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57% Discount for Purchasing Equipment Made-in-China, Have You Captured It All?

As early as in 1999, the Chinese government issued two separate rules to encourage the purchase of equipment made domestically. First of all, a Foreign Investment Company (FIE) within the qualified (encouraged) industries can obtain a refund of 17% VAT for qualified domestic equipment purchased. Secondly, 40% of the equipment value can be used to offset the incremental Enterprise Income Tax (EIT) liability in the current year, upon meeting the same industry and equipment tests. This means that with proper planning, a FIE can obtain a total of 57% discount in its fixed assets purchasing.

IT SOUNDS GENEROUS WHILE THERE ARE MANY IMPLEMENTATION UNCERTAINTIES

Although the above rule seems very straight forward, in practice there are several implementation difficulties:

- Stringent Documentation Requirement

  It is required under the rules that the applicant should fulfill a set of documents from different authorities at different stages of the equipment purchases. Even if the transaction in substance can qualify for the incentive, missing any documents or untimely obtaining any of the documents above would jeopardize the incentive.

- Multiple Tax Bureaus to Deal With

  The taxpayer normally needs to struggle with 3 different tax authorities for a flavor of the incentive. It's own in-charge tax bureau, the vendor's tax bureau and the VAT refund authority.

- Multiple Interpretation by Different Authorities

  To make the matter worse, the above authorities usually have different interpretations towards the rules. The state tax bureau obviously noticed this, too. There are around 20 subsequent notices while those still cannot fully solve the problem.

- Difficult to Qualify for the Equipment Test

  Unlike imported equipment, turn-key projects are not very often used for domestic equipments. To purchase the equipment in "trivial manys" from hundreds of suppliers often will result in a waste of the incentive opportunity. (As the rules provides, generally only equipments under tariff heading 84 - 90 can be eligible for the equipment test. The "trivial manys" normally will go to sections before 84.)

In addition, one of the documents required can only be obtained from the manufacturer only. This makes it almost impossible to do some planning through a trading company doing some systems integration work to qualify for the equipment test.

Recent Change May Provide Huge Planning Opportunity

A recent Circular in June 2004 clarified the following critical points:

- ❑ The original requirement to obtain a "VAT Special Payment Certificate" from the vendor is cancelled.
- ❑ The seller need not necessary to be a manufacturing company.

The impact of the above changes could be profound – it would relieve the need to deal with the vendor's tax authority, which is usually the most difficult one from a controllership point of view. In addition, to use a centralized supplier to bundle certain parts to qualify for the equipment test would become possible. Of course, the planning will incur some additional operation costs, but the benefits, 57% huge discount, would certainly out-weigh the costs.

Planning Techniques

Obviously, it is a very good timing to revisit this rule. Below are some planning techniques you may find useful.

- ❑ Let tax experts involved at the very beginning in developing your equipment purchase plan at the budgeting stage. If the purchase contracts are already signed, there is no way back to do some tax planning.
- ❑ Think of using a centralized supplier of domestic equipment. This can some times help to maximize the components that can qualify the equipment test. - There are many cases that several components are unqualified for the equipment test, but together they can be treated as a set thus meeting the requirement. In this regard, to have a customs expert help on this will be a huge plus.
- ❑ Develop a comprehensive tracking list/control list to track the documentation which are obtained at each stages of the equipment sourcing process. Keep in mind that missing one document would turn the gorgeous planning into vain.
- ❑ Lastly, keep an eye on your yearly EIT liabilities. 40% of the discount comes from that, at the pre-requisite that you should have enough **incremental** EIT in the current year. It certainly doesn't mean that you should "maneuver" your profits and income tax. However, in many cases, it should be flexible to accommodate your asset purchase plan to the availability of the incentive on a yearly basis.

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If you have any questions on the above, please contact Dennis Xu, our Tax Partner, at 8621 6335 3630. Or send us an email at the address below. We will be glad to help.

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