will no longer be subject to VAT. Similarly, the sale of services free of charge is no longer considered a taxable activity for VAT purposes.

4. Non-taxable income

The new VAT Law stipulates tax-exempt items. Taxpayers are not required to recognize taxable income for the following activities:

- a. services provided by employees to their employers in exchange for wages or salaries;
- b. administrative and public service fees and government funds received;
- c. compensation received resulting from lawful collection or expropriation; and
- d. interest income from bank deposits.

5. Tax rate

Tax rates have been simplified. The VAT Law stipulates that when calculating VAT using the simplified tax method, the applicable tax rate is 3 percent.

6. VAT calculation for overseas sales of services and intangible assets

The calculation of VAT for overseas sales of services and intangible assets has been revised. Under the new VAT Law, when a foreign entity provides services or receives royalties from a domestic entity, the sales price does not include VAT, whereas the price includes VAT under the current VAT regulations, which means the buyer is now liable for VAT.

7. Excessively high or low selling prices

Under the new VAT Law, tax authorities may review sales prices deemed excessively high or low and adjust the tax accordingly, whereas under the current VAT regulations, tax authorities conduct review only when prices are excessively low.

8. Excess input VAT

If the input VAT for the current period exceeds the output VAT, taxpayers may choose to either carry forward the excess to the next period for deduction, or apply for refund of the excess deduction amount, thereby improving liquidity.

9. Non-deductible input VAT

The regulations regarding non-deductible input VAT have been revised. The current Implementing Rules for input VAT stipulates that input VAT on passenger transportation services, loan services, residential daily services, and entertainment services shall not be deducted from sales tax. However, the scope of deduction has been changed. The VAT Law restricts the non-deductibility of input VAT on the aforementioned items only to those purchased and directly used for personal consumption. In addition, the new list of non-deductible input VAT does not include input VAT on loan services.

10. Criteria for determining mixed sales

The criteria for determining mixed sales have been refined. According to the current Implementation Rules, sales involving both goods and VAT-taxable services constitute mixed sales. Mixed sales by enterprises, corporate entities, and individual businesses engaged in the production, wholesale, or retail of goods are considered sales of goods and are subject to VAT. Mixed sales by other entities and individual businesses are also considered sales of services and are subject to VAT.

Under the new VAT Law, if a taxpayer's taxable transaction involves two or more tax rates or levies, the applicable tax rate or levy rate should be applied based on the principal business of the taxable transaction. The principal business refers to the main business that reflects the substance and purpose of the transaction.

Implications in the Application of the VAT Law

Several key provisions in the VAT Law could have significant implications for businesses and taxpayers.

1. Mixed sales vs. composite sales

Sales involving both goods and VAT-taxable services constitute mixed sales, whereas composite sales occur if taxpayers engage in multiple taxable transactions subject to different rates. If a taxpayer's taxable transaction involves two or more tax rates or levies, and there is a clear primary and secondary relation between the various transactions, the applicable tax rate or levy rate shall be applied based on the principal business of the taxable transaction. The principal business is the primary business, reflecting the substance and purpose of the transaction, while the secondary business is a necessary supplement to the principal business and is predicated on the occurrence of the principal business.

Distinguishing between mixed sales and composite sales is crucial for determining VAT. The new VAT Law provides clear definitions for these situations, especially when dealing with mixed sales involving different tax rates.

2. Deemed taxable transactions

The VAT Law simplifies the rules around deemed taxable transactions, limiting them to three basic scenarios: goods used for collective welfare or personal consumption, transfers of goods by taxpayers without consideration (i.e., gifts), and transfers of intangible assets, real estate or financial products by taxpayers without consideration. Consignment sales, transfers between branches in different provinces and cities, in-kind capital contributions, distributions to shareholders, and provision of services without consideration were previously deemed taxable transactions, but they are excluded in the VAT Law. However, it is important to note that even though taxpayers providing free services will no longer be required to treat the services as taxable transactions, if the free services involve provision of goods, the goods are subject to VAT based on the deemed sale requirements.

According to the VAT Law, the transfer of goods across counties/cities is not considered deemed taxable transaction. This means that in the future, VAT invoices may no longer be required for the transfer of goods between different organizations within the same company, thus simplifying the relevant tax processing procedures. However, this may also lead to situations where the party transferring the goods has a large amount of input VAT but no output VAT, while the party receiving the goods has output VAT but no input VAT.

3. Tax credit refund

The provision allowing taxpayers to choose to either carry forward the tax credit to the next period or apply for a refund (if the current input tax in the current period is higher than the output tax in the current period) elevates tax refunds from policy level to legal level. Taxpayers will have more certainty in claiming tax refunds, enabling them to allocate funds more rationally, effectively improving their cash flow. In addition, the financial pressure caused by capital tied up due to having input tax credit will be alleviated.

4. Sale adjustment mechanism

The VAT Law grants tax authorities the right to verify sales revenue when it is significantly high or low without justifiable reasons. Current regulations only apply to cases where sales are obviously low. This adjustment provides tax authorities a more comprehensive legal basis when facing

unreasonable practices such as reporting overinflated sales revenue. It helps regulate corporate tax behavior and prevents companies from manipulating sales through improper means, thus maintaining tax fairness and order.

5. **Tax rate simplification**
The VAT Law stipulates that the applicable VAT rate is 3 percent when using the simplified tax calculation method, but it does not mention the 5 percent rate currently applied to labor dispatch services, human resource outsourcing, real estate sale, real estate leasing and other services. This may mean that the VAT burden on these services may be reduced in the future.
6. **Non-taxable transactions**
The VAT Law clearly defines the composition of non-taxable transactions, further clarifying the tax obligations of businesses. The VAT Law stipulates four categories of tax-exempt income: wages or salaries earned by employees for services provided to their employers, administrative fees and government funds, taxes or expropriation compensation collected according to law, and interest income from deposits.
7. **Loan service deduction provisions**
Taxpayers cannot deduct their input tax on loan services, as well as on investment and financing advisory fees, handling fees, consulting fees, and other expenses directly related to the loans, from their output tax.
8. **Annual settlement of non-deductible input tax for mixed-use products**
When a taxpayer purchases taxable goods or services subject to the simplified tax calculation method or goods exempt from VAT, but cannot allocate non-deductible input tax, the taxpayer needs to calculate the non-deductible input tax for the current period using a predetermined formula. Adjustments should be made based on the annual summary data from the tax filing period in January of the following year.

Pitfalls in VAT Application

It is not uncommon for companies to make mistakes in VAT declarations. The following are some scenarios where errors are often committed.

1. **Deemed sales without VAT reporting**
If a company provides services, or donates or transfers assets without compensation, the services and goods should be considered having been sold and the company should pay VAT accordingly. The following are some real-world cases.
 - a. A car company gave gifts to its car buyers without compensation but did not consider them sales. But Tax authorities considered those gifts purchased goods. As a result, the company had to pay back tax based on the market value of the gifts, plus late-payment penalties.
 - b. Company A, a sportswear distributor, sponsored Company B's sporting events and donated sportswear to Company B without compensation for the purpose of enhancing brand awareness. Since Company A used the donated goods for sponsorship purposes, tax authorities considered the donation deemed sales. Therefore, Company A was ordered to declare VAT based on the market value of the donated goods and pay corporate income tax.
 - c. A company transferred some of its self-produced products to an individual without compensation as employee benefits. However, tax authorities considered the transfer as deemed sale. The company was required to account for those products at cost and pay back taxes and penalties.
 - d. A retail chain failed to declare inter-organizational transfer of goods across provinces. Since inter-organizational transfers of goods (unless within the same county or city) are considered deemed sales, the retail chain was ordered to pay back taxes.

- e. Rent and other expenses paid by headquarters for independent taxable stores through centralized contracts are considered deemed sales. A listed company's headquarters paid rent for an independent tax-paying store without treating it as deemed sale. It was required to pay back taxes and sales expenses totaling over RMB 50 million. (See more on this case in the next section.)
2. Failure to declare VAT on government subsidies
Taxpayers who receive government subsidies directly linked to income or sales volume of goods, labor, services, intangible assets, or real estate sold should calculate and pay VAT in accordance with relevant regulations. Enterprises should use government subsidy data sources to verify subsidy requirements and determine whether they have failed to pay VAT that should have been paid.
 3. Obtaining VAT invoices unrelated to substantial business and claiming input tax credits
This risk stems from taxpayers paying certain costs and expenses through third-party platforms and then claiming input tax credits for VAT invoices that are inconsistent with the actual business transactions. For example, a taxpayer paid employee performance-based salaries to a third-party payment platform, which then transferred the salaries to the employees' bank accounts. However, the taxpayer also claimed rebates paid to clients. It signed a promotional cooperation agreement with the third-party payment platform and obtained a special VAT invoice under the tax category "Modern Services - Service Fees." It then claimed input tax credits. Since the third-party payment platform did not actually provide any promotional services to the taxpayer, the related costs and expenses did not reflect the actual business transaction. Tax authorities determined that the special VAT invoices for these service fees were not consistent with the actual business transactions, and therefore, the taxpayer was not entitled to claim input tax credits.
 4. Failure to declare VAT on interest income from wealth management products
Taxpayers need to declare VAT on interest income from bank wealth management products. A taxpayer used idle funds to purchase a bank-guaranteed wealth management product with an annualized yield of 3.15% but failed to pay VAT and surcharges on the income from this product. According to the VAT Law, wealth management products should be included in the taxable scope of other financial products. Interest income (including guaranteed returns, remuneration, capital utilization fees, compensation, etc.) earned during the holding period of financial products is subject to VAT as loan services.
 5. Non-deductible input VAT items
Enterprises often mistakenly deduct non-deductible items. Purchased goods, processing and repair services, services, intangible assets, real estate, VAT-exempt items, goods used for collective welfare or personal consumption cannot be deducted. A taxpayer's social and entertainment expenses are considered personal consumption. Purchased loan services, catering services, daily household services, and entertainment services are not deductible either.

Deemed-Sale Case

In China, the VAT system taxes the sale of taxable goods or services by general taxpayers. Beyond standard sales, Chinese tax authorities may apply VAT when a company "provides" goods or services internally under the deemed-sales rule. That means if a company centrally pays for something that is then allocated to its subsidiaries, branches, or stores, tax authorities may treat that allocation as a VAT-taxable sale.

Yixintang was found violating this VAT deemed-sales rule and was ordered to pay back taxes and sales expenses totaling over RMB 50 million. Yixintang operated via many store-level subsidiaries that are independent taxpayer stores. The leases for those stores were signed by the corporate headquarters.

Rent was then allocated/charged to store-level subsidiaries. Chinese tax authorities viewed the rent allocation as a transfer or sale from the headquarters to the stores. Under VAT law, that allocation qualified as a deemed sale. The core compliance issue was that the company's rental expense model (centralized lease contracts at headquarters for many store-level subsidiaries) clashed with VAT rules around intra-group expense allocation. Tax authorities interpreted the aggregate rent allocation as a supply of services/goods subject to VAT (i.e. a sale), not as an internal cost-sharing. This kind of "headquarter-contract + allocate to stores" structure is common among chains with many stores. But under Chinese VAT regulation, doing so without proper VAT invoicing and declaration can trigger deemed-sale VAT liability. Once the tax authority raised this issue, Yixintang was required to re-assess retroactively, declare VAT for those internal rent allocations, pay VAT, surcharges, and late-payment penalties totaling RMB50,489,527.

Tax authorities applied the Deemed-Sale rule in this case because Yixintang headquarters was the legal tenant of the stores, but subsidiaries used the premises for income-generating business. In addition, the allocation of rent was not strictly internal because each subsidiary was a separate taxpayer. Under VAT law, the rent allocation matched the definition of a taxable service.

This case shows that centralized lease contracting is risky if subsidiaries are separate VAT taxpayers. For other multi-store companies in China, it is imperative that expense allocations be accompanied by proper VAT invoices. Internal charging must follow service-provision, not cost-sharing rules; otherwise it can trigger unexpected VAT liabilities under deemed-sale treatment. Companies managing rentals, internal charges or inter-company services need to carefully assess their VAT risk.

Conclusion

The enactment of the VAT Law marks a significant step forward in China's tax legislation process. The VAT Law aims to retain the existing basic tax system framework without creating any additional tax burden on taxpayers. It improves the VAT system to enhance fairness, efficiency, transparency and compliance with VAT administration. By essentially retaining the existing VAT policies, the VAT Law achieves a delicate balance between maintaining continuity of the tax system and constructing a more comprehensive and robust tax framework.

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