



# China Tax Alert

Issue 25, August 2017



## World Customs Organization opinion on royalties/license fees - China relevance

### Regulations discussed in this issue:

- WCO Valuation Committee issued Advisory Opinion 4.17 that provides guidance on whether the royalties and license fees should be included in the customs value for imported goods

### Background

The Technical Committee on Customs Valuation of the World Customs Organization (“WCO Valuation Committee”), issued Advisory Opinion 4.17 on the inclusion of royalties and license fees in the customs value of imported goods, at its 44<sup>th</sup> session held in Brussels in May 2017.

The opinion will be included in the WCO Valuation Compendium, following approval by the WCO Council in July 2017, and could be influential as guidance for China Customs in dealing with similar cases. Advisory Opinion 4.17 is examined in this China Tax Alert.

### Details of WCO Advisory Opinion 4.17

#### 1. Case facts

A franchise agreement (“the Agreement”) was signed between Company A (importer, buyer, manufacturer and franchisee) in an importing country and Company B (exporter, seller, and franchisor) in an exporting country:

- Under the Agreement, Company A operates stores using Company B’s ‘Brands’ (registered brands, service marks, commercial symbols) and ‘System’ (business systems and processes connected to the operation of the stores).
- The Agreement requires that the inputs that Company A uses, to manufacture the final products sold in its stores, can only be imported from Company B, or from vendors authorized (and quality-controlled) by Company B. Such inputs are unpatented and are not protected by any intellectual property rights.
- Company A pays Company B royalties for the use of the “Brand” and “System”, which are calculated as a percentage of Company A’s gross sales of final products in its retail stores, where the final products are manufactured using imported inputs .

## 2. Opinion of WCO Valuation Committee

- Although the inputs have to be purchased from Company B or a vendor authorized by Company B in order to meet the quality requirements, they are not branded goods nor are they patented, or manufactured under a patented process. Therefore, the royalties are not related to the imported goods.
- The payment under the Agreement, is made to allow Company A to use the Brands and System of Company B in the manufacture and sale of the products bearing the brand of Company B. If Company A does not pay the royalties, it will be forbidden to use the Brand and System of Company B. Nevertheless, Company A can still purchase from Company B or from those vendors authorized by Company B under the same conditions. Therefore, the payment of the royalties cannot be deemed as a condition of sale of the goods.
- The WCO Valuation Committee concluded that the royalties paid by Company A are not to be added to the price actually paid or payable for the imported goods, under the provision of Article 8.1(c) of the “General Agreement on Tariffs and Trade” (“GATT”). This states that royalties and license fees, related to the goods being valued, which the importer must pay as a condition of sale, should be included in the customs value of the imported goods.

## KPMG observations

As one of the World Trade Organization (“WTO”) members, China established its regulations in relation to the dutiability of royalties based on Article VII of GATT 1944. Under the current PRC customs regime, solely General Administration of Customs (“GAC”) No. 213 Order, i.e. “Measures of the PRC Customs on Determination of Dutiable Value for Imports and Exports” (“GAC Measures”), sets out relevant provisions for royalties in China.

Although Advisory Opinion 4.17 cannot be regarded as having a direct enforceable legal basis in China, it provides new sample cases and should have a positive influence in resolving interpretation issues, between China Customs and enterprises, on the dutiability of royalties.

Both the GAC Measures and Article VII of GATT 1994 stipulate that royalties shall be included in the customs value of imported goods if the following two conditions are both met:

- (i) the royalties are related to the imported goods; and
- (ii) the payment of royalties constitutes a condition for the sale of such goods.

In practice, China Customs and enterprises (especially manufacturing enterprises) hold different views when determining whether a payment of royalties is related to the imported goods.

The most controversial issue concerns the correlation between the license fees for technical assistance and the imported production inputs.

For instance, when purchasing parts from overseas suppliers, a Chinese importer may set basic requirements for the technical specifications and the quality of goods for its further use. This may be considered by the China's Customs as equivalent to the circumstance that the importer provides patent rights or proprietary technology for the suppliers to manufacture the required parts. Accordingly, Customs will determine that the royalty payments are related to the imported parts. In addition, from a practical point of view, China's Customs barely pays attention to whether the payment of royalties constitutes a condition of sales of the goods being valued, which is a core matter in both the GAC Measures and Article VII of GATT 1994.

Advisory Opinion 4.17 clarifies that the royalties paid by the importer are unrelated to imported goods, where the goods are not branded goods nor patented, or manufactured under a patented process. It is also clearly stated that since the importer can still purchase imported goods, under the same commercial conditions without paying royalties, the royalties paid cannot be deemed as a condition of sale of the goods.

In the past over two years, China Customs carried out a nationwide inspection on the payment of royalties in the industries of auto parts and electronics. Certain enterprises paid substantial royalties in case if they are considered by China Customs as part of customs value for the imported goods, China Customs will be empowered to request the enterprises to make tax repayment in relation to the royalty payments in the past, which will lead to significant impact on the operating status of enterprises involved.

Advisory Opinion 4.17 provides useful technical guidance for China Customs and enterprises in dealing with similar cases, although it has no enforceable legal impact in China. KPMG will keep you updated on further feedback and interpretation from China Customs in this regard.

### **KPMG assistance**

For royalty-related issues, KPMG can help with the following:

- Assist enterprises in answering inquiries raised by China Customs about royalties as well as other non-trade payments; Collect and review information, prepare explanation letters and accompany enterprises to submit documents for explanations.
- Assist enterprises in self reviewing and discovering non-trade payments that should be included in customs value, preparing a self-disclosure report and accompanying enterprises to voluntarily report the findings.

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The information contained herein is of a general nature and is not intended to address the circumstances of