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# Legal and Tax Issues on Commodity Trading Operations in the PRC

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The PRC trading system encompasses the foreign trade sector and the domestic trade sector due to historical reasons.<sup>1</sup> Before China's accession to WTO on December 2001, the Chinese government imposed a number of policy restrictions on foreign investor's access to the PRC trading rights. In the domestic trade sector, basically the wholesale and retail distribution right was not granted to foreign investors, with the exception of a few joint venture commercial enterprises set up by multinational corporations in designated cities within the PRC. In the foreign trade sector, foreign trade rights are granted to foreign investors who set up trading companies in the free trade zones. Outside the free trade zones, only the Foreign Investment Enterprise (FIE) production type was granted limited foreign trade rights. Since China's accession, the Chinese government has gradually lifted the policy restrictions on foreign trade rights and distribution services in the Chinese market. With effect from June 2004, foreign investors are permitted to set up foreign invested commercial enterprises (FICE) with the foreign trading rights and domestic trading rights. The FICE can carry on wholesale, retail and import-export businesses in the PRC.<sup>2</sup>

In what follows, we shall first discuss the development on the liberalisation of the PRC trading systems in the foreign trade and domestic trade sectors respectively, including a brief discussion on the scope and contents of the PRC trading rights. Second, we shall discuss the import-export right and the declaration rights within the contexts of the PRC foreign trade laws and the PRC customs laws. Third, we shall examine the administration of foreign exchange regarding export collections and import payments under the PRC foreign exchange administration rules. Fourth, we shall discuss the application of PRC legal rules in special economic areas (the SEA) including the legal rules on goods moving between the SEA and elsewhere in the PRC, and moving between the SPA and destinations in other countries. Finally, we shall compare the difference in the use of various legal entities to carry out trading business in the PRC. Commission agency and franchising business are not covered in this article due to space constraints.

## I. Foreign Trading Rights in China

In 2004, the Chinese government amended the "Foreign Trade Law" that includes the introduction of reform in the PRC foreign trade system. Before July 2004, both Chinese domestic companies and foreign investment enterprises needed to obtain administrative approval on foreign trade rights. The amended foreign trade law provides that foreign trade operators inside China are only required to follow the registration procedure with the Ministry of Commerce, removing the requirement for obtaining administrative approval.<sup>4</sup> As a result of the liberalisation of the foreign trade sector, both state owned enterprises and import-export trading corporations have lost their monopolistic positions in the foreign trade sector. Previously FIEs were granted a limited foreign trading right to the extent that the FIE could only import materials or parts for own use and export the self-produced finished goods. The only option for foreign investors engaging in import and export business was to set up trading companies in designated free trade zones (the FTZ). The foreign trade rights were not open to foreign investors in the PRC outside the FTZ with the exception a few joint venture foreign invested commercial enterprises on an experimental basis.<sup>5</sup> With effect from June 1, 2004, foreign investors can set up foreign invested commercial enterprises (the FICE) to carry on import-export trading business or wholesale and retail distribution business in China in the form of equity or co-operative joint venture enterprises. With effect from December 11, 2004, foreign investors are allowed to hold one hundred percent equity ownership in the FICE.<sup>6</sup> The Chinese government further relaxed the restrictions on trading rights later. As from April 2, 2005, production-type FIE can import or export goods without having undergone any manufacturing process and act as third party distributors after they obtain administrative approval on the amendment of the scope of business activities.<sup>7</sup>

## A. Registration Procedure for Foreign Traders

All production-type FIEs acquire the import-export right and declaration rights after obtaining the approval certificate and completing the customs registration. The import-export rights have a close relationship with the customs declaration rights. To obtain the declaration rights, FICE must obtain a customs registration certificate in accordance with the customs law and administrative order of the General Administration of Customs.<sup>8</sup> To obtain a customs registration certificate, the FICE must complete the registration procedure as a foreign trader in accordance with the foreign trade law and administrative order of the Ministry of Commerce.<sup>9</sup> The scope for registration as a foreign trader is applied as shown in Table 1 depending on the scope of business for the FIE/FICE:<sup>10</sup>

TABLE 1	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
FICE in FTZ	No	Yes (b)	Yes	Required
FICE	No	Yes	Yes	Required
FICE	No	No	Yes	Not required
FICE	No	Yes (c)	No	Required

(a) The production type FIE is given limited import-export right. It is not required to complete the registration procedure as the foreign trader.

(b) If the FICE is established in the free trade zone (the FTZ) or bonded logistic park, it is also required to complete the registration procedures as the foreign trader. See the administrative order no. 76 (2005) of the Ministry of Commerce.

(c) The FICE only buys goods from the Chinese market for export.

## B. Declaration Rights

International couriers or transportation companies established in the PRC have the right to declare goods for their principals which possess import-export rights. However, they are not allowed to engage in import and export trading because they do not possess the trading rights. Furthermore, the declaration right is limited in that they cannot declare goods on behalf of those who are not party to the transport service agreement. Professional customs declaration companies in China have the right to declare goods for their clients. They can declare goods at customs as independent service providers for those who have the import and export rights. However, their scope of activities is limited to providing customs declaration services; they cannot engage in import and export trading activities in that they do not have the trading rights. Table 2 may help illustrate the difference between trading right and declaration right.

An import-export corporation includes a Sino-foreign external trading company incorporated under the "Tentative measures concerning the establishment of Sino-foreign external trading company". With the exception of production-type FIE, those who have the import-export rights must complete the procedure for registration as a foreign trader in accordance with the PRC foreign trade law and regulations.<sup>11</sup> Those who have the import-export right must complete customs

registration in accordance with the PRC customs laws and regulations. Customs registrations are sub-divided into two types: those for declaration agents, and those for consignors and consignees.<sup>12</sup>

## II. Commodity Classification and Foreign Trade Administration

The Ministry of Commerce (the MOFCOM) is the administrative authority of foreign trade in the PRC.<sup>13</sup> Goods imported into China are classified into three categories:

- prohibited,
- restricted, and
- freely traded.

Foreign trading rights are subject to restrictions. First, those who acquire the foreign trade right are not allowed to import or export goods of prohibited category, or deal with goods that are banned from trading under the foreign trade law.<sup>14</sup> Goods infringing on the IP rights of other parties or ammunition are two of examples of banned items. Second, the Chinese government imposes licence and quota requirements on those who import or export goods in the restricted category.<sup>15</sup> Third, import goods falling into the freely traded category are subject to the requirement for automatic import licences.<sup>16</sup> Customs will not release goods in the absence of automatic import licences.<sup>17</sup> All Chinese companies or FIE having obtained import and export rights must comply with such requirements. The MOFCOM, working together with other ministries, formulates policies on the catalogues for imported goods classified as prohibited, restricted and freely traded, and announces the same.<sup>18</sup> Goods exported from the PRC are classified into prohibited, restricted and freely traded. The determination of categories on export goods follows the same process and procedures, except that there is no requirement for automatic export licence.<sup>19</sup>

## A. Domestic Trading (distribution) Rights

The Chinese law prohibited foreign investors from operating wholesale and retail businesses in China in the past. The Chinese government began to relax control in 1999. Under the Experimental Measures on Foreign Invested Commercial Enterprises (1999 Experimental Measures) promulgated on June 25, 1999, foreign investors are allowed to set up joint venture commercial enterprises. However, policy restrictions

TABLE 2	Import/export right?	Customs declaration right?
Foreign invested wholesale commercial Enterprise (the FICE)	Yes, it can do wholesale business, import and export own goods and third party goods	Yes, but limited to the goods they buy and sell in their own name
Foreign invested retail commercial Enterprise (the FICE)	Yes, it can do retail business, import goods for own retail sale and export domestically purchased goods	Yes, but limited to the goods they buy and sell in their own name
Foreign trade corporation or import and export trading corporation (I/E corporation)	Yes, it can import and export own goods and third party goods, but does not have domestic distribution rights	Yes, but limited to the goods they buy and sell in their own name
Production type FIE	Yes, but limited to importing materials for own use and exporting own made goods	Yes, but limited to material imported for own use and export own made goods
International courier or transportation company	No	Yes, but limited to the goods of the shippers that possess the import-export rights
Professional declaration agency company	No	Yes, provide declaration services to any party who has the import-export right.

on the requirement for the amount of registered capital, the percentage of foreign ownership, investor qualifications in terms of net assets and turnover, geographical coverage, the number of shops and branches still existed.<sup>20</sup>

Before China's WTO accession on December 11, 2001, the PRC Legislative body had amended three major pieces of the law for FIEs, including the removal of the requirements to:

- to balance its receipt and payment of foreign currency;
- to purchase from domestic market (the local contents);
- to achieve export performance; and
- to file the production plan with the government department for record.<sup>21</sup>

In April 2004 the Ministry of Commerce promulgated the "Administrative Measures of the Commercial Sectors for Foreign Investment", which basically removed the restrictions imposed by the "1999 Experimental Measures", with the exception for certain state trading commodities.<sup>22</sup> As from July 2005, FIEs established in free trade zones and bonded logistic parks have also been granted distribution rights to trade with companies situated outside FTZ/BLP (elsewhere in the PRC).<sup>23</sup> In addition, the Ministry of Commerce has issued other relevant administrative orders to make way for the implementation of the law on the liberalisation of the wholesale and retail sectors, which are illustrated by Table 3.

TABLE 3

Legal development after China's WTO accession		
	Administrative order	Details of the administrative order
I	Order No. 8 (2004) Effective on 1 <sup>st</sup> June 2004	Chinese government fully opened up the distribution sectors to foreign investors
II	Order No. 9 (2005) Effective on 2 <sup>nd</sup> April 2005	Production type FIE can distribute third party goods by expanding scope of business
III	Order No. 76 (2005) Effective on 13 <sup>th</sup> July 2005	FIE situated in FTZ and BLP is granted the distribution rights to do trading with companies situated outside FTZ/BLP
IV	Order 94 (2005) Effective 1 <sup>st</sup> March 2006	MOC delegates its approval authority to provincial governments

The PRC trading right should also include domestic distribution rights, which can be divided into wholesale distribution rights and retail distribution rights. The scope of the commodity distribution right of the FICE is also subject to legal restrictions:

(a) goods in China are also classified into the following categories:

- goods subject to state trading (such as silk and tea),
- goods subject to designated trading (such as steel and natural rubber), and
- general goods.

The law provides that other Chinese domestic companies or foreign investment enterprises must deal with designated enterprises. The restriction on trading rights for goods subject to designated trading was removed in December

2004. However, there will be no change for the state trading goods system; and

(b) administrative licensing is required for the distribution rights of certain commodities. In the case of retail distribution of books, newspaper and magazines, the retailer must obtain administrative approval to get an operating licence from the State Administration of Press and Publication.

Therefore, it is not sufficient for the foreign investment enterprise to have the business licence alone. It must also obtain approval for an operating licence to distribute the goods subject to the administration of specific laws and regulations. Note that the requirement for such approval comes before the Ministry of Commerce approves the establishment of the FICE. The same pre-approval licensing requirement applies to the distribution of pharmaceutical products, audio-video products, foodstuffs, cosmetics and beauty products, etc.<sup>24</sup> The Chinese commodity trading system is complicated in that possessing the distribution right (licence) does not mean that one has the foreign trade rights. For example, foreign investment enterprise having been granted the right to distribute books in the domestic market could only import the books to be sold in the domestic market through state owned agents.

### III. Scope of Business

The Administrative Measures provides that the scope of businesses for FICE is shown in Table 4:

TABLE 4

	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

Every FIE and FICE must obtain approval on the scope of business, which is stated in the business licence and is also an indispensable part of the Articles of Association.<sup>25</sup> It is also a requirement for the FIE/FICE to submit a list of goods or commodities to be imported or exported when submitting the application for approval or the application for an amendment in the scope of business.<sup>26</sup> The business lines of the FIE/FICE, including branches, must not fall outside the scope of foreign trade and domestic distribution rights under the provision of the PRC law and regulations. If the FIE/FICE or its branch deals with any goods that do not fall within the scope of its business without obtaining administrative approval for a change, it is unlawful and unconstitutional. The FIE/FICE that does not rectify the non-compliance will be subject to punishment by the governing administrative authority. If the unlawful business activities fall into the encouraged or the permitted categories, as stated in the Catalogue for Guiding Foreign Investment in Industries, the governing State Administration of Industry and Commerce will impose a fine ranging from CNY10,000 to CNY100,000.<sup>27</sup> If the unlawful



business activities fall into the prohibited or restricted categories, the administration shall revoke the business licence.<sup>28</sup> In a broad sense, the definition of distribution services within the domestic market in the PRC and her foreign trade sector includes transportation services, storage and warehousing, marketing and advertising services. Note that the provision of transportation services, storage and warehousing requires administrative approval from the administrative authority other than the Ministry of Commerce or its delegated authorities.<sup>29</sup>

#### IV. Trading Rights in Brief

Commodity trading right in China, excluding state trading goods, has the following scope and content.

First, it includes import and export right. However, the scope of the import-export rights excludes goods under the prohibited category. Likewise, goods of the restricted category are subject to licensing and quota requirements.

Second, the trading right includes declaration right, but those who can perform the customs declaration do not necessarily have the import-export right.

Third, domestic trading right includes wholesale distribution rights and retail distribution rights, but certain commodity distribution rights are either subject to the requirement of administrative licensing or state trading.

Possessing the distribution right for a particular good does not follow that one has the import-export rights for that particular good. It will all depend on the classification of the goods under the provisions of the foreign trade law and regulations. Fourth, all companies or enterprises only have the power to deal with the goods in accordance with the approved scope of business activities. In the absence of any one of those rights, the company or enterprise cannot carry out one-stop commodity trading activities in the PRC.

#### V. Commodity Classifications Under PRC Customs Law

In comparison with the Foreign Trade Law, the Chinese import-export laws and regulations classify goods into four categories:

- general goods,
- bonded goods,
- goods either exempted from duty and taxes, or subject to reduced duty and tax rates, and
- goods temporarily imported.

General goods are subject to the normal customs clearance formality:

- declaration,
- document verification,
- physical inspection,
- levy of taxes, and
- release.

General goods are freely circulated either in the domestic market or bound for destinations in other countries after completing customs formalities.

#### VI. Customs Procedures

In contrast to general goods, bonded goods, tax-reduced or tax-exempted goods, and temporarily imported goods are subject to special customs formalities divided into three separate stages:

- pre-importation stage,
- importation stage, and
- post-importation stage.

The procedures for the pre-importation stage include, without limitation to the following:

1. record filing of production contracts in export processing trade,
2. application for tax reduction or exemption certificates, and
3. placing of security deposit for duty and tax on the importation of bonded goods.

The procedures for the importation stage are the same as that for general goods except that the Chinese customs does not collect import duty and taxes. The procedures for the post-importation stage include, but without limitation to:

1. reconciliation and the verification of the import materials with the export shipment, in quantity and weight, under the production contract for the processing trade agreement,
2. application for the lifting of customs supervision on tax-exempt or tax-reduced goods, and
3. release of the security deposit for importation of bonded materials in export processing trade.

##### A. Import-export Declaration

Foreign traders are legal persons, other organisations, or individuals who have been granted a business licence. Foreign traders are also required to complete the registration procedures as foreign traders in accordance with the provision of the Foreign Trade Law. Foreign traders do not necessarily acquire customs declaration rights. Only those foreign traders who have obtained customs registration as the consignee or the consignor for import-export declaration purposes acquire declaration right. The branch of an FIE, which has the capacity to enter into purchase and sales contracts, cannot be a consignor (or consignee). The branch may be the importing or exporting party following the conclusion of a sale contract. In that case, the head office should declare the goods for the branch.

##### B. Legal Rights and Obligations for Consignor and Consignee

The import goods declaration form and the export goods declaration form are the basis on which the Chinese customs exercise supervision, levy duty, collect taxes, compile customs statistics, and perform customs audits. Second, the declaration forms are used as the documentary evidence for the verification and reconciliation of the import-export quantities and weights under processing trade, application for export rebates, and the completion of foreign exchange verification procedures. Third, the declaration forms are used as the documentary evidence for customs to combat smuggling activities and tax evasion, to determine whether there is any breach of administrative rules and breaches of foreign exchange administration.

The consignor, consignee and declaration agents shall make true declarations and assume legal responsibility for the correctness, accuracy and completeness of the declaration information. The declaration date refers to the date customs formally accepts the declaration through electronic or paper-based means. The consignor, consignee and their appointed declaration agents cannot alter the declaration information, nor can they withdraw the declaration after customs acceptance of it without customs' consent.<sup>30</sup> The consignee can request to examine the imported goods or take samples for the determination of the description, specification, model, and commodity code classification relating to the goods before making the customs declaration.<sup>31</sup> Note that by exercising its legal rights to inspect the goods before making the import declaration, the consignee can effectively avoid submitting incorrect declaration due to the wrong delivery made by the forwarding agent or the carrier. If the consignee does not do so, it will be exposed to uncalculated risks of administrative penalty or even criminal liability under the PRC customs rules.

### C. Time to Declare

The consignee or agent should submit import declaration within 14 days of the declared entry day of the inbound transportation carrying imported goods. Customs will impose on the consignee a surcharge for late submission of the import declaration, to be calculated at 0.05 percent of the dutiable value of the imported goods.<sup>32</sup> The consignor or agent should submit the export declaration 24 hours before loading the goods onto the outbound transportation following the arrival of the export goods at the customs supervision zone.

### D. Administrative Predetermination

The consignee or agent can apply for a predetermination by customs on commodity classification, valuation and country of origin before importation of the goods. At the time of submitting the import declaration, the consignee or agent should produce the administrative predeterminations.

## VII. Tariff Measures

Broadly, tariff is defined as the customs tariff (duty) and the internal taxes, such as VAT, consumption tax, and other levies, which are imposed on the imported goods. Import tariff also includes special duties including anti-dumping, countervailing, safeguard, and retaliatory duties. Tariff is reduced to the customs duty excluding special duty and internal taxes if it is defined in a narrow sense.

A tariff schedule (table) consists of items of commodities and tariff rates respectively. There is a unique HS code for each item of commodity in the table. Depending on the country of origin, the Chinese law classifies goods or commodities subject to import tariff rates into five categories, namely:

1. most-favoured-nation (MFN) rate,
2. treaty rate,
3. special preferential rate,
4. general rate, and
5. temporary rate.

The MFN rates apply to goods originating from countries (regions) which are WTO members, or those which have entered into bilateral trading agreement with China incorporating the MFN clause.

### A. Dutiable Base

In determining the base for the levy of tariff on imported goods, Chinese customs adopts the practices of transaction price. Normally that is the CIF price, subject to adjustments in accordance with the PRC customs rules.

The adjustment including the fees and charges borne by the buyer:<sup>33</sup>

1. Commission and brokerage;
2. The container considered to be the integrated part of the imported goods;
3. Packaging charges;
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 on the sale of goods after importation;
6. The payment to the overseas seller relating to the re-sale, disposal or use of the goods after importation.

The adjustments excluding the following:<sup>34</sup>

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 and internal taxes

Where Chinese customs consider that the declared price of an imported good is obviously lower than that for the identical or similar product without any credible evidence, or that the normal price is manipulated by arrangements between the importer and the exporter, customs may substitute the following valuation for the imported goods in descending order:<sup>35</sup>

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

## VIII. Accounting Rules and Customs Valuation

Let us use an example for capital transfer, as illustrated by Figure 1.

FIGURE 1

In WFOE's books of account	In holding company's books of account
Dr Equipment (costs) USD80,000	Dr Investment USD80,000
Dr Equipment (up-valuation) USD10,000	Dr loss in investment USD20,000 (to income statement)
Cr Capital reserve USD10,000	Cr Bank USD100,000
Cr Capital USD80,000	
Dr Fixed asset (Equipment) USD25,000	No entry required
Cr VAT payable USD25,000	

The holding company in Singapore pays U.S.\$100,000 to the supplier for a piece of production equipment to be used by a wholly foreign owned enterprise (the WFOE) in the PRC. But the Singaporean holding company of the WFOE chooses to use a lower declared value (say U.S.\$80,000 purchase from supplier) as capital contribution to WFOE, and the loss should be taken up in the income statement by the holding company. The holding company has to declare a value and issue an invoice (U.S.\$80,000) to the WFOE for the goods that are to be shipped into China. Chinese customs can make official valuation upon the importation of the equipment, regardless of the declared value. The customs valuation (say U.S.\$90,000) may not be the same as the declared value (invoiced value) (U.S.\$80,000). The difference of U.S.\$10,000 should be recorded in the capital reserve in the WFOE. It is assumed that there is no exchange difference, the equipment is imported as general goods, and that the amount of duty and VAT is U.S.\$25,000.

The accounting rule should be used to match the amount of capital with the equipment cost in the WFOE. The price difference including the exchange difference should be taken to the capital reserve account in order to keep the amount of capital as stated in the books of the WFOE in line with the amount of investment as stated in the books of the Singapore holding company. Note that the local currency RMB should be used for local reporting purposes. USD is used here for simplicity sake.

Let us see another example of a trading transaction.

A WFOE in Shenzhen imports materials for use in production. The invoiced value for the purchase contract is U.S.\$50,000 (CIF Shenzhen) at a contract rate of U.S.\$1 to RMB 8. Upon arrival, the customs valuation is U.S.\$51,000 at an exchange rate of 8.1 for import duty and VAT computation purposes. The WFOE accepts the valuation and does not lodge an application for administrative review. The original U.S.\$ purchase is converted to RMB400,000. The accounting treatment for the import transaction should be recorded as shown in Figure 2:

**FIGURE 2**

(i)	Dr. Purchase of import materials RMB 400,000	$50,000 \times 8 = 400,000$
(ii)	Dr. Other expenses RMB8,000 = $((51,000 - 50,000) \times 8)$	The difference arising from customs valuation
(iii)	Dr. Other expenses RMB5,100 = $(51,000 \times (8.1 - 8))$	The difference arising from exchange rate movements
(iv)	Cr. Accounts payable (or bank) RMB 413,100	$= (400,000 + 8,000 + 5,100)$

(i) Note that the accounting cost is used with appropriate accounting adjustments to bring the financial ledger balance in line with the customs valuation. The differences arising from customs valuation and exchange movements should be charged to the income statement.

(ii) If the import duty is nil and VAT is say RMB120,000, then the WFOE should record a debit of RMB120,000 to VAT payable, and a credit to the bank for the same amount. The import VAT paid can be used to offset the output VAT collected on sales from the buyer later.

(iii) If the imported materials are subject to consumption tax, there will be a debit to the cost of sale and a corresponding credit to the bank. The amount of consumption tax paid is charged to costs and cannot be passed onto the buyer later.

If the imported materials are subject to consumption tax, there will be a debit to the cost of sale and a corresponding credit to the bank. The amount of consumption tax paid is charged to costs and cannot be passed onto the buyer later.

## A. Difference Between Accounting and Customs Rules

The valuation of imported goods under the PRC accounting rules differs from that under the customs rules. First, the differences arise because the components forming the bases of the valuation for the accounting rules and customs rules are not identical. For example, the charges for installation and testing for imported equipment are included into the cost of equipment under the accounting rules, but they are not included under the VAT and customs rules in that installation and testing fees are related to the provision of services, which does not fall within the scope of VAT and customs duty. On the other hand, the accounting rules do not include in the cost of sales the royalty paid by the importer to the overseas seller on the sale of goods after importation, but the customs rules include the payment for the use of intangible rights inside the PRC into the dutiable base. Second, the reference to the exchange rate for customs valuation purposes falls on different days for accounting purposes. Third, the movements in exchange rate will have impact on the value of goods imported. The exchange rate agreed under the contract will not be the same as the rate used for customs valuation purposes.

## B. Computation of Import Duty and VAT

The applicable rate for the import tariff refers to that in force on the date Chinese customs accept the declaration for the import goods. If Chinese customs accepts the submission of declaration before the arrival of the imported goods, the applicable rate is the rate on the entry date as stated in the import declaration of the transport means that carry the imported goods. The applicable exchange rate for tariff computation shall be adopted by reference to the date of the applicable tariff rate. For that purpose, the applicable exchange rate is the base rate the People's Bank of China announces on the Wednesday in the third week of the preceding month.<sup>36</sup> If the Wednesday in the third week falls on a public holiday, the Wednesday in the fourth week shall be used as the reference.<sup>37</sup> The import tariff is calculated as shown in Figure 3:

**FIGURE 3**

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

If the CIF value of a set of lipsticks (HS code 33041000) from Japan is U.S.\$100 (exchange rate 1:8), importation of cosmetics is subject to VAT at 17 percent and Consumption tax (CT) at 30 percent, the customs duty, Import VAT and CT will be computed as shown in Figure 4:

FIGURE 4

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) * 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	

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)

Consumption tax = composite dutiable value x consumption tax rate

$(800+113.60) / (1-30\%) = 1,305.14$

$1,305.14 \times 30\% = 391.54$

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

- the applicable tariff schedule,
- the tariff code,
- the tariff rate,
- the exchange rate, and
- the dutiable base.

The country of origin certificate serves to determine the applicable tariff schedule. The commodity classification system serves to determine the applicable tariff code. The declaration date serves to determine the applicable tariff rate, and the exchange rate. The customs valuation will directly affect the dutiable base.

### C. Payment and Collection of Import Duty and Taxes

Import tariff, VAT and consumption tax are payable 15 days after receiving the customs' payment notice regarding the importation of goods into China.<sup>38</sup> After the payment, the importer and exporter for general goods may request that Chinese customs issue a certificate of import and export respectively, to be used as a proof of discharging the liability relating to the import and export goods. There will be a daily surcharge for late payment of RMB 5 per every RMB 10,000 (0.05 percent) on the amount of overdue taxes. Where the taxpayer fails to pay the duty and taxes within a period of three months, the director of the governing customs can take tax enforcement measures against the taxpayer, including the issue of written notice for the bank to deduct the duty and taxes from the taxpayer's account, and the sale of dutiable goods in the hands of customs and deduct the duty and taxes from the proceeds hereof.<sup>39</sup> If customs finds that during the prescribed period for tax payment the taxpayer is obviously trying to transfer his assets or to hide them in order that the assets are placed out of reach of customs, customs can order the taxpayer to put up a third party guarantee for the duty and taxes. If the taxpayer fails to do so, the director of the governing customs can take tax preservation measures against the taxpayer.<sup>40</sup>

### D. Under-taxation and Over-taxation

Within a period of one year from the date of releasing the goods, customs can recover any under-payment of taxes from the taxpayers if it is customs which discovers the under-payment or omission of the taxes. If the under-payment or omission is due to the taxpayer's non-compliance with the

legal rules, customs can recover the taxes within a period of three years from the date of releasing the goods.<sup>41</sup> Within one year from the date of releasing the goods, the taxpayer can request customs to refund any overpayment of taxes if the taxpayer discovers the overpayment. There is no time limit for the refund of overpaid taxes if it is customs which discovers the overpayment.<sup>42</sup>

### E. VAT Export Refunds

The VAT paid for the purchase of export goods in the Chinese market can be refunded in whole or in part, if the exporter can satisfy the following requirements:

1. The goods are subject to VAT or consumption taxes under Chinese tax regulations;
2. The nature of the export transaction must be treated as sales in the books of accounts for the exporter (as evidenced by the bill of lading or airway bills);
3. The goods must have physically left the country (except for that shipped to export processing zones);
4. The exporter has to produce evidence showing that the foreign exchange verification procedure governing the export collections has been completed.

The above are the general requirements. To the individual exporter, the goods it buys for purpose of export and VAT rebates should not fall outside the scope of its business as approved by the Chinese government. The exporter should possess general taxpayer status as defined under the PRC VAT tentative regulations. The exporter needs to submit the application for export rebates within 90 days of the export declaration and produce the prescribed documentary proofs to the tax bureau. If the exporter cannot produce all the required documents before the 15th day of the following month, all the export sales are deemed to be local sales under the PRC VAT rules. The exporter will be required to pay VAT at the standard rate of 17 percent.<sup>43</sup>

### F. 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 payment notice;
7. Appointment letter of export agent (if applicable).

### G. VAT Refund Computation

For production enterprises, the amount used to compute the export refund is the free on board (FOB) value of the export goods. For commercial enterprises, the amount used to compute the export refund is the amount of purchase. The pay-first-and-refund-later method is used in export refunds for commercial enterprises. In that connection, the exporter pays VAT on export sales to the VAT collection unit at the tax bureau and applies for a VAT refund from the VAT refund unit at the tax bureau. According to the input VAT paid for the purchase of the export goods, the amount of VAT refund is computed as follows:



1. If the refund rate is the same as the standard rate (17 percent), VAT refundable amount = amount of purchase x refund rate.
2. If the refund rate is lower than the standard rate (17 percent), VAT refundable amount will be: amount of purchase x refund rate = input VAT on export – amount not refundable; where the input VAT on export is the purchase amount x standard rate, and the amount not refundable is purchase amount x (standard rate – refund rate).

## H. Administrative Review

In case of disagreement with customs, the taxpayer and the guarantor can make application for an administrative review on the following matters:

- the party owing an obligation to pay taxes,
- determination of dutiable value,
- commodity classification,
- country of origin,
- applicable tax rate or exchange rate,
- tax exemption,
- back duty,
- tax refund,
- surcharge,
- computation method, and
- place of tax payment.

Note that there are two procedural steps to be followed:

1. the applicant for administrative review should pay the taxes before lodging the application within 60 days in accordance with the PRC Law for Administrative Review; and
2. the taxpayer cannot directly take the case to the People's court since it is a legal requirement that the aggrieved party should seek administrative review first.<sup>44</sup> If the taxpayer is not satisfied with the decision of the customs at higher level, it can take the case to the People's court.

## IX. Administration of Foreign Exchange

The Chinese legal rules do not impose any restriction on the cross-border movement of funds in settlement for obligations in trading transactions under the current account.<sup>45</sup> However, it does not follow that the full conversion between the CNY and foreign currency is without government control. Cross-border movements of funds are subject to administration of the foreign exchange verification system. Under the PRC foreign exchange regulations and rules, foreign traders inside China are required to comply with the verification rules on foreign currency payments and collections in respect of each import and export transaction beginning from pre-transaction records filing to post-transaction verification at the local office of State Administration of Foreign Exchange (the local SAFE).

The Chinese government has implemented a foreign exchange verification system, under which the information on foreign currency and physical movement of goods across the border is shared between the bank, customs and SAFE, to keep track on the foreign exchange

movements relating to each import and export transaction. The Chinese law does not allow the exporter to keep the foreign currency from export collections outside China.<sup>46</sup> Similarly the Chinese foreign exchange authority will scrutinise import payments without evidence of corresponding inbound cargos, or where the down payment is made over ninety days in advance of the arrival of import shipment.<sup>47</sup> The objective of verification is to guard against any unlawful diversion of foreign exchange away from the country. Non-compliance with the foreign exchange verification requirements will result in administrative fines and punishments.<sup>48</sup> Note that enterprises established in special economic areas such as free trade zones, export-processing zones and bonded logistic parks need not follow the rules on foreign exchange verification.

## A. Verification of Import Payments

The FICE must comply with the verification procedures within one month after the receipt of the shipment of import goods.<sup>49</sup> The import payment verification is divided into two parts:

- a. pre-importation record filing, which requires the importer to provide background information on the import shipment to the local SAFE, and
- b. post-importation verification, which requires the importer to produce supporting evidence of import shipment that matches the forex payments.

Depending on the method of settlement, the importer is obliged to follow the verification procedure for import payments. If the foreign currency payment is made upon the arrival of the import shipment, the importer is deemed to have completed the verification procedure upon the production of the import declaration form to the bank designated to handle foreign currency business. If the foreign currency payment is made under other settlement methods such as letter of credit, collection or advance deposit, the importer should submit to SAFE or its delegated agent the following information for verification purposes:

- pre-shipment record filing form;
- purchase contract;
- import payment verification note,
- the bill of lading and
- the import declaration form.<sup>50</sup>

A FICE which has not registered and been included into the "List of Import Enterprises Making Foreign Currency Payments" should also produce the approval certificate, business licence, organisation identity certificate, and foreign exchange registration certificate.

## B. Verification of Export Collections

Under the foreign exchange verification system, foreign traders inside China are required to comply with the verification procedures on export collections in respect of each export transaction.<sup>51</sup> Control by the administrative body begins before the physical shipment of the export. The export enterprise is required to obtain a pre-printed and numbered verification note for the export collections from SAFE regarding the export shipment. The bank, local customs and the local office of SAFE share the information of the export collection and the verification notes under the

electronic frontier port system. At the time of submitting the export declaration, the export enterprise is required to present the above-mentioned pre-numbered verification note to customs to secure customs release of the export shipment, and obtain from customs a copy of the export declaration to verify export collection at the local office of SAFE later. After dispatch of the export shipment and the receipt of payment or the confirmation of settlement at a determinable future date, the export enterprise shall complete the verification procedure on export collection at the local office of SAFE. The export enterprise will then discharge its legal obligation for verification of export collections if the amount of export shipment agrees with the receipt of foreign currency payment or the confirmation to receive foreign currency payment. Chinese customs will not release the next batch of export goods if the export collection procedure for the previous export shipment has not been complied with. The scope of export verification also covers the export processing trade. Both the enterprise that exports goods and the enterprise that performs export processing, including the transfer of bonded goods from the upstream factory to the downstream factory, shall comply with the requirement for export collection verifications.

### C. Comparison between Non-trade Transactions and Capital Transfers

An example may serve to illustrate how the verification system on export collection works:

Suppose a WFOE has an account receivable of U.S.\$100,000 from the holding company situated outside the PRC. At the same time there is a dividend payable of the same amount from the WFOE to the holding company. If the WFOE offset the account receivable against the dividend payable, it will act in violation of the PRC legal rules on foreign exchange administration. The dividend payable is a non-trade item and the account receivable is a trade item. They are currency account items but cannot be offset with each other even if it is no problem from a contractual and accounting point of view. To remit the dividends outside the PRC, the WFOE should follow the procedures for the repatriation of dividend. The WFOE should present a copy of the income tax payment certificate (or the income tax exemption certificate), a copy of the board resolution for the declaration of the dividend, and a copy of statement of retained earnings as well as the capital examination report as issued by a local certified public accounting firm, to the responsible SAFE for approval. After getting approval from the SAFE in-charge, the WFOE can buy the U.S. dollars from the bank for outward remittance transactions if it pays the dividend before receiving the payment from the holding company. On the other hand, the WFOE should follow the verification procedure for export collections regarding the account receivable.

Suppose that the WFOE has an account receivable of U.S.\$1 million from its holding company situated outside the PRC. The WFOE also wants to repay a loan about U.S.\$ 1 million advanced by the same holding company. Offsetting the amount of account receivable with the loan redemption is acceptable under the accounting rules but it is in violation of the PRC laws on foreign exchange controls. The receipt is a trade transaction under the current account, for which the

WFOE, as the exporter, is under a legal obligation to follow the verification procedures on export collections, but the retirement for the loan is a cross-border transfer of capital under the capital account, for which the exporter must obtain administrative approval. Note that the PRC foreign exchange regulations provide that the WFOE must have registered the foreign currency loan at the governing SAFE when the loan was raised. In the absence of such registration, the WFOE cannot convert local CNY into (or buy) foreign currency to settle its obligations to the holding company.

## X. Bonded goods

Bonded goods are defined under the PRC Customs Law as goods, entering the PRC territories with customs approval to defer the payment of duty and VAT, to be reshipped out of the PRC territories after being stored, processed and assembled.<sup>52</sup> The Chinese law provides two categories of bonded goods:

- bonded goods stored for later use; and
- bonded goods used in export processing or assembling.

There are several properties for bonded goods. First, since they are not treated as imports, bonded goods are not subject to the requirement for import licences. Second, one can add value to bonded goods by performing processing and assembly work on them, or one can just keep them in storage in original shape and condition for later use and consumption. If the bonded goods in storage are later sold for consumption in the PRC, Chinese customs shall collect import duty and VAT on the consignee who imported them. Accordingly, the status of the bonded goods changes from bonded goods into general goods, and the rules for import licence shall apply. If the bonded goods are later sold for consumption outside China, there will be no duty and tax consequences. One example of this tax exemption will be the fuel and consumable supplies imported for use by aircraft and ocean going vessels in international transportation. Bonded goods can be used in the manufacture of export goods under an export processing agreement. When this happens, the goods under export processing are subject to the special customs rules governing the reporting, use, movement and disposal of those goods.<sup>53</sup> Bonded goods can be used as a security for legal charges, pledged or be the subject of a lien, but bonded goods used for export processing are not permitted to have such financing arrangements.<sup>54</sup> Chinese customs shall not collect duty and VAT on bonded goods imported under export processing contracts on condition that they are reshipped out of China after the completion of the processing activities, within one year. Chinese customs shall collect duty and VAT if the bonded goods used in export processing stay inside the PRC after the allowed one-year period is over. In addition, the requirement for an import licence shall apply.<sup>55</sup> Third, since the export processing enterprise (the EPE) can take delivery of the imported goods without the requirement for the payment of duty and taxes, the Chinese law provides that the EPE needs to provide security for the importation of bonded goods.<sup>56</sup> In practice, the bonding system has two variants depending on the categories of the bonded goods used in export processing and the classification of the EPE by the governing customs.

One is for the EPE to place a refundable deposit with the financial institution as designated by the governing customs. The other is for the EPE to set up a nominal security accounts without the requirement to put up deposits.<sup>57</sup> Fourth, bonded goods are under customs supervision throughout the allowed period of stay inside the PRC, commencing on the date of customs release to the date of lifting customs supervision. Fifth, there is a legal requirement for customs verification that takes place before lifting of customs supervision over the bonded goods, in order that the EPE can discharge the legal liability for the importation of the bonded goods under the production contract.<sup>58</sup> The EPE can redeem the security deposit afterwards.

## XI. Duty and VAT Rules in Designated Economic Areas

Designated economic areas include free trade zones, export processing zones, and bonded logistic parks. The establishment of free trade zones (FTZ) requires the approval from the State Council.<sup>59</sup> The FTZs are excluded from the Chinese customs zones. Goods traded among enterprises situated in FTZs are not subject to duty and VAT. Goods shipped between a FTZ and destinations in other countries or regions are exempted from import duty and VAT. Production equipment imported for use by enterprises in designated FTZs is exempted from duty and VAT. Goods other than self-used production equipment imported from a destination in another country to the free trade zone are classified as bonded goods.<sup>60</sup> The duty and VAT treatment of bonded goods will vary depending on the way they will be used and where the final destinations will be, as shown in Table 5 below.

Goods delivered by an enterprise situated in a non-FTZ area (elsewhere in the PRC) to an enterprise situated inside an FTZ are considered exports and are eligible for VAT export rebates after the goods physically leave the FTZ for overseas destinations.

The establishment of an export-processing zone (EPZ) requires approval from the PRC state council. An EPZ must be located within an existing Economic and Technology Development Zone.<sup>61</sup> It is useful to compare the differences between FTZs and EPZs. First, trading, re-export, and exhibition business can be undertaken in an FTZ, but the same cannot be done in an EPZ. Second, only simple export processing activities may be undertaken in an FTZ, but substantive export processing may be done in an EPZ. Third, the same exemption of duty and VAT treatment applies to goods shipped between export processing zones and destinations in other countries (or regions). However, the duty and VAT treatments for the movement of the goods that take place between the zone and elsewhere in the PRC are different. Shipment of goods from an enterprise situated inside an EPZ to an enterprise situated outside an EPZ (elsewhere in the PRC) is treated as an import. Goods imported from an EPZ shall be subject to import duty and VAT on the full amount of the finished goods, with no distinction between imported and domestically purchased materials. Such tax treatment is different from the importation of goods from enterprises situated in an FTZ into the non-FTZ (elsewhere in the PRC) mentioned above. Shipment of goods from an enterprise elsewhere in the PRC to an enterprise situated inside an EPZ is treated as an export. However, the VAT export refund treatment is different from that in free trade zones:

- materials and semi-finished goods delivered by an enterprise situated in the non-EPZ (elsewhere in the PRC) to an enterprise situated within an EPZ are eligible for VAT export rebates immediately, without the requirement for those goods to physically leave Chinese territory;
- domestically manufactured production equipment sold by enterprises elsewhere in the PRC to an EPZ enterprise is also eligible for immediate export refunds.

TABLE 5

	Use and final destinations	Duty and VAT obligations
(i)	Bonded goods sold between enterprises within the FTZs	Exempted from duty and VAT
(ii)	Bonded goods used exclusively in the manufacture of export products by enterprises within the free trade zone	Exempted from duty and VAT, if the bonded goods after processing are shipped out of China within one year.
(iii)	Bonded goods shipped by enterprise inside the FTZ to enterprise outside the FTZ for exclusive use in the manufacture of export products	Exempted from duty and VAT, if the bonded goods after processing are shipped out of China within one year. Security for duty and VAT shall be provided under security account system.
(iv)	Bonded materials, parts and components sold by an enterprise situated inside the FTZ to an enterprise situated outside the FTZ (elsewhere in the PRC)	It is considered to be import and subject to duty and VAT.
(v)	Finished goods, consisting of imported components, are sold by an enterprise situated inside the FTZ to an enterprise situated outside the FTZ (elsewhere in the PRC).	It is subject to duty and VAT. If the finished goods consist of both imported and locally purchased components, the customs shall levy duty and VAT on the amount of imported components only.
(vi)	Bonded goods sold or returned to destinations in other country or regions	Exempted from duty and VAT if they are shipped out of the PRC within one year.
(vii)	Bonded goods stay within the PRC for a period exceeding one year.	In the absence of approval on extension of period of stay, liability for import duty and VAT arises.

1 See item 4 in Article 61 of the Detailed Implementation Regulations of the PRC Tax Law for Foreign Investment Enterprises and Foreign Enterprises, and the Tentative Measure on the Administration of Export Processing Trade under order no. 314 (1999) issued by the Ministry of Foreign Trade and Economic Cooperation on 27<sup>th</sup> May 1999.

2 See Article 22 of the Customs Policies on Free Trade Zones, issued by the General Administration of Customs on 1<sup>st</sup> August 1997.

3 See Article 30 of the PRC Customs Law.

Imported equipment sold by a non-EPZ enterprise to an EPZ enterprise does not receive the export refund treatment.<sup>62</sup>

Note that by “enterprise situated in the non-EPZ” (or the FTZ), it is meant the non-EPZ enterprise must be a general VAT taxpayer who has been duly registered as a foreign trader in accordance with Chinese law. Sellers situated elsewhere in the PRC who are not registered as foreign traders are not eligible for export refund treatments.<sup>63</sup> Goods shipped into and out of bonded logistic parks (BLP) receive the same duty and VAT treatment as that for an EPZ. FIEs situated in both FTZ and BLP can carry on import and export trading activities. With effect from July 13, 2005, the Chinese government has granted wholesale distribution right to FIEs situated in FTZ and BLP.<sup>64</sup> It is useful to compare the different scope of business activities that an FIE can perform in the designated economic areas as shown in Table 6:

TABLE 6	Designated Economic Areas (duty and VAT free)	Non-designated Economic Areas		
	Free trade zone	Export processing zone	Bonded logistic park	Elsewhere in the PRC
Trading	Yes	No	Yes (a)	Yes (b)
Exhibition	Yes	No	Yes	Yes
Re-export	Yes	No	Yes	Yes
Export processing	Yes (c)	Yes (d)	Yes (e)	Yes (f)
Storage	Yes	Yes	Yes	Yes
Transportation	Yes	Yes	Yes	Yes

(a) With effect from 13<sup>th</sup> July 2005, the foreign invested commercial enterprise (the FICE) located in the BLP can apply for the wholesale distribution right, in addition to the import-export rights.<sup>1</sup>

(b) With effect from 11<sup>th</sup> December 2004, the foreign invested commercial enterprise situated elsewhere in the PRC can apply for both the wholesale and retail distribution rights, in addition to the import-export rights.<sup>2</sup>

(c) The FIE can only carry on simple export processing activities.

(d) The FIE can carry on substantive processing activities and the sellers of the goods to the EPZ enterprises are eligible for immediate export refunds.

(e) The FIE can carry on simple export processing, packing, bulk-breaking, regarding, sorting and labeling activities.

(f) The FIE that carry on export processing trade is subject to the administration of the security system for importation of bonded goods, and since the transaction is conducted in foreign currency, the FIE should also comply with the verification procedure for import payment and export collection.

<sup>1</sup> See Order 76 (2005) jointly issued by the Ministry of Commerce and the General Administration of Customs on 13<sup>th</sup> July 2005.

<sup>2</sup> See Order 8 (2004) issued by the Ministry of Commerce on 16<sup>th</sup> April 2004.

## XII. Entry Modes

Foreign investors can carry on foreign and domestic trading business through the establishment of a foreign invested commercial enterprise (FICE) under the legal framework of the PRC Law for Sino-foreign Equity Joint Venture, the PRC Law for the Sino-foreign Co-operative Joint Venture, the PRC Law for Foreign Funded Enterprises, and the PRC Company Law.<sup>65</sup> At present, there are five entry modes to set up trading operations under the current PRC legal framework:

- Production-type FIE
- Production-type FIE expanding the business scope to trading
- Sales branch set up by an FIE/FICE
- FIE/FICE created in Special Economic Areas (SEA)
- FICE created elsewhere in the PRC.

### A. Comparison: FIE/FICE Created in SEA and Elsewhere in the PRC

The foreign investor may choose to set up a FICE in different locations in the PRC. If the FICE is to be set up in a free trade zone or bonded logistic park (special economic areas), the PRC legal rules shall apply differently regarding the customs, VAT, foreign exchange and import licence, depending on the origination and final destination of the goods. It is useful to make a comparison between a FICE located in a SEA and elsewhere in the PRC by listing the application of the PRC legal rules on the transactions, as shown in Table 7:

TABLE 7		VAT, customs duty, import/export license, and foreign exchange administration
	Origination and destination	
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
II	Goods delivered from enterprise in the SEA to enterprise situated elsewhere in the PRC	1. Import customs procedure applied 2. Import duty and VAT; (b) 3. Enterprise situated elsewhere in the PRC shall complete verification procedure for import payment 4. Import license required
III	Goods delivered from non-SEA enterprise to FTZ / BLP	1. Export customs procedure applied; 2. VAT export refund; (c) 3. Enterprises situated elsewhere in the PRC shall complete foreign exchange verification procedure on export collection 4. Export license required
IV	Goods traded among enterprise situated in special economic zones (FTZ / EPZ / BLP)	1. Customs procedures not applied in the same zone; 2. No VAT imposed; 3. No requirement for verification of import payment / export collections; 4. Import license not required

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

(b) If the goods are shipped from the FTZ to enterprises situated elsewhere inside the PRC, different rules for the levy of duty and tax on import goods shall apply. Please refer to the discussion earlier under the heading of “duty and VAT rules in designated economic areas”.

(c) Depending whether the goods are shipped to FTZ or EPZ, the customs adopt different administration rules on export refunds. See also discussion under “duty and VAT rules in designated economic areas”.

The PRC foreign exchange rules have different provisions depending on the types of transactions conducted by enterprises situated in a FTZ/BLP. In respect of transactions between a FTZ and the other countries or regions, the transaction must be denominated in foreign currency. In respect of transactions between a FTZ-enterprise and a



non-FITZ enterprise, the currency used for the transactions depends on the type of goods – the transaction:

- must be conducted in foreign currency for bonded goods;
- can be conducted in foreign currency or CNY for goods other than bonded ones.

In respect of transactions between enterprises inside the FITZ, it can be denominated in foreign currency or CNY.<sup>66</sup> Enterprises situated in a BLP follow the same requirements in principle.<sup>67</sup>

## B. Comparison: an FICE and an FIE Expanding Business Scope to Trading

The first difference lies in the sales mix. A FICE can carry out trading activities but a FIE engaged in production activities can only carry out trading activities to a limited extent. FIEs are not allowed to have trading revenue exceeding 30 percent of the total revenue earned from production and trading activities. If the FIE is to become a non-production FIE, the 30 percent limitation can be lifted. The second difference lies in income tax. If the production type FIE is enjoying the 2-plus-3 income tax concession, there is a possibility that the income derived from trading activities will automatically receive the same tax concession. The FICE cannot enjoy such preferential treatment. Third, if the FIE has previously been granted any income tax concession for export performance, the additional sales in the domestic market may have income tax impact.<sup>68</sup> The establishment of a separate FICE can retain the benefit of the tax concession received on export performance. Note that the FICE is required to complete the registration procedure as the foreign trader in accordance with the PRC law.<sup>69</sup>

## C. Comparison: Setting Up an FICE or Branch

### 1. Legal issues

There are some legal requirement for the FIE / FICE setting up a branch. First, the head office has to pay up all the capital; second, the head office must have passed the annual examination to ensure that it has a lawful and continued existence under Chinese law; third, the scope of business for the branch cannot exceed that for the head office; and fourth, the branch is required to apply for a branch business licence, national tax and local tax registrations in the same way as the head office.

### 2. Business considerations

The branch may be located in the same city or elsewhere depending on the business requirement. The management may have the following business considerations:

- whether the head office or branch will sign sales contracts,
- whether the branch will sell goods in its own name or act as an agent for the head office;
- whether the branch will collect cash or cheque payments;
- whether the branch is to carry on retail business; and
- whether the branch will be required to issue VAT special invoices or ordinary tax invoices.

If the branch is to sign sales contracts, then it has to issue a VAT special invoice or ordinary tax invoice, and receive the payment. The branch may sell goods on cash or credit terms. If the branch is to sell the goods in its own name, then it has to issue VAT special invoices or ordinary tax invoices. If the branch is to receive check payment, then it must issue VAT special

invoices or ordinary tax invoices. If the branch is to carry on retail business, then it must receive cash takings and, upon request, issue tax invoices to the buyer at its place of business.

### 3. Rules on use of tax invoices

When there is a need for the branch to issue VAT special invoices or ordinary tax invoices (tax invoices), the FIE/FICE must comply with the PRC legal rules on the use of tax invoices whether they are engaged in wholesale or retail business activities. The PRC legal rules do not allow blank tax invoices to be carried by hand or delivered by any means of transportation from one province to another, or from one municipality directly administered by the State Council to another directly administered municipality.<sup>70</sup> The use of tax invoices purchased from the tax authorities located at the cities of other province or municipality will invite administrative punishment.<sup>71</sup> If the branch is located in a different city but within the same province or municipality as the head office, it must obtain administrative approval from the tax authority such that the blank tax invoices can be hand-carried or delivered from the head office to the branch for its use.<sup>72</sup> In the absence of such approval, the branch is required to purchase tax invoices from the tax authority where the branch is located. In this connection, one must check with the tax authority whether the transportation of tax invoices across cities within the same province is lawful or not.<sup>73</sup>

### 4. Transfer pricing

The branch can enter into sales contracts in its own name but it has no import/export right. The head office has to import goods for the branch. Since the branch has to issue tax invoices and collect the sales proceeds, it has to buy goods from the head office. In the absence of a bench mark price, the PRC VAT rules require the head office to charge the branch in the following ways:

1. at a price comparable to the average price for similar goods sold for the current month;
2. at a price comparable to the average price for similar goods sold in the previous three months; and
3. at the composite price such that it equals to: cost x (1+ 10 percent deemed profit rate), in that order.<sup>74</sup>

### 5. Capital requirement

The old PRC company law provides that the capital requirement for the establishment of a wholesale company and a retail company are CNY500,000 and CNY300,000 respectively.<sup>75</sup> In October 2005, the PRC National People's Congress amended the PRC Company Law which provides that the minimum capital of a company is CNY30,000. Where the administrative regulations or rules lay down the minimum capital requirement for a company in any specific industry sector, the minimum capital requirement of CNY30,000 shall not apply.<sup>76</sup> The new Company Law provides a minimum capital of CNY100,000 if the company has one single shareholder.<sup>77</sup> It is certain that the new Company Law has lowered the capital requirement for setting up a FICE. It is uncertain whether the provision in the new law shall take precedence over the old one regarding the capital requirement for setting up a FICE. However, the latest information available to us is that the number as laid down by the old law shall apply.<sup>78</sup>

The capital contributed by the investors can take the form of cash or non-cash assets, which includes tangible properties, IP

rights, land use rights, and other forms of non-cash assets that are measurable in monetary terms and transferable in accordance with the Chinese law. In addition, the proportion of cash contribution to non-cash (in-kind) contribution should not exceed 30 percent of the registered capital.<sup>79</sup> The registered capital must be paid up within six months from the date of incorporation if the capital amount is payable in one lump sum. If the amount of registered capital is to be paid up by instalments, the first instalment, being no less than 15 percent of the total amount of registered capital, must be paid up within three months from the date of incorporation.<sup>80</sup> The rest of the registered capital shall be paid up within two years from the date of incorporation.<sup>81</sup>

If the importation of capital takes the form of tangible assets, the FICE or its agent should file for record at the governing customs information about the imported equipment as approved by the appropriate authority prior to importation. In the event that the customs valuation is higher than the amount of imported equipment filed at customs, customs shall not release the imported goods. In that connection, the FICE should obtain approval to amend the information about the imported equipment. After the importation of the capital equipment, the legal representative of the FICE should appoint a local accounting firm to perform an examination of the imported capital equipment and amend the amount of paid up capital as stated in the business licence on the strength of the capital examination report.

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- 1 The administration of PRC foreign trade and domestic trade was under the jurisdiction of the Ministry of Foreign Trade and Economic Co-operation (the MOFTEC) and the State Economic and Trade Commission respectively. Under a decision passed in the first session of the 10th P.R.C. National People's Congress on March 10, 2003, the Ministry of Commerce (the MOFCOM) was to be set up to take the place of the MOFTEC and the State Economic and Trade Commission. Since then, the MOFCOM has been the main administrator of the PRC trade systems.
- 2 The Ministry of Commerce, Order 8 (2004), April 16, 2004.
- 3 In line with the commitments made in the WTO accession, the Chinese government had an obligation to abolish the foreign trade approval system and liberalise the commodity and technology trading rights within three years from accession to WTO on December 11, 2001. See the "Protocol on the Accession of the PRC" and the "Report of the working party on the accession of China", December 11, 2001.
- 4 National People's Congress, Foreign Trade Law, Article 9, amended on April 6, 2004 and effective on July 1, 2004.
- 5 The Experimental Measure of Foreign Invested Commercial Enterprises, jointly issued by the MOFTEC and State Trade and Economic Commission on June 25, 1999, and repealed on June 1, 2004.
- 6 The Ministry of Commerce, Order 8 (2004), April 16, 2004.
- 7 The Ministry of Commerce, Order 9 (2005), April 2, 2005.
- 8 See Article 8 of the Administrative Order 127 (2005), issued by the General Administration of Customs on March 9, 2005.
- 9 The Ministry of Commerce, Order 14 (2004), June 25, 2004.
- 10 The Ministry of Commerce, Order 46 (2005), August 17, 2004.
- 11 The Ministry of Commerce, Order 14 (2004), June 25, 2004.
- 12 See Administrative Order 127 (2005), issued by the General Administration of Customs on March 9, 2005 and effective on June 1, 2005.
- 13 See Article 7 of the Administrative Regulation on Import and Export of Goods, promulgated by the State Council on October 31, 2001 and effective on January 1, 2002.
- 14 See Article 9 of the Administrative Regulation on Import and Export of Goods, promulgated by the State Council on October 31, 2001 and effective on January 1, 2002.
- 15 See Article 11 of the Administrative Regulation on Import and Export of Goods, promulgated by the State Council on October 31, 2001 and effective on January 1, 2002.
- 16 See Article 22 of the Administrative Regulation on Import and Export of Goods, promulgated by the State Council on October 31, 2001 and effective on January 1, 2002.
- 17 See Article 14 of the Implementation Regulations of Administrative Punishment by the PRC General Administration of Customs, promulgated under Decree No. 420 by the PRC State Council on September 19, 2004.
- 18 See Articles 8, 10, and 22 of the Administrative Regulation on Import and Export of Goods, promulgated by the State Council on October 31, 2001 and effective on January 1, 2002.
- 19 See Articles 33 and 35 of the Administrative Regulation on Import and Export of Goods, promulgated by the State Council on October 31, 2001 and effective on January 1, 2002.
- 20 The minimum amount of registered capital was CNY80 million and CNY50 million for wholesale and retail joint venture commercial enterprises respectively, as provided under the 1999 Experimental Measures.
- 21 In October 2000, the PRC Law for Wholly Foreign Owned Enterprises and the PRC Law for Sino-foreign Contractual Joint Venture Enterprises were amended by the Standing Committee of the National People's Congress. In March 2001, the PRC Law for Sino-foreign Equity JV enterprises was amended by the NPC.
- 22 Foreign invested retail commercial enterprises are not permitted to trade tobacco products. Foreign invested wholesale commercial enterprises are not permitted to trade salt and tobacco. See Article 17 of Order 8 issued by the Ministry of Commerce on April 16, 2004.
- 23 The Ministry of Commerce, Order 76 (2005), July 13, 2005.
- 24 The division of administrative authority in the Chinese government is as follows: distribution of pharmaceutical products requires approval from the State Food and Drug Administration; distribution of audio-video products requires the approval from the Ministry of Culture, etc. See the PRC Law for the Administration of Pharmaceutical Products, as promulgated by the National People's Congress on 2001, and the PRC Regulation for the Administration of Audio-video Products, as promulgated by the State Council and put into force on February 1, 2002.
- 25 Any amendment to the business scope requires the amendment to the Articles of Association, which in turn requires the approval from the approval authority.
- 26 See Article 12 of the Administrative Order No. 8 (2004), promulgated by the Ministry of Commerce on April 16, 2004.
- 27 See Article 27, the Notice of the Administrative Opinion on Several Issues Relating to the Applicable Laws for the Approval, Registration and Administration of Foreign Investment Enterprises, jointly issued under Order No. 81 (2006) by the State Administration of Industry and Commerce, the Ministry of Commerce, The General Administration of Customs, and the State Administration of Foreign Exchange on April 24, 2006.
- 28 Same Article 27 in the above Notice, see also the Administrative Regulation for the Registration of Companies, article 73, as amended by the PRC State Council on December 18, 2005.
- 29 The Ministry of Commerce only grants approval to set up an FIE or FICE. The provision of transportation services requires approval from the Ministry of Communication. The provision of warehousing and storage services requires the approval from the General Administration of Customs.
- 30 See Article 26 of the PRC Customs Law.

- 31 See Article 27 of the PRC Customs Law.
- 32 The amount of surcharge is calculated as per formula: surcharge = dutiable value x 0.05 percent x number of days in default. See Article 9 of Administrative Order 128 (2005), issued by the General Administration of Customs on March 3, 2005.
- 33 See Article 19 of the PRC Customs Duty Regulations on Imports and Exports, promulgated by the State Council on October 29, 2003 and effective on January 1, 2004.
- 34 See Article 20 of the PRC Customs Duty Regulations on Imports and Exports, promulgated by the State Council on October 29, 2003 and effective on January 1, 2004.
- 35 See Article 21 of the PRC Customs Duty Regulations on Imports and Exports, promulgated by the State Council on October 29, 2003 and effective on January 1, 2004.
- 36 General Administration of Customs, article 16 of Levy and Administrative Measures by the PRC Customs on Import-export Goods, Decree 124, January 4, 2005.
- 37 General Administration of Customs, Decree 53, 2005.
- 38 The National People's Congress, the PRC Customs Law, Article 60, as amended by the Standing Committee of the NPC on July 8, 2000.
- 39 The National People's Congress, the PRC Customs Law, Article 60, as amended by the Standing Committee of the NPC on July 8, 2000.
- 40 The National People's Congress, the PRC Customs Law, Article 61, as amended by the Standing Committee of the NPC on July 8, 2000.
- 41 See Article 62 of the PRC Customs Law, promulgated by the National People's Congress on January 22, 1987 and amended on July 8, 2000.
- 42 See Article 63 of the PRC Customs Law, promulgated by the National People's Congress on January 22, 1987 and amended on July 8, 2000.
- 43 See Guo Shui Fa 113 (2004), issued by the State Administration of Taxation.
- 44 See Article 64 of the PRC Customs Law, promulgated by the National People's Congress on January 22, 1987 and amended on July 8, 2000. See also Article 64 of the PRC Duty Regulations on Imports and Exports, promulgated by the State Council and effective on January 1, 2004.
- 45 See Article 5 of the PRC Foreign Exchange Administrative Regulations. In 1996, the Chinese government formally accepted the obligation under the IMF to remove exchange restrictions on trade and non-trade transactions under the current account. Since then Renminbi has been fully convertible on transactions of import and export trading. IMF confirms that China does not impose any forex restrictions on current account transactions.
- 46 See Article 8 of the PRC Foreign Exchange Administrative Regulations, promulgated by the PRC State Council.
- 47 See Article 9 of the Tentative Measure on the Supervision of Verification on Import Payments, issued by the State Administration of Foreign Exchange on January 17, 1997.
- 48 See Article 47 of the PRC Foreign Exchange Administrative Regulations, promulgated by the PRC State Council.
- 49 See Article 13 of the Tentative Measure on the Supervision of Verification on Import Payments, issued by the State Administration of Foreign Exchange on January 17, 1997.
- 50 See Article 5 of the Tentative Measure on the Supervision of Verification on Import Payments, issued by the State Administration of Foreign Exchange on January 17, 1997. See also Article 4 of the Administrative Measure for the Authenticity Checking on Import Payment Verification Relating to Goods, issued under order no. 199 (98) by the State Administration of Foreign Exchange.
- 51 See Article 11 of the PRC Foreign Exchange Administrative Regulations, promulgated by the PRC State Council.
- 52 See Article 100 of the PRC Customs Law.
- 53 Please refer to the Administration Measures by the PRC Customs over the Supervision of Bonded Goods under Export Processing, issued under Order 113 (2004) by the General Administration of Customs.
- 54 See Article 7 of the Administrative Measures by the PRC Customs over the Supervision of Bonded Goods under Export Processing, issued under Order 113 by the General Administration of Customs.
- 55 See Article 33 of the PRC Customs Law.
- 56 See Article 59 of the PRC Customs Law.
- 57 See Notice issued under Order Shu Jian 522 (1999) by the General Administration of Customs on July 12, 1999.
- 58 See Article 30 of the Administrative Measure for the Supervision by the PRC Customs over the Bonded Goods Used in Export Processing, issued under order 113 (2004) by the General Administration of Customs.
- 59 See Article 57 of the PRC Customs Law. See also Article 2 of the Customs Policies for Free Trade Zones, approved by the State Council and issued by the General Administration of Customs on August 1, 1997.
- 60 See Article 12 of the Customs Policies on Free Trade Zones, issued by the General Administration of Customs on August 1, 1997.
- 61 See Article 2 of the Tentative Administrative Measure by the PRC Customs for the Supervision over the Export Processing Zone, issued by the General Administration of Customs on May 24, 2000.
- 62 See Article 27 of the Tentative Administrative Measure by the PRC Customs for the Supervision over the Export Processing Zone, issued by the General Administration of Customs on May 24, 2000.
- 63 See Article 2 of the Tentative Administrative Measure for the Levy of Taxes in Export Processing Zones, issued under document Guo Shui Fa 155 (2000) by the State Administration of Taxation.
- 64 See document Shang Zi Zi 76 (2005) jointly issued by the Ministry of Commerce and the General Administration of Customs on July 13, 2005.
- 65 Article 218 of the PRC Company Law provides that the PRC Company Law shall apply to foreign investment enterprises, subject to any provisions in the laws for foreign investment enterprises.
- 66 See Article 7 of the Administrative Measure on the Foreign Exchange in the Free Trade Zone, issued under order 74(2002) by the State Administration of Foreign Exchange, effective on October 1, 2002.
- 67 See Article 1 of the Notice Relating to the Administration of Foreign Exchange for Bonded Logistic Parks, issued under order 92 (2005) by State Administration of Foreign Exchange.
- 68 See Article 75 of the Implementation Regulations for the PRC Tax Law for Foreign Investment Enterprises and Foreign Enterprises, promulgated by the PRC State Council on June 30, 1991.
- 69 See the Administrative Order 14 (2004), issued by the Ministry of Commerce, effective on July 1, 2004.
- 70 See article 27 of the Administrative Measures on the Administration of Tax Invoices, as issued by the Ministry of Finance on December 23, 1993.
- 71 The FIE/FICE will be subject to a fine not exceeding CNY10,000. See article 37 of the Administrative Measures on the Administration of Tax Invoices, as issued by the Ministry of Finance on December 23, 1993.
- 72 See article 26 of the Administrative Measures on the Administration of Tax Invoices, as issued by the Ministry of Finance on December 23, 1993.
- 73 The practices vary from province to province. The tax authority at Guangdong province permits the transportation of blank tax invoices across cities within the province subject to administrative approval. The tax authority in Jiangsu province does not permit the transportation of blank tax invoices across cities in the same province.
- 74 See Article 16 of the Detailed Implementation Rules for PRC VAT Tentative Regulations as issued by the Ministry of Finance, and the

- document Guo Shui Fa 154 (1993) as issued by the State Administration of Taxation.
- 75 National People's Congress, the Company Law, Article 23, December 29, 1993.
- 76 National People's Congress, the Company Law, Article 26, October 27, 2005.
- 77 National People's Congress, the Company Law, Article 59, October 27, 2005.
- 78 The Ministry of Commerce confirmed that the provision o the old law shall apply upon an enquiry from Trade and Industry Bureau of Shenzhen on the minimum capital requirement for a FICE.
- 79 The National People's Congress, Company Law, article 27, as amended on October 27, 2005.
- 80 See Article 9 of the Administrative Notice jointly issued under document Gong Shang Wai Qi Zi 81 (2006) by the State Administration of Industry and Commerce, the Ministry of Commerce, the General Administration of Customs and State Administration of Foreign Exchange on April 24, 2006.
- 81 See Article 26 of the PRC Company Law, as amended by the National People's Congress on October 27, 2005. See also the Administrative Regulation for the Registration of Companies, article 20, as amended by the State Council on December 18, 2005.