

China Customs & International Tax Alert

Year 2007 Ends In a Flurry of New Customs Related Regulatory Changes



Quality In Everything We Do

The year 2007 resulted in an unprecedented amount of amendments to the rules and regulations affecting goods imported and exported from China. Many of the rules were issued to address the fundamental economic issues of managing the trade surplus and guiding the growth of certain industries. This year's regulatory revisions culminated with the issuance of a number of regulations released in December 2007 that became effective in January 2008. Historically, the end of every calendar year end is an ideal time to revise regulations and begin the New Year with a fresh start.

The December announcements followed a continuing trend of regulatory revisions that took place throughout the year. Some changes throughout the year included: the export VAT refund regime and reductions in refund rates; tightening of the Prohibited and Restricted Lists for Processing Trade; as well as adjustments to certain import and export duty rates.

The following tables provide a brief illustration¹ of some regulations issued in December that could have a material impact on your business:

Table 1 – Regulation Issued by Customs

No	Name of Doc	Issuance Date	Effective Date
1	Notice of the Customs Tariff Commission of the State Council on the Implementation of Tariffs in 2008 (same as GAC Announcement No. 79)	Dec 14, 2007	Jan 1, 2008

Table 2 – Regulation Issued by Ministry of Finance

No	Name of Doc	Issuance Date	Effective Date
2	Circular on Abolishing Export Tax Refunds for Raw Grains such as Wheat and Powders - Cai Shui [2007] No.169	Dec 14, 2007	Dec 20, 2007

Table 3 - Regulations Issued by MOFCOM² & Customs

Ref. No	Name of Doc	Issuance Date	Effective Date
3	The Second Batch of Prohibited Category of Export Commodities Under Processing Trade 2007	Dec 24, 2007	Jan 21, 2008
4	MOFCOM and GAC Joint Announcement No. 100 on Catalogue for Import Goods Subject to Import License 2008	Dec 24, 2007	Jan 1, 2008
5	MOFCOM and GAC Joint Announcement No. 101 on Catalogue for Export Goods Subject to Export License 2008	Dec 29, 2007	Jan 1, 2008
6	MOFCOM and GAC Joint Announcement No. 115 on Catalogue for Import Goods subject to Automatic Import License 2008	Dec 29, 2007	Jan 1, 2008
7	MOFCOM and GAC Joint Announcement No. 116 on Catalogue for Dual-use Substances and Technologies subject to Import and Export License	Dec 29, 2007	Jan 1, 2008

¹ This is not an inclusive list of all customs related regulations issued during December but highlights some of the major announcements.

² A number of regulations have been jointly issued with other government agencies but still have an impact on Customs matters.

Since it is not possible to discuss every new regulation in great detail, we have selected the following three for a more in-depth review:

- Implementation of the 2008 Customs Tariff;
- Second Batch of Prohibited Processing Trade Products; and
- Reduction in Export VAT Refund Rates.

Implementation of the 2008 Customs Tariff

In December of every year, the State Council issues an updated customs tariff with changes to import and export duty rates for the upcoming year. On December 14, 2007, Notice [2007] 25 introduced significant changes the following three areas:

- **Most Favored Nation (“MFN”) import duty rates**

The duty rates on 45 different HS codes were permanently reduced in line with China’s commitments. A majority of the changes, 35 out of the total 45, related to the HS Chapter 39 which covers plastics and articles thereof. The affected Chapter 39 product duty rates were decreased from an average 7.6% to 6.5%, or roughly 14%. Other changes were less dramatic and in the range of import duty rate reduction of 3 - 8%.

- **Interim import duty rates**

China maintains a list of products where a temporary reduction in the MFN rate³ has been decided and applicable to products imported after January 1. These interim duty rates are subject to change throughout the year (i.e. some are revised and others continue for the full year). The interim import duty list for 2008 covers 620 HS codes with over 300 new additions in 2008. By including so many more products with lower interim rates, China appears to be providing favorable duty treatment for a number of foreign products and is further opening their marketplace.

Certain types of products clearly benefited more than others. The following tables illustrate the number of new additions in some product categories as well as an extract of big winners in terms of import duty rate reductions:

Table 4 – Big Winners With Newly Added Categories

HS Chapter	High Level Description	# of HS Code Additions
28	Inorganic chemicals; organic or inorganic compounds of precious metals; rare-earth metals	22
84	Machinery and mechanical appliances; and parts	122
85	Electrical machinery and equipment; parts thereof, sound and television recorders and reproducers	55
90	Optical glasses, lenses and frames	26
94-95	Mattresses, bedding, sleeping bags, tennis rackets, basketballs, exercise equipment, etc.	16

There were also significant reductions on many of the affected products with some of the biggest decreases illustrated in the following table:

Table 5 – Big Winners With Largest % Decrease in Duty Rate

HS Code	Product Description	2008 MFN Rate	Interim Rate	% Decrease
69049000	Ceramic building bricks	24.5%	15%	50%
70060000	Glass bent, worked, engraved	15%	3%	80%
70134100	Glassware of lead crystal	24.5%	15%	50%
73239100	Table, kitchen or household articles of cast iron	20%	10%	50%
73242900	Sanitary ware and parts of iron or steel	30%	15%	50%
84151010	Wall unit air conditioners	15%	8%	47%
84152000	Air conditioner for motor vehicle	20%	10%	50%
84211210	Clothes dryer	17.5%	8%	54%
84212110	Household water filters	25%	12%	52%
84431600	Flexographic printing machines	10%	5%	50%
84501190	Household or laundry-type washing machines	30%	15%	50%
85094090	Electro-mechanical domestic appliances	10%	6%	40%
85164000	Electric irons	35%	17%	51%
85176110	Drip coffee makers (and others)	32%	16%	50%
85279900	Reception apparatus for radio-telephony, radio-telegraphy or radio-broad-casting	27%	8%	70%
96032100	Toothbrushes	25%	10%	60%

³ This is known as an “interim” duty rate and is subject to change throughout the year.

As can be seen in the tables, many household appliances and other important items have been afforded a significant benefit with a reduced duty rate. Many companies may reconsider manufacturing these products overseas and importing them into China at the much reduced duty rate. Hopefully, the savings would translate to lower prices for the consumer.

It also appears that a number of the interim rates are slightly better than the concessionary rates provided in the Free Trade Agreements (“FTAs”) China negotiated with some of its trading partners. We will have to wait and see how these Partners will react but since the China-ASEAN FTA is expecting to decrease rates significantly in 2009, this may just be a preparatory strategy for next year.

Table 5 shows the percentage duty rate savings can be huge and there are certainly some Big Winners. But it is important to remember that these are temporary rates and open to readjustment at any time. So companies must act to take advantage of the lower rates now.

• *Interim export duty rates*

Included in the tariff update, China released a list of products subject to stiff export duty rates. This export tax is rarely utilized in other countries as it serves to restrict and/or reduce the export volumes of affected products. Other countries seek to promote as many exports as possible, while China is in the situation of having to restrain exports to balance the trade surplus.

China has applied export duties on targeted products for a number of reasons such as: to restrict export volumes to help balance the trade surplus; and discourage the exportation of products China deemed vital to domestic development. Thus, products like: steel, cement, magnesium, basic metals, etc. are assessed with export duties. There are now 334 HS codes attracting interim export duty rates ranging between 0% - 30%.⁴ These export taxes serve as a built-in mechanism forcing exporters to think twice before shipping an affected product out of China. The tax rates are at a high enough level to make it difficult for exporters to pay the tax and still remain profitable. However, some are able to pass the export taxes on to their customers resulting in much higher purchase prices for the affected Chinese goods.

Second Batch of Prohibited Processing Trade Products

Processing Trade is a program for export manufacturers that allows them to import raw materials “bonded”, or without the payment of duty and VAT, as long as they are incorporated

into exported finished goods. China, in 2007, was tinkering with the types of products contained in the Prohibited and Restricted Lists to encourage or discourage the development of certain industries and products. This reduced the number of manufacturers enjoying the benefits of Processing Trade.

The Prohibited List was updated numerous times last year and targeted products that: a) caused environmental pollution; b) consumed large amounts of energy in the production process; c) used China’s natural resources; and d) were considered low-value add. These criteria were also used when refining the export VAT refund rates throughout the year.

On December 21, 2007, another batch of 589 HS codes were added to the Prohibited List. The regulation will become effective on January 21, 2008 and provides for the grandfathering of certain companies with processing contracts already in place before the effective date. The rule applies to all bonded zones but does not impact companies already established in bonded zones prior to the issuance of this Notice.

The main groups of products introduced to the Prohibited List this time are:

- Any product (e.g. animal meat, fur, vegetable, purse, hand bag, beauty products, clothing, etc.) that contains or uses parts of plants, fish or animals that are considered to be in imminent danger.
- Mineral products (Chapter 25 and 27) such as salt, cement, mineral fuels/oils, petroleum oils, etc.
- Inorganic chemical, organic/inorganic compounds of precious metals (Chapter 28). This Chapter was the hardest hit with almost 200 new HS codes being prohibited.
- Tanning or dye extracts; dyes; pigments; colouring (Chapter 32) - a large portion of this chapter was also impacted.
- Iron and steel (Chapter 72) – eighty-two new HS codes from this Chapter were included in 2008.
- Others.

As can be seen by the summary above, the affected products selected for the Prohibited List appear to follow the four targeting criteria used previously. If a company can no longer use Processing Trade for export production, then duty and VAT will be charged on the imported raw materials. Unfortunately in China there is no duty drawback program so once customs duty has been paid by an importer it becomes a sunk cost. In addition, many of the prohibited products have a very low, or even zero percent, export VAT refund rate and thus a significant VAT cost may be incurred upon exportation of these goods.

⁴ Products with an interim export duty rate of 0% still have a recorded export duty rate (some as high as 50%) and as a result remain on this list as they may, at any time, lose their “interim” status revert back to the permanent rate.

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 130,000 people are united by our shared values and an unwavering commitment to quality.

For more information, please visit www.ey.com

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

© 2008 EYGM Limited.
All Rights Reserved.

Companies producing goods for export that are now on the Prohibited List must reconsider whether their processing activities make financial and commercial sense going forward. Certain alternatives may be considered to reduce the impact, but the addition to the Prohibited List is a big disadvantage for a manufacturer in China producing goods for export.

Export VAT Refund Rates Reduced Again

The Ministry of Finance abolished VAT refunds on 84 agricultural products to further discourage exportation of key food and grain related items. Products, mostly in Chapter 10-12, such as wheat, grains, rice, corn, oats, barley, soybeans, etc. will no longer enjoy a VAT refund if exported out of China. Contracts where the export price is unalterable may be able to enjoy the historic VAT refund rate until February 29, 2008. Starting in March 2008, all affected products, irregardless of when the contract was executed, will be subject to the new rate.

Conclusion

The recent regulatory changes are having a material impact on Chinese exporters, overseas buyers who purchase goods made in China, as well as those importing and distributing in China. If the flurry of new regulatory activity at the end of 2007 is any indication of what to expect in 2008, then it could be another unsettling year for export manufacturers. The reduction in VAT refund rates and continued expansion of the Processing Trade Prohibited and Restricted Lists will impact the cost competitiveness of goods produced in China. Many companies are reconsidering whether China “makes sense” for current and future export manufacturing operations. We have heard of more and more companies actively researching whether to locate a factory in another country due to the uncertainty surrounding China’s treatment on exports as well as increasing costs from land, labor, raw materials, corporate taxes, export VAT refunds, etc. that are driving up the historically competitive “China price”.

Luckily it is not all bad news. China approximately doubled the number of products that have an interim import duty rate lower, and in some cases significantly lower, than the MFN rate. These reductions could help foreign manufacturers compete better on costs, increase import volume (thus reducing the trade surplus), as well as further open China’s market of over 1.3 billion to the rest of the world.

At the beginning of 2008, the Chinese Authorities have the demanding tasks of balancing the trade surplus, securing and protecting their natural resources for domestic use, reducing pollution and energy consumption all at the same time. The Authorities are implementing revisions to Customs, import and export regulations to address some of these fundamental issues. Thus, we expect the Authorities to monitor the developments and further refinement can be expected throughout the year. Due to the increasing importance of these Customs areas to a successful and profitable business, companies must actively understand the changes and then implement strategies to mitigate the impact, if any. Ernst & Young can help.

For specific queries, please contact one of our China customs specialists:

Robert Smith
Partner, China & Hong Kong
Tel: (86-21) 2405 2328
robert.smith@cn.ey.com

William Chea
Director, China & Hong Kong
Tel: (852) 2629 3440
william.chea@hk.ey.com

Adrian Ball
Partner & Regional Leader
Tel: (852) 2629 3810
adrian.ball@hk.ey.com

Oleg Kolobenchuk
Director, China
Tel: (86-21) 2405 2803
oleg.kolobenchuk@cn.ey.com