Chinese Bonded Areas: Choosing the Right Location

By Michael Pfaar and Xiaodan Wang

Michael Pfaar and Xiaodan Wang give advice on how to choose the right Chinese bonded area. Michael Pfaar is a partner with Ernst & Young International Tax Services in Dusseldorf, Germany, and heads E&Y’s China Competence Centre in Germany, Switzerland, and Austria. Xiaodan Wang is a certified Chinese tax agent and a senior with E&Y International Tax Services in Dusseldorf. The views expressed are those of the authors and do not necessarily reflect the views of Ernst & Young GmbH.

There are a variety of bonded areas throughout China: free trade zones (FTZs), export processing zones (EPZs), bonded logistics parks (BLPs), bonded ports (BPs), and comprehensive bonded zones (CBZs). All these areas are under the special supervision of the Chinese customs authorities and are called customs specially supervised areas (CSSAs). Each type of CSSA allows different business activities, and there are substantial regulatory differences from customs, tax, and foreign exchange perspectives. The biggest differences are caused by applying the export VAT refund formula, which can lead to a heavy net tax burden on exports if coming from the wrong location (far from the theoretical VAT exemption as stipulated in the VAT law). Many investors don’t know that the nondeductibility of Chinese input VAT related to exports is not calculated based on the ratio between domestic sales and exports but on the free on board (FOB) price of exports only. Another issue is the effect of customs duty and import VAT when a substantial part of the products end up in the Chinese market. There are also timing differences as to when the export VAT refund is triggered depending on the chosen location.
Hence, the foreign investor is often puzzled when making a choice between the available CSSAs (alternatively, the non-bonded mainland territory). This article describes the tax regimes of the CSSA and provides recommendations as to the right location depending on the individual fact pattern. An important determining factor is the target market for the products. This article compares four principal transactions that a manufacturing enterprise in the CSSA may carry out:

- raw materials sourced from Chinese non-bonded areas;
- raw materials sourced from overseas;
- finished goods sold overseas; and
- finished goods sold to Chinese non-bonded areas.

Export VAT Refund Mechanism

The export VAT refund mechanism closely relates to the CSSA, and many tax planning ideas revolve around this topic. An export VAT refund could initially be misunderstood to provide:

- no output VAT on export sales; and
- full refund of input VAT previously paid on the purchase of goods or services used for the production/purchase of exported goods.

However, the Chinese export VAT refund mechanism in practice does not allow full recovery of the input VAT incurred for raw materials or components imported or purchased locally. Taking a manufacturing enterprise as an example, the export VAT refund mechanism applicable is “exempt, credit, and refund”:

- “exempt” means there is no output VAT on export sales;
- “credit” means the input VAT will first be reduced by any “nonrecoverable VAT,” and any surplus will be used to offset the output VAT liability (if any) on the taxpayer’s other domestic sales; and
- “refund” means any further surplus input VAT after the above credit is refunded.

It is, however, possible and not uncommon that the nonrecoverable VAT exceeds the existing input VAT and that an additional tax payment obligation arises. This is the result of the following calculation formula of the nonrecoverable VAT (followed by the other computation formulas for the exempt, credit, and refund methods):

Nonrecoverable VAT = (FOB export price - cost, insurance, and freight (CIF) price of the bonded imported materials, if any) x (applicable VAT rate - applicable export VAT refund rate).

Net VAT payable or refundable = output VAT on local sales, if any - (Net VAT of current period - nonrecoverable VAT).

Exempt, credit, and refund VAT = (FOB export price - CIF price of the bonded imported materials, if any) x applicable export VAT refund rate.

The actual VAT refund paid to the taxpayer is the lower of the net VAT refundable or the exempt, credit, and refund VAT.

There are five ranks of export VAT refund rates: 17 percent, 15 percent, 13 percent, 9 percent, and 5 percent. The lower the VAT export refund rate is, the higher the exporter’s VAT cost is. These costs (that is, nonrecoverable VAT in the above formula) are referred to as “export VAT leakage.” As noted above, the first formula is the result of the difference between the statutory VAT rate and the applicable VAT refund rate multiplied by the FOB price of the exports. Assuming there are no bonded imported input materials, this formula has the effect of taxing the entire value added portion related to the exports as nonrecoverable VAT. Surprisingly, there is no link to the ratio between domestic and export sales to determine the nonrecoverable VAT. As a result, if there is a high value added by the Chinese production of exports, the nonrecoverable VAT will also be high, which is illustrated by the following example:

A manufacturing enterprise is established in mainland China. It sources all raw materials for its production in mainland China at a value of [EURO]10 million. The entire production is exported for an FOB price of [EURO]100 million. The VAT refund rate for the products is 13 percent.
Applying the formulas, the nonrecoverable VAT is equal to \([\text{EUR}]100\text{ million} \times (17\text{ percent} - 13\text{ percent}) = \[\text{EUR}]4\text{ million}\). As there is only an input credit from the Chinese VAT paid on raw materials of \([\text{EUR}]1.7\text{ million} \times 17\text{ percent})\), an additional payment obligation of \([\text{EUR}]2.3\text{ million}\) arises. In effect, in this example, not only does the enterprise lose any input credit for the raw materials sourced for exports, but the export is effectively taxed at \([\text{EUR}]2.3\text{ million}\).

This odd result is caused by the negative experiences of the central Chinese tax administration, the State Administration of Taxation (SAT), after the introduction of the VAT refund. Seemingly, there were a lot more refund applications than input VAT paid, so the SAT no longer trusted the input VAT invoices.\(^1\) Therefore, the refund system was adjusted to link the input credit to the FOB price of the exported products, which was seen as a more reliable source.

The export VAT leakage issue can bring about significant tax costs to China-based manufacturing enterprises with export activities. Therefore, many VAT planning ideas focus on how to minimize the export VAT refund leakage. Using the CSSA is one of them -- for example, relocating the manufacturing activities to an EPZ to reduce the FOB export price, which is the base for the calculation of export VAT refund leakage.

**History of the CSSA**

The development of the CSSA can be divided into three phases.

**First Phase**

In the 1990s, 15 FTZs, which combine the functions of bonded warehousing, export processing, international trade, and product display, were approved by the Chinese State Council to be set up in 13 cities. To better manage the processing trades, promote exports, and crack down on the illegal sale of duty-free imported raw materials, the EPZs were gradually approved to be set up by 2000.

**Second Phase**

With China joining the WTO, the Chinese economic focus changed from being simply export-oriented to containing both import and export transactions. To facilitate logistics (and eventually to reduce logistical costs for the enterprises), the BLPs were introduced in 2003 as an interface between ports and the FTZs.

**Third Phase**

The early CSSAs had separate regimes and were not part of a common legal framework. Starting in 2005, the Chinese government enacted rules to integrate the CSSA regimes. Major changes included:

- Establishing BPs in geographical proximity to the ports. The Chinese State Council approved the establishment of BPs in 2005; administrative measures regarding BPs were issued to combine the advantageous policies of FTZs, EPZs, and BLPs.
- Establishing CBZs in the inland regions in 2006 to enable FTZs that are not adjacent to ports to enjoy the same benefits as BPs.
- Expanding the functions of EPZs. In 2007 China allowed seven EPZs as pilots to transform EPZs from single processing areas to upgraded areas with bonded logistics, R&D, trial production, procurement, processing, testing, maintenance, export, and distribution functions. On December 31, 2008, the State Council issued a circular\(^2\) to expand the pilot program to all EPZs.

From a tax perspective, customs duties and import VAT will not be levied on imported goods that enter any CSSA. If the goods from the CSSA are sold to the Chinese domestic market, they will be subject to both import customs duty and import VAT. The costs incurred inside the CSSA (for example, storage and transportation expenses) should be included in the customs value for duty assessment purposes. If the goods are sold to the overseas market, they are exempt from customs duty and VAT.
Differences Among CSSAs

**FTZs**

*Definition, Locations, and Allowed Business Activities*

Internationally, a free trade zone is known as:

- “An area where goods may be traded without any barriers imposed by customs authorities like quotas and tariffs.”

- “An area within which goods may be landed, handled, manufactured or reconfigured, and reexported without the intervention of the customs authorities. Only when the goods are moved to consumers within the country in which the zone is located do they become subject to the prevailing customs duties.”

- “Airport, seaport, or any other designated area for duty-free import of raw materials, components, sub-assemblies, semi-finished or finished goods where such items can be stored, displayed, assembled, or processed for re-export or entry into the general market of the importing country (after paying the required duties).”

Chinese FTZs are supposed to be the “territories outside the customs territory and inside the borders of the country,” or designated areas to allow the free flow of foreign goods exempt from customs duty and VAT. Although the 15 Chinese FTZs are commonly known and translated as “free trade zones,” they are actually called “bonded zones” in Chinese. To some extent the Chinese FTZs are still “within the customs territory” and do not totally fall into the definition of free trade zone.

To increase exports and foreign investment, China approved 15 FTZs in the 1990s, most of which are located in the central cities and economic hubs around the coastal area. Although most FTZs are established near ports, they do not include the ports. The FTZs and the ports are thus under the management of two different customs authorities, complicating clearance procedures. Those FTZs are:

- Dalian FTZ;
- Fuzhou FTZ;
- Guangzhou FTZ;
- Haikou FTZ;
- Ningbo FTZ;
- Qingdao FTZ;
- Shanghai Waigaoqiao FTZ;
- Shantou FTZ;
- Shenzhen Futian FTZ;
- Shenzhen Shatou FTZ;
- Shenzhen Yantian Port FTZ;
- Tianjin Port FTZ;
- Xiamen Xiangyu FTZ;
- Zhangjiagang FTZ; and
- Zhuhai FTZ.

Bonded warehousing, international trade, export processing, and product display are four basic functions of the Chinese FTZ. The FTZs also permit simple processing and other functions.

**Tax and Customs Treatment**

**Transaction 1: Raw Materials Sourced From Chinese Non-Bonded Areas.** According to the measures of China’s General Administration of Customs (GAC), when a manufacturing enterprise in an FTZ purchases raw materials from a Chinese vendor located in a Chinese non-bonded area, from a customs perspective the transaction is deemed to be an export by the Chinese vendor. Normally, no export customs duty is triggered unless raw materials fall into the export customs duty dutiable category. The VAT treatment of such a transaction, however, has been a tricky issue since July 1, 1995. According to a circular released jointly by the Ministry of Finance and the SAT in 1995, effective July 1, 1995, the Chinese vendor that exports goods from a Chinese non-bonded area to the FTZ is no longer allowed to apply for the export VAT refund, which applies to normal export transactions. Consequently, the Chinese vendor is liable for VAT on the sales. The only exception when the enterprise in a Chinese non-bonded area can still apply for the export VAT refund is when its goods are stored temporarily...
by a storage enterprise within the FTZ before they are exported to overseas customers. In other cases, the export VAT refund can be applied for by the enterprise inside the FTZ only when the goods are actually (processed and) exported overseas by the FTZ enterprise. This regulatory change was China’s biggest move ever regarding the FTZ tax regime. It substantially weakens the position of the FTZs as “territories outside the customs territory and inside the borders of the country.”

Transaction 2: Raw Materials Sourced From Overseas. Raw materials sourced from foreign vendors are purchased by the FTZ enterprise on a bonded basis; that is, no Chinese import customs duty or import VAT will be triggered.

Transaction 3: Finished Goods Sold Overseas. When the finished goods are sold to the overseas market, they should be exempt from export customs duty and export VAT. As discussed regarding Transaction 1, when the processed goods are actually exported overseas and contain locally sourced raw materials, the FTZ enterprise can apply for the export VAT refund. However, in practice it is usually very difficult for the FTZ enterprise to obtain the refund. This is mainly caused by the gap between the formal requirements and the special nature of FTZ transactions. For example, the FTZ enterprises typically submit special export declarations and comply with special foreign exchange declaration procedures; and there are electronic data transmission problems between the FTZ customs authorities and the local tax authorities. Consequently, it is hard for an FTZ enterprise to fulfill the export VAT refund requirements “designed” for the enterprises located in Chinese non-bonded areas. Only Ningbo FTZ, Shanghai Waigaoqiao FTZ, and Tianjin Port FTZ have overcome these difficulties and can handle the export VAT refund applications of their FTZ enterprises. Billions of U.S. dollars of export VAT refund are still pending processing.

Transaction 4: Finished Goods Sold to Chinese Non-Bonded Areas. When the finished goods are sold to the Chinese market, the customs authorities will examine and determine the customs value based on the original price of raw materials sourced from overseas instead of on the entire value of the finished goods. In this case, the name, quantity, and value of raw material sourced from overseas contained in the finished goods should be exactly identifiable and documented. Oddly, this treatment does not apply if all raw materials are sourced overseas, in which case the total price of the finished goods will be subject to customs duty and import VAT. In this situation, it is recommended to split (bifurcate) the production for documentation purposes or set up the manufacturing site in a Chinese non-bonded area directly. Since the taxable base of import VAT should be equal to the customs value plus customs duty plus consumption tax (if any), the import VAT amount for the two scenarios would also be different because of the different customs value.

Example: A manufacturing enterprise is located in an FTZ. Some of its finished goods are sold to the Chinese market at a price of [EURO]100 million. To produce these goods, raw materials in the amount of [EURO]30 million are needed.

Scenario 1: Raw materials of [EURO]30 million are sourced overseas. When the finished goods are sold to Chinese customers, import customs duty (and consequently import VAT) will be levied based on the entire value of the goods -- that is, [EURO]100
million. (The customs and tax treatment for an EPZ, BLP, BP, and CBZ is in principle identical with that in Scenario 1.)

**Scenario 2**: Of the raw materials, [EURO]25 million is sourced overseas and [EURO]5 million is sourced from a Chinese non-bonded area. Provided specific conditions are met, import customs duty (and import VAT) will be levied based on the raw materials sourced from overseas, that is, [EURO]25 million instead of on the entire value, [EURO]100 million, of the finished goods.

**EPZs**

**Background, Location, and Allowed Business Activities**

On April 27, 2000, the Chinese State Council approved the first 15 EPZs. EPZs were introduced to encourage export processing after the FTZs lost their sparkle as “territories outside the customs territory and inside the borders of the country.” The export VAT refund measures adopted by the EPZ are similar to those of the “old” FTZ -- that is, immediate export VAT refund once the goods enter the EPZ from a Chinese non-bonded area. The EPZs have specifically been formed to house the export processing enterprises previously located in the FTZs.

All EPZs must be established within the confines of the existing economic and development zones. There are approximately 60 EPZs in China.8

Originally, the EPZs were only used to house bonded manufacturing activities for export purposes. The main features of the EPZs are export processing, assembling, and warehousing related to processing activities. Compared with FTZs, EPZs permit fewer business activities inside the zones. Enterprises inside the EPZs may not operate retailing, general trade, entrepôt trade,9 or any other business. The focus of the EPZ on processing activities allows it to offer more incentives that are not available in the FTZ to encourage and attract export processing enterprises (for example, more streamlined customs clearance or advanced electronic control administration).

Previously, the sale of goods from the EPZs into China’s domestic markets was strictly controlled by customs authorities. However, because of the development of the domestic processing chain, the sale of goods into the Chinese domestic market has become a normal practice.

The establishment of the EPZ encourages the development of bonded logistics (for example, warehousing, distribution, and transport) related to export processing. Hence, there is a great demand for bonded logistics, and the allowable business of the EPZ will be subject to expansion. In 2007, upon permission of the State Council, the GAC issued a circular10 to approve seven EPZs (Beijing Tianzhu EPZ, Chongqing EPZ, Jiangsu Kunshan EPZ, Shandong Yantai EPZ, Shanghai Songjiang EPZ, Shanxi Xi’an EPZ, and Zhejiang Ningbo EPZ) as pilots to expand their business scope and cover bonded logistics, R&D, testing, and maintenance activities. Effective December 31, 2008, the State Council allowed the pilot program to be expanded to all EPZs.11

Because the bonded logistics function is newly established in the EPZ and is still underdeveloped, the enterprises within the EPZ that intend to use this function may encounter some practical problems. Meanwhile, because the locations of the EPZs are more inland, the product flow may require more lead time and costs.

**Customs and Tax Treatment**

**Transaction 1: Raw Materials Sourced From China Non-Bonded Areas.** When an enterprise in the EPZ purchases raw materials from a Chinese vendor, the transaction is deemed to be an export by the Chinese vendor. Normally, no export customs duty will be triggered unless raw materials fall into the export customs duty dutiable category. The Chinese vendor can apply for the export VAT refund once the raw materials enter the EPZ. This is a big difference compared with the current FTZ regime.

**Transaction 2: Raw Materials Sourced From Overseas.** Raw materials sourced by the EPZ enterprise from overseas are considered as bonded goods (that is, no import customs duty or VAT will be triggered).

**Transaction 3: Finished Goods Sold Overseas.** Processed goods that are exported are exempt from customs duty and VAT. No
export VAT refund is available since the input VAT has already been refunded to the Chinese vendor. (See Transaction 1.)

**Transaction 4: Finished Goods Sold to Chinese Non-Bonded Areas.** When the finished goods enter the Chinese non-bonded area, the transaction will be considered as an import by the Chinese customers or their agents. Import customs duty and VAT are payable by the Chinese importers. Unlike in the FTZ, customs duty and VAT will be imposed based on the entire value of the finished products.

**BLPs**

*Background, Location, and Allowed Business Activities*

Although most of the existing 15 FTZs are located near the ports, the ports are not part of the FTZs. Until 2007 the EPZs were not entitled to provide a platform for the logistics industry. Therefore, to integrate the advantages of the FTZ with the loading and transport functions of the ports and to promote the logistics industry, in 2003 the State Council introduced the bonded logistics parks as a new form of CSSA. The Waigaoqiao BLP was the first BLP, and it linked the Shanghai Waigaoqiao FTZ and the port in Shanghai. Later the State Council approved BLPs in Dalian, Fuzhou, Guangzhou, Qingdao, Shenzhen Yantian Port, Tianjin, Xiamen Xiangyu, and Zhangjiagang.

BLPs are independent enclosed zones set up within the planning areas of the FTZ or special ports adjacent to the FTZ. A channel is opened between the BLP and the adjacent port. The setup of the BLP connects the FTZ and the port, which is used specifically for developing the modern logistics capacity. The so-called zone-port interaction allows the BLP to combine the function of bonded warehousing with cargo handling and transport functions of the nearby port. The FTZs and the ports are integrated; nevertheless, the BLPS and the ports are still controlled by different customs authorities, which leads to duplicate customs clearance when the goods enter or leave the zones and ports. The repeated and complex procedures increase business operation costs and reduces efficiency.

Businesses in BLPs may carry out the following activities:

- storing of import and export goods and other goods that have not yet passed customs clearance;
- performance of simple processing (such as classification, selection, pasting signs, and change packages) and value added services for the stored goods;
- international entrepôt trade;
- international sourcing, allocation, and distribution;
- international transit business;
- testing and maintenance;
- exhibition of commodities; and
- other international logistic business as approved by the customs authorities.

The above scope of business allows the BLPS the following international economic functions:

- **Transshipment:** Imported or domestic goods can be taken into the BLP for assembling and simple processing and then transshipped to other countries -- similar to the business scope of ports and shipping companies.

- **International distribution:** Imported goods can be taken into the BLPS for assembling and simple processing and then distributed to domestic or overseas markets -- similar to the FTZs.

- **International sourcing:** Imported or domestic goods can be taken into the BLPs for assembling and simple processing and then sold to domestic or overseas markets. This is the biggest advantage of the BLPS for the following two reasons:
  - Foreign purchasers can purchase goods in China in their own names and use the BLP as a distribution center.
  - Goods entering the BLP are regarded as being exported by the upstream Chinese vendors and can enjoy the export VAT refund directly. If the goods are resold into the Chinese non-bonded area to a downstream Chinese processing enterprise, the import may be executed by the downstream enterprise on a bonded basis. Thereby the traditional “Hong Kong U-turn” can be replaced by the “BLP U-turn.” The international transport and logistics costs are significantly reduced, and the export VAT refund cycle is also shortened.
Reexport: Imported goods are taken into the BLPs for warehousing and then reexported to other countries without any processing activities – similar to the FTZs.

Retail, processing and manufacture, renovation, dismantlement, and any other business should not be carried out within the BLPs.

Customs and Tax Treatment
Based on a circular issued by the SAT in 2004, BLPs will refer mutatis mutandis to the tax treatment of the EPZ. Therefore, export VAT refund is eligible for the Chinese vendors once their goods enter the BLP.

BPs and CBZs
Background, Location, and Allowed Business Activities
The State Council designated BPs as special zones at an international port or specific areas adjacent to a port that serve composite functions of port, logistics zone, and processing zone. In June 2005 the first BP was approved and established in Shanghai and combined the port logistics capabilities and the special functions of various CSSAs. BPs integrate all the advantages of the FTZ, the EPZ, the BLP, and the port. The BP can be regarded as the most updated version of the CSSA.

The CBZ is a type of CSSA in the inland region where highly concentrated bonded logistics functions are located. CBZs have the same allowed range of activities and enjoy the same regulatory framework as BPs.

The State Council approved the following BPs:
- Chongqing Lianglucuntan BP;
- Dalian Dayaowan BP;
- Fuzhou BP;
- Guangxi Qinzhou BP;
- Guangzhou Nansha BP;
- Hainan Yangpu BP;
- Qingdao Meishan BP;
- Shanghai Yangshan BP;
- Shenzhen Qianhaiwan BP;
- Tianjin or Tianjin Dongjiang BP;
- Xiamen Haicangbao BP;
- Yantai BP; and
- Zhangjiagang BP.

The State Council also approved the following CBZs:
- Beijing Tianzhu CBZ;
- Chongqing Xiyong CBZ;
- Guangxi Pingxiang CBZ;
- Guangzhou Baiyun Airport CBZ;
- Haikou CBZ;
- Heilongjiang Suifenhe CBZ;
- Jiangsu Kunshan CBZ;
- Shanghai Pudong Airport CBZ;
- Suzhou Industrial Park CBZ; and
- Tianjin Binhai New Area CBZ.

BPs and CBZs allow not only simple processing but also deep processing. The following business activities may be conducted within BPs and CBZs:
- storing of import and export goods and other goods that have not yet been processed for customs clearance;
- international entrepôt trade;¹⁴
- international procurement, distribution, and delivery;
- international transit shipment;
- inspection and after-sales service and maintenance;
- commodity exhibition;
- R&D, processing, and manufacturing;
- port operation; and
- other business with the approval of the customs authorities.

Customs and Tax Treatment
BPs and CBZs are subject to the same tax treatment as EPZs.¹⁵ Export VAT refund is eligible for the Chinese vendors once their goods enter the BP or CBZ. Instead of being governed by different customs authorities, the BPs and CBZs and the adjacent ports are supervised by one customs authority. The functions of BPs and CBZs and the ports are fully integrated.

Tax Burden Comparison
The tax implications on the processing enterprises in the CSSA are affected by factors such as the operation (processing) model, the portion of raw materials to be sourced from China and overseas, the portion of finished goods to be sold to China and overseas, and the ratio of the value of raw materials against the finished goods. The
choice of location needs to be analyzed case by case. Below are two sample scenarios that illustrate the different tax implications of the FTZ, the EPZ, and the Chinese non-bonded area.

**Scenario 1**  
*Business Assumptions*

In options 1 and 2, enterprise A is qualified to be set up in the FTZ or the EPZ.

In options 1 and 2, raw materials sourced from overseas amount to [EURO]10 million, of which [EURO]6.5 million is used in the finished goods sold to the Chinese non-bonded area and [EURO]3.5 million is used in the finished goods sold to the overseas market.

In options 1 and 2, raw materials sourced from Chinese vendors amount to [EURO]10 million, of which [EURO]6.5 million is used to produce the finished goods sold to the Chinese non-bonded area and [EURO]3.5 million is used to produce the finished goods sold to the overseas market.

In Option 3, enterprise A produces under a full-fledged manufacturing model -- that is, raw materials sourced from overseas are not imported by A on a bonded basis.

All the amounts above do not include taxes.

**Tax Assumptions**

The import customs duty rate is 30 percent. No export customs duty applies. The applicable Chinese VAT rate is 17 percent, and the applicable export VAT refund rate is 13 percent.

Raw materials sourced from overseas that are contained in the finished goods sold to the Chinese market can be identified. Therefore, customs duty and VAT are imposed only on the overseas raw materials for the FTZ case.

In Option 3, the “exempt, credit, and refund” mechanism applies to enterprise A.

The input VAT of the Chinese customer can be credited against its output VAT; therefore, it is not a final cost of the Chinese customer.
The actual costs (including export VAT leakage and import customs duty) of A are the lowest in the EPZ:

- EPZ (0) FTZ (1.26) Chinese non-bonded area (1.4).

However, the overall actual costs for the whole scenario are:

- FTZ (3.21) Chinese non-bonded area (4.4) EPZ (19.9).

The main reason is because the FTZ has a limited base for calculating the import customs duty (that is, value of the raw materials sourced from overseas) when the goods are sold to the Chinese non-bonded area. Therefore, in general the FTZ may be better than the EPZ and the Chinese non-bonded area for this scenario, although the EPZ may have advantages over the FTZ in transactions 2 and 3.

Nevertheless, for the goods sold overseas (Transaction 3), the EPZ is still the most beneficial location because there is no export VAT leakage. The immediate export VAT refund of the EPZ (Transaction 2) also allows a better cash flow than the FTZ and the Chinese non-bonded area.
Transaction 1: Raw Materials Sourced From Overseas. Obviously the FTZ and the EPZ are better than the Chinese non-bonded area because of the bonded treatment.

Transaction 2: Raw Materials Sourced From China. The EPZ offers more tax certainty than the FTZ because of the immediate export VAT refund entitlement when the goods enter the zones. The actual practice of the EPZ in this respect is far clearer than that of the FTZ. Theoretically, the VAT implication of the FTZ here should be similar to Option 3 (the Chinese non-bonded area), which is also our basis for the calculation here. However, in reality the competent authorities in different localities may have different practices and interpretations; thus, the VAT treatment of the FTZ in this step is subject to the final discretion of the customs and tax authorities in charge.

Transaction 3: Finished Goods Sold Overseas. The EPZ is clearly better than the FTZ and the Chinese non-bonded area since no export VAT refund issue is triggered in the EPZ. Again, the VAT treatment of the FTZ will be analyzed case by case according to the locality. The FTZ is slightly better than the Chinese non-bonded area, as the raw materials sourced from overseas on a bonded basis can be deducted from the calculation base of the export VAT leakage.

Transaction 4: Finished Goods Sold to Chinese Non-Bonded Areas. The FTZ is much more beneficial than the EPZ because of the imposition of import customs duty and taxes on the overseas raw materials (when specific conditions are met) instead of on the entire value of finished goods. For the Chinese non-bonded area, no import customs duty will be triggered when the finished goods are sold on the domestic market.

Scenario 2

Business Assumptions
In options 1 and 2, enterprise A is qualified to be set up in the FTZ or the EPZ.

In options 1 and 2, raw materials sourced from overseas amount to [EURO]50 million.

In options 1 and 2, raw materials sourced from the Chinese vendor amount to [EURO]20 million.

In options 1 and 2, finished goods amount to [EURO]100 million, and 100 percent is sold overseas.
In Option 3, enterprise A produces under a full-fledged manufacturing model (that is, raw materials sourced from overseas are not imported by A on a bonded basis).

All the amounts above do not include taxes.

**Tax Assumptions**

The import customs duty rate is 30 percent. No export customs duty applies. The applicable Chinese VAT rate is 17 percent, and the applicable export VAT refund rate is 13 percent.

In Option 3, the “exempt, credit, and refund” mechanism applies to enterprise A.

The customs and tax implications are similar to those in Scenario 1. However, the difference between Scenario 2 and Scenario 1 is that 100 percent of the finished goods in Scenario 2 are sold overseas. In this case, the advantage of the EPZ becomes very obvious because of the immediate export VAT refund regime. The actual costs are:

- EPZ (0.8) FTZ (2) Chinese non-bonded area (19).

The Chinese non-bonded area is the worst among the three, since A not only bears the export VAT leakage (without deduction of bonded imported raw materials as in the FTZ), but also suffers from the significant import customs duty (Transaction 1).

**Summary**

A comparison of the main characteristics of CSSAs is shown in Table 3.
The decentralized structure of the Chinese tax and customs authorities leaves space for the interpretation of the regulations by the local authorities, which leads to a gap between the national regulations and the local practices. Regarding new and untested regulations, the interpretation can be quite exotic. Therefore, when identifying the proper business location in China, a foreign investor should always take into account the maturity of the available rules and the reputation of the administration of the respective bonded zones to ensure compliance and avoid surprises. However, each CSSA can, and often does, offer its own incentives. For example, local authorities can negotiate terms on land-use rights or provide utility incentives. Therefore, the availability of local incentives would be another factor that the foreign investor may need to consider when selecting a location. As the CSSAs are usually outside big city centers, the availability of qualified human resources plays another big role in the location choice.

As a result, the use of a CSSA can make sense in several business scenarios, especially if the Chinese production and assembling involves a lot of cross-border transactions of raw materials and finished goods. This article has shown big differences between the CSSAs regarding the timing and ease of export VAT refund, basis for customs duty and import VAT, scope of permitted activities, responsibility of customs authorities, and other tax factors. It is worthwhile to have a detailed picture of the envisaged transactions upfront before choosing the most efficient location from a tax and customs duty point of view.

<table>
<thead>
<tr>
<th>Categories of CSSA</th>
<th>1st phase</th>
<th>2nd phase</th>
<th>3rd phase</th>
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<td>Bonded logistics business</td>
<td>Yes</td>
<td>Yes since 2007</td>
<td>Yes</td>
</tr>
<tr>
<td>Separate customs authorities than adjacent ports</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Immediate export VAT refund in Transaction 1</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Possible to impose tax/duties only on overseas raw materials in Transaction 4</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

Table 3. Comparison of the Main Characteristics of CSSAs
Endnotes


7. Article 29 of the Order of GAC No. 148.

8. Beihai, Caohaijing, Changshu, Changzhou, Chengdu, Chenzhou, Chongqing, Cixi, Dalian, Fuqing, Fuzhou, Ganzhou, Guangzhou, Guangzhou Nansha, Hangzhou, Huai’an, Huhehaote, Huichun, Jiaxing, Jinan, Jinqiao, Jiujiang, Kunming, Kunshan, Langfang, Lianyungang, Mianyang, Minhang, Nanchang, Nanjing, Nanjing (south), Nantong, Ningbo, Qingdao, Qingdao Xihai’an, Qingpu, Quinhuangdao, Quanzhou, Shenyang, Shenyang Zhangshi, Shenzhen, Songjiang, Suzhou (high-new technology area), Tianjin, Tianzhu, Weifang, Weihai, Wuhan, Wuhu, Wujiang, Wulumuqi, Wuxi, Xiamen, Xi’an (two EPZs), Yangzhou, Yantai (two EPZs), Zhengzhou, and Zhenjiang.

9. Entrepot trade is trade engaged in the import of goods from a foreign country not for consumption but for re-export to another country. The goods so imported are kept in a bonded warehouse, and after due payment of duties, they are re-exported. See http://www.rajputbrotherhood.com/knowledge-hub/business-studies/what-are-the-reasons-for-entrepot-trade-business-studies.html.


12. Updated according to the Order of GAC No. 190, dated Mar. 15, 2010.


15. Guoshuihan [2006] No. 1226, Circular of the State Administration of Taxation on Relevant Tax Issues Concerning Yangshan Bonded Port Zone and CSSA.

16. The BP and the CBZ in principle follow the same tax treatment as the EPZ.
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