

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 44th 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.

For any enquiries, please send to our public mailbox: taxenquiry@kpmg.com or contact our partners/directors in each China/HK offices.

Khoonming Ho Head of Tax, KPMG Asia Pacific Tel. +86 (10) 8508 7082 khoonming.ho@kpmg.com	Northern China David Ling Head of Tax, Northern Region Tel. +86 (10) 8508 7083 david.ling@kpmg.com	Christopher Xing Tel. +86 (10) 8508 7072 christopher.xing@kpmg.com	Wayne Tan Tel. +86 (28) 8673 3915 wayne.tan@kpmg.com	Jean Li Tel. +86 (755) 2547 1128 jean.j.li@kpmg.com	Barbara Forrest Tel. +852 2978 8941 barbara.forrest@kpmg.com
Lewis Lu Head of Tax, KPMG China Tel. +86 (21) 2212 3421 lewis.lu@kpmg.com	Cheng Chi Tel. +86 (10) 8508 7606 cheng.chi@kpmg.com	Irene Yan Tel. +86 (10) 8508 7508 irene.yan@kpmg.com	Jessie Zhang Tel. +86 (10) 8508 7625 jessie.j.zhang@kpmg.com	Tanya Tang Tel. +86 (25) 8691 2850 tanya.tang@kpmg.com	Sisi Li Tel. +86 (20) 3813 8887 sisi.li@kpmg.com
Beijing/Shenyang David Ling Tel. +86 (10) 8508 7083 david.ling@kpmg.com	Conrad Turley Tel. +86 (10) 8508 7513 conrad.turley@kpmg.com	Sheila Zhang Tel. +86 (10) 8508 7507 sheila.zhang@kpmg.com	Janet Wang Tel. +86 (571) 2803 8088 janet.z.wang@kpmg.com	Mabel Li Tel. +86 (755) 2547 1164 mabel.li@kpmg.com	John Kondos Tel. +852 2685 7457 john.kondos@kpmg.com
Tianjin Eric Zhou Tel. +86 (10) 8508 7610 ec.zhou@kpmg.com	Milano Fang Tel. +86 (532) 8907 1724 milano.fang@kpmg.com	Tiansheng Zhang Tel. +86 (10) 8508 7526 tiansheng.zhang@kpmg.com	John Wang Tel. +86 (21) 2212 3438 john.wang@kpmg.com	Kelly Liao Tel. +86 (20) 3813 8668 kelly.liao@kpmg.com	Kate Lai Tel. +852 2978 8942 kate.lai@kpmg.com
Qingdao Vincent Pang Tel. +86 (532) 8907 1728 vincent.pang@kpmg.com	Tony Feng Tel. +86 (10) 8508 7531 tony.feng@kpmg.com	Tracy Zhang Tel. +86 (10) 8508 7509 tracy.h.zhang@kpmg.com	Eric Zhou Tel. +86 (10) 8508 7095 ec.zhou@kpmg.com	Mimi Wang Tel. +86 (21) 2212 3250 mimi.wang@kpmg.com	Travis Lee Tel. +852 2143 8524 travis.lee@kpmg.com
Shanghai/Nanjing/Chengdu Anthony Chau Tel. +86 (21) 2212 3206 anthony.chau@kpmg.com	Rachel Guan Tel. +86 (10) 8508 7613 rachel.guan@kpmg.com	Central China Anthony Chau Head of Tax, Eastern & Western Region Tel. +86 (21) 2212 3206 anthony.chau@kpmg.com	Grace Xie Tel. +86 (21) 2212 3422 grace.xie@kpmg.com	Maria Mei Tel. +86 (592) 2150 807 maria.mei@kpmg.com	Irene Lee Tel. +852 2685 7372 irene.lee@kpmg.com
Hangzhou John Wang Tel. +86 (571) 2803 8088 john.wang@kpmg.com	Helen Han Tel. +86 (10) 8508 7627 h.han@kpmg.com	Michael Wong Tel. +86 (10) 8508 7085 michael.wong@kpmg.com	Andy Chen Tel. +86 (21) 2212 3298 andy.m.chen@kpmg.com	Jennifer Weng Tel. +86 (21) 2212 3431 jennifer.weng@kpmg.com	Alice Leung Tel. +852 2143 8711 alice.leung@kpmg.com
Guangzhou Lilly Li Tel. +86 (20) 3813 8999 lilly.li@kpmg.com	Josephine Jiang Tel. +86 (10) 8508 7511 josephine.jiang@kpmg.com	Yasuhiro Otani Tel. +86 (21) 2212 3360 yasuhiro.otani@kpmg.com	Bruce Xu Tel. +86 (21) 2212 3396 bruce.xu@kpmg.com	Ling Lin Tel. +86 (755) 2547 1170 ling.lin@kpmg.com	Ivor Morris Tel. +852 2847 5092 ivor.morris@kpmg.com
Fuzhou/Xiamen Maria Mei Tel. +86 (592) 2150 807 maria.mei@kpmg.com	Henry Kim Tel. +86 (10) 8508 7023 henry.kim@kpmg.com	Johnny Deng Tel. +86 (21) 2212 3457 johnny.deng@kpmg.com	Jie Xu Tel. +86 (21) 2212 3678 jie.xu@kpmg.com	Michelle Sun Tel. +86 (20) 3813 8615 michelle.sun@kpmg.com	Malcolm Prebble Tel. +852 2684 7472 malcolm.j.prebble@kpmg.com
Shenzhen Eileen Sun Tel. +86 (755) 2547 1188 eileen.gh.sun@kpmg.com	Li Li Tel. +86 (10) 8508 7537 li.li@kpmg.com	Cheng Dong Tel. +86 (21) 2212 3410 cheng.dong@kpmg.com	William Zhang Tel. +86 (21) 2212 3415 william.zhang@kpmg.com	Bin Yang Tel. +86 (20) 3813 8605 bin.yang@kpmg.com	David Siew Tel. +852 2143 8785 david.siew@kpmg.com
Hong Kong Karmen Yeung Tel. +852 2143 8753 karmen.yeung@kpmg.com	Lisa Li Tel. +86 (10) 8508 7638 lisa.h.li@kpmg.com	Marianne Dong Tel. +86 (21) 2212 3436 marianne.dong@kpmg.com	Hanson Zhou Tel. +86 (21) 2212 3318 hanson.zhou@kpmg.com	Lixin Zeng Tel. +86 (755) 2547 3368 lixin.zeng@kpmg.com	Murray Sarelius Tel. +852 3927 5671 murray.sarelius@kpmg.com
	Thomas Li Tel. +86 (10) 8508 7574 thomas.li@kpmg.com	Chris Ge Tel. +86 (21) 2212 3083 chris.ge@kpmg.com	Michelle Zhou Tel. +86 (21) 2212 3458 michelle.b.zhou@kpmg.com	Hong Kong	John Timpany Tel. +852 2143 8790 john.timpany@kpmg.com
	Larry Li Tel. +86 (10) 8508 7658 larry.y.li@kpmg.com	Chris Ho Tel. +86 (21) 2212 3406 chris.ho@kpmg.com	Lilly Li Head of Tax, Southern Region Tel. +86 (20) 3813 8999 lilly.li@kpmg.com		Lachlan Wolfers Tel. +852 2685 7791 lachlan.wolfers@kpmg.com
	Alan O'Connor Tel. +86 (10) 8508 7521 alan.oconnor@kpmg.com	Henry Wong Tel. +86 (21) 2212 3380 henry.wong@kpmg.com	Jason Jiang Tel. +86 (21) 2212 3527 jason.jt.jiang@kpmg.com		Steve Man Tel. +852 2978 8976 steve.man@kpmg.com
	Vincent Pang Tel. +86 (10) 8508 7516 +86 (532) 8907 1728 vincent.pang@kpmg.com	Flame Jin Tel. +86 (21) 2212 3420 flame.jin@kpmg.com	Penny Chen Tel. +86 (755) 2547 1072 penny.chen@kpmg.com		Ayesha M. Lau Tel. +852 2826 7165 ayesha.lau@kpmg.com
	Naoko Hirasawa Tel. +86 (10) 8508 7054 naoko.hirasawa@kpmg.com	Sunny Leung Tel. +86 (21) 2212 3488 sunny.leung@kpmg.com	Sam Fan Tel. +86 (755) 2547 1071 sam.kh.fan@kpmg.com		Daniel Hui Tel. +852 2685 7815 daniel.hui@kpmg.com
	Shirley Shen Tel. +86 (10) 8508 7586 yinghua.shen@kpmg.com	Michael Li Tel. +86 (21) 2212 3463 michael.y.li@kpmg.com	Joe Fu Tel. +86 (20) 3813 8823 joe.fu@kpmg.com		Chris Abibis Tel. +852 2826 7226 chris.abibis@kpmg.com
	Joseph Tam Tel. +86 (10) 8508 7605 laiyiu.tam@kpmg.com	Karen Lin Tel. +86 (21) 2212 4169 karen.w.lin@kpmg.com	Ricky Gu Tel. +86 (20) 3813 8620 ricky.gu@kpmg.com		Darren Bowdern Tel. +852 2826 7166 darren.bowdern@kpmg.com
	Joyce Tan Tel. +86 (10) 8508 7666 joyce.tan@kpmg.com	Christopher Mak Tel. +86 (21) 2212 3409 christopher.mak@kpmg.com	Fiona He Tel. +86 (20) 3813 8623 fiona.he@kpmg.com		Erica Chan Tel. +852 2847 5108 yvette.chan@kpmg.com
	Jessica Xie Tel. +86 (10) 8508 7540 jessica.xie@kpmg.com	Henry Ngai Tel. +86 (21) 2212 3411 henry.ngai@kpmg.com	Angie Ho Tel. +86 (755) 2547 1276 angie.ho@kpmg.com		Adam Zhong Tel. +852 2685 7559 adam.zhong@kpmg.com
	Cynthia Xie Tel. +86 (10) 8508 7543 cynthia.py.xie@kpmg.com	Ruqiang Pan Tel. +86 (21) 2212 3118 ruqiang.pan@kpmg.com	Aileen Jiang Tel. +86 (755) 2547 1163 aileen.jiang@kpmg.com		Lu Chen Tel. +852 2143 8777 lu.l.chen@kpmg.com
		Amy Rao Tel. +86 (21) 2212 3208 amy.rao@kpmg.com	Cloris Li Tel. +86 (20) 3813 8829 cloris.li@kpmg.com		Wade Wagatsuma Tel. +852 2685 7806 wade.wagatsuma@kpmg.com
					Natalie To Tel. +852 2143 8509 natalie.to@kpmg.com
					Matthew Fenwick Tel. +852 2143 8761 matthew.fenwick@kpmg.com
					Sandy Fung Tel. +852 2143 8821 sandy.fung@kpmg.com
					Charles Kinsley Tel. +852 2826 8070 charles.kinsley@kpmg.com
					Stanley Ho Tel. +852 2826 7296 stanley.ho@kpmg.com
					Becky Wong Tel. +852 2978 8271 becky.wong@kpmg.com

kpmg.com/cn

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2017 KPMG, a Hong Kong partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. © 2017 KPMG Advisory (China) Limited, a wholly foreign owned enterprise in China and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.