CHINA TAX ALERT

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Updates on China Customs Valuation Regulations

Regulations discussed in this issue:

- *Measures of the Customs of People's Republic of China for Assessment of Dutiable Price on Domestic Sale of Bonded Goods,* GAC Order No. 211, issued by the GAC on 25 December 2013, effective from 1 February 2014
- *Measures of the Customs of People's Republic of China for Assessment of Dutiable Price on Imports and Exports*, GAC Order No. 213, issued by the GAC on 25 December 2013, effective from 1 February 2014

In a bid to address some key concerns among processing trade companies and related party importers, the General Administration of Customs (GAC) recently released a raft of measures, which should lay the foundations for more transparent, standardized, and predictable means to appraise products for Customs purposes and in accordance with World Trade Organization (WTO) principles. A current concern among companies importing into and exporting from China is that, although China adheres to the Customs Valuation Agreement since it became a WTO member in 2001, there are still many areas that have to be standardized locally. In the absence of such standard rules, there could be varying interpretations between importers and Customs under different circumstances that may cause some unpredictability in assessing a company's overall duty and VAT costs.

The following regulations which were released by GAC last 09 December, and came into effect on 1 February 2014 respond to these concerns:

- *"Measures of the Customs of People's Republic of China for Assessment of Dutiable Price on Domestic Sale of Bonded Goods" (GAC Order No. 211) (hereinafter "Measures on the Dutiable Price of Domestic Sales"); and*
- *"Measures of the Customs of People's Republic of China for Assessment of Dutiable Price on Imports and Exports" (GAC Order No. 213) (hereinafter "Measures on the Dutiable Price").*

Processing trade or bonded zone enterprises and those involved in general trade between related parties are particularly affected. For example, one such gray area has been the appraisement of goods that are imported under processing trade but resold domestically. Meanwhile, for transactions involving related parties, Customs may raise questions on whether the "relationship influenced the price". Again, since there have been no standard procedures for this the exact duty/tax outcomes are not always certain for companies.

The release of GAC Order 211 and GAC Order 213 aim at reducing these previous uncertainties about the actual duty and VAT cost of general trade imports and bonded domestic sales.

As such, these developments are expected to enhance the overall business atmosphere for China's general trade, processing trade and bonded logistics enterprises. We expect these developments to greatly promote China's cross border trade environment.

Background

China's legislation on customs valuation can be divided into three layers. The first is related to the GAC's administrative framework under PRC Law. The second deals with regulations on how import and export duties are levied under State Council Order No.392. The third is related to both *Measures on Dutiable Price of Domestic Sales* and *Measures on Dutiable Price*.

Historically, the measures on the dutiable price (such as GAC Order No.33) and the measures on the dutiable price of domestic sales (such as GAC Order No.73) of China Customs were governed by separate regulations. To align itself with WTO requirements, China Customs revised and executed the new *Measures on the Dutiable Price of Imports* (GAC Order No.95) on 1 January 2002 and at the same time, included in it the *Measures on the Dutiable Price of Domestic Sales*. Later, the *Measures on the Dutiable Price of Domestic Sales* (GAC Order No.148) was revised for the second time and executed on 1 May 2006. That makes, GAC Order No.211 and GAC Order No.213 the third revision of the *Measures on the Dutiable Price,* and a return to the original set-up of having separate *Measures on the Dutiable Price of Domestic Sales*.

Key Points of the Revisions

1. **Measures on the Dutiable Price of Domestic Sales**.

- **Domestic sales of bonded goods by import processing businesses outside Special Customs Supervision Areas**

  The basic principle of using the original transaction value of bonded raw material imports as the basis for customs duties still applies, but details are added to explain that if the original import transaction price of bonded raw materials is difficult to determine, the weighted average method can be applied to compute the dutiable price, whereas in the past, some local customs houses would compute using the highest of the raw material batch values as the basis for customs duties. The issuance of GAC Order No.211 may stop this adverse practice.

- **Domestic sales of bonded raw materials and finished goods under processing trade arrangements in Special Customs Supervision Areas**

  Previously, Customs determined the dutiable price based on the transaction values of identical or similar goods at or about the same time the domestic sale is made. Under the new Measures, the actual transaction value of the domestic sale should be the basis on which to determine the dutiable value. This means that the new regulations are more aligned with market rules, and they make it more convenient for companies to provide documentary support for their declared price by simply presenting domestic sale contracts and the relevant payment documents.

  It is worth noting that in 2013, more favourable pilot policies began to emerge. Processing trade enterprises located in the Hengqin New Area, Pingtan Comprehensive Experimental Zone and Shanghai Pilot Free Trade Zone can now choose to pay customs duties/VAT based on the original imported raw material or the status of the actual goods domestically sold. It remains to be seen whether GAC Order No.211 will take a similar path in the future.

- **Domestic sales of bonded logistics goods in Special Customs Supervision Areas**

  For those goods stored or undergoing other logistics processing in Special Customs Supervision Areas, the *Measures* re-defines that the cost of insurance, storage, and transportation and related costs incurred within the Special Customs Supervision Areas and are seperately listed can be excluded from the dutiable price, thus giving further tax cost reductions for companies.

- **Domestic sales of scrap and by-products of processing trade enterprises**

  For scraps and by-products, the domestic sale price will remain as the basis for determining the dutiable value. This domestic sale price is defined as the total amount actually paid or payable by the Chinese enterprise to the seller (i.e. Processing Trade companies) for the purchase of the bonded scraps and by-products, excluding the custom duties and taxes. This clearer and more practical definition makes it simpler and more convenient for Customs to verify documentary proof provided by companies.

- **New provisions relevant to procedures**

  For the first time, the *Measures* clarifies that if the domestic sale price of bonded goods cannot be immediately determined, Customs shall use the transaction value of identical or similar goods, deducted or computed value, as well as other reasonable methods, in that order of preference, to arrive at a proper dutiable base. Furthermore, according to the GAC Circular [2014] No.14, Customs should follow the same procedures used in the assessment of general trade imports & exports to assess the value of bonded goods. This may reduce inconsistency in procedures when determining the customs value of bonded goods, and reduce the impact of potential arbitrary customs valuation on processing trade enterprises.

2. **Measures on the Dutiable Price:**

- **New Article 18 on how customs should assess the special relationship between buyers and sellers**

  A newly added Article 18 brings China's customs valuation system to closer alignment with the principles of the *WTO Customs Valuation Agreement*. The said Article provides that if Customs is able to confirm that the pricing of the goods is consistent with common commercial practice after conducting a circumstances of sale test, this should be sufficient to conclude that the relationship between the buyer and the seller did not influence the transaction value.

- **Transportation and relevant fees**

  Actual freight, transportation and other relevant logistics costs can now be used instead of benchmarks as previously required that freight and insurance for goods transported through railways and highways be computed at 1% of the total goods value.

  In addition, as Customs did not specify how the freight (rate) of the transportation industry in the corresponding period can be used as a reference if actual transportation fees of imported goods are undeterminable under GAC Order No. 148, the new GAC Order No. 213 clarifies that Customs shall base its assessment on comparable transportation expenses at the time the goods are imported.

- **Dutiable price of exports**

  The duty base of products subject to export duties may increase in circumstances involving commissions. This is because the new *Measures* repeals a previous provision in GAC Order No. 148 that allows for an exclusion of separately charged sales commission from the dutiable price of exports.

- **Additional contents in the glossary**

  The new *Measures* has made changes to definitions of key terms in the glossary such as:
  - added definitions of "before discharging" and "before embarking" with respect to determining the dutiable price of imports and exports;
  - revised the definition of "about the same time" in the price evaluation of identical or similar goods; and
  - specified that "forms of media" of software, words, music, graphics, images or similar contents should include magnetic tapes, disks and CDs.

KPMG observations

Although the overall intention of the new regulations is positive and commendable, we still expect challenges down the road and it is advisable that companies pay close attention to the following in relation to the new *Measures*:

- Since processing trade companies in China mostly import from related-parties, determining whether or not the original import price is at arm's length would still be a major challenge when reviewing the dutiable price of domestically sold bonded goods.

  Most processing trade companies in China rely on overseas shareholders or group procurement centres to arrange their import. Hence, multinationals should carefully consider if they satisfy the requirements of both tax and customs authorties when drafting and revising their transfer pricing policies.

  When conducting periodic adjustments on import prices according to group pricing policies, they should consider if they should communicate and discuss with Customs beforehand to avoid delays caused by Customs inquiry during clearance of goods. Companies should also check whether a foreign exchange remittance can be arranged together with the price adjustment.

- With regard to the valuation of domestic sales of bonded goods in Special Customs Supervision Areas, it remains to be seen how the new approach of appraising customs duties on the actual domestic sale price of the goods will be implemented.

  There are two major forms of domestic sales of bonded goods in some Free Trade Zones (FTZ) in China: the goods can either be sold to clients outside the FTZ with the clients making the necessary customs declarations and paying the applicable duties and taxes, or the FTZ company can pay the duties and taxes prior to selling the goods to clients outside FTZ.

  In the former situation, it would be convenient to provide domestic sales contracts to justify the domestic prices for Customs review.In the latter situation, actual domestic sales have not yet occurred when goods are cleared from Customs. The FTZ company and Customs may find it difficult to determine the actual domestic selling price at this point. Therefore, we would suggest companies plan ahead and consider the various customs, tax and operational implications in this model.

- It is still not clear how these new measures will be applied to factory transfer goods

  GAC Order No 211 defines factory transfer price as the price actually paid or payable by the "transfer-in" company to the "transfer-out" company for purchasing the goods. In practice, however, some factory transfers occur among three or more parties located in or outside China. Since the transaction value actually paid or payable for the transfer-in company to buy the goods is paid to an overseas supplier and such value would likely be different from what is received by the transfer-out company, a detailed analysis of possible business and foreign exchange risks may be required to arrive at a proper appraisement of the value of the goods.

At its core, customs valuation is a highly technical issue and can considerably impact the overall tax burden of companies depending on the type of business model they operate, or plan to operate in.

The issuance of these updated customs valuation regulations has made it even more imperative for importers and exporters, especially those engaged primarily in related-party transactions, to conduct a separate review of their existing transfer pricing policies and relevant procedures from the Customs' perspective so as to minimise risks of future customs challenges.

In order to reduce uncertainty and compliance risk caused by customs valuation disputes, Customs has recently implemented relevant pilot programmes such as advanced valuation review and advance price registration. Companies can consider using these lines of communications with Customs to negotiate and ascertain their import prices or proposed pricing adjustments.

Finally, companies with plenty of factory transfer transactions or those in Special Customs Supervision Areas may have to assess the potential impact of these new *Measures* on their operations as soon as possible, so that they can plan ahead to leverage opportunities and avoid any potentially adverse impacts to their overall tax burden and supply chain efficiency.

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