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Legal and Tax Issues for Trading Operations in the PRC

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PRC trading rights

It consists of foreign trading right and domestic trading rights

PRC trading rights

Foreign trade rights:

- Import-export rights and Declaration rights

Domestic trading (distribution) rights

- commission agent, wholesale, retail, and franchise

Foreign trade rights

1. Relationship between I/E rights and declaration rights
2. Production type FIE
3. International courier / transportation company
4. Professional declaration agency

Registration as foreign trader

How does the FIE/FICE obtain the I/E right?

- By completing the registration procedure as foreign trader

Why register?

- Only foreign trader can apply for customs registration

Types of customs registration

FIE/FICE	By obtaining a customs registration	As consignor or consignee
International courier, and transportation company	By obtaining a customs registration	As agent
Professional declaration company	By obtaining a customs registration	As agent

What is consignor or consignee?

- Consignor/Consignee<=>Exporter/Importer
- Consignor/consignee is one who has completed the registration procedure as foreign trader

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Comparison between international courier/ transportation company with declaration agent

1. Both provide declaration services to the consignor/consignee
2. International courier/transportation co can only declare goods for the consignor or consignee under contract of carriage
3. Declaration agent can make customs declarations for anyone who have got the I/E rights

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Legal development

Liberalization of trading rights

in PRC

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Before China's WTO accession

Amendment in the PRC law for the FIE that removes following requirements for the FIE:

1. to balance its receipt and payment of foreign currency
2. to purchase from domestic market (local contents)
3. to achieve export performance; and
4. to recording file the production plan with the government department

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After China's WTO accession

	Administrative order by MOC	Details of the administrative order
1	Order No. 8 (2004) Effective on 2004.6.1	Chinese government fully opened up the distribution sectors to foreign investors
2	Order No. 9 (2005) Effective on 2005.4.2	Production type FIE can import, export and distribute third party goods by expanding scope of business
3	Order No. 76 (2005) Effective on 2005.7.13	FIE situated in FTZ and BLP is granted the distribution rights to do trading with companies situated outside FTZ/BLP
4	Order 94 (2005) Effective on 2006.3.1	MOC delegates its approval authority to provincial governments

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Limitation to scope of PRC trading rights

1. Foreign trade right
2. Declaration right
3. Distribution right
4. Scope of business

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Scope of business and foreign trade registration

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Scope of business

MOC Administrative Order No. 8 (2004): -

	Retail distribution	Wholesale distribution
1	Merchandise goods retailing;	Merchandise goods wholesaling
2	Imports of merchandise goods on the list of own trading items	Commission agent (except for auctioneering)
3	Sourcing domestic goods for export	Import and export of merchandise goods
4	Other related subordinated services	Other related subordinated services

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Scope of business activities (I)

	Production activities	Import/export trading activities	Domestic trading activities	Registration as foreign trader?
FIE	Yes	Yes (a)	No	Not required
FIE expanding business scope	Yes	No	Yes	Not required
FIE expanding business scope	Yes	Yes	No	Required

(a) FIE is granted limited I/E rights.

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Scope of business activities (II)

	Production activities	Import/export trading activities	Domestic trading activities	Registration as foreign trader?
FICE in SEA (i)	No	Yes	Yes	Required
FICE	No	Yes	Yes	Required
FICE	No	No	Yes	Not Required
FICE	No	Yes (ii)	No	Required

i. SEA includes free trade zone and bonded logistic parks.

ii. FICE only sources goods from Chinese market.

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PRC customs law and practices

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Classification of imported goods under PRC customs law

	Types of goods	Customs procedure
1	General goods	General
2	Bonded goods	Special
3	Tax-exempt goods	Special
4	Temporarily imported goods	Special

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Customs procedures

	General customs procedure	Special customs procedure
1	None	Pre-importation approval and record filing
2	Importation formality	Importation formality *
3	None	Post-importation Supervision

* Duty and VAT not collected

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Customs formality (General goods)

1. Import Declaration
2. Documents examination
3. On the spot physical inspection
4. Levy of import duty and VAT
5. Release

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Computation of import duty and VAT (general goods)

1. Import duty rate : the date the Chinese customs accept the declaration for the import goods
2. Date of exchange rate: the date for the applicable tariff rate
3. Exchange rate: the base rate the PBOC announces on the Wednesday in the third week of the preceding month

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Computation modes: -

1	CIF value x duty rate	Duty is levied by the value of import (ad valorem)
2	Import qty x rate per unit	Duty is levied by the quantity of import

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Example:

- The CIF value of a set of lipsticks (HS code 33041000) from Japan is US$100 (exchange rate 1:8)
- Importation of cosmetics is subject to VAT at 17%, and Consumption tax (CT) at 30%
- Customs duty, Import VAT and CT will be computed as follows: -

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Example: (continued)

1	Duty = CIF value x duty rate	(US$100 x 8) x 14.2% = RMB113.60	Preferential tariff rate is 14.2 %. (Note 1)
2	VAT = (CIF value + duty + CT) x VAT rate	(800 + 113.60 + 391.54) x 17% = RMB221.87	Computation of CT as per below (Note 2)
3	Total = Duty, VAT and CT	113.60 + 221.87 + 391.54 = RMB727.01	

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Example: (continued)

Note 1: Japan is one of the WTO member countries that are qualified for the preferential rate.
Note 2: Computation of consumption tax is as per following formula: -

>Composite dutiable value
= (CIF value + duty) / (1 – consumption tax rate)
= (800+113.60) / (1-30%) = 1,305.14

>Consumption tax
= composite dutiable value * consumption tax rate
= 1,305.14 X 30% = 391.54

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Computation of import duty and VAT

The import duty of goods subject to ad valorem tariff is affected by the following factors:

1. Applicable tariff schedule
2. Tariff code (classification)
3. Tariff rate
4. Exchange rate, and
5. Dutiable base

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Dutiable base (1A)

- Base is transaction price (the CIF price), subject to the adjustments including fees and charges borne by the buyer: -

1. Commission and brokerage
2. Cost of container to be the integrated part of the imported goods
3. Packaging charges

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Dutiable base (1B)

4. The value on the provision of materials, tooling, moulds, consumables and similar goods at no consideration or below costs; R & D expenses, design fee and related service charges
5. The royalty paid to the overseas seller for sale of imported goods in the PRC

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Dutiable base (2)

Subject to adjustments that exclude the following: -

1. The cost of installation, testing, maintenance and technical service fees for imported machinery and equipment
2. The inland freight charges and the insurance premium from port of import to final destination
3. Import duty, VAT and CT

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Non-arms length pricing (1)

Customs may use the following valuation for imported goods in the descending order: -

1. The transaction price of identical goods in the exporting country (or region)

2. The transaction price of similar goods in the exporting country (or region)

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Non-arms length pricing (2)

3. The cost of goods in country of export plus profit, transportation and insurance expenses
4. The sum of the following items: costs of materials, processing charges, the profit derived from the sale of same or similar goods in China, transport charges and insurances incurred before the arrival at the port of discharge in the PRC
5. Other reasonable valuations

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Different components between accounting cost and customs valuation

1. Customs valuation includes payment for use of intangible rights
2. Customs valuation excludes payment for import duty and VAT, and provision of services (installation and testing charges, etc)
3. Adopting different exchange rate

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Customs declaration and transfer pricing

- Tax mitigation vs. obligation to declare true and genuine information
- Impact of reduced export value

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Customs declaration and transfer pricing

- Impact of reduced export value:
  (I) Income tax reduced (comm enterprise)
  (GP = export sales – purchase)

(II) VAT refund increased and income tax reduced (production enterprise)

→VAT refund
= Output VAT – (Input VAT - disallowed credit)
→Disallowed credit
= (Export – import) x (standard rate – refund rate)

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VAT Export refunds

(general requirements)

VAT paid for the purchase of export goods can be refunded in whole or in part, if exporter can satisfy 4 specified requirements

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General requirements

1. The goods are subject to VAT, or CT
2. The export transaction must be treated as sales in the books of accounts (B/L or airway bills)
3. The goods must have physically left the country (except for shipment to EPZ)
4. The foreign exchange verification procedure on export collections has been completed

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Specific requirement for individual exporter

1. The goods it buys for purpose of export should not fall outside the scope of its business
2. The exporter should be a general taxpayer
3. The exporter needs to submit the application for export rebates within 90 days of the export declaration and produce prescribed documents to the tax bureau
4. If the exporter cannot do so before the 15th day of the following month, all the export sales are deemed to be local sales

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Documents for VAT export refund application:-

1. Special Invoice for export goods
2. Customs declaration for export goods
3. Foreign exchange verification notes for export collections
4. Proof of settlement of export collections;
5. VAT Special invoice for purchase of export goods
6. Paid VAT demand notice
7. Appointment letter of export agent (if applicable)

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VAT refund computation

	Production enterprise	Commercial enterprise
Computation base	FOB value for export	Input VAT paid
Method	Exempt-offset-refund	Pay-first-and-refund-later

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VAT refund computation (continued)

1	Refund rate = standard rate (17%)	VAT refundable amount = Amount of purchase x refund rate
2	Refund rate < std rate (17%)	VAT refundable amount = Input VAT paid on export – amount not refundable

Input VAT on export
= purchase amount x standard rate;
Amount not refundable
= purchase amount x (standard rate – refund rate)

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VAT liability

- Export sales = 2,000,000
- Local sales = 0
- Local purchase = 1,500,000 (Paid)

Computation (I)

- VAT payable

= 2 million x 0% - (1.5m x 17% - 1.5m x 4%)

- VAT payable

= 0 – 255,000+60,000= -195,000
Debit balance => VAT refund

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Computation (II)

VAT payable = Output VAT x 17%
VAT payable = 2 million x 17%
VAT payable = 340,000

Reason for above

- Taxpayer have not got recognized to be general VAT taxpayer, and
- Annual sales > 1.8 million (or 1 million)

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Entry modes

Five entry modes to set up trading operations under the current PRC legal framework

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What are they?

1. Production type FIE
2. Production type FIE expanding the business scope to trading
3. FICE set up in Special Economic Areas
4. FICE set up elsewhere in the PRC
5. Sales branch set up by an FIE/FICE

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Comparison: FIE/FICE set up in the SEA and elsewhere in the PRC

	Origination and destination	VAT, customs duty, import/export license, and foreign exchange administration
I	Goods shipped between SEA and destination in other countries (regions)	1. Import/export procedures applied 2. No duty imposed, No VAT export refunds (a) 3. No requirement for verification on import payment and export collections 4. Import / export license not required

(a) Exception: goods that physically leave the FTZ for destinations in other countries (regions) are eligible for VAT export refunds.

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Comparison: FIE/FICE set up in the SEA and elsewhere in the PRC

	Origination and destination	VAT, customs duty, import/export license, and foreign exchange administration
II	Goods delivered from SEA to enterprise situated elsewhere in the PRC	1. Import customs procedure applied 2. Import duty and VAT; (b) 3. Importer completes verification procedure for import payment 4. Import license required

(b) Depending whether finished goods are shipped from the FTZ or from the EPZ to enterprises situated elsewhere in the PRC, different tax rules shall be applied on imported components.

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Comparison: FIE/FICE set up in the SEA and elsewhere in the PRC

	Origination and destination	VAT, customs duty, import/export license, and foreign exchange administration
III	Goods delivered from non-SEA enterprise to enterprises situated in FTZ / BLP	1. Export customs procedure applied; 2. VAT export refund; (c) 3. Exporter completes foreign exchange verification procedure on export collection 4. Export license required

(c) Depending whether the goods are shipped to FTZ or EPZ, the customs adopt different administration rules on export refunds.

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Comparison: FIE/FICE set up in the SEA and elsewhere in the PRC

	Origination and destination	VAT, customs duty, import/export license, and foreign exchange administration
IV	Goods traded among enterprise situated in special economic zones (FTZ / EPZ / BLP)	1. Customs procedures not applied in the same zone and among zones; 2. No VAT imposed; 3. No requirement for verification of import payment / export collections; 4. Import license not required

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Comparison: a FICE and an FIE expanding its business scope to trading

1. The sales mix: Trading revenue < 30% of the total revenue earned from production and trading activities
2. In case of 2-plus-3 income tax concession, trade income will automatically receive the same concession
3. For export-oriented enterprise, additional sales in the domestic market may have unfavorable income tax impact

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Comparison: Setting up a FICE or a branch (1)

Legal requirements

1. Head office has to pay up all the capital
2. Head office must have passed the annual examination
3. Scope of business for the branch cannot exceed that for the head office
4. The branch is required to apply for a branch business license, national tax and local tax registrations

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Comparison: Setting up a FICE or a branch (2)

Business consideration for the branch to be located in the same city or other cities

1. Whether the H.O. or branch will sign up the sales contract
2. Whether Branch will sell goods in own name or as commission agent
3. Whether Branch will collect cash or cheque payments
4. Whether Branch will be required to issue tax invoices
5. Whether Branch will carry on retail business

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Comparison: Setting up a FICE or a branch (3)

1. PRC legal rules on the use of tax invoices across cities
2. Blank tax invoices: to be carried by hand or delivered by any means of transportation

- From one province (municipality) to another (municipality) → Disallowed
- From city to city in same province → Must obtain administrative approval from the tax authority

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Comparison: Setting up a FICE or a branch (4)

Transfer pricing rules for goods sold between HO and branch

- HO (GZ)=> imported goods => Branch (Su Zhou) => domestic buyer

1. I/E rights vs. contractual rights
2. Avg. selling price for similar goods Composite price for VAT computation purposes = Cost x (1 + 10%)

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VAT Planning - domestic transactions

VAT liability and terms of payment

VAT obligation arises

- Cash sales : receipt of sale money
- Credit sales : payment date by agreement

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VAT planning – domestic transactions

Deferral of VAT obligations

1. Credit sales : Pmt date by agreement
2. Consigned sales : receipt of statement of consigned sales

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