

# China alert

## Tax and regulatory developments

TAX

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### Update on the VAT refund policy for purchase of domestically manufactured equipment

#### In brief

- The VAT refund policy for purchases of domestically manufactured equipment has been significantly revised
- The range of enterprises or entities that qualify for such VAT refunds has been significantly reduced, while the range of eligible equipment has been increased
- This issue of China alert presents the key changes associated with the new regulations

#### Relevant regulation discussed in this issue:

*Notice Concerning Adjusting Scope of Tax Refund Policy for Purchase of Domestically Manufactured Equipment by Foreign Investment Project*, Caishui [2006] No. 61, issued on 10 May 2006 jointly by the Ministry of Finance and the State Administration of Tax (Circular 61)

#### Background

The VAT refund policy for the purchase of domestically manufactured equipment was first introduced by the State Administration of Tax (SAT) in September 1999. A qualified foreign-invested enterprise (FIE) can be entitled to a refund of input tax on procurement of domestically manufactured equipment. In the seven years since issuing the policies, the SAT has also promulgated other rules and regulations to clarify various issues that emerged during the implementation of the VAT refund policy.

As the economy has developed, however, the China government has fine-tuned its foreign investment policies to reflect changing realities. While before almost all foreign investment was embraced, China now has a much more selective approach, and is adjusting various incentives originally designed to attract foreign investment.

To this end, the SAT issued Circular 61 in May 2006 to adjust the scope of the VAT refund policy for domestically manufactured equipment. The adjustments narrow the range of entities that qualify for a refund, while broadening the range of equipment that qualifies for refunds. The regulations also stipulate that the VAT refund policy also applies to equipment purchased by operating branches of FIEs, and equipment purchased by FIEs for engineering projects that are outsourced to subcontractors.

### Range of FIEs eligible for refunds narrowed

From 10 May 2006 onwards, small-scale taxpayers and non VAT payers, such as FIEs engaged in logistics, education, and other services, will cease to be eligible for VAT refunds.

The range of qualified FIEs has been narrowed so that only the following types of FIEs will qualify for VAT refunds:

- General VAT taxpayers with “officially encouraged” project types<sup>1</sup>
- FIEs engaged in transportation and development of ordinary residential real estate properties
- Contractors under production sharing contracts for offshore oil exploration.

Operating branches of the above FIEs may also receive VAT refunds on domestically manufactured equipment that is purchased by the branches themselves.

FIEs eligible for input tax credit on fixed asset procurement as part of a new pilot program in the North-eastern region of China also cease to qualify for such VAT refunds.

### Range of qualified equipment broadened

Circular 61 has considerably broadened the range of qualified equipment. Previously, only some large-scale items of equipment and machinery were eligible for VAT refunds. However, changes as a result of Circular 61 mean that FIEs can now receive VAT refunds for small and medium-scale items of equipment and machinery, such as those used for power generation, oil exploration, engineering and manufacturing. Home appliances, office equipment and motor vehicles continue to fail to qualify for VAT refunds.

Accessories and spare parts purchased together with qualified equipment as part of the purchase contract are deemed to be part of the qualified equipment for VAT refund purposes. Previously, such accessories were confined to plastic parts, rubber parts, ceramic parts and pipelines for petrochemicals projects only.

Circular 61 redefines domestically manufactured equipment and for the first time includes the equipment manufactured under processing arrangements.

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<sup>1</sup> “Officially encouraged” project types are listed as “encouraged” in *Foreign Investment Industrial Guide Catalogue* and *Catalogue of Priority Industries for Foreign Investment in the Central and Western Regions*.

## Contact us

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## Equipment purchased for engineering projects

According to Circular 61, FIEs can also apply for VAT refunds for qualified equipment purchased by its sub-contractor for engineering projects, provided that:

- The subcontractor provides both construction services and required materials; and
- The subcontractor purchases the qualified equipment on behalf of the FIE according to their contract, and relevant VAT invoice is addressed to the FIE directly.

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