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CHINA TAX ALERT

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Is the China – Switzerland Free Trade Agreement for you?

Regulation discussed in this issue:

- The Free Trade Agreement Between the Swiss Confederation and the People's Republic of China

Background

China and Switzerland signed a landmark free trade agreement (FTA) on 6 July 2013, paving the way for significant reductions in Customs duty rates between both parties that may commence as early as the middle of next year. This further solidifies economic relations between the two countries as it only comes nine months after Hong Kong, China's Special Administrative Region (SAR), entered into a double tax treaty (DTT) with Switzerland to encourage joint investments between Swiss and Hong Kong based companies. Even though Hong Kong, as an SAR, is not a party to the FTA, Hong Kong companies that are investing and engaged in the manufacture of goods in China could be among the biggest beneficiaries of this FTA.

Benefits

Swiss companies importing from China, and Chinese companies importing from Switzerland have reason to be excited and are encouraged to rethink their trade strategies and financial projections over the next five to 15 years since a significant number of products will be granted duty free status within this time period (albeit some sooner or later than others). Below are some high-level descriptions about the tariff reduction schedules of each country:

Switzerland exports or China imports	If you are a Swiss exporter or Chinese importer of Swiss goods and currently pay Customs duties in China at a rate of five percent or less in China, your duty costs will likely be reduced to zero by mid-2014.
	If your current China duty rate is higher than five percent, then you can expect a gradual reduction, starting with a few percentage points in mid-2014, ultimately leading to zero duties in a span of five, 10, 12 or 15 years.
China exports or Switzerland imports	For Chinese exporters or Swiss importers of Chinese goods, practically all duties on industrial products (except for a few types of albumins) will be eliminated, thereby giving unprecedented access to China made products in the Swiss market. However, a number of agricultural tariffs are excluded or subject to gradual tariff reduction schedules.

Tariff reductions for Swiss 'best sellers' in China such as watches, pharmaceuticals, and dairy products will be relatively slow. Although they will not immediately enjoy zero duty benefits, they will be granted reductions averaging from one to three percentage points in the first year. These reductions will continue in the subsequent years until the eventual elimination of Customs duties within 10 to 12 years.

On the other hand, nearly all of China's major exports to Switzerland, mainly textiles, light consumer goods, and equipment, will immediately enjoy benefits when the FTA becomes effective.

From the structure of the tariff reduction schedule, it appears that more market access opportunities have been granted for Chinese products being imported into Switzerland.

Given that the implementation of the FTA is less than a year away, companies (especially Chinese exporters) are encouraged as early as now to familiarise themselves with the technical intricacies of the agreement – particularly the rules of origin. Each Harmonised System (HS) Chapter would have its own set of rules, which could either be a change in tariff classification, a minimum value content requirement of up to 70 percent, a specific type of manufacturing process, or a combination of these.

Common misunderstandings

One common misconception that companies make in their interpretation of FTAs is that a mere transshipment through an FTA party or simple packaging process undertaken in an FTA member would be sufficient for their products to qualify. By taking a closer at the rules of origin, one can better appreciate that a "substantial transformation" (Article 3.2.b of the FTA) will have to take place on the products either in Switzerland or in China before it can enjoy FTA benefits. Simple processes (examples of which are enumerated in Article 3.6) in an FTA member country or merely transiting the goods, do not confer originating status on the products.

Another common and related error is the notion that any form of transshipment through a non-FTA member would automatically disqualify products from enjoying the FTA rate at the country of importation. While it is true that direct consignment (i.e., products should be shipped directly from manufacturer to importer) is the general norm for FTA qualification, the rules of origin, particularly Article 3.13, specify that transshipments are still allowed on the condition that the products are not further processed and remain in Customs control in the non-FTA member.

Extended opportunities

One interesting provision under paragraph 2 of Article 3.13 allows consignments to be split in non-FTA member countries and still enjoy FTA treatment at the ultimate destination provided that the aforesaid conditions are met. This augurs very well for companies that have, or are planning to set-up, logistics hubs/regional distribution centres that will segregate and re-export goods between Switzerland and China.

With a good working knowledge of the rules of origin, Swiss and Chinese companies can also consider using this FTA as a staging point to launch even more ambitious supply chain restructuring endeavours such as leveraging the broader FTA network of China (with 25 parties), and Switzerland (with 39 parties apart from the EU) for comprehensive market access. Since raw materials and semi-finished goods can be imported into Switzerland and China at zero or reduced rates, this can encourage manufacturers based in these countries to produce finished goods that can enjoy reduced duty or duty free benefits in countries which China and Switzerland have FTAs with, provided that the relevant rules of origin for these separate FTAs can be met.

The soon to be implemented China – Switzerland FTA will be far from China's last. In fact, there is a rather substantial pipeline of potential FTAs currently being considered and negotiated:

	Bilateral	Regional
China's current FTA network	• Hong Kong • Macau • Taiwan • Costa Rica • Chile • Iceland (signed) • New Zealand • Peru • Singapore • Switzerland (signed) • Pakistan	• Asia Pacific Trade Agreement – comprising Bangladesh, India, Laos, South Korea, Sri Lanka • Association of Southeast Asian Nations – comprisingf Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam
Under consideration	• India • Korea • Japan-Korea	
Under negotiation	• Gulf Cooperation Council FTA – comprising Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman • South African Customs Union FTA – comprising Botswana, Lesotho, Namibia, South Africa, and Swaziland. • Australia • Norway	

Multi-disciplinary effort

Owing to the large potential this FTA affords for Swiss and Chinese companies alike, manufacturers and traders in both countries are advised to closely examine these rules to properly configure their functions and operations in accordance with the FTA requirements. In some cases, this may take a firm-wide initiative where members of various departments such as finance, supply chain/logistics, customer service, manufacturing, engineering, and information technology (IT) must be involved in order to ensure a coordinated approach.

The critical role of IT

IT, in particular, has increasingly become a major factor in FTA implementation strategies, especially with the advent of sophisticated Enterprise Resource Planning (ERP) based solutions and bolt-on modules designed to manage trade compliance. For companies that need to keep track of thousands of raw materials and stock keeping units (SKU), having an IT solution is often the only reasonable way to comply with FTA requirements. However, these modules are only as good as the team that configures it, according to the FTA and local regulatory requirements. Therefore, since these modules have to be properly customised to each company's needs, external support would be recommended on the content, configuration, and execution of these modules.

The time is now

With less than a year to prepare, companies need to act now to determine whether this FTA is an enterprise worth pursuing. For companies in the path of this FTA, doing nothing is not an option because if they do not seriously and consider this opportunity now, other companies that are eventually able to plan ahead and capture its benefits will undoubtedly have a competitive advantage.

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