EY 安永

Building a better working world

How should China's cross-border e-commerce on the racing track of investment hotspots get prepared for the capital market

Introduction

After a period of rapid development, China's cross-border e-commerce has entered its mature period in recent years, with steady growth in industry size, increasing integration of supply chain processes, gradual shift to more refined and localized operation, and ongoing penetration of innovation models such as new retail and live-streaming marketing. In spite of the impact of the COVID-19 pandemic on the global economic development in 2020, advantages of cross-border e-commerce was highlighted. Switching of consumption pattern to online in a large scale spurred the rapid development of the global e-commerce retail industry, resulting in a continuous increase in penetration rate and sales. It is forecast by eMarketer that the global e-commerce sales will reach US$4.9 trillion in 2021, at the compound growth rate of 20.8% from 2018 to 2021[1]. At the same time, driven by its robust advantages in high cost-to-performance and high efficiency, China's cross-border e-commerce became a new economic accelerator in China and a hot investment and financing spot in the capital market.

1. https://www.emarketer.com/content/global-ecommerce-forecast-2021

1 China's cross-border e-commerce has become a hot investment spot for private equity funds

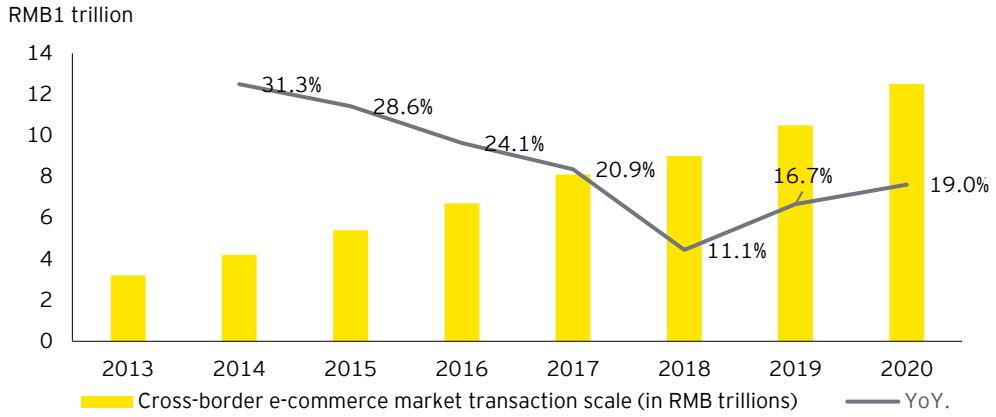
Cross-border e-commerce becomes a new accelerator in China's foreign trade

Exports have always been one of the three drivers of China's economic growth. Since the beginning of the 21st century, China's export growth can be clearly divided into two stages. According to the data of the General Administration of Customs, China's trade in goods exports increased from about RMB2 trillion to RMB12.3 trillion from 2000 to 2011, an increase by nearly six times, with a compound annual growth rate of nearly 18%[2]. Such growth slowed down significantly after 2012. The export volume of goods trade was RMB17.9 trillion, at an annual compound growth rate of 4.3% from 2011 and the actual annual growth rate was around such rate as well[3].

Despite the overall slowdown in export growth, we notice a continuous growth of the total import and export volume and transaction volume of China's cross-border e-commerce. According to customs statistics, China's cross-border e-commerce recorded a total import and export volume of RMB1.69 trillion in 2020, up 31.1% year-on-year; it maintained its development momentum in the first two quarters of 2021, with total import and export volume of RMB886.7 billion, up 28.6%[4] year-on-year. According to the data from 100EC.CN and China Everbright Securities, China's cross-border e-commerce recorded a transaction volume of RMB12.5 trillion in 2020, up 19% year-on-year, accounting for more than 30% of the total import and export value. The continuous growth of cross-border e-commerce has brought Chinese enterprises with greater opportunities to present their brands overseas[5].

2. Statistics of China's Import and Export Goods Trade from 1950 to 2019 (sohu.com)
3. China's Total Import and Export Value Reached RMB32.16 Trillion in 2020, up 1.9% Year on Year, Greatly Consolidating Its Position as the Largest Country in Goods Trade (New Data, New Highlights) (customs.gov.cn)
4. General Administration of Customs: China's Cross-Border E-Commerce Imports and Exports Reached RMB1.69 Trillion in 2020, up 31.1%_Main Measures (sohu.com)
5. Stabilize the Basic Position of Foreign Trade, Show a New Attitude of Opening Up -- The Cross-Border Trade Facilitation "Speeds up" at the New Start (customs. gov.cn)

Fig 1 China's cross-border e-commerce market transaction scale in 2013-2020



Data source: 100EC.CN and China Everbright Securities

China's advantages in supply chain and infrastructure construction provide opportunities for the development of cross-border e-commerce

- **Supply chain ecology:** As the world factory, China's manufacturing industry has been supported by a strong supply chain system. Take the garment industry as an example: China, being one of the core bases of the world's garment supply chain, with years of vigorous development, has not only the huge production capacity but a flexible supply chain system that can achieve both production and cost efficiencies.

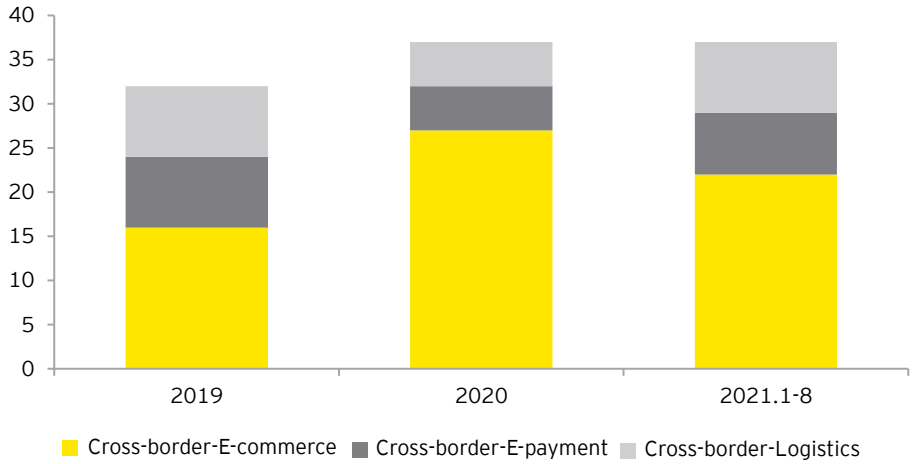
- **Customer traffic acquisition and management:** As the world's development leader, China's e-commerce and social media have accumulated rich experience and cultivated a large number of talents to greatly support the export of Chinese brands and products.

- **Logistics infrastructure:** China's logistics industry is highly developed, with transportation capacity better than that of developed countries in Europe and America. China's cross border logistics is mature, where the customs clearance process becomes increasingly simple and the terminal efficiency is enhanced through construction of overseas warehousing and local logistics system. In addition, local consumers have become long accustomed to the low efficiency of the e-commerce logistics, late receipt of packages is not necessarily a decisive factor affecting their shopping desire, especially for those price-sensitive consumers, to whom the shipping cycle of goods from China is completely acceptable.

Cross-border e-commerce is attracting more and more investors, and constantly innovating its modes

With the constant development in scale, the cross-border e-commerce industry sees more and more frequent investment and financing in the primary market. According to the statistics of 36kr, investment cases over RMB100 million appeared on the racing track of cross-border e-commerce in the primary market every month in 2021 and investment accumulated RMB2.5 billion in the first two quarters, most of which were concentrated in round B and before, and the leading brands such as Anker and SHEIN reached the market value/valuation of RMB10 billion.

Fig 2 **Number of investment and financing events relating to cross-border e-commerce from 2019 to August 2021 (unit: times)**



Data source: CVSource

For those major cross border e-commerce players, they mainly adopted the D2C mode, B2C platform and standalone website models. The products can directly reach consumers under these models. By redirecting flow through streaming media and other channels, it promotes and attracts fans on social media like Facebook, Twitter, YouTube, Instagram and cooperates with the KOLs (key opinion leaders) and KOCs (key opinion consumers) in local markets to gain recognition and popularity.

EY teams believe that cross-border e-commerce has become more and attractive for private equity investment mainly because: 1) domestic customer traffic has peaked, while overseas traffic is relatively a blue ocean with great room for growth; 2) as mentioned above, China's supply chain has already gained the obvious advantages; and 3) China's e-commerce and social media are far more mature than overseas markets, which have cultivated a large number of talents for Chinese brands to go abroad and have the ability to directly reach customers. Therefore, cross-border e-commerce will surpass offline traditional brands in the growth scale, especially in the garment and cosmetics sectors; the cross-border e-commerce brands will also replace offline fast fashion and become the mainstream choice of young people in the future, which also provides enough imaginary space for investors. EY teams also believe that not only cross-border e-commerce will continuously remain the investment attraction, but the supporting services including cross-border logistics and SaaS for cross-border e-commerce will also be favored by investors.

2 Upsurge in IPOs of China's cross-border e-commerce companies

Cross-border e-commerce initiates its IPO upsurge as it becomes one of the most popular industries in the capital market. According to the latest publicly disclosed information, 10 Chinese cross-border e-commerce companies have been listed or plan to get listed on China's A-share market, four on Hong Kong Stock Exchange and one on the New York Stock Exchange. Details are as follows:

Company name	Transaction code	Listing location	Listing status[Note]	Market value[Note] or the last financing value	Dynamic P/E ratio[Note]
Anker Innovations	300866	China	ChiNext	RMB42.96 billion	52.6
Vesync	2148	Hong Kong, China	Main board	HKD14.85 billion	29.8
Sailvan Times	None	China	In application for ChiNext listing	Unknown	Unknown
Sfc Holdings	None	China	In application for ChiNext listing	Unknown	Unknown
Ziel Furniture	None	China	In application for ChiNext listing	Last financing valuation: RMB650 million	Unknown
LightInTheBox	LITB	US	New York Stock Exchange	USD130 million	9.6
DHgate.com	None	Hong Kong, China	In application for main board listing	Unknown	Unknown
Aukey	None	China	Termination of application for STAR Market	Unknown	Unknown
KJT	2640	China	Main board	RMB3.96 billion	3.5
Shein	None	Unknown	Unknown	Unknown	Unknown
Zibuyu	None	Hong Kong, China	In application for main board listing	Unknown	Unknown
DealeXtreme	8086	Hong Kong, China	ChiNext	HKD32.58 million	-0.3
Tiza	300209	China	ChiNext	RMB2.12 billion	-1.1
Huading	60113	China	Main board	RMB4.28 billion	12.4
Lianluo Internet	2280	China	Main board	RMB15.35 billion	47.4

Note: Data of the listing status, market capitalization and dynamic P/E ratio are from exchange data on 31 August 2021.

It is the key for enterprises to seize market opportunities and raise capital smoothly in primary market or through IPO so as to grow bigger and stronger and achieve break-through for the original development scale. The tax compliance of cross-border e-commerce enterprises in its process of financing become an important consideration for practitioners, investors and regulators.

3 Addressing tax compliance issues has become imperative for China's cross-border e-commerce enterprises

China cross-border e-commerce enterprises with key North American and European markets are facing challenges with respect to tax compliance issues given the complex tax regime in the US and the new tax policies issued in Europe this year regulating cross-border e-commerce. Our observation from the rules that govern companies' initial public offering is that most cross-border e-commerce enterprises that are going for IPO or already listed do place emphasis on disclosing overseas tax risks. Regulators have raised queries on tax compliance issues when they perform the review of the listing application. On the other hand, facing such strict supervision, due diligence advisors engaged by investors and IPO auditors would usually, in a full scale, investigate and disclose the tax risks faced by cross-border e-commerce enterprises. Our view is that improving tax compliance is one of the essential and key issues to be addressed by cross-border e-commerce enterprises that are on their way to the capital market. We therefore summarize below EY teams' observation with respect to the typical tax challenges encountered by Chinese cross-border e-commerce enterprises in the two major markets, i.e., US and Europe.

US

Customs duty

China cross-border e-commerce enterprises are facing challenges in handling US tariff, despite the different operation model they adopt, having a local operating entity or not and whether the import is realized by general trade or postal parcel. Common issues that we have seen in the market include:

- Identification of importer of Record (IOR)
- Whether the imported merchandise is valued reasonably
- Whether the US Customs special rules for low-value shipments are properly used

In addition to the local tax issues, China cross-border e-commerce enterprises also need to pay attention to the selection of appropriate export codes, when dealing with exportation fromChina. Submission of supporting documents, settlement of foreign exchange, tax refund and other relevant issues relating to exportation declaration shall also be properly handled.

Federal income tax

The particular business model of cross-border e-commerce allows a foreign company to carry out business and sell goods to US consumers without actually setting up a company in the United States. However, not having a company in the United States does not imply that it is not subject to US taxes. Instead, the company should consider whether its activities (including the activities of its agents) in the United States performed by its foreign entity are sufficient to constitute a US trade or business (USTB) or permanent establishment (PE) in the United States. If a USTB or PE is constituted, the profits attributable to the USTB or PE could be subject to federal income tax in the United States.

Some Chinese cross-border e-commerce enterprises sell goods to US consumers through Hong Kong entities within the group. Since Hong Kong does not have a double tax treaty with the US, the PE concept would not apply and instead, USTB standard with lower threshold and hence easily to be met, will be applicable when determining whether any federal income tax liability will arise in the US. Therefore, there may be high risk for Hong Kong entities to be considered by the IRS as a USTB and thus be required to pay federal income tax in the US.

State and local taxes

In terms of sales and use taxes in the US, the third-party e-commerce platforms have been required to withhold and pay sales and use taxes on behalf of platform sellers since 2018 in certain states. As of 1 July 2021, most states have made such requirement. Enterprises should carefully assess whether they are subject to state and local income taxes based on factors such as whether they hold inventory in the US, whether they have employees or offices located in the US, the volume of sales in each state, etc. Due to the absence of a third-party platform to withhold and pay the taxes, the enterprises adopting the self-built website operation model shall pay special attention to its compliance of sales and use taxes, including pricing, the criteria for determining the economic nexus, filing and payment of sales and use taxes according to state regulations, etc. For the enterprises adopting the transshipment and distribution model, it is necessary to determine whether the end retailer or the transshipment and distribution party is obliged to withhold and pay the sales and use taxes.

EU

EU's VAT reform brings compliance challenges to Chinese cross-border e-commerce enterprises

The reformed VAT rules related to cross-border e-commerce enacted by the EU officially came into effect since 1 July 2021, while UK underwent VAT reform on 1 January 2021. The regulations cover sales within the EU and also distance sales from non-EU countries to EU countries. The newly formulated regulations can be complicated for cross-border e-commerce enterprises, who may be exposed to tax risks if they fail to comprehend the regulations and fulfill the requirements of tax compliance.

We have summarized the most relevant tax policy changes in EU that are applicable for Chinese cross-border e-commerce enterprises as follows:

Changes in the import tax policy for distance sales

- Abolition of VAT exemption for shipments with a low value*
- VAT only due in the Member State of destination
- Change of time of indebtedness for distance sales
- Ability to apply the Import One Stop Shop (IOSS) compliance mechanism
- Exemption for import VAT when submitting IOSS number

**Shipments with a low value are goods with a value of less than EUR10 or EUR22. The threshold for the customs duty exemption (≤EUR150) will continue to exist.*

Import One Stop Shop (IOSS) compliance mechanism

IOSS changes

- New optional Import One Stop Scheme (IOSS)
- For low value consignments (≤€150) imported in the EU
- Declaration and payment in one single Member State of the VAT due in all Member States of destination (only one IOSS registration required), rather than declaration and payment in all Member States of destination separately
- Exemption for import VAT when submitting IOSS number
- Filing a monthly IOSS return and monthly VAT payment
- Record keeping obligations for 10 years

Alternative VAT payment and reporting system for imports

- Alternative optional simplification regime
- Especially designed for postal operators, express carriers and other customs agents declaring goods on behalf of the customers
- For low value consignments (≤€150) imported in the EU
- Declarant (e.g. postal operators) collects, reports and pays import VAT monthly

Impact on China's cross-border e-commerce enterprises:

- The most important is that the import VAT and output tax exemption for low-value goods has been abolished. Hence, from 1 July 2021 onwards, all commercial goods supplied by Chinese e-commerce sellers to its customers and imported into the EU will be subject to VAT, irrespective of their value.
- VAT is due in the Member State of destination, which means that the supplied goods are subject to the local VAT rate(s) of the Member State of destination.

In consideration of the two main operation models adopted by Chinese cross-border e-commerce in Europe, we suggest that special attention should be given to the following tax risks and companies shall consult with professional advisors for solutions:

Selling via own websites

- What is/should be included in your general terms and conditions with respect to the responsibility and payment of import VAT and duties;
- Monitoring of EUR150 threshold for exemption of import VAT and duties (I-OSS);
- Monitoring applicable VAT rates in all EU Member States where customers are located (as part of (I)OSS filings);
- Customer satisfaction in case customer is confronted with import VAT and duties on top of the purchase price;
- Arrangements with customs agents and logistics providers to secure correct filing of customs declarations;
- Customs valuation (e.g., what is the right custom value).

Selling via third-party platforms

- If and when is the platform fiction applicable and who is responsible for correct VAT remittance, platform or seller;
- What are the general terms and conditions as set by the platform with respect to payment of import VAT and duties towards the customers;
- Monitoring of EUR150 threshold for exemption of import VAT and duties (I-OSS);
- VAT and customs impact of Amazon FBA stock movements;
- Customs valuation (e.g., what is the right custom value).

Other tax considerations

On top of the above typical tax challenges, we have also observed the following tax risks that the Chinese cross-border e-commerce enterprises may be exposed to:

- Challenges to the transfer pricing among related parties;
- Tax issues arising from the mismatch of the entity conducting trade and the entity receiving payment;
- Additional tax burden caused by an inefficient shareholding structure.

4 Financial audit matters to be considered by cross-border e-commerce companies

Due to its particularity, cross-border e-commerce industry has a rather different financial accounting from traditional industries, mainly reflected in revenue recognition and inventory stocktaking at each period end.

Revenue recognition of cross-border e-commerce industry
Cross-border e-commerce enterprises usually sell products through the platform distribution system or third-party warehousing and distribution services, and it is difficult to obtain the client acceptance time for each order in practice due to the large number of orders and the different settlement rules of different platforms. Therefore, it is a very complex accounting problem for cross-border e-commerce industry to match revenue recognition timing with external records. In practice, enterprises often need to make a comprehensive judgment on the timing of transfer of risk and reward of the products sold by referring to settlement terms of different platforms, estimated delivery time, platform's settlement statement and other external records.

Inventory stocktaking at each period end
Cross-border e-commerce enterprises have complicated warehousing processes which involve domestic warehouses, overseas self-owned warehouses and FBA warehouses, and it is difficult to complete inventory stocktaking of all warehouses at a certain point.

For domestic warehouses and overseas self-owned warehouses, enterprises should establish a comprehensive internal control of inventory stocktaking system for timely and effective monitoring of their inventory status in light of the daily cycle inventory stocktaking and year-end inventory stocktaking. For FBA warehouses, because they are usually distributed around the world and under different platform management standards, it is often impossible to perform inventory stocktaking on the spot. the enterprises usually assign IT experts to verify the effectiveness of the platform API interface to ensure the authenticity and integrity of the backend data of FBA warehouses, and extract some samples to confirm the inventory situation with the platform customer service.

EY credentials in leading service knowledge in cross-border e-commerce

In order to help China's cross-border e-commerce companies move forward steadily, and to assist in solution to inquiry that may be made by investors or regulators at the time of raising capital in the primary and/or secondary markets in the future, EY teams can provide the following services in tax and finance:

- **Tax health check service:** EY teams can assist your company in reviewing tax compliance for previous years, identifying and assessing the potential tax risks.

- **Assisting in compliance disclosure, tax declaration and payment:** EY teams can assist your company in disclosing tax risks matters in the historical periods to the tax authorities in a reasonable manner so as to mitigate the tax exposure and better prepare for IPO.

- **Tax planning service for optimizing operating structure:** EY teams can assist in optimizing your global operating structure with the aim to promote business development and reasonably reduce your tax burden.

- **Audit health check service and IPO audit services:** The data analysis tool (EY Helix) continuously developed and applied by EY teams contains a variety of analyzers that can analyze the massive basic data of the cross-border e-commerce company, accurately identify abnormal data, evaluate the quality of the accounting information, identify trends and anomalies in the process and focus on key audit areas. It helps a lot when we help the enterprise to control the risk and improve audit quality during its IPO.

  In addition, EY teams have put into use the inventory scheduling automation tool, which is capable of intelligently matching and allocating the inventory locations and inventory personnel, developing a more efficient and economical inventory plan through intelligent route, and focusing on inventory costs through schedule optimization and information management. More importantly, it helps to promote smooth and efficient operation of the time-sensitive and regional inventory stocktaking during the epidemic time.

  In consideration of the characteristics of the cross-border e-commerce industry, we customize more reasonable and targeted verification procedures for the issuer and make full use of EY teams' accumulated advantages in big data analysis and digital audit, so as to better fulfill our duties for control as an intermediary agency and meet the increasingly rigorous regulatory requirements.

- **Information system and operational data evaluation service:** Cross-border e-commerce enterprises usually have close cooperation with third-party e-commerce, logistics and distribution, payment and other platforms. Their own IT systems, such as ERP systems, integrated data management systems, etc., are also relatively complicated. For this type of entities, regulators pay special attention to the effectiveness of the internal control over information systems, the integrity of the operation data and the rationality of data logic. Auditor or professional consultants are required to fully verify the reliability of the financial information and the authenticity of revenue. EY digital assurance service team not only has extensive industry experience in information system and big data audit, risk control and compliance, but also has accumulated many tools and methods for data collection, cleaning, analysis, processing and visualization. In addition to providing the evaluation service, we are also devoted to building the bridge of information transmission, translation and decoding among various professional teams of business, finance, operation, legal and others, helping enterprises with better integration of business and finance so as to improve their internal control, management level and the operation efficiency.

Closing remarks

After a period of disordered development of presenting abroad, China's cross-border e-commerce enterprises should, on the premise of taking the capital market as the target, improve and meet their compliance by understanding the requirements in a more proactive manner, the requirements on accounting and taxation of the target countries, instead of just relying on such external factors as waiting the authorities for cross-border e-commerce to change the tax regulations, and to form a long-term development commercial pattern with compliance as the premise and cost control as the goal, and get better prepared for listing in the future.

Contact us

Denis MK Cheng
Ernst & Young Hua Ming LLP
Greater China Consumer Industries Leader
+86 10 5815 3848
denis-mk.cheng@cn.ey.com

Stella Yuan
Ernst & Young (China) Advisory Services Limited
Greater China Private Equity Leader
+86 21 2228 3078
stella.yuan@cn.ey.com

Michael CY Liu
Ernst & Young (China) Advisory Services Limited
International Tax and Transaction Services Partner
+86 10 5815 2918
michael-cy.liu@cn.ey.com

Runald Li
Ernst & Young (China) Advisory Services Limited
Greater China Strategy and Transactions Markets Leader
+86 21 2228 2359
runald.li@cn.ey.com

Sarah Chang
Ernst & Young (China) Advisory Services Limited
Strategy and Transactions Services Partner
+86 10 5815 2089
sarah.chang@cn.ey.com

Ho Sing Mak
Ernst & Young (China) Advisory Services Limited
International Tax and Transaction Services Partner
+86 755 2502 8289
ho-sing.mak@cn.ey.com

Jessica Wu
Ernst & Young Hua Ming LLP
Assurance Services Partner
+86 10 5815 3066
jessica.wu@cn.ey.com

Amy CL Zhang
Ernst & Young Hua Ming LLP
Digital Assurance Services Partner
+86 10 5815 4325
amy-cl.zhang@cn.ey.com

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

APAC no. 03013198
ED None.

ey.com/china

Follow us on WeChat
Scan the QR code and stay up-to-date with the latest EY news.