Issue 156 • July 2015

CHINA BRIEFING

From Dezan Shira & Associates

Importing and Exporting in China: A Guide for Foreign Trading Companies

www.china-briefing.com

Introduction

Over the past few decades, China has developed into a manufacturing and trading powerhouse. Now known as the Factory of the World, China's economic model has been built on producing often low-end goods and exporting them in mass volume across the world. This model was pushed with strong government support across the board. Many tax, zoning and administrative policies still reflect this focus, such as the Processing Trade Relief, a program that waives duties and taxes for companies in China that manufacture solely for export.

However, the nature of China's economy is changing. The country is moving towards a more consumption-driven economy, which drastically alters the type of products that are now being imported. Luxury goods, foreign foods and art are replacing electrical components and raw materials for textiles. As demand continues to be weak in major export markets such as the U.S., Western Europe and Japan, Made in China is finding new customers across emerging markets. With the technological capabilities of Chinese companies reaching new levels of sophistication, Western producers of aircraft components, medical devices or telecom equipment suddenly find themselves competing with Chinese players for global market share.

Alberto Vettoretti
Managing Partner
Dezan Shira & Associates

In this issue of China Briefing, we discuss the latest import and export trends in China, and analyze the ways in which a foreign company in China can properly prepare for the import/export process. With import taxes and duties adding a significant cost burden, we explain how this system works in China, and highlight some of the tax incentives that the Chinese government has put in place to help stimulate trade.

With kind regards,

Alberto Vettoretti

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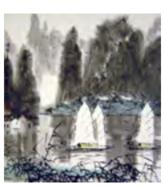

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Credits
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Senior Editor / Samuel Wrest
Editors / Steven Elsinga & Qian Zhou
Editorial Assistant / Kimberly Wright
Design / Jessica Huang & Estela Mi

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Unit 1618, 16/F., Miramar Tower
132 Nathan Road, Tsim Sha Tsui
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A Period of Change: Current Import and Export Trends in China

By Dezan Shira & Associates
Editor: Kimberly Wright

China is in a period of economic transition. As global demand has cooled for Chinese exports, the country has struggled to transition from an export-based economy to one driven by domestic consumption. In order to achieve a targeted 6 percent growth in trade for this year, the government has taken steps to increase domestic consumption and the inflow of imports. This can be seen through various government initiatives, such as the lowering of duties on certain consumer goods, the opening of new Free Trade Zones in Guangzhou, Fujian and Tianjin with simplified customs procedures, and the nationwide abolishment of restrictions for foreign companies to engage in e-commerce.

Major import and export statistics

Total import-export volume

In 2014, the total value of exports and imports of goods was US$4.3 trillion – an increase of 2.3 percent from 2013. Exports were valued at US$2.34 trillion, an increase of 4.9 percent from the previous year, and imports were worth US$1.96 trillion, down 0.6 percent from 2013. In comparison, the United States imported US$2.41 trillion and exported US$ 2.35 trillion in 2014, while Japan's imports reached US$813 billion and exports US$691 billion.

While total trade in China rose 3.4 percent in 2014, this number was significantly below the government's projection of 7.5 percent. Much of this can be explained by the global economic slowdown, as in the United States imports and exports only rose by 3.3 percent and 2.9 percent respectively, while Japan's imports and exports both fell by 1.3 percent and 4.4 percent.

As can be seen from the fastest-growing imports and exports, China is taking steps to transform its economy. While electronic parts and clothing still lead in terms of volume, with space- and aircraft as one of the fastest growing exports, we can see that China's economy is moving towards more high-value production. Much in the same way, foods and high-end consumer items such as art and precious stones signal the increasing role consumption is playing in the Chinese economy.

Import and export restrictions, prohibitions and quotas

Investors should note that certain products are prohibited or limited from import and export. A general outline is given on the next page. For certain goods, there is a quota on how many of these may be imported or exported.

Related Reading

*For information on **Chinese Taxes**, please see our publication on the subject.*

DOWNLOAD

2014
TRADING WITH CHINA
The good, the bad & the ugly

- Exports from China (orange)
- Imports into China (blue)

Top 5 FASTEST GROWING IMPORTS & EXPORTS

Exports from China	
+114%	Air- and spacecraft
+115%	Feathers, plastic flowers, hair
+124%	Cocoa
+320%	Art, antiques, collector items
+403%	Gems, precious stones, coins

Imports into China	
+2281%	Art, antiques, collector items
+311%	Cereals
+286%	Gems, precious stones, coins
+224%	Dairy, eggs, honey
+165%	Tobacco

Top 5 IMPORTS & EXPORTS BY VALUE

(US$ Billion)

Electronic equipment	571
Machines, engines and pumps	400
Furniture, lightning and signs	93
Clothing	92
Medical equipment	82
Electronic equipment	425
Oil	317
Machines, engines and pumps	180
Ores, slag and ash	136
Medical equipment	106

Top 5 DESTINATIONS OF CHINESE IMPORTS & EXPORTS

(US$ Billion)

United States	397.2
Japan	149.6
South Korea	100.4
Germany	72.7
The Netherlands	64.9
South Korea	190.3
Japan	163.1
United States	160.1
Taiwan	152.3
Germany	105

Restricted IMPORTS & EXPORTS

- Cultural relics
- Chemical compounds
- Lead and aluminum alloys
- Rare Earth Minerals and Compounds
- Products manufactured with citric acid
- Natural rubber
- Copper, zinc, lead, magnesium and other metal ores
- Raw materials for plastics
- Polyester
- Raw materials for chemical fibers
- Cotton, cotton yarn, cotton cloth
- Certain steel products

Prohibited IMPORTS & EXPORTS

- Charcoal
- Copper and copper alloys, silver and silver alloys, nickel
- Peat and forest biomass products
- Pesticides
- Rare or endangered animals and animal products, such as ivory
- Natural sand
- Silicon and quartz
- Chemical Compounds
- Substances with chlorofluorocarbon (CFC)
- Arms, ammunition and explosives
- Lethal poisons and illicit drugs
- Radioactive, medical, sewage, industrial and other waste
- Seeds, seedlings and fertilizers
- Rare or endangered animals and animal products, such as ivory
- Blue asbestos
- Animal and food products from areas with epidemics
- Used medical devices, household

Understanding Business Models When Trading with China

By Dezan Shira & Associates
Editor: Steven Elsinga and Qian Zhou

There are several different approaches that foreign companies can take when importing from or exporting to China. Not all of these require the foreign investor to set up an entity in China. Depending on one's situation, certain approaches work better than others. In our 2013 magazine **Sourcing from China**, we discuss the different models available when importing from China . This section will discuss some of the options a company that exports products to China might want to use.

Agents and distributors

Small to medium-sized companies often rely on either agents or distributors when selling their products in China. While in both cases, the foreign company itself does not need to have a presence in China, there are differences between the two approaches.

An agent typically finds customers in China for the foreign company in return for a commission on sales. It does not own the goods. A distributor, however, purchases the goods from the foreign supplier and sells them in China on its own account. Having a distributor means that the foreign company can be less involved in the process and bear less risk, but at the same time, it has to shed some control as well, such as in the marketing, branding and pricing of the products.

Setting up a company in China

There are various reasons why a foreign company will want to set up a subsidiary in China when exporting its goods to the country. Without having an entity in China, the foreign company will be unable to hire staff. It will also be unable to issue VAT invoices to Chinese customers, or directly take payment in and convert RMB. With the entity selling the products under its own name, it can set the price itself. If the foreign company has personnel on the ground in China, it can establish firmer control over matters such as intellectual property protection, communication between customers and the foreign headquarters, logistics and quality control.

This would, however, require a far larger upfront investment, and would be more costly and time-consuming than going through an agent or distributor. Setting up a company in China takes several months and results in a higher tax burden. Foreign firms additionally need to consider how to repatriate profit and stay in compliance with China's laws and regulations.

Licenses required for import and export

A number of licenses are required when setting up a company for import and export. Some of these need to be applied for during the incorporation process. The trading of certain goods requires a license, such as food, drugs or medical devices. When this type of business is included in the company's business scope and business license, the investor will often need to get the product specific license first, before being granted the business license.

After the company is set up, it needs to apply for an import/export license. The procedure is as follows:

- Apply for Foreign Trade Operator Filing with the local branch of the Ministry of Commerce;
- Register with customs;
- Registration and record-filing with the China Inspection and Quarantine Bureau;
- Register with e-port;
- Foreign currency exchange registration with the local branch of the State Administration of Foreign Exchange.

If the company is trading goods that are subject to a quota – as mentioned in the first article – it will need to apply for a separate license for each individual batch of goods as well.

Tax considerations of importing and exporting

When importing goods into China, companies face three types of taxes. These are value-added tax (VAT), consumption tax and customs duties.

Consumption tax is imposed on companies that manufacture, import, sell or process under consignment the following goods:

- Products whose overconsumption is harmful to health, social order and the environment, e.g. tobacco, alcohol, firecrackers and fireworks;
- Luxury goods and non-necessities, such as jewelry and cosmetics;
- High-energy consumption products, such as cars and motorcycles;
- Non-renewable and non-replaceable petroleum products, such as gasoline and diesel oil; and
- Motor vehicle tires.

Import duties are levied on the price the importer paid for the goods, including insurance and transport. The tariff rate for the goods differs per product, based on the product's HS code. The HS code can be looked up online, and roughly corresponds to the ones used in the US and Europe. Export duties are calculated the same way, but are only levied on a small number of raw materials and semi-manufactured goods.

Import VAT is calculated over the price of the imported goods, including customs duties and (if applicable) consumption tax. The rate is usually 17 percent. A small selection of goods is subject to a lower rate of 13 percent, including water, gas, edible oils, agricultural products, feed and fertilizers.

Import VAT = (price of goods + customs duty + consumption tax) x 17% (or 13%)

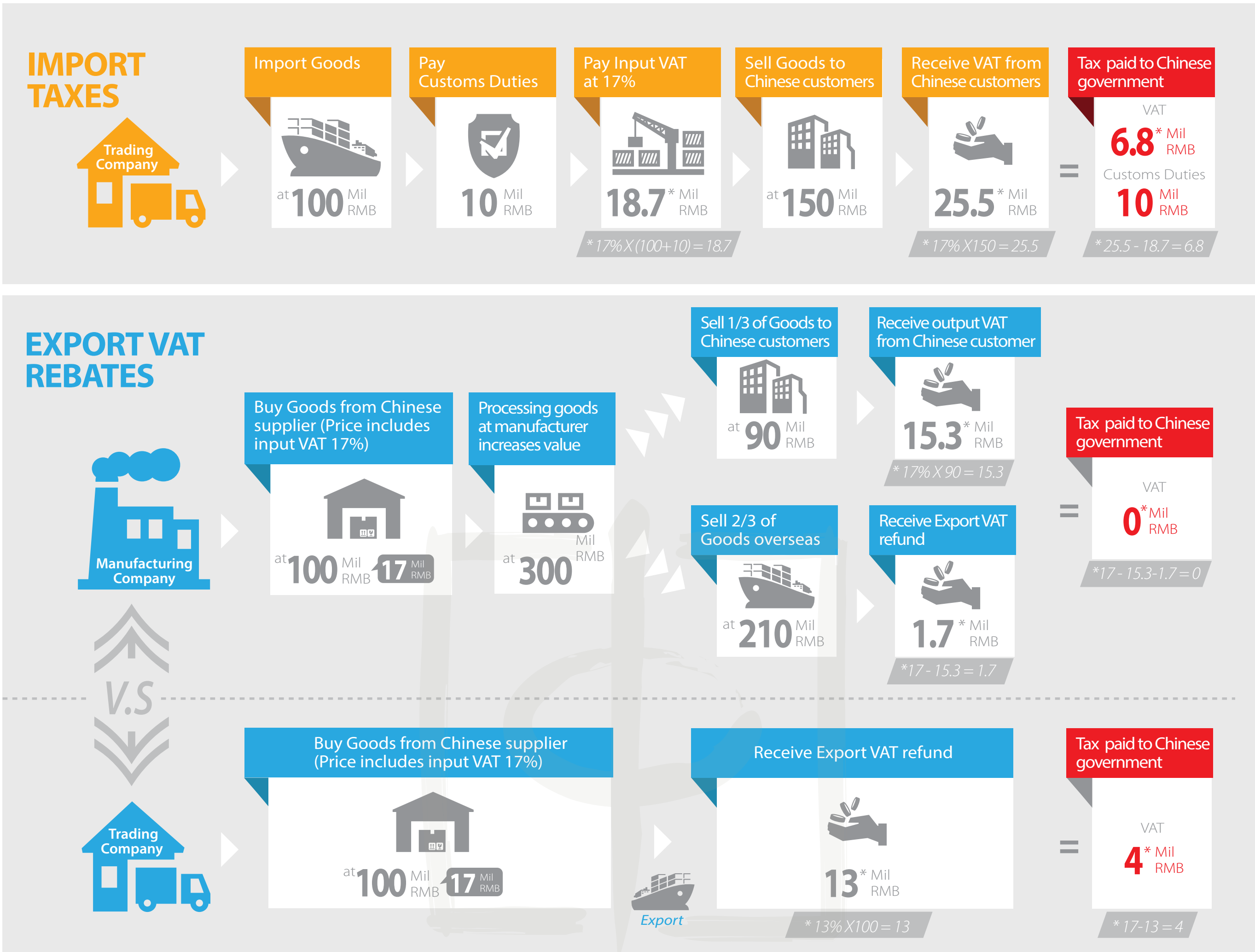
Upon export, the company receives a VAT rebate for the goods exported. There are two types of Export VAT rebates, one for manufacturing companies and one for companies that do not engage in manufacturing (i.e. companies that do not have manufacturing in their business license).

Trading companies and other non-manufacturing enterprises follow the Exemption – Refund (ER) system. Exemption stands for the fact that no VAT is withheld by the trading company when selling goods to an overseas party. The exporter is therefore unable to offset its input VAT on its purchases with output VAT on its overseas sales. Instead, the Chinese government refunds some of the VAT the company would normally have been able to collect – the Refund part of the system.

The trading company however would not always get a full refund. Instead, the Chinese government gives a refund at a percentage of the goods. If this percentage is less than the percentage of input VAT paid (as mentioned, usually 17%) the company ends up with an added tax burden.

The refund rate depends on the type of good being exported, i.e. its HS code. There are six different export VAT refund rates: 5%, 9%, 11%, 13%, 16% and 17%. Especially goods that the central government wants to discourage companies from producing are given lower rebate rates. These include industries that deplete natural resources or pollute the environment.

IMPORT & EXPORT TAXES IN CHINA



Therefore, selling goods overseas often means a company gets less of its VAT refunded than it would if the goods were sold in China.

Manufacturing enterprises follow the Exemption – Credit – Refund (ECR) system. As with the ER system for trading companies, when a manufacturing company exports goods, it cannot withhold output VAT from its overseas customers (Exemption). The manufacturing company may then use the output VAT it received from domestic customers to offset its input VAT. This is what the Credit part of the system refers to. If any input VAT remains (as is the case in our example in the infographic above), the government will refund that remaining VAT. This tends to occur when the value of exports is high relative to domestic sales.

However, it is also possible that the output VAT on domestic sales exceeds the input VAT. In that case, the manufacturing company is left with excess output VAT it received from domestic customers.

The manufacturing company will then have to pay the excess output to the government. This may happen when the manufacturing company sells a large amount of its goods in China, with a high added value relative to the price of the raw materials it purchased. In that case the input VAT it paid would be very low, but the output VAT it received from customers would be very high.

Therefore, foreign investors are well advised to carefully plan their VAT exposure. For this reason, many foreign companies have decided to set up in special customs zones, as discussed in the next article.

Beneficial Tax Schemes: Processing Trade Relief, Bonded Zones and EPZs

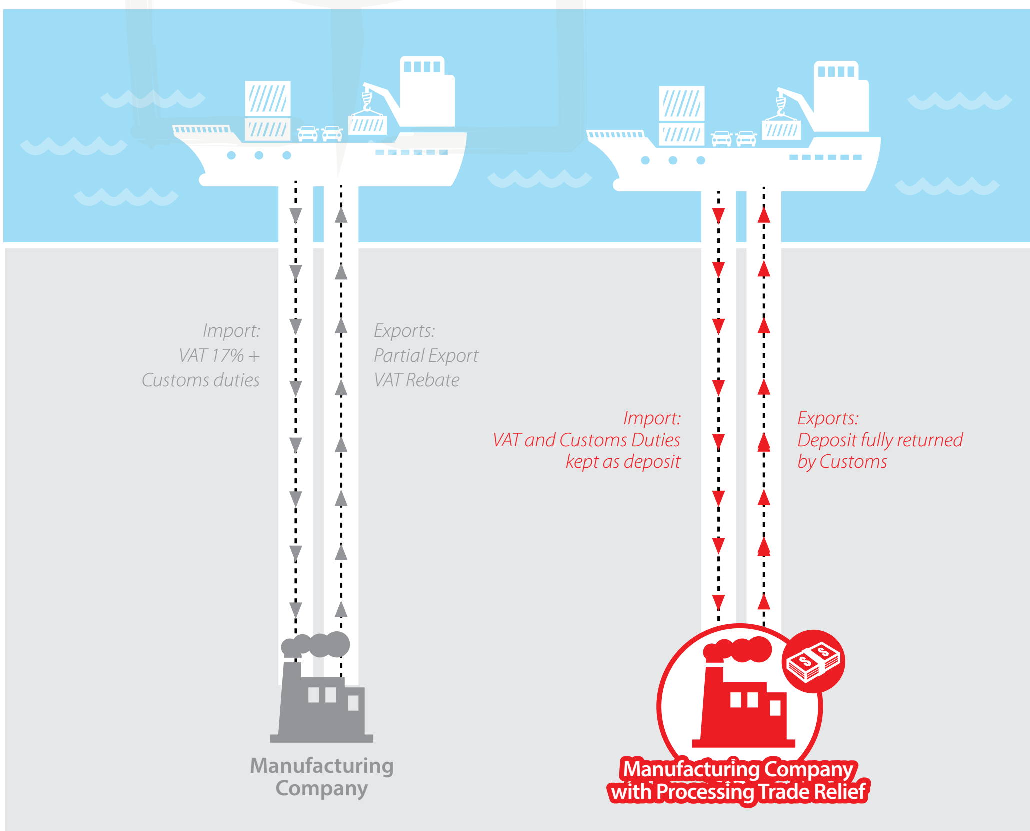
By Dezan Shira & Associates
Editor: Steven Elsinga

Processing Trade Relief

Chinese customs law makes a special allowance for companies that import all their raw materials from abroad and subsequently sell all finished goods overseas. Known as processing-on-order, VAT and customs duties are fully waived for these activities, unless the imported raw materials or exported finished goods are on the ***Catalogue of Prohibited Goods for PTR***.

Two models are eligible:

- Processing of Consigned Imported Material: an overseas company provides raw materials it owns to the Chinese entity. The Chinese entity manufactures these into finished goods for a fee, and sends them back to the overseas company.
- Processing of Purchased Imported Materials: the Chinese entity purchases all of its raw materials abroad, manufactures these into finished goods and sells them for a profit to overseas companies.



Companies that participate in this scheme are under strict supervision of Chinese Customs. They need to track the receipt of materials, storage, use and ultimate export of products manufactured from these imported materials in a Customs Handbook. When a company applies with Chinese Customs to engage in this scheme, it will receive such a Handbook, known informally as the Yellow Book. Note that during the manufacturing process, Chinese Customs will require the company to leave a deposit for the VAT and customs duties owed, which will be returned when the goods are exported.

Zones

Since opening up to foreign investment, China has set up a host of special bonded zones around the country to attract foreign investors. These zones are treated as being outside of the Chinese customs area, so that transactions between companies inside and outside the zone are treated as import-export. Chinese companies buying from the zone are seen to be importing, and need to pay import duties and VAT. Chinese enterprises selling to the zone are exporting, and receive an export VAT rebate.

The several dozen zones spread around the country come in many forms, each with minor differences. Many have added requirements for the type of business that can be set up in a zone. Here we compare two.

Bonded Zone

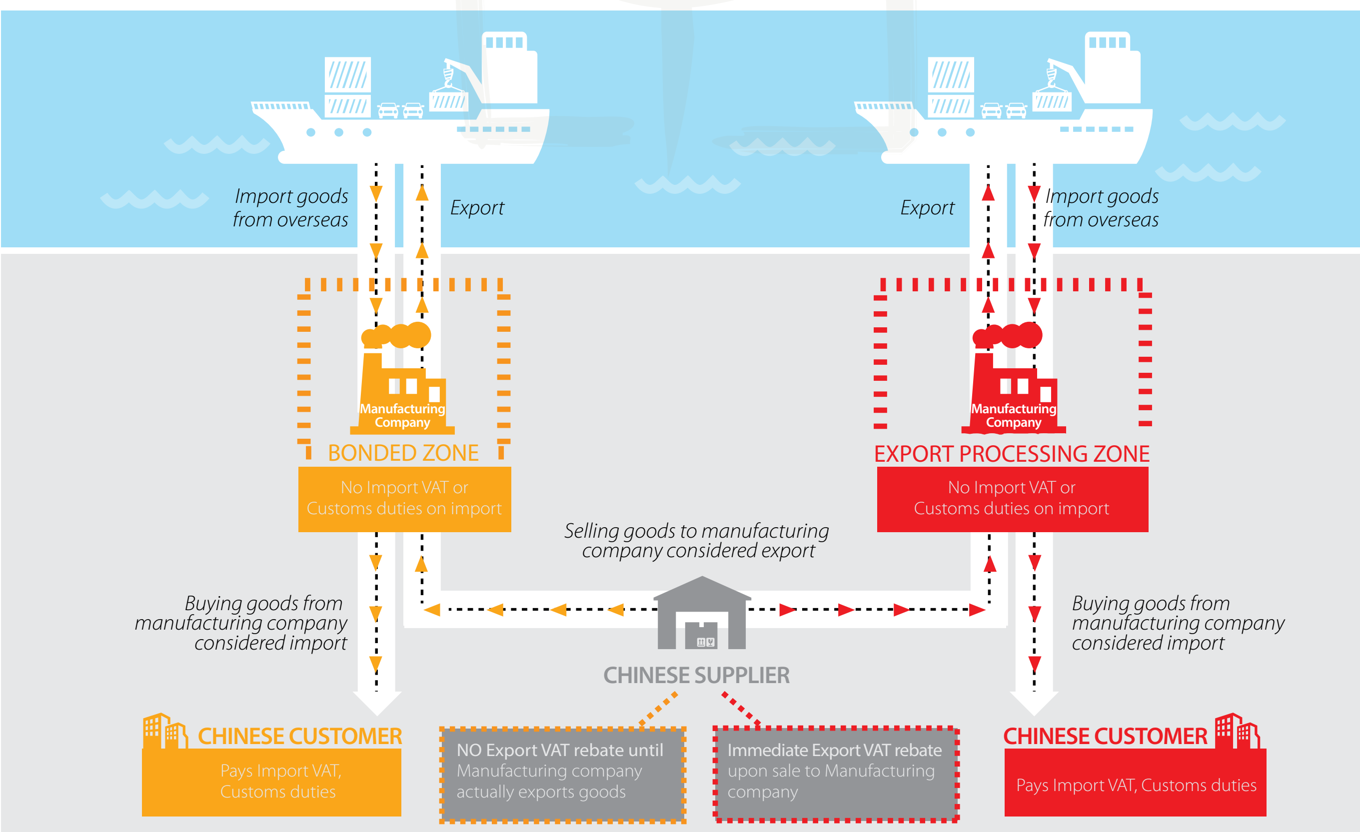
Bonded zones usually permit both manufacturing and trading companies, and are often used for warehousing, trading, export processing and product display.

A downside to the bonded zone is that Chinese suppliers that sell (i.e. 'export') goods to enterprises in the zone can only get their export VAT rebate once the goods have actually left the country. This means the Chinese supplier will have to wait for the company in the zone to ship the goods, before it gets the refund.

The way the customs value of goods are determined differs per type of zone. In many bonded zones, for goods sold from the zone that contain materials sourced both locally and abroad, the customs value is based on the price of the raw materials sourced overseas. This benefit however does not apply when goods are made with materials fully sourced overseas.

Export Processing Zone

Export Processing Zones function much like Bonded Zones. The crucial difference is that Chinese suppliers receive their export VAT rebate immediately upon selling goods to the company in the Export Processing Zone. The customs value of goods leaving the zone is the price of the finished goods.



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