



Crossing international boundaries

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SELLING IN CHINA – WHAT ARE THE CONSIDERATIONS?

With over 1.3 billion people and the increasing purchasing power of the population, more and more retailers and luxury brands are casting their eyes on China. According to the National Bureau of Statistics, China's retail sales grew 17.7% from a year earlier and were up 1.35% from August 2011. Sales of automobile and household durables have also recorded impressive results. While some luxury brands have decided to expand their geographical coverage in China by opening more stores in China, some property developers have also been developing more shopping complexes in their overall planning.

In this newsletter, we aim to provide you with information about the current Chinese market and how has it been forecast to perform in the coming years. In addition, we also set out some factors that should generally be considered if one wants to enter the Chinese market.

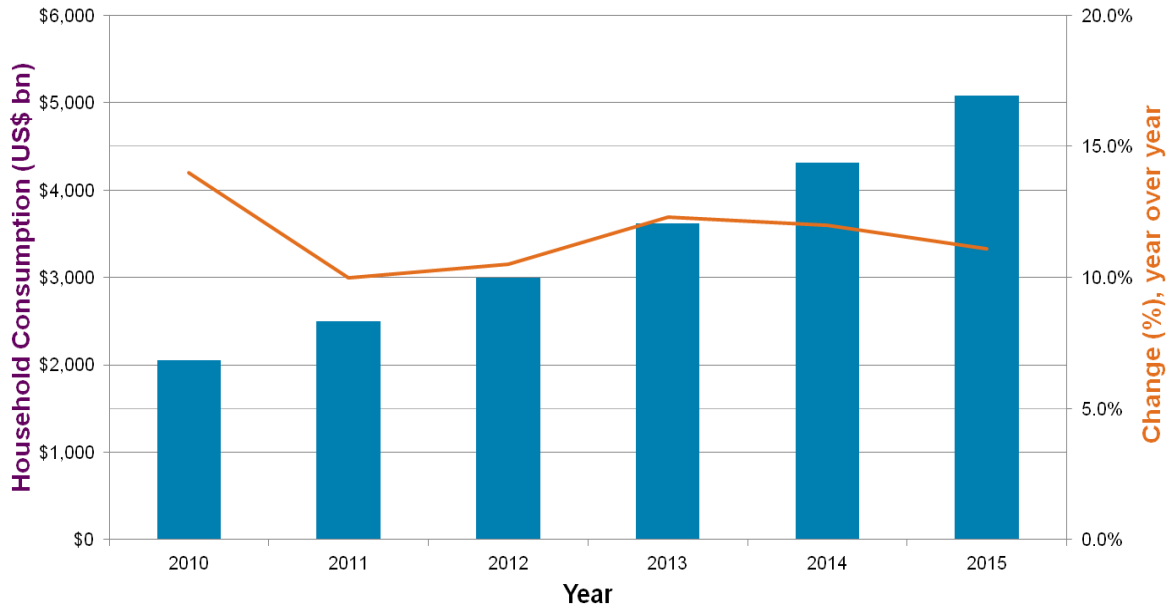
I. Introduction

China has traditionally been the “global factory”. Goods would normally be assembled in China before being distributed to the rest of the world. However, the Chinese domestic market has been growing as is evidenced by the following table and graph which summarize some related statistics and forecasts of the Chinese market:

	2010	2011	2012	2013	2014	2015
Population (m)	1,312	1,320	1,328	1,335	1,342	1,349
GDP (US\$ bn at market ex rate)	5,878	6,821	8,090	9,569	11,196	12,973
GDP per head (US\$ bn at market ex rate)	4,479	5,166	6,092	7,166	8,341	9,618
GDP (US\$ bn at PPP)	10,241	11,388	12,724	14,162	15,756	17,533
GDP per head (US\$ at PPP)	7,803	8,625	9,582	10,606	11,738	12,999
Household consumption (US\$ bn)	2,050	2,499	2,996	3,615	4,315	5,075
Household consumption per head (US\$)	1,560	1,890	2,260	2,710	3,210	3,760
Exports of goods & services (% change)	15.8	8.6	9.6	9.0	8.9	9.1
Imports of goods & services (% change)	14.0	10.0	10.5	12.3	12.0	11.1

Source: EIU 2011

Household Consumption compared to Imports of goods and services



Notwithstanding the enormous potential existing in the Chinese market, the complicated business regulations and government control in China have been some of the hurdles facing foreign companies when entering the Chinese market. In the subsequent sections, we will discuss about the factors to be considered, some possible structures and the business considerations with respect to selling in China.

II. Factors to be Considered

Selling goods in China is subject to various government controls and tax implications as follows:

- Currency and exchange control – The People’s Bank of China and the State Administration of Foreign Exchange in China manage and control foreign currencies in China. Businesses in China need to adhere to the prevailing rules with respect to conversion, retention and transfers of foreign currencies.
- Invoice administration – Organizations need to adhere to rules laid down by the State Administration of Taxation (“SAT”) with respect to the printing, purchasing and safe-keeping of invoices. Categories, copies, contents and range of application of invoices are also subject to the relevant regulations of the SAT.
- Logistics arrangement – Goods sold by a Chinese supplier to a non-Chinese buyer would need to be exported out of China. If the goods would eventually be sold to Chinese customers, these goods may need to be exported out of China before being re-imported. Customs duty and customs clearance would also need to be considered.
- Value added tax (“VAT”) implications – Entities or individuals engaged in the sales of goods within China would be subject to VAT.
- Enterprise income tax (“EIT”) implications – All enterprises operating within the territory of China will need to pay EIT on their income from production and business operations.

As a result of the above control measures, a foreign (i.e. non-Chinese) company is not allowed to buy from Chinese suppliers and sell to Chinese customers directly.

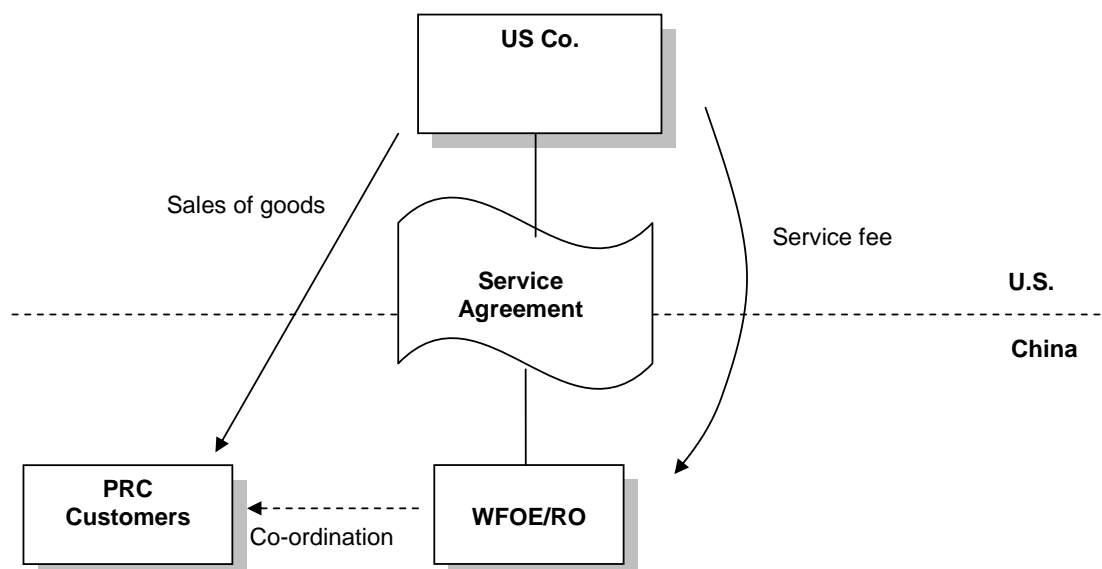
III. Possible Structures to Adopt for Selling in China

Summarized in the following table are some of the possible structures that business may consider to adopt:

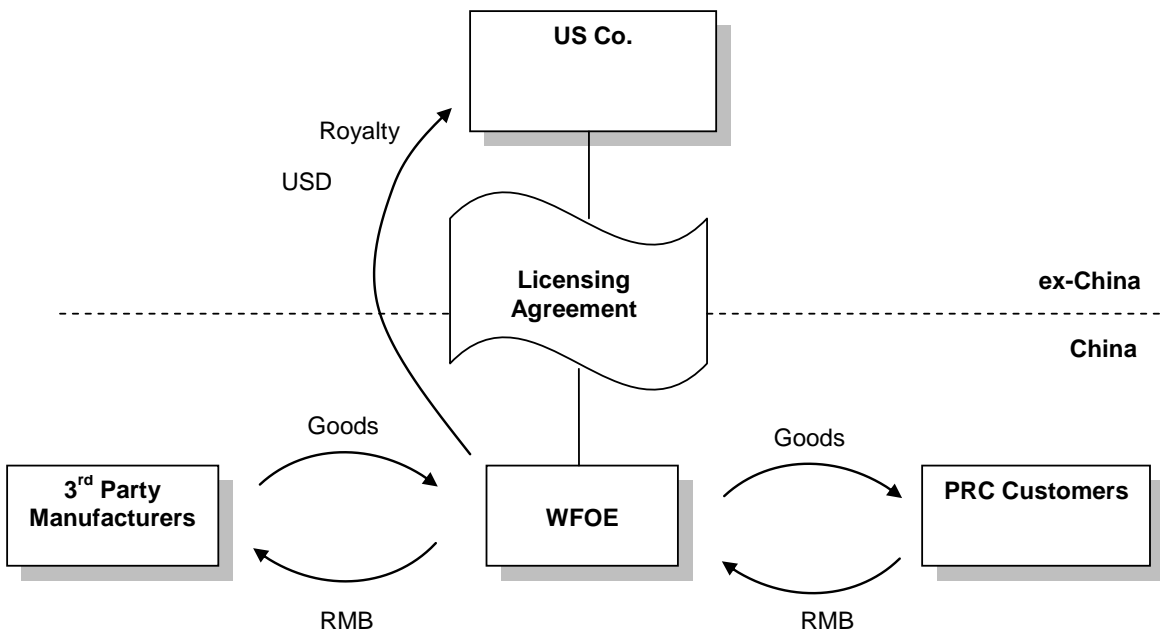
Scenario	Supplier	Customer	Transaction currency	Structure
1 Direct Sales	Outside China	China	Generally USD	Foreign Co. sells to Chinese customers direct, Representative Office (“RO”) / Wholly Foreign Owned Enterprise (“WFOE”) as sales office
2 Local trading company	China	China	Renminbi (“RMB”)	Trading through WFOE in China
3 Round-trip to Hong Kong	China	China	Generally USD	Foreign Co. sells to Chinese customers direct, goods are sent to Hong Kong and then re-imported by Customers
4 Logistics Park	China	China	Generally USD	Foreign Co. sells to Chinese customers direct, goods are sent to logistics park and then to Customers

The above scenarios and the related implementation issues are depicted below.

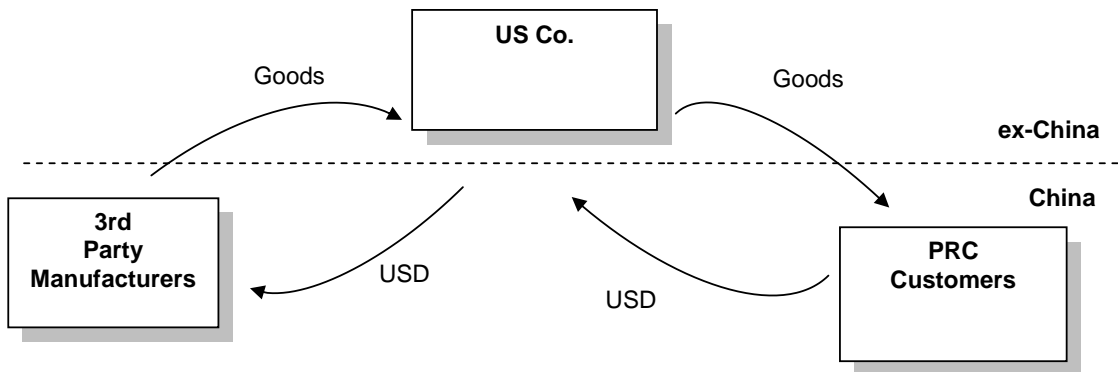
Scenario 1 – Direct sales from foreign country (e.g. US) to China



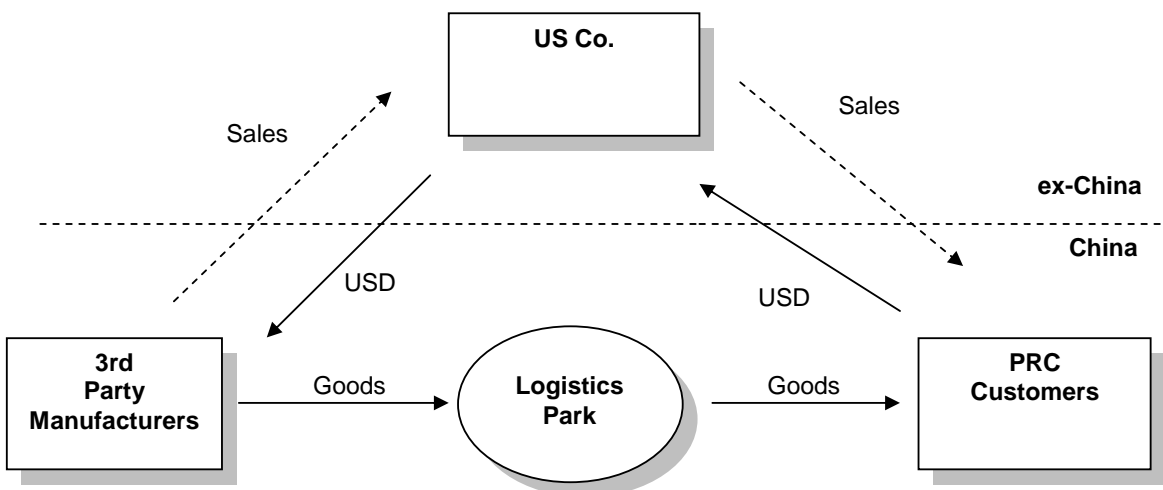
Scenario 2 – Setting up a local entity in form of a trading WFOE to conduct the sales



Scenario 3 – Goods round-tripped to Hong Kong and re-import for sales to Chinese customers



Scenario 4 – Goods delivered to logistics park for subsequent sales to Chinese customers



Logistics parks are special zones in China. Operators in PRC logistics parks could help to eliminate the needs of shipping goods out of China physically and re-importing those goods into China. As indicated in Section II, if a non-Chinese company (e.g. US Co. in the above scenarios) buys goods from a Chinese supplier for subsequent sale to a Chinese customer, the goods would need to be exported out of China first, before being re-imported into China for sales to the Chinese customer. The use of a logistics park could reduce the logistics burden in terms of both time and cost in the transactions.

In Scenario 4, the operators in the logistics park could help the 3rd party manufacturer to declare exports and help the Chinese customers to declare importation of the goods by moving the goods into and out of a logistic park. The operator will generally charge a service fee at 1% to 2% of the FOB value of the goods.

The implications with respect to the various factors identified in Section II are summarized in the following table:

	Scenario 1 Direct sales	Scenario 2 Local trading company	Scenario 3 Round-trip to Hong Kong	Scenario 4 Logistics Park
Flow of goods	From Foreign to China	Within China	Export to Hong Kong Re-import into China	Within China
Customs Declaration	PRC customs duty payable by Customer	N/A No PRC customs duty	PRC customs duty payable on re-import	Same as scenario 3
Flow of invoice	US to invoice to Chinese customer	WFOE to buy and sell	Foreign Co. to buy and sell	Foreign Co. to buy and sell
Flow of cash	Generally USD	RMB	Generally USD	Generally USD
VAT	N/A	WFOE to pay VAT	Export VAT refund for 3 rd party manufacturers; PRC customers to pay customs duty and VAT	Same as scenario 3
Income Tax	US Co: 35%	PRC (WFOE): 25%	US Co: 35%	US Co: 35%

IV. PRC Tax and Business Considerations

As noted from the last table in the preceding section, there are certain PRC customs duty and VAT implications in the above scenarios. Customs Duty (“CD”) and VAT would be payable on importing goods into China. For certain items, Consumption Tax (“CT”) is imposed as well. The importer on record or its agent in China shall perform the customs clearance formalities and settle the relevant duties/taxes. CD rates vary according to the tariff code under the Harmonized System. Most-Favor Nation (“MFN”) rates generally apply. The calculation basis of the duties/taxes is as follows:

Taxes	Calculation Basis
CD	CD Payable = Cost, Insurance, Freight (“CIF”) Value x Tax Rate
CT	CT Payable = Assessable Value x Tax Rate $\text{Assessable Value} = \frac{\text{CIF Value} + \text{Import Custom Duty}}{1 - \text{CT Rate}}$
VAT (import level)	VAT Payable = Assessable Value x Tax Rate Assessable Value = CIF Value + CD + CT

To illustrate the potential CD and VAT implications for Scenario 2, 3 and 4, we have set out below an example for reference.

For Scenario 2 only

Assumptions

• Purchase price from PRC supplier	\$500 plus VAT
• Selling price to PRC customer	\$720 plus VAT

Accounting entries of WFOE

	P&L	VAT A/C	Total
Sales	\$720	\$122.40	\$842.40
Cost of sales	(500)	(85)	(585)
Gross profit	220	-	-
VAT payable to tax bureau	-	37.4	(37.4)

For Scenario 3 and 4 only

Assumptions

• Purchase price from PRC supplier	\$500
• Selling price to PRC customer	\$600
• PRC customs duty rate	20%
• PRC customs duty payable	$\$600 \times 20\% = \120
• PRC VAT payable	$(600 + 120) \times 17\% - \122.40

Total amount incurred by PRC customer $(\$600 + \$120 + \$122.40) = \842.40

Gross profit of Foreign Co. $\$600 - \$500 = \$100$

Apart from the above, the following considerations should also be taken into account in determining the strategy to enter the Chinese market:

- Setting up a WFOE in China could allow buying and selling within China with transactions denominated and settled in RMB. However, it involves capital commitment in form of capital injection to the WFOE which may not be reduced/repatriated during the term of the WFOE.
- The concept of having a virtual office and without employees for a WFOE does not work in China. There are stringent government control and measures in China. Tax and other compliance in China would be more time consuming than in most developed countries. Stationing full time management in China is of vital importance.
- Net income of the WFOE will be subject to EIT at 25% in China.
- If the proposed arrangement involves the transfer or licensing of intellectual property rights, royalty payment is generally capped at 5% of the WFOE's revenue. In general, royalty payment is subject to 15% withholding taxes (business tax and EIT) in China.
- Dividend from the WFOE will be subject to 10% withholding tax in China.

V. Conclusion

The PRC CD rates (MFN rate) for most products range from 0% to 20%. For those products with high customs duty rates, Scenarios 3 and 4 would result in additional cost to the PRC customer. Scenario 2 could help to achieve a higher gross profit margin from the transaction.

As the PRC export VAT refund rate for most of the products is below 17%, PRC suppliers would be indifferent as to whether the products would be sold to a WFOE direct or exported to an overseas buyer, provided that the selling price (excluding VAT) is the same as before.

Under both Scenarios 3 and 4, Foreign Co would be considered as trading with China instead of trading in China. As such, Foreign Co would not be subject to PRC taxes.

The logistics cost involved would depend on the location of the suppliers and customers. In some cases, the "Hong Kong round-trip arrangement" (i.e. Scenario 3) may be more cost effective than using a logistics park (i.e. Scenario 4).

As noted from the above, there are different alternatives to conduct sales in China but these alternatives come with different levels of tax implications and other compliance matters. China has a complex system of government and regulatory controls. As such it would be important to start any operations in China correctly as there could be significant time and costs associated with rectifying any inappropriate structure. An upfront and thorough consideration of all aspects of the proposed Chinese operations to determine the most appropriate and optimal structure would be of utmost importance to enhance a sound and continuous expansion in the Chinese market.

Last but not least, home country tax considerations in respect of investment in China or doing business with China shall also be taken into account in order to have a holistic perspective of all the issues involved.

RSM NELSON WHEELER TAX ADVISORY LIMITED

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- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client's representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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