

## Tax Developments in China

On November 10, 2008, the PRC State Council promulgated the amended Provisional Regulations on Value-Added Tax (the "VAT Regulations"), the amended Provisional Regulations on Business Tax (the "Business Tax Regulations") and the amended Provisional Regulations on Consumption Tax (the "Consumption Tax Regulations"). The Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT") subsequently provided the official interpretations of these regulations during a joint press conference. All these regulations will take effect on January 1, 2009. According to MOF and SAT, the regulations are intended to reform the value-added tax ("VAT") system, and to further regulate the turnover tax system in China, which consists primarily of VAT, business tax and consumption tax.

The VAT Regulations introduce significant changes to the current VAT system in China. First, beginning on January 1, 2009, the input VAT on fixed assets (including equipment and machinery, and other instruments and appliances related to manufacturing and operation) will now become deductible against the output VAT. At the same time, certain previously available VAT preferential treatments (such as the VAT exemption or refund applicable to equipment imported or purchased locally by foreign-invested enterprises ("FIE") with "encouraged" foreign investment project status) have been terminated. Second, the VAT rate applicable to most smaller enterprises will decrease from the current rate of 4% or 6% to 3%. Third, the VAT rate for mineral products will be increased to 17% from the current rate of 13%. In addition, among other procedural changes, the VAT Regulations adjust the venue for VAT payment and extend the VAT declaration deadline from 10 days to 15 days.

The Business Tax Regulations and the Consumption Tax Regulations contain mostly procedural revisions with respect to the collection of business taxes and consumption taxes, such as adjustment to the tax payment venues and extension of the tax declaration deadlines.

Of the regulations discussed above, only the VAT Regulations provide for substantive changes to the existing laws, although all these regulations have been simultaneously amended in order to streamline and simplify the rules applicable to the three major types of turnover taxes in terms of certain procedural matters, including but not limited to tax declaration deadlines.

Based on these recently-issued regulations, it appears that China's tax reform efforts are increasingly focusing on VAT reform, aiming at a transition from the existing production-based VAT system to a consumption-based one, which would enable Chinese enterprises to effect VAT deductions on "fixed-assets" spending. The removal of VAT benefits, previously extended to FIEs, further levels the playing field for domestic entities. These fundamental transitions may have substantial effects on tax planning and the related structuring of Chinese enterprises.

Despite the elimination of certain previous VAT exemptions and benefits, the VAT Regulations will generally not create an extra tax burden on affected enterprises (exceptions to this might include certain mineral producers), though FIEs that previously qualified for VAT exemption would lose the efficiency of exemption at the point of import. The input VAT on fixed assets will become deductible against output VAT,

regardless of whether such fixed assets are imported from abroad, or domestically produced and procured. Therefore, taxpaying enterprises may obtain VAT tax recovery on all fixed assets as a result of such new deduction. Furthermore, the deduction of input VAT on fixed assets will reduce the VAT burden on enterprises that were previously not entitled to any VAT deduction, exemption or refund, and thereby may encourage technical upgrading in equipment and machinery in these enterprises. However, the “fixed assets” for which the input VAT may be deducted under the VAT Regulations have only been described in very general terms as “machinery, equipment, transportation vehicles, and other equipment, instruments and appliances related to manufacturing and operation.” It appears that the specific scope of “fixed assets” will need to be further defined by the Chinese tax authorities so that taxpayers can effectively take applicable deductions.

---

**Chicago Office**

+1.312.583.2300

**Frankfurt Office**

+49.69.25494.0

**London Office**

+44.20.7105.0500

**Los Angeles Office**

+1.310.788.1000

**New York Office**

+1.212.836.8000

**Shanghai Office**

+86.21.2208.3600

**Washington, DC Office**

+1.202.682.3500

**West Palm Beach Office**+1.561.802.3230

---