

Pitfalls, considerations and the latest regulations for Processing Trade in China

[27 February, 2009 Issues 4]

China's processing trade has gone through many development stages during its 30 year history, and it continues to play a vital role in China's economy. Offering comparatively low land, labour and production costs, many foreign investors carry out processing trade in the Pearl River Delta, and indeed, over the last thirty years, this region has frequently been referred to as the 'Factory of the World'. Although processing trade has brought in billions of dollars of revenue, its presence also leads to environmental pollution and the use of the discouraged low technologies. It is worth noting that the Chinese authorities have been strengthening their administration of processing trade by promulgating a number of tax, customs, foreign exchange and business regulations. Keeping track of regulations and any ensuing business implications can pose a challenge for foreign investors.

Enterprises carrying out processing trade should pay attention to avoid potential pitfalls. In practice, the local authorities' administration of processing trade may vary from area to area. Many practical considerations may arise during the operations of processing trade, which include:

- The correct methods for the disposal of defective goods and scraps.
- Assessing the level of unit consumption rate and wastage rate.
- Correct factory transfer arrangement.
- Discrepancies between the quantities of physical inventory, inventory records in customs handbook and accounting ledgers.
- Verification and cancellation of customs handbook.

In addition, foreign investors need to evaluate which processing trade arrangement is the most suitable for their business needs - contract processing arrangement or import processing arrangement.

Before making a final decision, foreign investors may consider certain key factors, such as the importation of bonded equipment, the percentage of domestic sales over total sales, any export VAT refund rates, selecting the right locality from amongst various bonded zones (e.g. export processing zones, free trade zones, bonded logistic zones) as well as the overall tax burden.

This article serves to discuss the common pitfalls and relevant considerations when carrying out processing trade in China. In addition, we highlight the latest regulation and their impacts for processing trade operators.

Prior to our discussion on potential pitfalls, the common features of contract processing arrangements compared with import processing arrangements are highlighted below.

Contract Processing Arrangement

Under a contract processing arrangement, a foreign consignor will engage a domestic company or a foreign invested enterprise (FIE) to act as the processor. The foreign

consignor supplies raw materials free of charge to the processor. The processor will process the raw materials and then return the finished goods to the foreign consignor. The processor will charge a processing fee to the consignor. Under this arrangement, the foreign consignor has the ownership of the raw materials and finished goods throughout the whole processing process.

Before entering into a contract processing arrangement, the processor should register a production contract with the local Ministry of Commerce (MOFCOM) to obtain approval for the importation of bonded raw materials, i.e. free of custom duty and import VAT. The production contract should state the list of raw materials and finished goods and their estimated quantities, specifications and amount. The valid period of a production contract is normally six months.

Under a contract processing arrangement, domestic sales of the finished products are not permitted under Chinese law.

Import Processing Arrangement

Under an import processing arrangement, the FIE purchases the raw materials from overseas or from domestic suppliers, and the legal titles of the raw materials are held by the FIE throughout the processing process. After processing the raw materials into finished goods, the FIE will then sell the finished goods to its customers.

An FIE can import bonded raw materials free of custom duty and import VAT for further processing into finished goods and then export the finished goods to overseas customers. Similar to the contract processing arrangement, the FIE should register its production contract under import processing arrangement to the local MOFCOM.

Under an import processing arrangement the FIE is permitted to conduct domestic sales.

Common pitfalls when carrying out Processing Trade

1. Evaluation of locality and type of Processing Trade

The local practice, requirements and preferential treatments for carrying out processing trade may be different from one area to another area. The regulations and treatments for contract processing arrangements are also different from those for import processing arrangements from customs, foreign exchange, taxation and business perspectives. In view of this, it is highly recommended that foreign investors evaluate these factors and make a comparison between contract processing and import processing arrangements before making a final decision.

2. Estimation of Unit Consumption Rate and Wastage Rate

To estimate accurate unit consumption rate and wastage rate of bonded raw materials is not easy. In practice, the unit consumption rate and wastage rate declared by the enterprises are likely to be different from those average unit consumption rate and wastage rate adopted and announced by the customs authority. The discrepancy may cause problems when the enterprise performs a verification and cancellation of its production contract.

Customs authorities are vested in greater power to attest the authenticity and accuracy of unit consumption rates. They can establish upper and lower unit consumption rates.

All of the above poses difficulties for processing trade operators. Furthermore, under certain circumstances, the enterprise might be subject to penalties by the customs in-charge. Negotiation with the customs authorities should be arranged where appropriate.

3. Disposal of Scraps

According to the prevailing regulations, if the scraps arising from processing trade are sold domestically without obtaining any prior approval from the competent authorities, the enterprises may be penalized with back payment of import duties. Enterprises should be aware that the dutiable value of scraps can vary in different zones such as Export Processing Zones and Free Trade Zones. Enterprises should pay attention to the proper compliance and consequences for disposal of scraps.

4. The discrepancy of inventory quantities amongst records

The possible discrepancy amongst the quantities of physical inventory in the warehouses, the inventory records stated in customs handbooks and the accounting ledgers is often a headache to processing trade operators. If an enterprise fails to explain the reasons for the discrepancy, and in cases where the customs in-charge deems the missing bonded inventory as having been sold by the enterprise to domestic customers instead of exports, it may encounter barriers in performing verification and cancellation of the production contracts and be required to pay for the imported custom duty and VAT for the missing bonded inventory.

The latest amendments to Processing Trade regulations

In order to cope with the stern situation of import and export trade caused by the global financial crisis, the Chinese government has adopted a series of measures to maintain the growth of import and export trade. At the same time, Chinese Customs also adopted different measures to enforce the administration on processing trade and the collection of customs duty and import VAT.

1. Frequent Update of Export VAT Refund Rates

The Chinese government increased the export refund rates for the fourth time in 2008.

According to Caishui [2008] No.144, the fourth round of increases focuses on certain high value-added products, labour intensive products and high-tech products such as plastic, forestry, mould and glass products, sea food or river food, bags, shoes, hats, umbrellas, furniture, bedding products, lights, watches and bells, certain chemical products, stone products, non-ferrous metal products and certain electrical machinery. The updated tax refund rates for these products now range from 9% to 14%. For details, please refer to Caishui [2008] No.144.

With constantly changing export VAT refund rates, it can be a challenge for processing trade operators to comply with the latest regulations.

2. New Tariff Scheme

In order to promote the steady increase and structural optimization of imports and exports, China has announced its new tariff scheme, which became effective from 1 January 2009. The Customs Tariff Commission promulgated Shuiwaihui [2008] No.40, which defines the new customs tariff implementation scheme.

Under Circular 40, the Chinese government has adjusted its tariff scheme, including changes to the: • Most Favored Nation rate • Interim duty rate • Preferential tariff rate • Special preferential tariff rate • Other tariff items It is recommended that enterprises review the tariff codes of their raw materials and finished goods so as to ensure compliance with the latest development.

3. New Administration for Country of Origin

The PRC General Administration of Customs (GAC) issued Customs Order No.181 on 8 January 2009. This sets out the administrative measures and operational guidelines for country of origin (COO). Order No. 181 will become effective from 1 March 2009. Enterprises should be aware of the new requirements for COO certificates and COO declarations. Requisite documents should be submitted to the customs authorities. Any inconsistency between documents or missing documents may be regarded as an inaccurate declaration and may result in penalties.

4. Customs Deposits

In 2007, MOFCOM and the GAC jointly issued Circular GAC [2007] No.44, which officially took effect from 23 August 2007. According to Circular No. 44, all Categories A and B processing trade enterprises in Eastern China will have to pay deposits equal to 50% of customs duties and import VAT when they either import or export commodities which fall into the restricted category under processing trade. Categories C processing trade enterprises will have to pay deposits equal to 100%. In effect, this measure forces the majority of processing trade enterprises to pay some form of deposit, and which in turn can place a heavy strain on an enterprise's cash flow.

In this context, Eastern China includes Beijing, Tianjin, Shanghai, Liaoning, Hebei,

Shandong, Jiangsu, Zhejiang, Fujian and Guangdong.

In order to alleviate the financial difficulties faced by enterprises under the current economic crisis, MOFCOM and the GAC jointly issued Order No.97 [2008] (Order 97), which became effective from 1 December 2008. Under Order 97, the customs authorities temporarily suspended the 'actual payment' of custom deposits for 1,853 tariff items under the restricted exports category and 272 tariff items under the restricted import category for textile products for Categories A and B processing trade enterprises. Keeping track of the frequent changes in the classification of restricted and prohibited categories under processing trade is challenging for operators and non-compliance may result in penalties.

5. VAT Reform

Effective from 1 January 2009, China implemented a VAT reform.

Prior to the VAT reform, enterprises are not allowed to claim the creditable input VAT for purchasing machinery and equipments. FIEs which fall within the 'Encouraged Category' can import machinery and equipments free of custom duty and import VAT whilst processors under contract processing arrangement can import machinery and equipments free of custom duty and import VAT.

However, under this VAT reform, enterprises are allowed to claim the creditable input VAT for purchasing machinery and equipments. Enterprises cannot however enjoy the VAT exemption for the importation of machinery and equipments and cannot enjoy the VAT refund for the purchase of domestically manufactured machinery and equipments from 1 January 2009 (or from 1 July 2009 if certain conditions can be fulfilled).

Processors under contract processing arrangement are also required to pay import duties for the importation of equipment.

VAT reforms will have an impact on most processing trade operators. Enterprises should evaluate the potential impacts on their business model, tax burden and cash flow.

Conclusion

It is envisaged that in the near future, the Chinese authorities will further strengthen the administration of the processing trade and will expect processing trade enterprises to improve their compliance status. As the Chinese government is determined to tackle environment problems arising from manufacturing activities, measures to eliminate high polluting industries or products are to be expected.

Enterprises must consider upgrading their production process and equipment in order to reduce pollution, whilst considering the use of more environmentally-friendly materials during manufacturing.

In order to improve compliance with processing trade regulations and to ensure good preparation for potential inspection by the customs authorities, it is recommended that

processing trade enterprises engage professionals and conduct a health check on their processing trade operations. A thorough and comprehensive customs and VAT health check is helpful in identifying an enterprise's existing non-compliance issues, to quantify the potential non-compliance exposures and to devise possible solutions where appropriate.