

China Customs & Trade Alert

Tightening of Processing Trade (Bonded Manufacturing) Rules

Affected companies should undertake a strategic review of their business model and existing supply-chain cost-benefit assumptions.



Introduction

The government is responding to energy resource, environment protection, trade surplus and trade dispute issues by changing the Processing Trade policy. The changes tighten the threshold and approval procedure for Processing Trade. As a result, some enterprises will find that their operating cost and indirect tax cost in China will increase.

Forbidden Catalogue for Processing Trade

Processing Trade refers to the bonded importation of raw materials and export of finished goods. Customs duty and import VAT (17%) is not assessed on the imported raw materials. The manufacturing entity is supervised by the Customs authority.

The Ministry of Commerce (MOFCOM), the General Administration of Customs (GAC) and the State Administration of Environment Protection (SAEP)

jointly issued Circular No.17 effective 26 April 2007. Over 184 products have been added to the new Catalogue including certain types of fertilizers, chemicals, shoes, furs, paper and stone materials. Companies now need to ask themselves: are raw materials to be imported and finished goods to be exported in the new Forbidden Catalogue?

Goods under the HS Codes set out in the new Catalogue are forbidden from importing under Processing Trade, or exporting under Processing Trade, or both importing and exporting under Processing Trade. This means the goods will now be declared to the Customs authority under General Trade. Customs duty and VAT will now be assessed, increasing existing manufacturing cost-benefit assumptions.

Enhanced Administration of Processing Trade

MOFCOM has issued a Notice on Enhancing the Administration of Processing Trade (Shangchanfa No.133 (2007)). The notice tightens the approval of Processing Trade by increasing the approval threshold in the following areas: energy consumption; environment protection; low value-added manufacturing; operation status and manufacturing capability; labor protection; capital equipment obsolescence, and domestic sales.

Companies will have to give consideration to the following additional factors:

- Are the products themselves categorised as obsolete?
- Is the capital equipment and technique categorised as obsolete or restricted?
- What levels of environment protection exist?
- Are labour hiring, wage and social insurance payments compliant?
- What levels of energy consumption exist?

- Is the value-added element in the supply-chain sufficient?

Meeting these new requirements may increase the cost of qualification for Processing Trade, therefore reducing the net customs duty and import VAT cost savings that can be achieved by obtaining approval for bonded manufacturing.

Business model and cost-benefit implications

Strategic Level

New factors now have to be given full consideration alongside the traditional criterion when deciding which business model – bonded or non-bonded – is most appropriate. Some of the cost differences between bonded and non-bonded manufacturing are highlighted below:

Cost Considerations	Processing Trade (bonded)	General Trade (non-bonded)
Imported RM	Used in FG for export	No Restrictions
Customs duty burden	No	Yes
VAT burden	Lower NCNR [†]	Higher NCNR [†]
Administration Effort	Higher	Lower
Customs Compliance Effort	Higher	Lower
MOFCOM Administration	Higher	Lower

[†] Non-creditable-non-refundable VAT (NCNR)

In addition to the already published Prohibited List a new Restricted List is expected to be released soon. Goods falling into the new Restricted List will also be subject to customs duty and import VAT if the operation is outside of an FTZ/EPZ. Relocation of operations to an FTZ/EPZ may therefore become an option for some companies.

Operational Level

If the business model is changed then operational level issues such as cancellation of Customs Handbooks will have to be considered. This can include a claw-back of customs duty and import VAT and/or audit by the Customs authorities. Customs approval for transfer of bonded equipment may also be required if a change in site location is contemplated.

General Trend and Outlook

Ongoing uncertainty for certain industries and companies

The Prohibited List was first introduced in 1999 and since then the Prohibited List has been updated eight times. More frequent changes have taken place since 2003. The trend is for the Prohibited List to include increasingly more products per the listing of HS Codes. GAC officials have disclosed that the Prohibited List will be updated again before the end of 2007.

China is increasingly using Processing Trade prohibitions and export VAT refund rates to ease frictions with trading partners and to implement domestic economic policies. Changes in Processing Trade prohibitions and export VAT refund rates will continue to take place at short notice and they may be imposed on a temporary or permanent basis.

As China moves towards its development goals, companies should expect that processing trade prohibitions and export VAT refund rates will continue to be used to help steer that development. If sourcing or producing lower technology products (which consume important resources) or sensitive items for overseas trading partners, expect to see unfavourable changes. Conversely, if sourcing or producing higher technology goods, including electrical machinery, current policies may well be improved.

Next Steps

The information contained within this update is for general guidance on matters of interest only. The application and impact of Processing Trade rules can vary widely, based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PricewaterhouseCoopers client service team.

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