These are exciting times for the automotive industry in China. The country recently overtook the United States to become the world’s largest car market and shows no signs of slowing down. As more and more Chinese enter the middle class, their demands for mobility increase. As a result, car use in China has exploded.

In its wake we find the industry that makes the wheels spin: the automotive parts industry. Attracted by the rapid demand for cars, thousands of automotive parts companies have sprung up across China, resulting in the highly fragmented sector we find today. Up until recently, car makers were able to exert pressure on parts manufacturers, drawing the attention of China’s anti-trust regulators. Following a host of harsh fines and penalties meted out to the major car makers, auto parts manufacturers are now able to sell directly to repair shops and consumers – a move that enhances their price setting capability.

In this issue of China Briefing, we present a roadmap for investing in China’s automotive industry. We begin by providing an overview of the industry, and then take a comprehensive look at key foreign investment considerations, including investment restrictions, tax incentives and manufacturing requirements. Finally, we discuss foreign investment opportunities in a part of the industry that receives substantial government support: new energy vehicles.

With our specialized knowledge and experience in China’s automotive industry, Dezan Shira & Associates can help foreign companies either establish or expand their operations in China and beyond.

With kind regards,

Alberto Vettoretti
Managing Partner
Dezan Shira & Associates

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- [The New Free Trade Zones Explained, Part II: The Negative List](#)
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- [Pre-Investment and Entry Strategy Advisory](#)
- [Malaysia GST: Implications for Manufacturers](#)
- [New Foreign Trade Policy to Back-end Export Targets](#)
- [Vietnam’s Auto Industry could have Fastest Growth in Southeast Asia, but Challenges Remain](#)

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Following several years of strong growth, China overtook the United States as the world’s largest car market in 2010. Going from just 2.4 million car sales in 2001 to 23 million in 2014, car use in China has exploded in little over a decade.

**Government policy**

The government placed the car industry at the forefront of China’s economic policy by naming it a ‘pillar industry’, a term reserved for industries that make up over 5 percent of the country’s GDP. As such, car companies received numerous subsidies, totaling US$2.3 billion between 2001 and 2011. The industry benefited from reduced car sales tax, the development of roads, and direct subsidies for rural car sales as well.

Higher disposable incomes, increased urbanization, as well as government focus on the development of infrastructure, will continue to have a strong upward impact on Chinese car demand.

**Constraints in Car Use**

The rapid growth of car use has placed substantial strain on traffic conditions in many of China’s major cities, and is one of the main causes of the country’s heavy air pollution, an everyday concern. This has moved city officials to restrict the issuing of license plates and implement other measures to limit car usage. Shanghai, for example, only grants between 9,000 and 10,000 license plates a month, auctioned at an average price of RMB 82,000 (Shanghai average annual income: RMB 65,400).

**Car Parts Manufacturers Operate in a highly Fragmented Industry**

Driven by strong car sales, the car parts industry in China has expanded rapidly in a short amount of time. With the industry growing faster than the country’s GDP, the number of registered automotive parts producers went from 4,200 in 2003 to over 10,000 today. An estimated 15,000 additional, unregistered auto parts companies are in operation. This makes China one of the largest producers of automotive parts worldwide.

The industry is highly fragmented and mainly consists of small companies producing just one part, or a component of a part. None of the players hold any significant market share, the largest having 4.2 percent, followed by two to three companies with around 1 percent. These companies still largely rely on labor, make relatively little use of technology compared to most car producing countries and often lack economics of scale. R&D expenditure is often at a fifth of what is common internationally. Most companies produce simpler parts, the more advanced ones being imported.

This is, however, rapidly changing due to outputs rising faster than investment in fixed assets. As quality is improving, so too is foreign demand for Chinese-produced car parts, although exports have recently been put under pressure by the appreciating Yuan.
While the auto parts sector in China is made up of several thousand different players, the assembly end of the supply chain is highly concentrated. Here, five companies hold 60 percent of the market. Due to this lopsided industry structure, OEMs (original equipment manufacturers) are able to exert considerable pricing pressure on the large array of smaller-scale companies.

Peter Bo Pan of the risk consultancy Grapevine Asia commented that for foreign investors the OEM (or new car) parts would now be too tough to break into, except when buying into it through good acquisitions. He therefore expects further consolidation in the coming years through mergers, offering foreign newcomers to the market a way in. He also sees opportunities in the after sales stores, as these are still at an early stage.

Anti-trust Suits Brought against Car Assemblers

Using their strong position in the market, car assemblers have been forcing parts manufacturers to sign exclusivity agreements with them, eliminating their ability to sell parts to the aftermarket. This forces Chinese consumers to either purchase parts from repair shops controlled by the car makers, or buy counterfeit parts. The practice is in violation of China's anti-trust laws and has substantially driven up the price of spare car parts.

In response, the Chinese government has commenced an anti-trust crackdown on car assemblers, meting out harsh fines and penalties to many major international companies. Following these events, China-based car assemblers quickly moved to cut prices and open up sales channels for parts makers to the independent repair shops.

Conclusion

Internationally, investments in car manufacturing tend to show a finished car to car parts ratio of 1:1.3, but in China this is 1:0.3. However, this is rapidly changing. In 2011, the total output value of China’s car parts sector first exceeded RMB 200 trillion – a growth of 33.6 percent. As car sales and the aftermarket for parts continue to grow, the industry is expected to reach an output of RMB 330 million in 2015, maintaining double-digit growth.
Gearing Up: Investing in China’s Automotive Parts Industry

By Dezan Shira & Associates, Shanghai Office
Editor: Qian Zhou and Steven Elsinga

Legal Considerations

The Catalogue for the Guidance of Foreign Investment

Like many countries, China restricts foreign investment in certain sections of its economy. The Chinese government maintains a list of these restrictions in a document known as the Catalogue for the Guidance of Foreign Investment. The Catalogue is comprised of encouraged, restricted and prohibited lists. Foreign companies that are engaged in the encouraged industries may enjoy preferential policies such as tariff exemptions for imported equipment, or tax incentives. Restricted industries may require additional approval, or are subject to foreign equity caps.

In the 2015 Catalogue, a variety of subsectors of the automotive industry are encouraged. These include the manufacturing of engines, key components, electronics, and specifically car parts of new energy vehicles. In two subsectors, the Catalogue mandates that foreign investors seek a Chinese joint venture partner to set up a business: the manufacturing of electronic buses in a car’s electronic system and of the electronic controls in Electronic Power Steering (EPS) systems. The production of embedded systems was restricted to joint ventures in earlier versions of the Catalogue, but was removed in the 2015 version.

The main restriction is on finished cars. The 2015 Catalogue explicitly restricts the production of finished cars, formalizing the requirement that foreign car makers set up 50-50 joint ventures with Chinese companies – in practice all state-owned – to assemble and sell cars in China. In addition, the latest version of the Catalogue states that a single foreign entity may not set up more than two joint ventures of the same category, the categories being motorcycles, passenger vehicles or commercial vehicles. This limitation, however, does not apply when the joint venture acquires an additional business through a merger or acquisition.

The fact that the manufacturing of finished cars has officially been moved from the encouraged to the restricted list shows that the Chinese government intends to solidify its policy of backing up local car producers. In the area of auto parts, the trend has overall been positive for foreign players, as shown by continuing rounds of liberalization in that sector.

The Negative List and the Free Trade Zone

As part of the preferential policies in the Free Trade Zone (FTZ), the Shanghai government released its first Negative List in 2013 and a second version in 2014. The document sums up the industries in which foreign investment is restricted or forbidden – in all other sectors, foreign investors will have the same treatment as domestic investors.

In the matter of finished vehicles, the restriction is exactly the same as in the Catalogue. The other two automotive-related restrictions are on the
production and development of embedded systems in cars, and the production of batteries in new energy vehicles. Foreign investment in the production of new energy vehicles may not exceed 50 percent. The manufacturing of embedded systems must be conducted through a joint venture, but there is no mandated equity ratio.

Earlier this year, the State Council approved the creation of three new Free Trade Zones and the expansion of the present Shanghai FTZ. Both the Shanghai FTZ and the three new ones (Guangdong, Fujian and Tianjin) will share the same Negative List. Compiled by the State Council, the list removes the restriction on new energy batteries and embedded systems, but maintains the restriction on finished cars. The former two restrictions had already been removed with the 2015 Catalogue.

The Negative List, effective May 8, 2015, adds a new restriction to the production of new energy vehicles. Companies producing passenger vehicles that are purely driven by electricity must use their own brand and their own intellectual property and patents.

**Required Licenses for the Production of Auto Parts**

To engage in the production of certain car parts, a Production License is required. Under China’s regulatory regime, the Administration of Quality Supervision, Inspection and Quarantine (AQSIQ) requires a license for the items shown at the bottom of this page.

To apply for a Production License, the company needs to submit the application materials to AQSIQ at the State or Provincial level. The AQSIQ office in question will then review the application and conduct a product test in a procedure that takes between 50 to 70 days.

**CCC Certification Requirements for Auto Parts**

The Standardization Administration of China (SAC) issues the national standards (including technical standards for production) known as the Guobiao. The SAC maintains a database of these standards, which is searchable in Chinese and English. Mandatory standards are prefixed GB, while voluntary standards are prefixed GB/T.

If a GB standard is mandatory, it means that the product must be produced in accordance with the standard for it to be imported or produced and sold in China. To demonstrate that a company produces a product in accordance with the relevant Guobiao standard, it must obtain a China Compulsory Certificate, often referred to as a CCC Mark. The CCC mark is administered by the Certification and Accreditation Administration, which designates a Quality Certification Centre to process CCC mark applications.

**Some of the Car Parts That Require China Compulsory Certificate**
The certification process usually takes between four to eight months. A designated test laboratory in China will test product samples and the Quality Certification Centre will send representatives to inspect the manufacturing facilities. CCC certificates are valid for five years from the date of issuance. The CCC certificate and permission to print the CCC mark must be renewed annually as part of a follow-up certification, which involves a one-day factory audit.

**Tax Considerations**

Auto parts enterprises are subject to several taxes, the major ones being Consumption Tax (CT), Value-added Tax (VAT) and Corporate Income Tax (CIT).

**Consumption Tax (CT)**

In the automotive industry, CT is levied on vehicle tires, small and medium-sized commercial vehicles and passenger vehicles with cylinders. The tax rates are given below:

<table>
<thead>
<tr>
<th>Vehicle Type</th>
<th>CT Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Car parts</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Vehicle Tires</strong> (Radial Tires Exempt)</td>
<td>3%</td>
</tr>
<tr>
<td><strong>Passenger Cars with a Cylinder Capacity</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Small &amp; Medium Commercial Vehicles</strong></td>
<td></td>
</tr>
<tr>
<td>litre ≤ 1</td>
<td>1%</td>
</tr>
<tr>
<td>1.0&lt;litre ≤ 1.5</td>
<td>3%</td>
</tr>
<tr>
<td>1.5&lt;litre ≤ 2.0</td>
<td>5%</td>
</tr>
<tr>
<td>2.0&lt;litre ≤ 2.5</td>
<td>9%</td>
</tr>
<tr>
<td>2.5&lt;litre ≤ 3.0</td>
<td>12%</td>
</tr>
<tr>
<td>3.0&lt;litre ≤ 4.0</td>
<td>25%</td>
</tr>
<tr>
<td>litre&gt;4.0</td>
<td>40%</td>
</tr>
</tbody>
</table>

Under the current CT regime, only producers, importers and subcontractors are required to pay CT when they sell a taxable product, based on the price at which that company sells the part. Distributors do not pay CT. For this reason, manufacturing companies with an affiliated distribution company may save CT by selling their products at a low price to its in-group distributor.

**Value-added Tax (VAT)**

Over the past few years, China has replaced the old Business Tax with the Value-added Tax (VAT). The VAT system allows businesses to offset VAT paid on goods and services it purchased, eliminating double taxation.

Cars and car parts are subject to the general VAT rate of 17 percent.

It is important to note that China’s VAT categorizes between two types of taxpayers: small-scale taxpayers and general taxpayers. These are distinguished according to their annual taxable sales amount, with the threshold between RMB 500,000 and 5 million, depending on whether a company is engaged in manufacturing, or retail and wholesale business.

Small-scale taxpayers pay the lower amount of 3 percent and general taxpayers pay the general VAT rate of 17 percent. However, general taxpayers are able to offset VAT paid through the use of special VAT invoices or fapiao, whereas small-scale taxpayers cannot. Newly set-up companies that have not yet reached the required level of sales may apply for general taxpayer status, if certain conditions are met.

Also, consumer purchases of certain vehicles are subsidized by the central government. In such a case, companies only need to withhold VAT on the amount that the consumer actually paid.

**Corporate Income Tax (CIT)**

Resident enterprises are subject to a 25 percent CIT rate. For non-resident enterprises, a 10 percent withholding tax is applied to China-sourced income. Nevertheless, certain tax incentives may apply to auto parts manufacturers.
HNTE incentives
As stipulated in the CIT law and its implementation guidelines, the High and New Technology Enterprises (HNTE) are granted a 15 percent preferential CIT rate, which auto parts manufacturing companies are often eligible for. Companies need to meet the following standards to apply for this tax reduction:

• The enterprise must be registered in mainland China;
• Intellectual property for the core technology of its key products or services must have been independently obtained by means of independent research and development, assignment, acceptance of a gift or merger or acquisition during the past three years, or through exclusive licensing for more than five years;
• In the current year, technical staff (i.e. holding specialized degrees or qualifications) constitutes over 30 percent of total staff, and staff engaged in R&D must constitute at least ten percent;
• To meet these requirements, companies may consider outsourcing labor intensive activities or using dispatched staff for certain functions, as these employees will not add to the companies staff count.

A certain percentage of the enterprise’s expenditure must be allocated to R&D, depending on its size:

• At least 6 percent for companies with revenues below RMB 50 million
• At least 4 percent for companies with revenues between RMB 50-200 million
• At least 3 percent for companies with revenues over RMB 200 million
• The revenue from high-tech products or services constitutes more than 60 percent of the total revenue of the enterprise in the current year.

R&D Expenditure Deductions
Certain R&D expenditures may be deducted from the company’s revenues pre-tax.

These include:

1. Design fees for new products, changes in workflow processes and costs of technical books and translation fees for materials directly related to R&D activities;
2. Costs of materials, fuels and power directly consumed in R&D activities;
3. Wages, bonuses, allowances, social insurance contributions etc. of staff employed to engage directly in R&D activities;
4. Depreciation or rental of instruments and equipment used specifically for R&D activities;
5. Amortization expenses of intangible assets such as software, patent and non-patented technologies used specifically for R&D activities;
6. Development and manufacturing expenses for molds and equipment used specifically for intermediate experiments and trial manufacturing of products;
7. Demonstration, appraisal and acceptance inspection expenses for R&D;
8. Expenses incurred for acquisition of samples, prototypes and general testing means which do not constitute fixed assets; and
9. Expenses for evaluation of R&D results.

To apply for R&D tax deductions, companies must submit sufficient documentation to support the authenticity and eligibility of the R&D project. As R&D expenses are usually allocated among R&D and manufacturing operations, it is important to ensure that there is a direct and reasonable connection between the manufacturing activities and the allocation of costs to the R&D cost center. To demonstrate that staff were involved in R&D activities, the company must provide documentation showing that staff costs were allocated to the R&D project or cost center.

Related Reading
Tax, Accounting, and Audit in China 2015 (7th Edition)
This seventh edition of Tax, Accounting, and Audit in China, updated in 2015, offers a comprehensive overview of the major taxes foreign investors are likely to encounter when establishing or operating a business in China, as well as other tax-relevant obligations.
Work Safety

China has been struggling with a high number of industrial accidents for years. Just in 2014, there were roughly 270,000 industrial accidents, resulting in around 57,000 deaths. Car part factories are among the common locations where these accidents occur.

The most lethal accident in 2014 in fact occurred at an automobile factory in Kunshan, a satellite city of Shanghai in Jiangsu province. An explosion at the plant, which manufactures aluminum wheels, killed 75 and injured another 190 people. The company was a subcontractor of a parts supplier to General Motors. While General Motors had no direct dealing with this company, it did suffer damage to its reputation as a consequence. Following the incident, China quickly sharpened up its work safety regulations.

While strong laws on work safety have been in force for quite some time, enforcement of these laws often leaves much to be desired. As such, the new Work Safety Law, which was enacted on December 1, especially strengthens inspection and enforcement mechanisms.

It is important to note that if an employee is injured during a work-related accident, the employer is liable for damages. This is in addition to the compensation the employee is entitled to under the Work-related Injury Insurance scheme, a social insurance that employers need to pay into. Exoneration clauses that limit or reduce the liability the employer faces in case of a work-related accident are not valid.

If an employee is to be exposed to potentially hazardous situations, these hazards need to be explicitly stated in the contract. If not, the employee may refuse to perform these tasks, or renegotiate the contract.

In addition, the new law requires that companies which are active in metal smelting or the production, storage and handling of hazardous materials have a full time safety executive, who is a certified safety engineer. Safety executives need to hold inspections, provide employee education and hold emergency drills. If a safety executive in a company active in the handling of hazardous materials is appointed or dismissed, the company needs to notify the local Administration of Work Safety. The principal person (e.g. the General Manager) in charge at such a company needs to take a work safety test.

The construction and design of facilities for conducting these activities needs to undergo a safety assessment by the local authorities. These facilities need to have emergency rescue equipment and procedures.

The State Administration of Work Safety, aided by the labor unions, has far-reaching authority to inspect factories and implement measures in the interest of work safety. If production safety is found to be lacking, it may go as far as seizing equipment and shutting down the factory.

Whether a foreign investor is looking to set up facilities in China, acquire a stake in a local company, or merely source parts from a Chinese partner, it is important to ensure that production facilities meet the safety standards provided by law. Failure to do so can result in one’s business being shut down.

Expert Analysis - Investing in China’s Auto Industry Stocks

Jack Perkowski, of JFP Holdings and a well-known name in the Chinese Auto Components industry, suggested that foreign investors could invest in the automotive industry in China. Citing examples such as CAAC, who manufacture steering systems (listed on the NYSE), Minth, who manufacture plastic trim, and Weichai, who are in commercial vehicles (both listed in Hong Kong), these companies have had to go through more stringent checks and balances than is required in mainland China and may represent good value.
Expert Commentary: Opportunities in New Energy Vehicles

By Fabian Knopf, Dezan Shira & Associates

Driven by concerns about air pollution and China's dependence on oil imports, the Chinese government has embarked upon a policy to promote the use of electric vehicles.

Since 2009, local governments in certain pilot cities have been required to purchase electric vehicles for various public purposes. These include police cars, taxis, sanitation trucks and city buses. Both the car quotas and cities covered in the scheme have since increased.

Like in many other countries, China has rolled out preferential policies for private car purchases as well, with the central and certain local governments offering numerous subsidies and incentives. The subsidies from the central government range from RMB 33,000 to 57,000, depending on the type of car. Most city governments double the central government subsidy, but often only for locally produced electric cars. For example, the Daimler BYD car developed and produced in Shenzhen gets approximately RMB 120,000 in subsidies per car. These protectionist tendencies relate to the close relationship some municipal governments have with local car producers.

Many city governments also exempt new energy vehicles from the license plate policies they have in place to restrict car use. For example, Beijing requires its residents to take part in a lottery for the right to buy a license plate. For new energy vehicles, there is a separate lottery with fewer participants, and therefore a bigger chance of getting a license plate. Shanghai auctions its license plates for regular cars, but for selected new energy vehicles, the license plate is free.

Despite subsidies, new energy vehicle use has hardly taken off, as new energy vehicles often still cost double the price of a regular car. The battery is the main culprit, which makes up half of the price in Chinese-produced new energy vehicles. The Chinese government is also pursuing the conflicting goal of stimulating the country’s domestic car industry, so imported cars – with cheaper batteries – are not covered by the subsidies.

Chinese producers lack the technology to make their new energy vehicles as reliable and price-competitive as foreign carmakers. Added to the already weak enforcement of intellectual property are the strict requirements for technology transfers on foreign companies looking to produce and sell cars in China. With many car makers reluctant to give away key technology, a lot of the recently developed new energy technology has failed to reach the Chinese market.

Another issue is the lack of charging infrastructure. While expanding rapidly, currently only the cities covered in the new energy policy have anything in the way of charging facilities.

Despite these hurdles, a large number of foreign carmakers have flocked to China to sell electric vehicles. Their day in the sun might be around the corner, as new energy vehicles sales in China hit 27,000 in December 2014 - for the first time surpassing US sales of that month.
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