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Reforming China's VAT

Input value added tax recovery may be expanded nationwide, write *Alan Wu* and *Kenneth Leung*

A proposal to expand the scope of the input value added tax recovery partly to stimulate investments in China has been submitted recently to the State Council for review and approval.

The current production-based VAT system in China generally disallows the recovery of input VAT incurred on the purchase of fixed assets and requires it to be capitalized as costs of

fixed assets. But reforms introduced in 2004 granted deduction of input VAT on such purchases for specific qualified industries in certain provinces.

The reforms enabled certain taxpayers to recover input VAT they paid when buying "VAT-able" fixed assets such as machinery and equipment. Details of the reforms vary, depending on:

- Geographic limitation – the VAT

reforms initially covered northeastern China and were subsequently expanded to central China, eastern Inner Mongolia and some areas affected by the Wenchuan earthquake.

- Industry limitation – only qualifying industries in the above regions could enjoy the input VAT credit.
- Limitation on the amount of input VAT credit – the credit for



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northeastern and central China and eastern Inner Mongolia is limited to the year-on-year increase in VAT payable during the same period. The VAT reform did not mention industry or credit limits for areas affected by the earthquake.

Although VAT reforms vary, these programmes were introduced to stimulate investment in selected areas or industries. They also serve as a test-run for expanding the scope of VAT credit to the rest of the country and across all industries if the trials prove successful.

Under the proposal, the input VAT on the purchase of certain “VAT-able” fixed assets may be fully recovered, which, if approved, may side step restrictions on input VAT recovery in northeastern and central China and eastern Inner Mongolia.

The State Council has yet to discuss the proposed plan to further reform VAT. There are suggestions, however, to set the implementation early next year.

The proposal would certainly be good news to businesses planning to make further investment in machinery and equipment since the recovery of input VAT will lower the cost of investment. Nevertheless, China’s VAT revenue as a whole is expected to drop.

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lower the cost of manufactured goods as the buyer no longer needs to absorb the VAT on equipment purchases, which is eventually incorporated into the cost of manufactured goods via depreciation. As a result, selling prices may come down.

As the relevant Chinese government departments still have to study the scope and timing of the potential VAT reform, it is uncertain whether all proposed features would be included.

Businesses wishing to make further investments on their machinery and equipment should consider if the timing of such purchases are commercially viable.

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