Why structure with your HK company and subsidiary WFOE in China?

As many foreign companies continue to source from China via Hong Kong (HK), it is worthwhile to take a closer look as to why this model enjoys ongoing popularity and how to implement an efficient set-up. There are many good reasons for companies to manage their supply chain from HK: a good infrastructure, a legal framework based on British law, a transparent and efficient banking system, fair taxation, a fully convertible currency and a qualified workforce.

1. No storage costs and less financial risk

The option of selling goods 'Free On Board' (FOB) from China has become a huge success factor for foreign companies that have set up shop in HK. The big retailers in US & Europe who are a major customer group of many toy, textile and hard goods trading companies are increasingly asking for this option which also helps the traders avoid many of the former risks associated with selling big numbers of merchandise. By opening a letter of credit to the HK Limited Company which is then passed on to the China supplier, the danger of non-payment by the customer can be easily eliminated. This has particular significance if the order is customised specifically according to the customer's needs: special brand name, colour, functionality or simply the packaging make it impossible to sell goods to another customer. Apart from smaller financial risks, the cost of logistics and expensive storing – which often make up 3-5% of a transaction – can be saved. Thus, direct FOB business leads to a faster time to market and to lower prices both of which can boost competitiveness in times of rising sourcing costs throughout the region.

2. Lower Tax rates through HK company operation offshore with it's WFOE in China

Let's assume a 25% corporate income tax rate for China Mainland and a 16.5% for Hong Kong. The Chinese entity will be the one running the operations, while the HK entity will allow for optimization of the company's offshore corporate structure.
Once the goods are produced or traded in China mainland, they can be sold to it's HK parent company. The pricing for the transaction, as usual, will have to account for both the full industrial cost and a margin. This latter must be configured in order for the Chinese entity to reach a sound financial and fiscal performance, but still providing wide enough space, to the HK entity, to build its margins. In practice, the margin can vary considerably and must be carefully chosen according to industry sector and the actual financial performance, among other factors. The HK company will then realize its turnover by selling to its clients, according to its marketing strengths. The margin involved in this latter transaction will then build the majority profits. The proper offshore corporate structure can save approximately USD 0.07 for every one dollar worth of goods. A considerable difference.

3. HONG KONG company as a black box

Sourcing operations in HK that serve European and American customers often need to walk a tightrope to meet demands. With product life cycles getting shorter and disloyal customers merely looking at the price tag, these customers might try doing direct business with the respective Chinese suppliers. Therefore, many buyers have found it very useful that by channelling business via a HK company the risk of disclosing their Chinese suppliers can be avoided. When the final goods are shipped, all related documents, labels, addresses and other hints are rewritten in HK so that customers as well as suppliers only know the HK Limited Company, but do not know each other.

4. Easy relax constraints on restructuring operations

If these weren't enough of an advantage, let's take a look of the advantages of having a structured investment in China mainland as opposed to a direct one. China's regulations and company laws are being refined and, although they benefit from decades of experience by looking at developed countries, they are far from simple handling. Investing in China does not have to be confused with the simple setting up of manufacturing WFOE, Trading WFOE or provision of services to local clients: it involves a long term commitment to play by the local rules in China: Mergers, Acquisitions, company restructuring, reallocation of shares among investors, or even buying out the investor, are all paths which lie ahead of any investment and should not be underestimated in the initial formulation of the strategy.
So how can an offshore structure relax constraints on these operations? The idea of buffer entity comes in moving the hub of corporate restructuring operation back into the offshore investment vehicle, as opposed to a direct involvement of the Chinese company itself. The ease and freedom in reallocation of shares or sale of part of, as well as all of the equity stake in an Hong Kong company, is considerably more attractive than having to confront Chinese regulations which, at times, have proven not so supportive and responsive.
In practical, a reallocation of shares among investors in Shanghai may cost investors 2 months to accomplish all licenses. While in Hong Kong, it takes 1 week only.
As a matter of fact, a full blown model for offshore structures would recommend an offshore investment vehicle on the back of each investment into China Mainland. The pros and cons of such a complete model as opposed to a single buffer holding company must be evaluated on a single client base.

CONCLUSIONS

Needless to say, such a structure involves setup and maintenance costs and time. Hong Kong's world renowned business services infrastructure will make this process less of a burden. With Path To China's professional advice, such an offshore structure can be setup in a matter of weeks and then enjoys all the benefits of this structure arrangement and avoiding some of the weaknesses of China investment structure.