

China Outlook*

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China's New Policy Impacts the Processing Trade Program

Based on a Xinhua News Agency report dated July 23, the Chinese government issued a notice ("the Notice") that will increase the export costs for many Chinese manufacturers who currently enjoy the benefits of a "Processing Trade Program". According to the report, this Notice will become effective on August 23, 2007, and it will affect product items ranging from plastics, furniture, textiles and many other labor-intensive orientated export items (i.e., "listed products under China customs classification system").

In connection with the release of this notice, the Ministry of Commerce ("MOC") and China Customs jointly released a statement stating that under the Notice, most processing-trade manufacturers will be required to make guaranteed deposits at designated banks for bonded materials used in processing finished goods for re-export. The guaranteed deposit could be forfeited if the manufacturer fails to properly execute its processing trade contracts.

During a news conference, Mr. Wei Jianguo, vice minister of the MOC, provided the rationale behind this new policy: "We are striving to improve the development of China's processing trade in a bid to promote trade balance and reduce trade surplus."

The Xinhua report states that this new policy will affect many processing-trade manufacturers who have located their highly polluting or high energy consumption operations within China's coastal or eastern regions, including areas such as Beijing, Tianjin, Shanghai, Zhejiang, Fujian and Guangdong. This statement can be found on the MOC ministry website.

The notice also states that the Chinese government will no longer issue additional processing trade permits to enterprises located within the above regions, with the exception of enterprises that have already obtained export permits before July 23, 2007.

PwC Observations

This new policy is another attempt by the Chinese government to curb the continued export of low-value-added products which consume a big chunk of the nation's limited resources while contributing to the trade imbalance and exacerbating disputes with its major trading partners.

Processing Trade Program

Processing trade is one of the most popular programs adopted by many foreign owned Chinese manufacturers who use imported components to make finished goods for re-export.

China Outlook is a newsletter designed to provide you with insights into the China marketplace and how that can impact your business. We hope that this newsletter will be informative for you and would appreciate any feedback you would care to offer.

If you have any comments, please contact our editors: Alex Pan, Debbie Chan, and Peter Kao.

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Under this program, qualified foreign owned manufacturing enterprises may apply for bonded contracts from the Chinese government to defer or exempt payments on import duties and value-add-tax (“VAT”).

Without the benefit of this program, Chinese manufacturers would have to bear additional costs on the imported materials or components used for making export products. Depending on the components imported, an average of 9% customs duty and 17% of VAT on the imported material value will need to be paid when materials are imported. Under the current China duty and export VAT refund rules, the paid-in duty and a portion of import VAT are not refundable when finished goods are exported. Accordingly, without the bonded contracts, Chinese manufacturers will incur additional operating cost for their products exported.

Chinese government statistics show that processing trade export volume has increased dramatically over the past two decades. In 1981, China’s total processing-trade exports were about \$2.5 billion, while in 2006 the amount jumped to \$831.9 billion, representing a 333% increase in 25 years.

An updated China customs release provides that China’s processing trade volume continues expanding astronomically. In the first six months of 2007, processing trade exports reached a new high of \$440.9 billion which represents a 17.6% increase over the same period in 2006 and accounts for approximately 45% of China’s total international trade (imports and exports) during the period.

Legacy System vs. New System

Under the legacy system, a qualified processing trade manufacturer could obtain a bonded contract from the China government to defer or abate the payments of import duties and VAT for imported materials used for making export products. The contract would be released when all the bonded materials are manufactured or assembled into export goods and a new contract would be obtained for the next cycle of processing trade operations.

The legacy program was also fairly lenient with requirements to provide a guaranteed deposit against the deferred duties and import VAT on imported materials. In general, the legacy program exempted most participants from making cash deposits.

The new system, mandated by the Notice, requires all manufacturers in the coastal provinces/cities benefiting from the processing trade program to make guaranteed cash deposits. The requirement will only apply to those manufacturers who either use materials or export goods that are specified by this Notice, which includes a list of 1,853 materials/products.

As a result, working capital will be tied up and this will limit manufacturers’ ability to expand their processing-trade operations within China’s coastal and eastern regions.

Reduced Guaranteed Deposits for Good Standing Taxpayers

The Notice allows taxpayers in good tax standing to reduce their mandatory guaranteed deposits under the new processing trade program requirements. Processing-trade manufacturers with Category A

or Category B tax status are allowed to reduce their guaranteed deposit amounts by half of the statutory amount. Taxpayers with less favorable Category C tax status are required to deposit the full statutory amount to reflect the deferred imported duty and VAT cost.

With respect to a taxpayer’s tax standing, the Chinese tax authorities periodically review the status of each taxpayer. Depending on the size of the operation and the taxpayer’s record of reporting and paying of various taxes, a taxpayer may receive a rating of A, B or C. The taxpayer’s rating will be adjusted based on previous ratings and their subsequent degree of compliance with China’s tax laws and regulations.

EPZ/FTZ Manufacturers Are Not Affected

Manufacturers located in an export processing zone (“EPZ”) or free trade zone (“FTZ”) should not be negatively impacted by the Notice. These EPZ/FTZ manufacturers will continue enjoying the deferral VAT and import duty benefits without making guaranteed deposits. Under the current EPZ and FTZ regulations, foreign owned enterprises may still be eligible to establish operations within these zones. To evaluate the possible relocation of existing processing trade operations into an EPZ or FTZ, multiple factors should be evaluated to determine the overall benefit of setting up EPZ/FTZ operations.

Western Region Attracts Processing Trade Operations

The Notice provides exceptions to encourage foreign owned enterprises to establish or to relocate their processing trade operations to China’s western region.

(Continues on next page)

U.S. and China Agencies Agree to Work Together to Improve Product Safety

In a September 11, 2007 news release, the U.S. Consumer Product Safety Commission (“CPSC”) stated that it had reached an agreement with China’s General Administration of Quality Supervision, Inspection and Quarantine (“AQSIQ”) to help improve the safety of imported toys, as well as other products.

Nancy Nord, Acting Chairman of the CPSC, heralded the agreement, stating, “This is an important signal from the Chinese government that it

is serious about working with CPSC to keep dangerous products out of American homes. We will also be looking for meaningful cooperation on the ground - that means not just with the Chinese government, but also with industry at both ends of the supply chain.”

Key provisions of the agreement are:

- AQSIQ agrees to take steps to eradicate the use of lead paint in toys manufactured in China for export to the U.S.
- The two agencies also plan to collaborate to enhance the safety of toys, fireworks, cigarette lighters and electrical products, as these four categories of products are commonly found to have safety issues.

- AQSIQ agrees to an increase in inspections of products exported to the U.S.
- AQSIQ will also facilitate the tracing of hazardous products the responsible party in China.
- The two agencies will review the plan in one year to determine its effectiveness.

PwC Observations

Based on Chinese government statistics, China exported about 22 billion toys last year, accounting for 60% of all toys sold worldwide. Exports to the U.S. alone totaled over \$7 billion in 2006. Due to the sheer volume of these and other consumer product exports, both the U.S. and Chinese governments have a vested interest in ensuring the quality of

New Policy (cont)

Qualified west-region processing trade manufacturers with good tax standing status (i.e., category A or B taxpayers), may be able to obtain a waiver of the guaranteed deposit requirement on their bonded import materials.

In general, China’s western region provides a relative abundance of labor, land, energy and other natural resources that are needed to support processing trade operations. However, until recently, the western region’s infrastructure was inferior to the coastal provinces/cities. The Chinese government has begun allocating resources to develop infrastructure in the western region to promote continued inland growth.

Based on Chinese government statistics, in 2006, the western region only contributed to 2.6% of China’s total exports under the processing trade program. It is believed that the western region may offer additional opportunities or benefits to attract more processing trade manufacturers to the region.



Agencies Agree to Work Together to Improve Product Safety (cont)

Chinese manufactured goods. The U.S. government has started to increase scrutiny not only of toys, but also to examine the quality and safety of a wide range of products.

The Chinese government has also initiated a variety of measures to reassure consumers about the safety of Chinese manufactured products, including the suspension or revocation of business licenses of over 300 Chinese toy manufacturers for failing to meet product safety standards (Xinhua News Agency, September 21, 2007).

The key lesson to be learned from all the recent publicity around Chinese manufactured goods is that both U.S. importers and U.S. owned Chinese manufacturers should re-examine their procurement procedures to ensure that product design, materials used and production processes all meet with U.S. quality standards. Any company importing into the U.S. should be careful to scrutinize all of the vendors and suppliers in their supply chain to ensure that any outsourced materials/components will meet with U.S. requirements.

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The Chinese Business Network

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China Outbound

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