

# China Tax Alert

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## China - U.S. Trade Conflict and Implications to Import and Export Enterprises in the Two Countries

### Topic discussed in this issue:

- *Presidential Proclamation on Adjusting Imports of Steel into the United States and Presidential Proclamation on Adjusting Imports of Aluminum into the United States*
- *Notice of Determination and Request for Public Comment Concerning Proposed Determination of Action Pursuant to Section 301: China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation*
- *Notice of the Customs Tariff Commission of the State Council on Discontinuing Tariff Concession Obligations for Certain Imported Goods Originating in the United States* (Shui Wei Hui [2018] No.13)
- *Announcement of Imposing Additional Tariffs on Certain Products Originating in the U.S.* (Announcement of Ministry of Commerce 2018 No.34)

### Background

President Donald Trump of the United States has released a series of tariff measures since March 2018, including imposing a 25% tariff on imported steel and a 10% tariff on imported aluminum products (Section 232 tariff measures), and **released a proposed list of Chinese-origin products that could be subject to an additional 25% tariff. The list was published following the U.S. investigation under Section 301 of the Trade Act of 1974**, which **covers approximately 1,300 8-digit HS codes under U.S. Harmonized Tariff Schedule, and includes aircraft, spacecraft, mechanism, pharmaceutical, telecom, and electronic appliances products.**

In response to U.S. Section 232 tariff measures, China decided to impose a 15% tariff on 120 products originating from the U.S., including fresh fruits, dried fruits and nut products, wines, American ginseng, and seamless steel pipes, and impose a 25% tariff on 8 U.S. origin products, including pork and its products, recycled aluminum and other products. These additional tariffs were effective as of 2<sup>nd</sup> April 2018. In addition, China intends to impose additional tariffs of 25% on 106 products across 14 categories, including soybeans, automobile, chemical products, etc. The effective date for these tariffs has not yet been announced.

On 24 April, U.S. President Trump said that U.S. officials will come to China to discuss trade issues.

From 3<sup>rd</sup> to 4<sup>th</sup> May 2018, U.S. Secretary of the Treasury Steven Mnuchin led a U.S. delegation to China as a special envoy of U.S. President. Chinese Vice Premier Mr LIU He discussed with the U.S. delegation on solutions to trade conflicts between the two countries. According to the published news, the representatives of China and the U.S. exchanged views on topics including expanding U.S. exports to China, bilateral trade in services, two-way investment, protection of intellectual property, resolution on tariff and non-tariff measures, and reached certain consensus in some areas.

## KPMG Observation

Trade conflicts between China and the United States will have negative impacts including increased duty cost and management risks for companies in both countries who import / export the goods subject to tariffs. Additionally, the upstream and downstream enterprises may also be impacted due to the increased tariffs borne by its clients / suppliers.

It should be noted that the additional tariffs will be imposed based on the country of origin of goods, and not the loading country or trading country. As such, the country of origin determination for "U.S.-made" or "China-made" products is an important matter under the China-U.S. trade conflict.

### Determination of Country of Origin

Based on the *Agreement on Rules of Origin* issued by WTO, "for the country to be determined as the origin of a particular good to be either (1) the country where the good has been wholly obtained or, (2) when more than one country is concerned in the production of the good, the country where the last substantial transformation has been carried out".

There is no unified rule governing the determination of the country of origin among different WTO member countries. Each country is free to determine their own rules of origin, and may maintain preferential and non-preferential rules of origin depending on their particular purpose (e.g. different rules of origin can be applicable for preferential tariffs under free trade agreements, for preferential tariffs granted to least developed countries, or for tariffs on products originating from most-favored-nation countries). Regarding the current China-U.S. trade conflict, a non-preferential rule of origin is applicable.

### Non-preferential Rules of Origin of China

According to the *Regulation on Country of Origin of Imports and Exports of China* and the *Criteria on Substantial Transformation in Non-preferential Rules of Origin*, China Customs takes tariff shift as the basic criterion for assessing substantial transformation. When tariff shift fails to reflect substantial transformation, an ad valorem percentage and manufacturing or processing operation should be applied as the supplemental criteria.

- Tariff Shift refers to a situation where the raw materials did not originate from the country but are further manufactured or processed in the country resulting in a change of four-digit tariff classification of the goods derived under China Tariff Schedule.
- Ad valorem percentage refers to, raw materials not that did not originate from a county but are manufactured or processed in the country (region) and the value added exceeds 30% of the total value of the goods.
- Manufacturing or processing operations refers to the principal operations carried out in a country (region) which confer essential characteristics to the goods following manufacturing or processing operations.

Compared with preferential rules of origin, Direct Transport is not required in non-preferential rules of origin. In addition, rules of Accumulation, De Minimus and Fungible Material are not specified in the non-preferential rules of origin of China.

## Non-preferential Rules of Origin of the U.S.

In the United States, the general, non-preferential “country of origin” rule is set out in the customs marking regulations. Generally, this rule establishes that further work or material added in another country must effect a “substantial transformation” in order to render such other country the “country of origin.” The “substantial transformation” rule has historically been based upon judicial decisions, customs regulations and customs interpretations, which is different to China from regulation framework perspective. Nevertheless, the rules and concepts followed by the U.S. are similar with China, which primarily focus on changes in use or character. The name criterion is generally considered as the least compelling of the three factors for substantial transformation.

- Change in character evaluates whether (1) there been a substantial alteration in the characteristics of the imported material or components; (2) if the changes to imported product are merely cosmetic; (3) how much labor or material cost are required to assemble / create the end product.
- Change in use evaluate whether (1) if the end-use of imported material interchangeable with the end-use of the product after post-importation processing; (2) if the end-use of the imported material pre-determined at the time of importation.
- Change in name evaluates whether the imported components / parts retain their names after assembly into the end product.

## Recommendations to importers / exporters

With the aim to reduce the potential negative impact to the importers / exporters in China and the U.S., companies may consider taking the following steps:

### Country of Origin Determination

- If it is confirmed that the goods are included in the list, confirm the country of origin. Also, the application for an advanced ruling can be considered where necessary;
- For non-U.S. originating goods imported from the U.S. and non-Chinese originating goods exported to the U.S, origin marks should be made accurately and clearly. Moreover, non-preferential certificate of origin should be applied where possible, in order to avoid obstacles in customs clearance.
- Country of Origin determination can be challenging to be managed manually for certain companies due to the complex rules of origin adopted by the two countries, as well as the fluctuation of production cost, selling prices of finished products, and the different BOM components for a product. For these companies, it is critical to manage this process through automated process and ensure each determination process and result is audited and stored, to ensure compliance risks are managed.

### Accuracy of declared HS codes

- The importers / exporters in China and the United States should also carefully review the accuracy of declared HS codes. In the event of uncertainty, it is essential to understand the advanced ruling mechanism and judicial prudence mechanisms in the two countries as soon as possible, to ensure the accuracy of customs declaration.

## Others

- Review and develop qualified suppliers in other countries as alternatives;
- Consider preferential duty exemption policies or adopt processing trade mode for importation, if these regimes are applicable to the business model and purpose of importation, thus reducing the duty cost;
- Review the terms of international trade contracts and consider renegotiating contract terms related to the responsibility for duties, contract price, risk transfer, etc.;
- Consider cost unbundling opportunities, and whether the current transaction flows can be optimized to reduce the additional duty cost;
- U.S. importers can explore the ability to implement First Sale for Export regime (i.e. imposition of customs duties on the selling price between China manufacturer and middleman as opposed to the selling price on the second sale – from the middleman to the US importer).

## How KPMG's Trade & Customs practice can help:

- KPMG's Trade and Customs practice can help companies in two countries to analyze impacts of the trade conflicts, and provide possible impact mitigation opportunities;
- KPMG's Trade and Customs practice can help the companies to review process and results on country of origin and HS codes determination and assist in ruling application or communication with government organs;
- Last but not least, KPMG's Trade and Customs practice includes a unique combination of policy, process and technology specialists. By tapping into our wide range of country-by-country trade knowledge and experience, we can deliver a successful trade solution implementation to improve the efficiency velocity and costs of managing trade operations globally. While facing the above stated challenges, KPMG can help to provide insights from extensive implementation experience on how trade management technology improvements can support the current challenges.

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