



China Tax for the **Auto Industry**

China tax planning for **cross-border transactions** of China's auto industry

Introduction

As one of the pillar industries in China, the automotive and auto component sector is under the scrutiny of the Chinese tax authorities due to its operational scale, capital size and organisational structure. The challenges are even greater for foreign multinational corporations with a large number of cross-border transactions.

In this issue, we highlight the major tax, customs and foreign exchange issues commonly seen in cross-border transactions in the auto industry in China. We also explore potential tax planning ideas, which are important for mitigating risks and improving efficiency from tax and customs perspectives.



Key China tax issues



Compensation for moulds

It is a common industry practice for overseas auto parts suppliers to seek compensation from its customers for the cost of developing or purchasing moulds required for parts production. These customers include auto OEMs and higher tier auto parts manufacturers.

The current foreign exchange regime in China makes it difficult for such auto OEMs or higher tier auto parts manufacturers in China to remit the compensations to foreign parts suppliers since there is actually no physical importation of the moulds into China. To circumvent such forex restrictions in some cases, the parts suppliers resort to increasing the unit price of their products to obtain compensation for the moulds-related costs. However, such an arrangement may trigger various tax and customs issues since the inclusion of the moulds-related costs can cause the unit price of the products from the suppliers to fluctuate substantially. To complicate matters, the suppliers normally prefer to recover costs as early as possible, e.g., from the early batches of the products rather than evenly over a period of time. Moreover, such an arrangement also makes it difficult to evidence any transfers of the legal title of the moulds.

However, as an alternative, the overseas suppliers and the OEMs or higher tier auto parts manufacturers may consider arrangements such as mould leasing or development. It should be noted, however, that there may be other China tax issues to consider, e.g., Corporate Income Tax (CIT), Value Added Tax (VAT) or Business Tax (BT).

Similar tax and foreign exchange issues may also arise where overseas OEMs make the same payments to auto parts suppliers in the PRC.

Conversely, where both the parts supplier and the manufacturer are located in China, VAT credit on the moulds may be denied if the moulds are not physically delivered to the customer.

In light of the above, it is advisable for both the parts suppliers and manufacturers to review their current or proposed arrangements in relation to moulds and improve how they handle the tax, foreign exchange and customs risks.

Customs valuation

Customs valuation is a hot topic for companies that operate import and export businesses. To ensure the payment of proper duties and taxes, China Customs has paid more attention to the valuation of related party transactions, especially non-trade payments such as royalties and service fees. As a high duty industry, the auto industry has been subject to close scrutiny by China Customs.

When Customs raises a price query regarding a related-party transaction, the importer is required to provide evidence to prove that the transaction price approximates the price of the same or a similar product sold to a third party buyer that has been accepted by PRC Customs. Otherwise, Customs will determine an import price based on valuation methods stipulated in relevant laws and regulations, which will sometimes result in higher duty and import tax burdens. A similar process applies to a non-trade payment such as royalties or service fees. If the intangible asset underlying a royalty is established as related to imported goods, the royalty should form part of the

dutiable value of the imported goods and be subject to import duty and taxes accordingly.

In the event of such queries from Customs, it is important that proper explanations are prepared on the Transfer Pricing (TP) policy adopted and a benchmarking analysis is performed to show that the policy is consistent with the Chinese company's functions and risks. A 'circumstances of sale' test may be carried out to show that the price was set on an arm's-length basis and settled within industry pricing norms.

For non-trade payments that are challenged by Customs as being related to imported goods, a detailed analysis on the nature of the payments and the characteristics of the associated arrangement should be performed so that an adequate explanation can be provided to Customs as to why such payments should not be dutiable.

Tariff classification

Determining the correct Harmonised System (HS) code for tariff classification purposes is important since the applicable customs duty rates, import licenses/certificates, and VAT refund rates for specific imported/exported goods are determined based on this HS code. More often, companies now face challenges from PRC Customs on the accuracy of the HS code used and penalties may be levied if the adoption of an incorrect HS code results in an underpayment of duties and taxes, an over-refund of VAT for export, or the absence of an appropriate import license/certificate.

This issue is especially important for the importation or exportation of auto parts. The determination of their HS codes is usually complex, and the existence of special rules for auto parts means that a detailed study on the coding issues should be carried out by customs and technical specialists. Certain issues need to be considered such as how the composition of rubber elements can change the HS code, or what level of processing could change the HS code of a metal auto structural part.

Further, different HS codes also apply depending on the physical state of the goods – different tariff classifications and rates can apply depending on how the goods are assembled and how they are broken down into components, sub-assemblies or individual parts. It is important to pay close attention to the rules governing how





and when different tariff classifications come into play.

Ownership of customer-based intangibles

China tax officials have long contended that seemingly limited-function/limited-risk PRC entities are undertaking valuable local marketing efforts and should be compensated appropriately for their ownership and development of these local customer-based marketing intangible assets. This is especially so when it comes to the auto and auto parts industry. Although many auto suppliers develop and maintain OEM relationships at the head office level, there has also been increasing scrutiny placed on the role that local auto parts manufacturers are playing in the process.

TP considerations regarding the creation or existence of valuable intangibles

In many cases, a local auto manufacturer is characterised in the TP value chain as a 'contract manufacturer' performing limited functions and assuming limited risks in its role. Typically, this functional characterisation may be outlined in the associated intercompany agreement and relevant planning and/or compliance documentation.

However, activities performed as part of its sales efforts or interactions with the locally-based OEM/higher tier auto supplier/associated commercial vehicle manufacturer, or even end-customer channels, may call into question the characterisation of this entity. Although an intercompany agreement may be used to evidence the function of the entity in answering a TP investigation, in practice, we have seen authorities assert the importance of the commercial substance of intercompany arrangements over the legal form of the transaction outlined in an intercompany agreement.

As a result, an accurate functional characterisation is critically important in a company's TP documentation. Even if an auto manufacturer is undertaking certain marketing activities, it would be prudent to also outline how the activities are managed, directed, and how any expenses are subsequently allocated. The role of the intangible property owner in providing strategic direction for any of these activities should also be outlined in order to defend whether or not the activities undertaken by the local manufacturer may be considered strategic or tactical by local authorities. However, if the local manufacturer's networking efforts and client relationships are contributing to the market penetration of the foreign-owned automotive brand, then taxpayers should pre-emptively try to take any contributions to the intangible

base into account when determining the arm's-length compensation. This may mitigate certain risk associated with potential inquiries from local authorities on the extent of functions undertaken by the local manufacturer.

Selecting the appropriate method to test intercompany transactions

The State Administration of Taxation (SAT) has expressed its preference for applying the Residual Profit Split Method (RPSM) instead of the more commonly applied Transactional Net Margin Method (TNMM) in determining the appropriate level of profitability attributable to the local manufacturer's contribution to the intercompany transaction. Taxpayers should bear in mind this fact, especially if the local auto manufacturer or sales entity is seen to be developing local marketing intangibles. The use of the RPSM will allow additional profitability to be kept at the local Chinese manufacturing affiliate in order to provide compensation, not only for the performance of manufacturing activities, but also regarding the ownership of valuable intangible assets.

Certain nuances of the Chinese market have been identified by relevant authorities and are used to justify a higher profit maintained in China. Therefore, a more flexible TP structure will likely be more effective in defending any subsequent audit inquiries.

Transfer pricing implications of barriers to entry in the market

Auto companies operating in China face unique challenges and barriers to entry that may not be commonly seen in other international markets. For instance, auto manufacturers must receive formal approval from the National Development and Reform Commission in order to operate in China. Effectively, this imposes an implicit quota on the number of market participants in China and reduces competition. This allows for an auto manufacturer to capture higher than average profits associated with its operations than it would in a market with fewer regulatory, administrative or operational requirements.

Since these barriers to entry are specific to China, TP officials have justified the application of a market premium in order to retain higher profit levels at the local Chinese affiliate of an auto company. The main challenges associated with applying a market premium comprise providing empirical evidence regarding the existence and measurability of such premiums, and determining how to accurately and effectively attribute the premiums to the respective parties involved. Even a TP structure that is implemented globally by an MNC may be challenged in China in order to justify a larger portion of profits to be kept in China.

Certain aspects of the burgeoning auto industry in China are eroding the fundamental basis of the market premium argument for the industry. For instance, the emergence of domestic Chinese manufacturers producing similar products at lower prices has shifted some of the consumer demand to domestic cars rather than imported/foreign-branded cars. The potential to capture a larger share of the market based on the barriers to entry is declining due to the weakening market concentration among the top foreign automotive brands operating in China.

However, separate factors specific to the Chinese market may also provide additional market barriers to entry to auto manufacturers. For instance, Chinese customers characteristically have high demand for certain types of automobiles, such as imported luxury brands. As such, domestic or lesser-known foreign automotive manufacturers may be limited in the amount of market share they can potentially take from the foreign-owned luxury automotive brands. The price of these high-end automobiles is substantially





higher in China compared with other countries even excluding importation-related taxes in China. So theoretically, auto companies selling these branded cars in China are likely to earn a profit that is in excess of comparable distributors in developed countries.

All of these examples may be capitalised on by tax authorities that are looking to retain a higher share of the profits attributable to the local Chinese affiliate in a global value chain for an auto MNC through the application of a market premium to the profit at the Chinese related party. Taxpayers should acknowledge that this may be a key argument during a TP investigation, and attempt to proactively address this issue. For example, a company may consider applying a market premium to the target profit margin at their Chinese affiliate (before the tax authorities assert their own premium on top of the targeted margin). Alternatively, a company could perform a comparable company benchmarking analysis using only Chinese comparable companies, since the profitability seen at these companies would already supposedly capture any market premium associated with the Chinese market.

Summary



China's auto industry has become more internationalised. Cross-border transactions of the auto part suppliers and car manufacturers are being closely scrutinised by the Chinese foreign exchange, customs and tax authorities. Therefore, it is critical that players in the China auto industry proactively manage the risks and capture the opportunities.

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