Selling in China: Considerations for US companies

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Leading today’s discussion

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Today’s agenda

- China as a market
- Factors to consider
- Possible structures
- PRC/US tax & business considerations
- Q&A

China as a market

- Growing of Chinese domestic market
- Global factory and supply chain logistics – assembled in China before distribution to the rest of the world
- Complicated business regulations and government control
### The Chinese market

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (m)</td>
<td>1,312</td>
<td>1,320</td>
<td>1,328</td>
<td>1,335</td>
<td>1,342</td>
<td>1,349</td>
</tr>
<tr>
<td>GDP (US$ bn at market ex rate)</td>
<td>5,878</td>
<td>6,821</td>
<td>8,090</td>
<td>9,569</td>
<td>11,196</td>
<td>12,973</td>
</tr>
<tr>
<td>GDP per head (US$ bn at market ex rate)</td>
<td>4,479</td>
<td>5,166</td>
<td>6,092</td>
<td>7,166</td>
<td>8,341</td>
<td>9,618</td>
</tr>
<tr>
<td>GDP (US$ bn at PPP)</td>
<td>10,241</td>
<td>11,388</td>
<td>12,724</td>
<td>14,162</td>
<td>15,756</td>
<td>17,533</td>
</tr>
<tr>
<td>GDP per head (US$ at PPP)</td>
<td>7,803</td>
<td>8,625</td>
<td>9,582</td>
<td>10,060</td>
<td>11,173</td>
<td>12,999</td>
</tr>
<tr>
<td>Household consumption (US$ bn)</td>
<td>2,050</td>
<td>2,499</td>
<td>2,996</td>
<td>3,615</td>
<td>4,315</td>
<td>5,075</td>
</tr>
<tr>
<td>Household consumption per head (US$)</td>
<td>1,560</td>
<td>1,890</td>
<td>2,260</td>
<td>2,710</td>
<td>3,210</td>
<td>3,760</td>
</tr>
<tr>
<td>Exports of goods &amp; services (% change)</td>
<td>15.8</td>
<td>8.6</td>
<td>9.6</td>
<td>9.0</td>
<td>8.9</td>
<td>9.1</td>
</tr>
<tr>
<td>Imports of goods &amp; services (% change)</td>
<td>14.0</td>
<td>10.0</td>
<td>10.5</td>
<td>12.3</td>
<td>12.0</td>
<td>11.1</td>
</tr>
</tbody>
</table>

Source: EIU 2011

### Household Consumption compared to Imports of goods and services

<table>
<thead>
<tr>
<th>Year</th>
<th>Household Consumption (US$ bn)</th>
<th>Change (%), year over year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>2,050</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>2,499</td>
<td>20.0%</td>
</tr>
<tr>
<td>2012</td>
<td>2,996</td>
<td>15.0%</td>
</tr>
<tr>
<td>2013</td>
<td>3,615</td>
<td>10.0%</td>
</tr>
<tr>
<td>2014</td>
<td>4,315</td>
<td>5.0%</td>
</tr>
<tr>
<td>2015</td>
<td>5,075</td>
<td>0.0%</td>
</tr>
</tbody>
</table>
Today’s agenda

- China as a market
- **Factors to be considered**
- Possible structures
- PRC/US tax & business considerations
- Q&A

Factors to consider U.S. Companies

- Selling goods in China is subject to various government controls, including:
  - Currency and exchange control
  - Invoice administration
  - Logistics arrangement
  - VAT implications
  - Corporate income tax implications

- A non-Chinese company is not allowed to buy from Chinese supplier and sell to Chinese customers directly because of the above mentioned control measures.

- Each region in China may have its unique interpretations of Chinese laws and regulations.
Today’s agenda

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Possible Structures

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Supplier</th>
<th>Customer</th>
<th>Transaction currency</th>
<th>Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1 US Export</strong></td>
<td>Outside</td>
<td>China</td>
<td>USD</td>
<td>US Co. sells to Chinese customers direct, RO/WFOE as sales office</td>
</tr>
<tr>
<td><strong>2 Direct Sales</strong></td>
<td>China</td>
<td>China</td>
<td>RMB</td>
<td>Trading WFOE in China</td>
</tr>
<tr>
<td><strong>3 Round-trip</strong></td>
<td>China</td>
<td>China</td>
<td>USD</td>
<td>US Co. sells to Chinese customers direct, goods to Hong Kong and then re-imported by Customers</td>
</tr>
<tr>
<td>to Hong Kong</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>4 Logistics</strong></td>
<td>China</td>
<td>China</td>
<td>USD</td>
<td>US Co. sells to Chinese customers direct, goods to logistics park and then to Customers</td>
</tr>
<tr>
<td>Park</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**Scenario 1 - U.S. Export**

US Co. [Sales of goods to WFOE/RO] [Service Agreement] [Coordination] [SERVICE] [Agreement] [PRC Customers] [Co-ordination] [U.S. China] [Service fee]

**Scenario 2 - Direct Sales**

US Co. [Goods] [USD] [ex-China] [China] [Licensing Agreement] [Goods] [PRC Customers] [WFOE] [3rd Party Manufacturers] [RMB] [RMB] [RMB]
Scenario 3 - Round-trip Hong Kong

3rd Party Manufacturers → US Co. (Goods, USD) → PRC Customers (ex-China, USD)

Scenario 4 - Use of Logistics Park

3rd Party Manufacturers → Logistics Park (Goods, USD) → PRC Customers

Logistics Park → US Co. (Sales, USD) → ex-China (Goods, USD)
Logistics Park

- Operators in PRC logistics parks could help to eliminate the needs of shipping goods out of China physically and re-importing into China.
- The operator could help the 3rd Party Manufacturers 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.
- Service fee will be charged by the operator, usually at 1% to 2% of the FOB value of the goods.

Common Logistics Parks

- Ningbo: http://www.nftz.gov.cn/
- Qingdao: http://www.sdeport.gov.cn/homepage/InfoQuery/..%5Cmpages%5Czhuan_lan%5Cwuliu_yuanqu%5Cwuliu_index.htm
- Xiamen: http://blp.xmedi.com.cn/
- Tianjin: http://www.tjftz.gov.cn/
- Shanghai: http://www.wblz.com.cn/

Comparison

<table>
<thead>
<tr>
<th>Scenario 1</th>
<th>US Export</th>
<th>Scenario 2</th>
<th>Direct Sales</th>
<th>Scenario 3</th>
<th>Round-trip to Hong Kong</th>
<th>Scenario 4</th>
<th>Logistics Park</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flow of goods</td>
<td>From US to China</td>
<td>Within China</td>
<td>Export to HK</td>
<td>Re-import into China</td>
<td>Within China</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Customs Declaration</td>
<td>PRC customs duty payable by Customer</td>
<td>N/A</td>
<td>No PRC customs duty</td>
<td>PRC customs duty payable on re-import</td>
<td>Same as scenario 3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flow of invoice</td>
<td>US to invoice to Chinese customer</td>
<td>WFOE to buy and sell</td>
<td>US Co. to buy and sell</td>
<td>US Co. to buy and sell</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flow of cash</td>
<td>USD</td>
<td>RMB</td>
<td>USD</td>
<td>USD</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VAT</td>
<td>N/A</td>
<td>WFOE to pay VAT</td>
<td>Export VAT refund for 3rd party manufacturers; PRC customers to pay customs duty and VAT</td>
<td>Same as scenario 3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income Tax</td>
<td>US: 35%</td>
<td>WFOE: 25%</td>
<td>US: 35%</td>
<td>US: 35%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

US Tax Issues: VAT and Custom can only be deducted. Whether the income tax is qualified for foreign tax credit will depend on the US company’s global structure. Global transfer pricing will have impact on VAT, Custom, and income tax.
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PRC Tax Considerations

<table>
<thead>
<tr>
<th>Tariff code</th>
<th>PRC Customs Duty – MFN Rates</th>
<th>PRC Customs Duty – Normal Rates</th>
<th>PRC Export VAT refund rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>7321110000</td>
<td>15%</td>
<td>80%</td>
<td>9%</td>
</tr>
<tr>
<td>7321990000</td>
<td>21%</td>
<td>80%</td>
<td>9%</td>
</tr>
<tr>
<td>8516090000</td>
<td>23%</td>
<td>80%</td>
<td>9%</td>
</tr>
<tr>
<td>8516299000</td>
<td>10%</td>
<td>100%</td>
<td>17%</td>
</tr>
<tr>
<td>8521100000</td>
<td>23%</td>
<td>80%</td>
<td>5%</td>
</tr>
<tr>
<td>8523990000</td>
<td>20%</td>
<td>80%</td>
<td>9%</td>
</tr>
<tr>
<td>8215990000</td>
<td>18%</td>
<td>80%</td>
<td>9%</td>
</tr>
<tr>
<td>8215000000</td>
<td>18%</td>
<td>80%</td>
<td>9%</td>
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<tr>
<td>7325109000</td>
<td>20%</td>
<td>90%</td>
<td>5%</td>
</tr>
<tr>
<td>7322900000</td>
<td>20%</td>
<td>80%</td>
<td>5%</td>
</tr>
<tr>
<td>7326909000</td>
<td>8%</td>
<td>90%</td>
<td>9%</td>
</tr>
</tbody>
</table>
### PRC VAT
(Scenario 2 only)

**Assumptions**
- Purchase price from PRC supplier: US$500 plus VAT
- Selling price to PRC customer: $720 plus VAT

**Accounting entries of WFOE**

<table>
<thead>
<tr>
<th>P&amp;L</th>
<th>VAT A/C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$720</td>
<td>$122.40</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(500)</td>
<td>(85)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>220</td>
<td>-</td>
</tr>
<tr>
<td>VAT payable to tax bureau</td>
<td>-</td>
<td>37.4</td>
</tr>
</tbody>
</table>

### PRC Customs Duty and VAT
(Scenarios 3 & 4 only)

**Assumptions**
- Purchase price from PRC supplier: US$500
- Selling price to PRC customer: $600
- PRC customs duty rate: 20%
- PRC customs duty payable: $600 x 20% = $120
- PRC VAT payable: (600 + 120) x 17% = $122.40

**Total amount incurred by PRC customer:**

($600 + $120 + 122.40) = $842.40

**Gross profit of US Co.:**

$600 – $500 = $100
Other PRC Tax Issues for Scenario 2

- Net income of the WFOE shall be subject to 25% corporate income tax in China
- Royalty payment is generally capped at 5% of the WFOE’s revenue
- Royalty payment is subject to 15% withholding taxes in China
- Dividend from the WFOE shall be subject to 10% withholding income tax in China

Summary – China Considerations

- The PRC customs duty rate (MFN rate) for most products range from 0% - 20%. For those products with high customs duty rate, Scenarios 3 and 4 would result in additional cost to the PRC customer.
- As the PRC export VAT refund rate for most of the products is below 17%, PRC suppliers would not mind selling to a WFOE direct provided that the selling price (excluding VAT) is the same as before.
- Under both Scenarios 3 and 4, US Co. would be considered as trading with China but not trading in China. As such, US Co. will not be subject to PRC taxes.
- In terms of logistics cost, it depends on the location of the suppliers and customers. Sometimes “Hong Kong round-trip arrangement” may be more cost effective than using a logistics park.
Summary - U.S. Considerations

- How will the Chinese structure fit in the U.S. company’s global strategy?
- The business practice in China is vastly different than at home. There are a lot more registration requirements that will take time.
- Cash Flow Planning – It’s difficult to get cash out of China
- Select the right entity treatment for US income tax purposes for the WFOE.
- Transfer pricing is a hot issue in both countries.
- Foreign Tax Credit eligibility
  - Enterprise income tax and withholding tax may qualify
  - VAT and business tax do not qualify

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Who to contact

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