Tax, Infrastructure and Finance

Client Alert

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10 November 2008

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China Announces a Massive US$586 billion Stimulus Package

Over the past three months, China has taken a series of steps to bolster its weakening economic growth. China has fought the effects of the global slowdown with interest rate cuts, lower bank reserve requirement ratios, higher credit quotas, injections of central government funds and increased focus on infrastructure construction. However, none of these steps have been on the scale of the steps taken by China over this past weekend.

On Sunday, 10 November 2008, China announced that the State Council adopted a massive stimulus package that will include approximately RMB 4 trillion (approximately US$586 billion) of spending over the next two years to finance programs in 10 major areas, including low-income housing, rural infrastructure, water, electricity, transportation, the environment, technological innovation and rebuilding from several disasters, most notably the May 12 earthquake (the "**November Stimulus Plan**").

PRC media reported that this amount equals to at least one third of China's fixed asset investment for 2007 and should result in China's economic growth remaining above 8.5% for this year. For the remainder of 2008, the central government will invest RMB 100 billion with an additional RMB 20 billion already earmarked for earthquake relief to be released in 2009. This investment should stimulate additional funding by local governments and the private sector, so that total spending in 2008 should reach RMB 400 billion. Further details on spending for 2009 and 2010 have not yet been released. In addition, the National Development and Reform Commission will expedite related approvals and relax applicable requirements to ensure the success of the November Stimulus Plan.

In addition to investing substantial funds in infrastructure to boost the domestic economy, the State Council also announced that along with the November Stimulus Plan, it will be adopting "active" fiscal and "moderately active" monetary policies. This is important as this is the first time in history China has indicated a policy shift towards "moderately active" currency policies. The Chinese government had already given some indications of a new attitude in the arena of monetary policy, as evidenced by the recent deposit reserve ratio reductions and interest rate adjustments by the People's Bank of China. Even during the 1997 Asian financial crises, China only adopted what was referred to as "moderate and *stable*" currency policies. This terminology may indicate the Chinese government is changing the nature of its monetary policies, and that the resulting more relaxed monetary policies will potentially further encourage foreign investments in China.

The November Stimulus Plan also includes a comprehensive reform in value-added tax ("**VAT**"), which could potentially cut industry costs by 120 billion RMB (the "**VAT Reform**"). The State Council has indicated that the focus of the November Stimulus Plan is to boost China's domestic demand. The relief in the VAT area and the increased spending in a number of areas that should result in additional opportunities for both Chinese and foreign contractors, and could provide for a welcome sign of relief amidst a very challenging time globally.

The focus of this alert is to briefly explain the current VAT system and outline what we know of the VAT Reform announced over the weekend with the November Stimulus Plan, as well as describe steps companies may consider in light of this change. Lastly, this alert will briefly discuss the ten areas of focus for the November Stimulus Plan.

1. VAT Reform

1.1 China Current VAT System

VAT applies to any person or unit engaged in the selling or importation of goods in the PRC, as well as to the provision of processing, repair and replacement services in the PRC. China adopts a production-based VAT system. Generally, VAT is paid by a party when it purchases goods (**input VAT**) from other companies, and such inputs may be offset against VAT collected when such party sells its products (**output VAT**). However, under the current VAT laws and regulations, input VAT on purchases of fixed assets is not creditable against output VAT when the products produced from that machinery are sold, resulting in a significant cost associated with investments in capital equipment by effectively trapping the VAT cost on that equipment.

Additionally, under the current VAT system, Customs Duty ("**CD**") and import VAT are levied on goods imported into China. The CD rates vary depending on the type of goods imported, while the import VAT rate is generally 17%. Effective from 1 January 1998, foreign-invested enterprises ("**FIEs**"), which fall within the Encouraged Category under the *Catalogue of Foreign Investment Industrial Guidelines*, were exempted from CD and imported VAT on imported equipment for its own use and within the total investment of the FIEs. If equipment is purchased domestically, FIEs can generally obtain a refund of the VAT paid. While many FIEs have benefited from this policy, many companies have seen the current system as a substantial cost because either the equipment is purchased domestically without a similar exemption of VAT refund, the FIE is not "encouraged", or the quota permitted has been exceeded.

1.2 VAT Reforms to Date

The VAT Reform is aimed at shifting from a production-based VAT regime to a consumption-based system, which is practiced in most countries. Over the years, China has implemented a gradual reform to allow input VAT credit for the purchase of qualified fixed assets, and the scope of input VAT credit for fixed assets has gradually been extended to certain industries in different regions of China. In July 2004, input VAT credit was allowed for purchases of qualified fixed assets for certain areas in the Northeast region in order to encourage new capital investments and revitalize the economy in that older industrial base. In July 2007, a similar policy was extended to certain specific areas in the Central region. In 2008, this policy further expanded the input VAT credit for fixed assets to certain areas in Eastern Inner Mongolia and to the earthquake hit areas in the vicinity of Sichuan province.

1.3 The November Stimulus Plan

Over this past weekend, the State Council announced that under the November Stimulus Plan, this move to a consumption based VAT system will be applied to all industries nationwide. No formal notices or regulations have been released by the Chinese Finance Ministry, but it is understood that this nationwide VAT Reform could be introduced as of January 1, 2009.

As mentioned above, in the announcement of the November Stimulus Plan, it was estimated that the change to a consumption-based system could result in savings of RMB120 billion (approximately US$17.8 billion) to investors.

1.4 Tax Planning Strategies

Since a nationwide VAT Reform is forthcoming, companies intending to make capital investments in the near future may want to time the investment transactions in order to take advantage of these input VAT credits. Here are some points to consider:

- If your company is currently considering making capital investments; if possible, delay the official purchase two months until after January 1, 2009.
- If your company cannot delay the purchase, we suggest you structure the purchase on an installment-basis or negotiate with the seller to delay issuing the invoice. The time at which VAT liability arises upon the sales of goods in an installment sale is generally on the date payment is receivable as agreed upon in the sales contract. Therefore, if the purchase can be arranged such that some of the payments are made after January 1, 2009, then the input VAT paid may be creditable against future sales.
- For those FIEs that are still eligible for CD/VAT exemption/refund policy, the VAT Reform initiative may not be as attractive. The CD/VAT exemption/refund policy permits a waiver or a refund of the CD and import VAT upfront, while presumably the current reform initiative will require VAT taxpayers to pay input / import VAT first and then credit this against output VAT later. For instance, we understand it is possible that the two incentives currently available for qualified FIEs mentioned in section 1.1 (VAT exemption on certain imported equipments and VAT refund on purchase of domestically produced equipments) will both be repealed under the VAT Reform. In times of economic strain, output VAT may not cumulate as quickly. For these FIEs, now is a time to be vigilant and monitor any potential substitution of the CD/VAT exemption/refund policy with the VAT Reforms discussed above.

2. Ten Areas Of Focus

According to the State Council, focus on the following 10 areas is expected to have a positive impact on the economy, with specific effects on cement, iron and steel producers, as well as other industries focused on infrastructure investment. Commercial lenders are also expected to benefit as loan ceilings are abolished, while medium- to small-sized companies are likely to benefit from preferential policies.

The 10 major areas of focus in the November Stimulus Plan are:

- **Finance:** removing lending quota control on commercial banks; increasing the lending scale; increasing credit support to priority projects, rural areas, medium- and small-sized companies, technical innovation and industrial rationalization through mergers and acquisitions; as well as ensuring improved access to a stabilized consumer credit market;

- **Housing:** building more affordable and low-rent housing, as well as expanding the pilot program to rebuild rural housing;
- **Rural infrastructure:** improving countryside roads and power grids, as well as spreading the use of methane to replace the use of coal and wood and to ensure drinking water safety; expediting the North-South water diversion project and improvements on identified at risk reservoirs;
- **Transportation:** building more airports in the western areas, as well as building more dedicated passenger rail links and coal routes;
- **Health and education:** improving health and medical system in rural areas; focusing on the development of the cultural and education sectors and junior high school construction in rural western and central areas;
- **Environment:** increasing support for energy conservation and pollution-control projects; improving environmental protection by enhancing the construction of sewage and rubbish treatment facilities and preventing water pollution in key areas;
- **Industry:** enhancing innovation and industrial restructuring and supporting the development of the high-tech and service industries;
- **Disaster rebuilding:** focusing on reconstruction in the areas hit by the May 12 earthquake;
- **Incomes:** raising average incomes in rural and urban areas and next year's minimum grain purchase and farm subsidies; increasing subsidies for low-income urban residents and pension funds for enterprise employees and allowances for those receiving special services; and
- **Taxes:** Extending production-based VAT reforms to all industries nationally.

With the exception of the VAT Reform, concrete details and specific measures of the November Stimulus Plan have not yet been released. Although reports in the PRC media indicate that most of these measures will consist of expediting existing plans and programs, it is expected that more details will be forthcoming in the near future.

Our Baker & McKenzie lawyers in Greater China are ready to help you assess how the November Stimulus Plan might affect your China operations. For further information, please contact any of our partners with their areas of speciality listed in this alert.