



## China Indirect Tax Alert - Potential Expansion of the Scope of VAT Recovery

### Potential VAT reform

The current VAT system generally disallows the recovery of input VAT incurred on the purchases of fixed assets and requires it to be capitalized as costs of fixed assets. This is called "production-based" system. Since 2004, VAT reform programs have been launched to enable deduction of input VAT incurred on fixed asset purchases. This is called "consumption-based" system. Recently, it has come to our attention that a plan regarding further VAT reform has been formulated and submitted to the State Council for discussions. This Alert is aimed to share the information available up to now.

### Brief history of VAT reform programs

As mentioned above, VAT reform programs have been introduced since 2004 to specific areas to enable certain taxpayers to deduct input VAT incurred on the purchases of VAT-able fixed assets such as machinery and equipment. These VAT reform programs have been developed with different features in the following three aspects:

- **Geographic limitation**

Geographically, the first VAT reform program covered the North-eastern Region. In the subsequent programs, the coverage has been expanded to include Central Region, Eastern Inner Mongolia and certain areas affected by the Wenchuan Earthquake.

- **Industry limitation**

Only qualifying industries could enjoy the input VAT credit under the North-eastern Region, Central Region and Eastern Inner Mongolia VAT reform programs. Please note that the qualifying industries are different under the above three regions. The industry limitation has not been mentioned in the VAT reform program for the areas affected by the Wenchuan Earthquake.

- **Limitation on the amount of input VAT creditable**

The amount of VAT credit for the North-eastern Region, Central Region and Eastern Inner Mongolia VAT reform programs is limited to the year-on-year increase in VAT payable during the same period. The said limitation has not been mentioned in the VAT reform program for the areas affected by the Wenchuan Earthquake.

Although there are variations between different VAT reform programs, these programs were introduced with one common theme – to stimulate investment in selected areas and/ or industries needing a capital investment boost. In addition, these programs also served the purposes of testing the potential impact that could be caused by the expansion on the scope of VAT credit.

### Potential expansion of scope of VAT recovery

It has been a plan that after the trial-run of the previous programs for those selected industries in specified regions and at the appropriate stage, the scope of VAT recovery would be expanded potentially with the following features:

- **Nation-wide coverage**

The potential expansion may not only cover specific geographic areas. Instead, the recovery of input VAT should apply on a nation-wide basis.

- **Industry-wide applications**

Other than certain restricted industries, the potential expansion may be applicable to general VAT taxpayers in all industries.

- **Full input VAT recovery**

The input VAT incurred on the purchases of VAT-able fixed assets such as machinery and equipment may be fully creditable. The restrictions on input VAT recovery that are applicable to North-eastern Region, Central Region and Eastern Inner Mongolia may not apply.

It is noted that the potential VAT reform has been proposed to and would be discussed by the State Council. Subject to the outcome of the discussions and further actions, the potential expansion may come into force in early 2009.

## **PwC Observation**

The potential expansion is perceived to be one of the measures to stimulate investment activities as slower-than expected economic growth is predicted for the coming years.

The potential VAT reform may provide a more generous scope of input VAT recovery. It would certainly be good news to businesses planning to make further investments on machinery and equipment. On the other hand, there could be significant impact on the country's VAT revenue.

The potential expansion of scope of VAT recovery would help lower the cost of investment with respect to expenditures on the purchase of machinery and equipment. The currently non-creditable input VAT that should be added to the cost of purchases would be eliminated by the potential expansion if full input VAT recovery would be allowed. This would also, to a certain extent, reduce the cost of manufactured goods (as the VAT on equipment purchases would no longer have to be absorbed by the buyer and capitalized in the cost of equipment which would eventually be incorporated into the cost of manufactured goods via depreciation) and possibly the selling price of these manufactured goods.

From the VAT cost and cashflow perspectives, the potential expansion would be advantageous to those enterprises which plan to upgrade their machinery and equipment.

As the scope and the timing of the potential VAT reform would be studied and examined by the relevant government departments, it is uncertain whether the potential VAT reform would incorporate all the abovementioned features.

However, businesses wishing to make further investments on their machinery and equipment may consider the timing of such purchases if it would be commercially viable. Businesses should also ensure that they keep up to date with any further development on the potential VAT reform.

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