

News Flash

China Tax and Business Advisory

November 2008 | Issue 13



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Our China Indirect Tax Team comprises a team of professionals with rich indirect tax experience and integrated knowledge, both internationally and domestically, stationed in our Beijing, Guangzhou and Shanghai offices. Apart from advising clients on Chinese indirect tax issues, we are also provoking thought-leadership to the Chinese authorities to make the Chinese indirect tax regime more taxpayers-friendly. Our Indirect Tax Team in China is part of PwC global indirect tax network of 1,800 experienced and specialized professionals.

VAT Reform in Time of Financial Crisis

The recent global financial crisis has brought unprecedentedly significant impact to the global economy. As a response to current instability and challenges lying ahead to the domestic economy, the Chinese State Council has proactively come up with and announced on 9 November 2008 ten fiscal measures, collectively earmarked as “Economy Stimulation Plan” to combat the adversity brought/ to be brought by the tumultuous international economic environment. As reported, the overall new investments under this “Economy Stimulation Plan” could amount to RMB 4 trillion (or US\$586 billion) to be input by 2010.

Value-Added Tax (VAT) reform appears as one of the ten fiscal measures announced by the State Council. The long-awaited and proposed transformation of the production-oriented VAT system to consumption-oriented VAT system (“Transformation”) is now confirmed and will play a vital role in the “Economy Stimulation Plan”. Surrounding the Transformation, there are also other components in this round of VAT reform.

On 11 November 2008, the Chinese Ministry of Finance (“MOF”) and State Administration of Taxation (“SAT”) organised a press conference, and revealed the details of the VAT reform. VAT reform is a part of the Turnover Tax reform. Subsequently on 14 November, the Xinhua News Agency released the amended Provisional Regulations on VAT, Business Tax and Consumption Tax approved by the State Council. In this Issue, we will discuss the new details in this round of VAT reform and in our next issue of News Flash, we will discuss the amendments to these regulations in details.

Detailed features of Transformation

Currently, the recovery of input VAT incurred on the purchased of fixed assets is disallowed. The input VAT would be capitalised as costs of fixed assets and this creates the problem of multiple taxation. The Transformation is not only aiming to reduce the tax burden on investing on equipment, but also achieving multiple objectives such as, encouraging domestic consumption, promoting advancement of technology, guiding structural developments and stimulate economic growth as a whole.

Besides, the Transformation will also help gear-up the VAT system for more substantial future changes, including the upgrading of the legal status of the current VAT rules to VAT Law.

In our China Tax and Business News Flash Issue 8 in September 2008, we discussed the possible major features of the Transformation, namely:

1. Nation-wide coverage
2. Applicable to virtually all industries; and
3. Full input VAT recovery

Please refer to the abovementioned Issue for more background information. These features have now been confirmed and the effective date of the Transformation is 1 January 2009. In addition, the following new features are worth-noting:

- Applicable on new purchase of “equipment”

The Transformation applies to “equipment” newly purchased on or after 1 January 2009. The scope of “equipment” covers machines, machinery and means of transportation and other equipment, tools and utensils related to production and operation. Immovable properties such as building and structure are not included in the scope. However, input VAT recovery is specifically disallowed for the purchase of small motor cars, motor cycles and yachts that are subject to Consumption Tax and could be used for private purposes.

- Carry-forward of excess input VAT

If the amount of input VAT recoverable is greater than the amount of output VAT charged on sales within a VAT reporting period, the excess input VAT may be used to offset future output VAT. No refund of excess input VAT shall be granted.

Other components in the VAT reform

In addition to the Transformation, other significant changes that are introduced to the current VAT system at this round are as follows:

- Cancellation of import VAT exemption treatment for imported equipment

There has been a preferential VAT treatment on importation of equipment from overseas by exempting the import VAT for equipment brought from overseas.

As reported in the MOF/SAT press conference, this preferential VAT treatment has brought problems, such as unfair tax burden between foreign investment enterprises and domestic enterprises.

- Cancellation of VAT refund treatment of “domestically-made” equipment purchased by foreign invested enterprises

This preferential VAT treatment will be cancelled as the input VAT incurred on the purchase of “domestically-made” equipment should be creditable under the forthcoming Transformation.

- Reduction of VAT collection rate for small-scale VAT taxpayer

The VAT collection rates for the small-scale commercial enterprises (4%) and manufacturing and other enterprises (6%) will be reduced to 3%. Since these enterprises will not be benefited from the Transformation which is only applicable to General-VAT taxpayers, such VAT collection rate reduction policy is introduced to alleviate their VAT burdens.

Also the MOF and SAT announced that the minimum-income thresholds for collection of VAT and Business Tax will be raised to help the development of small businesses.

- Resumption of VAT rate of mineral products to 17% (from 13%)

Mineral products have been subject to the reduced VAT rate of 13% with the aim to stimulate development of the mining industry.

As the Transformation will allow input VAT to be recovered on equipment to be purchased by mining businesses, the overall VAT burden could be lowered. This, together with the goals to promote resource conservation and environmental protection, the VAT rate of mineral products will be shifted back to the standard rate at 17%.

Amendments to Chinese Turnover Tax regulations

On 14 November, the Xinhua News Agency released the amended Provisional Regulations on VAT, Business Tax and Consumption Tax which have been approved by the State Council. These amendments are part of the Chinese Turnover Tax reform.

Although most of the amendments to the principles with regard to the Transformation and surrounding reform are mentioned in the amended Provisional Regulations on VAT, practical details are yet to be seen. We believe that the details are left to be addressed in the amended Implementation Rules to the VAT Provisional Regulations. These amended Implementation Rules are aimed to be released by the end of this year.

Apart from reflecting the above mentioned VAT reform measures, amendments have also been made to improve the assessing practice of the three sets of Provisional Turnover Tax regulations. The amendments to these regulations will be discussed in details in our next issue of News Flash to be shortly.

PwC Observations

• Macro

- The Chinese government is determined to withstand the turbulence of the current global financial market while sustaining the economic growth. Changes to the VAT system (e.g., the recent rounds of increase in export VAT refund rates and the forthcoming Transformation) have been adopted as an integral part of its plan to meet the objectives.
- The forecast on the budgetary impact due to the Transformation would amount to RMB 120 billion. The magnitude of the changes is reported to be the most significant change on a single type of tax throughout the Chinese tax reform history so far.
- It is apparent that the Chinese government now uses VAT regime to play an increasingly important strategic role in the adjustment of the Chinese economy, rather than merely a tax raising tool.
- This upcoming VAT reform is just a first step and the amendments to the Turnover Tax regulations are the next. There should be more massive and critical adjustments to VAT, and the other two Turnover Tax systems in future.

• Micro

- It is obvious to see that the Transformation is the core of this round of VAT reform. It is seen as a welcoming move to alleviate the VAT burden for taxpayers in general, which is most needed in the time of the economic downturn.
- All the other components introduced in this reform are either elimination of the existing preferential treatments to avoid duplication (i.e. cancellation of import VAT exemption treatment for imported equipment; cancellation of the VAT refund treatment of “domestically-made” equipment purchased by foreign invested enterprises; and resumption of VAT rate of mineral products), or matching of the benefit (i.e. reduction of VAT collection rate for small-scale VAT taxpayer).
- With regard to the cancellation of import VAT exemption treatment for imported equipment, it may potentially hit the import costs for some businesses that are not registered as General-VAT taxpayers, because they would not be able to recover the import VAT to be paid upon equipment import into China. It is also unclear whether the customs duty exemption applicable for importation of equipment used to be granted together with import VAT exemption would be affected.
- The cancellation of the VAT refund treatment of “domestically-made” equipment purchased by FIEs may potentially jet up the cost for some businesses. For instance, as the input VAT incurred on the purchase of “domestically-made” equipment would no longer be refundable but only creditable, it may take a long time for export orientated manufacturing FIEs with small domestic sales to offset the excess input VAT. This may create cashflow pressure to these businesses.

As we mentioned above, the amended Provisional Regulations on VAT has been released, and further details on the implementation of the Transformation and the surrounding reform measure should be promulgated shortly to catch up with the relatively short time-frame before the Transformation comes into effect on 1 January 2009.

Businesses should stay tune for the details while reevaluating their operations to ensure they would continue to be effective under the waves of changes. Resources should also be invested to develop strategic plans aiming to explore the direction of future tax and business regulatory policy changes in light of the current economic climate.

In the context of this News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

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