

China Is Changing the Rules on Export Manufacturers

Processing Trade - Is this engine of China's economic development shifting gears?

August 2007

ERNST & YOUNG

Quality In Everything We Do

Processing Trade has been one of the biggest drivers behind China's economic ascension and has saved companies billions. Recent changes to this program will significantly impact company operations but also could fundamentally transform how and where China's economy develops.

The magnitude of economic growth in China over the last few years has been truly astonishing. China's GDP has expanded an average of 9.6% each year for over 25 years. Overall trade volume has exploded to more than US\$1.76 trillion¹. The trade surplus, a staggering US\$177.47 billion², has ballooned to untenable levels. The waves are being felt on a global basis and are forcing the Chinese Government to rethink and reshape the strategies responsible for fueling much of this historic growth while continuing to focus on the long-term need for sustainable growth.

China used to provide generous tax breaks and other such incentives to lure vast quantities of foreign direct investment ("FDI") into China. This strategy worked well for decades and export manufacturers arrived in droves, built modern factories and hired millions of workers. The economy overall benefited. But things in China change quickly and these incentives are being phased out.

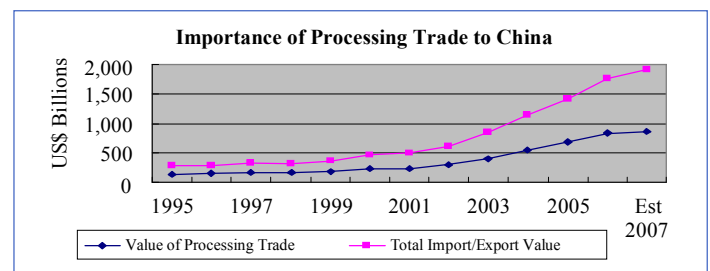
One of the cornerstones behind China's success has been the growth in export manufacturing through a program called Processing Trade. This program has saved companies billions of dollars in duty and VAT costs. Without Processing Trade, prices for Chinese export goods would be less competitive. But recent regulatory changes to Processing Trade are increasing costs, adding operational complexity and causing companies to reconsider China's status as a preferred global manufacturing base.

The following article outlines the basics of how the Processing Trade regime works, the impact to company operations from recent changes, common issues encountered by Processing Trade entities and some thoughts regarding what the future may hold for export manufacturers.

Introduction to Processing Trade

Processing Trade is the name given to the program which permits a company to import raw materials free of duty/VAT for producing export goods. It is used by a majority of export manufacturers to legitimately manage indirect tax costs.

In just over 25 years the value of Processing Trade has increased 333 times from US\$2.5 billion in 1981 to US\$831.9 billion in 2006. In the first half of 2007, the Processing Trade total import and export value rose 17.6% to US\$440.9 billion⁴.



The following two types of manufacturing structures are employed under the Processing Trade program in China:

- Contract Manufacturing (进料加工) – The manufacturer purchases all raw materials for their own account, owns the goods through production and sells the finished goods to customers. They earn a profit on sale of the goods.
- Toll Manufacturing (来料加工) – An overseas company purchases the raw materials for their own account and consigns them to the manufacturer. The manufacturer imports the materials but is only responsible for the processing activities and does not sell the finished goods. Revenue is earned through a "processing fee".

Most factories manufacture under Processing Trade using one of the above structures.

¹ China Customs Statistics

² As of December 31, 2006

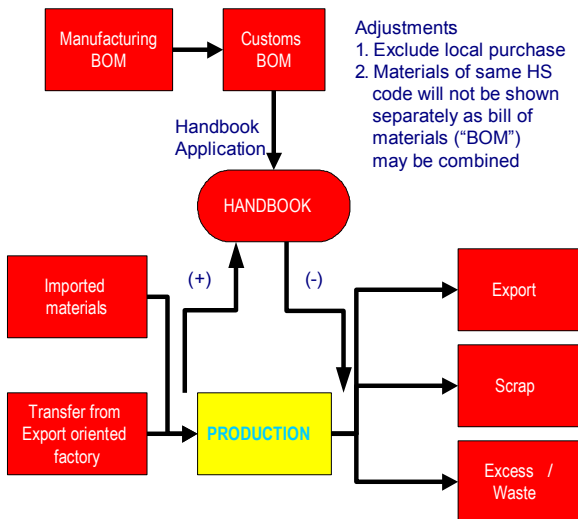
³ First Finance Daily, July 25, 2007

⁴ China Customs website – www.customs.gov.cn

How Does Processing Trade Work?

The Processing Trade program allows for the upfront exemption of duty and VAT on imported raw materials, which are considered to be in a “bonded” state. These bonded raw materials must be tracked and reconciled to the final exported finished goods. With such a program, Customs is concerned that raw materials which were never duty/VAT paid are introduced into the domestic market without payment of the relevant taxes⁵. Thus, a tracking mechanism is necessary to monitor the inputs and outputs.

Processing Trade’s tracking mechanism is commonly referred to as a “customs handbook” or “customs logbook”. A customs handbook can be either a paper-based book or can be an electronic version, sometimes referred to as either an “e-handbook” or “network supervision”. The picture below is a simple graphic illustration of how inputs into the customs handbook are tracked and reconciled to outputs:



The actual procedures are much more complex than outlined above and can be difficult to practically apply in a compliant manner. But since the program may save the export manufacturer significant costs, it is usually worth the additional administrative burden if implemented correctly.

Recent Changes to Processing Trade – Prohibited, Restricted and What Next?

There has been a flurry of new Processing Trade regulations promulgated over the last couple of years. Unfortunately, the new regulations are triggering concerns over how it will impact the operations of export manufacturers. Many of these rules were issued with little or no warning and/or without detailed implementation measures. For example, a recent rule was announced one day and became effective the very next day. Companies are expressing their frustration at the suddenness and lack of transparency accompanying these rules and wondering how it is possible to make long-term decisions when the rules of the game change so frequently.

But the Chinese Authorities have a difficult job too and it is impossible to satisfy everyone. As China endeavors to address international trade, economic, social and political challenges, it is increasingly utilizing trade programs, such as Processing Trade and export VAT refunds, as “tools” to guide certain macro-economic policies and adjust long-standing investment patterns. The Vice Minister of MOFCOM, Wei Jianguo, stated that “we are striving to improve the development of China’s Processing Trade program in a bid to promote trade balance and reduce the trade surplus”. Many different Agencies⁶ have a vested interest in making sure their opinion is incorporated into the changes.

Not all companies and types of production can enjoy the benefits of Processing Trade. Companies must be approved by MOFCOM and Customs to conduct such activities. In addition, there is a list of products and processes which are prohibited from using Processing Trade. Finally, a new “Restricted” category was recently introduced.

Prohibition List

There has always been a list of designated products which China does not allow to be produced under Processing Trade. The most recent List places prohibited products into the following categories: exported finished goods; imported raw materials; and combinations of finished goods made with certain imported raw materials. Prohibited products can be manufactured for export but the raw materials cannot be imported on a bonded basis. That is, customs duty and VAT would be payable at the time of importation and this increases manufacturing costs.

The following recent policy adjustments have significantly expanded the product coverage of the Prohibition List over the last year:

- Decree No. 139 and 145 (September 2006) stated that products with a 0% export VAT refund rate would be placed on the Prohibition List;
- Announcement No. 82 (November 2006) released an updated version of the Prohibition List;
- Announcement No. 17 (April 2007) added items to the List as well as consolidated different Prohibition Lists;
- Supplement to Announcement No. 17 (July 2007) included additional items and clarified others that are not on the List;
- Others.

Many of these rules were confusing, contradictory or inconsistently interpreted by various local Authorities. From now on, the Authorities will no longer issue a formal regulation every time the Prohibition List is updated. Rather, it will be updated online and companies must monitor the changes. The ease with which the online Prohibition List can be revised is likely an indication to expect future changes, possibly both additions and deletions.

⁵ China Customs may consider this tax evasion and in the worst case could be categorized as smuggling.

⁶ Recent regulations have been jointly issued by no less than the Ministry of Finance, Ministry of Commerce, General Administration of Customs, State Administration of Taxation, Environmental Protection Agency and others.

The Authorities have stated they intend to target products and activities which are not entirely in line with China’s long-term strategic goals (i.e., those with high energy consumption; create high levels of pollution; use China’s natural resources; and are considered to be low-value add).

Restricted List

A new “restricted” category was added to the changing landscape of Processing Trade. On July 23rd, Announcement No. 44 created a list of restricted products that covers over 1,800 tariff codes and places monetary and geographic restrictions on export manufacturers. The new restrictions can have a serious impact on a company’s supply chain, cash flow and operating location.

A summary⁷ of the HS chapters of products affected is provided in the table below:

Chapter 39	Chapter 44	Chapter 51 – 56
Chapter 59	Chapter 60	Chapter 63
Chapter 69	Chapter 70	Chapter 74
Chapter 75	Chapter 76	Chapter 78 – 80
Chapter 94	Chapter 96	

These products were selected for a number of reasons, but the approach was to identify products with relatively low-value add, high amounts of manual intensive labor and those causing friction with China’s trading partners. By targeting such production and encouraging the westward movement of investment, the Authorities are hoping to address a number of social issues at the same time.

The following restrictions are imposed on affected products:

- Companies must post cash deposits for the estimated⁸ amount of their duty/VAT liability. Companies with an A or B grading are allowed to post only 50% of the amount, while C grade companies will have to post 100%. If an A or B grade company is already located in middle and Western China, then the deposit requirement may be waived.
- If a factory to manufacture restricted products was not approved to conduct Processing Trade before July 23rd, then the company will not be allowed to conduct this activity in the coastal provinces⁹ of China. That is, the company will need to be located in middle and Western China (or special zones) to manufacture under Processing Trade.
- A company currently manufacturing under Processing Trade without import/export rights must obtain the rights before October 23rd to be able to continue producing such products.

- The restricted list applies to E-handbooks but does not apply to special zones (e.g., export processing zone, bonded zone, etc.) and special types of bonded factory transfers¹⁰.

There is a relatively short transition period under which companies can delay some of the above requirements. Companies can submit their export contracts and must receive approval from MOFCOM and Customs by August 23rd in order to continue under the old rules (i.e., not required to lodge a cash deposit). The information contained in a registered contract cannot be changed and once the total quantity has been reached or the handbook expires, then the new rules will apply. Thus, companies producing goods on the Restricted List should act immediately to register a contract and obtain a customs handbook.

What’s Next?

It is tricky to attempt to predict the next Processing Trade changes to be introduced by the Authorities. This is especially true in the current environment where changes are announced with little or no warning. However, it is apparent that further changes will be coming as they seek to further improve the program and address a multitude of challenges.

The Prohibition List is likely to be in a continual state of revision. This List is now published online and this gives the Authorities greater flexibility to add and delete items.

The Restricted List will be monitored and likely adjusted from time to time. The Authorities are keen to understand the economic and operational impact of these changes and are willing to listen to how this affects businesses. They may even initiate certain adjustments where the results differed from the expected outcome. The geographic restrictions satisfy China’s long-term goals of developing not only the coastal regions but cascading employment opportunities to Western provinces, so we see this restriction also expanding further.

Currently, HS codes are being used to select the affected products. This is not a perfect method as products which were not targeted to be in the Prohibition or Restricted Lists may end up being captured therein. Thus, it may be plausible for additional criteria, other than just the HS codes, to be contemplated in future changes.

An even more radical position may be to ask “*whether Processing Trade, in its current form, has outlived its usefulness?*”. If so, then fundamental changes in the program or a scrapping of the entire program may be necessary. The Authorities are already contemplating alternatives, but such structural change will not come easily.

⁷ Not all products under the listed Chapters are on the restricted list. This only provides a high-level idea of the scope of coverage.

⁸ Announcement No. 44 provides a formula upon which the estimated cash deposit should be based upon.

⁹ Basically all coastal provinces except for Hainan and Guangxi provinces.

¹⁰ This is a bonded transfer within China (sometimes called “indirect export”) from one factory to another factory.

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Common Issues

As mentioned, Processing Trade provides huge cost savings to export manufacturers. To enjoy the benefits companies must understand the regulations and employ operational procedures to ensure compliance. Failure to do so will result in additional duty/VAT liabilities payable. Given the large volumes and quantities of goods manufactured for export, the resulting costs can be material and usually come as an unwelcome surprise.

A few of the most common issues are listed below:

- Outdated handbook system – the old handbook was not very flexible and data reported at the beginning of the registration process (e.g., values, quantities, wastage and consumption rates, etc.) changes frequently. It is a challenge to update the handbook regularly to reflect these facts but the e-handbook is simplifying the process.
- Inability to reconcile bonded inventory – it can be difficult to appropriately track the usage of the bonded raw materials and many times there is a large variance between the quantity Customs has in their records and the actual physical quantity in the warehouse. Customs will view a negative variance as unfavorable and require duty/VAT to be paid on the difference.
- Domestic sales – some manufacturers will sell goods to both the domestic and export markets. Bonded raw materials may be included in goods sold domestically. Domestic sales including bonded raw materials must be reported to Customs and duty/VAT paid thereon. Many companies forget, or overlook the requirement, to report their domestic sales in a timely manner.
- Closure of a handbook – many times it is too difficult for the operational staff to reconcile the inventory at the time of handbook closure. Thus, the irreconcilable ending balances are “rolled forward” to the beginning balances of a new handbook. The irreconcilable balances then compound over a period of time and increase the risk exposure to the company.

We have seen many companies start operations under Processing Trade without detailed internal controls, policies and procedures in place to avoid noncompliance. Most who have faced a serious issue with Customs say they wished upfront time had been invested to design procedures that could have prevented the issue. This is also more evident when the company does not have dedicated customs staff to manage the process or when there is a high rate of employee turnover.

Conclusion

Processing Trade has and will continue to play an important role in the development of China's economy. The Authorities are beginning to experiment with the program as a “tool” to engineer and force changes they believe are necessary for China's long-term growth. By prohibiting, restricting or encouraging production in certain industries or of specific products, they hope to nudge the economy towards a level of higher value-added manufacturing.

The new regulatory changes can significantly impact company operations as well as future investment decisions. With all the restrictions and complexity to manufacture in China these days, many companies are closely scrutinizing the business case for locating export-oriented factories in China versus other countries. The Authorities recognize that these changes negatively affect a number of businesses and are monitoring the impact. But they seem willing to accept a certain level of downside to address the larger issues such as the trade surplus, environmental pollution, limited energy and natural resources, balance of wealth in China and social order. They probably recognize that some FDI will be lost as a result, but are hoping that this is from companies at the lower end of the value-add spectrum.

It will be interesting to watch as the effects from these changes are manifested in the economy. Companies will be casting a wary eye to see how these changes are implemented. The Authorities are also eager to see if this experiment in tinkering with Processing Trade will pay off as expected. Either way, we will have to wait for a while to see how this all plays out.