

# Customs Valuation in China

April 2015



# Agenda

- Overview of Customs Valuation
- Key focuses of Customs Valuation
  - ü Related party transactions
  - ü TP adjustment
  - ü Royalty
- Effective Management on Customs Valuation
- Questions & Answers

# Overview of Customs Valuation

# Overview of Customs Valuation

## Significance of Customs Valuation



| Additional taxes contributed by Customs Audit<br>in 2014 | Amount<br>(RMB: million) |
|--|--------------------------|
| Customs classification                                   | 923                      |
| Customs valuation  | 9,628                    |

# Key Focuses of Customs Valuation

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## Hot Topics of Customs Valuation

### Related party transactions

- Rationality of the transfer pricing policy from Customs valuation perspective;
- Implementation of the transfer pricing policy, including the use of transfer pricing methods to determine the import and export prices and profit adjustment (if any).

### TP adjustment

- Rationality of the transfer pricing policy and the soundness of the implementation;
- Rationality of the TP adjustment and the adjusted amount;
- Un-reported adjustment in the past;
- Adjustment in future.



### Royalty and other non-trade arrangement

- Whether royalty should be included in the dutiable value of imported goods;
- Other non-trade arrangement which should be included in the dutiable value of imported goods (such as assistance)

# Key focuses of Customs valuation

## Related Party Transactions

Same principle, different requirements – arm’s length principle

|                 | Tax authorities  | Customs   |
|-----------------|--|---|
| <b>Target</b>   | <ul style="list-style-type: none"> <li>Goods, service, financing, intangible assets transaction between related parties</li> </ul> | <ul style="list-style-type: none"> <li>Tangible goods</li> <li>Intangible assets transfer (royalty) and service related to the goods</li> </ul>   |
| <b>Focus</b>    | <ul style="list-style-type: none"> <li>Lower sales price or <b><u>Higher import price</u></b></li> </ul>                           | <ul style="list-style-type: none"> <li><b><u>Lower import price</u></b> (lower export price in some cases)</li> <li>Royalty and other dutiable charges</li> <li>Import price fraud</li> </ul>   |
| <b>Concerns</b> | <ul style="list-style-type: none"> <li>Lower profit margin of the company as a whole</li> </ul>                                    | <ul style="list-style-type: none"> <li>Lower import price of one single transaction<br/> </li> <li>Lower import price of the companies during certain period<br/> </li> <li>Lower import price of the companies during certain period for different products</li> </ul> |

# Case Study 1

## Change of Global TP Policy

### Background

- Company A, which has entered into the Chinese market for a long time, and is an EU luxury brand engaged in the fashion retail sector.
- All of its products are imported into China from its related party in HK.
- The import prices are determined based on its global TP policy.
- At the beginning of 2012, Company A adjusted its supply chain and started to import goods directly from EU headquarters.
- To better build its branding, the group also revisited and changed its global TP policy.
- The price of imported goods into China decreased significantly to follow the updated changes.

### Questions

- Is there any potential risk of Company A regarding the import prices ?
- Should Company A communicate with Customs proactively? What would you do?
- How to deal with the risk if any?
  - ü Customs will know very fast that the price has dropped as they have their database.
  - ü So, they will immediately challenge and hold the goods at the port pending question.
  - ü They will not believe the change in TP Policy and may raise formal challenge.



# Case Study 1

## Change of Global TP Policy

### Best practice

#### Being prepared before a Customs challenge

- Assessment and control of Customs Valuation risk associated with:
  - ü Changes to import transaction model or import price
  - ü Transfer pricing policy
  - ü Non-trade payment
  - ü Free-of-charge imports
- Securing formal or informal pre-Valuation advise from Customs;
- Supply chain planning

**Solution for Company A: Implementing an advanced ruling - this is the first time of its kind of arrangement with Customs and the approach is considered as trailblazing.**

# Key focuses of Customs valuation

## TP Adjustment

### Customs implications of TP adjustment

- TP adjustment on the price of imported goods has Customs implications and becomes a focus of Customs' supervision.
- There is no detailed Customs rule regarding TP adjustment.
- Chinese Customs has started to understand TP adjustment made by companies and encourages companies to have communication with Customs regarding the TP adjustment in advance.
- Upward adjustment is easier for Customs to accept than downward adjustment.
- Upon collecting of additional import taxes for upward price adjustment, Customs can issue tax completion certificate which can support remittance of payment to overseas.
- Downward adjustment is difficult to implement due to the lack of supporting Customs documentation.

# Key focuses of Customs valuation

## TP Adjustment

### The risk of improper communication with Customs

- Without proper advanced communication, TP adjustment on import price can invite Customs investigation.
- Additional Customs duty and import VAT can be collected, but the Customs documents issued in such situation may not be accepted by banks for foreign exchange remittance.
- In the worst case, penalties would be imposed.

### The benefit of advanced communication with Customs

- Set up a communication channel with Customs and gain Customs' trust.
- Proactively obtain Customs' suggestion/guidance on the TP adjustment.
- Upon Customs' approval, obtain Customs declaration form to facilitate overseas remittance.
- Obtain Customs' verbal or written confirmation of the Company's annual TP adjustment in the long run, to mitigate future Customs risks.
- Pre-valuation, Formula Pricing, Customs APA, etc.

# Case Study 2

## TP Adjustment

### Background

- Multinational Corporate A sells its products to domestic subsidiary B, company B then sells the products to foreign third parties
- Corporate A adopts the transactional net margin method (“TNMM”) as the group pricing method.
- At the end of 2009, the tax head of corporate A in Asia noticed that company B’s profit rate was HIGHER than the interquartile range.
- The tax head hoped that it could adjust company B’s profit into the normal range in order to lower the risk of related party transaction.
- What kind of tax and Customs implications could be for the adjustment
- Assuming that at the end of 2010, the tax head of corporate A in Asia identified that company B’s profit rate was LOWER than the interquartile range and hoped to increase the profit. What’s the tax and Customs implications under this situation?

# Case Study 2

## TP Adjustment

### Our insight

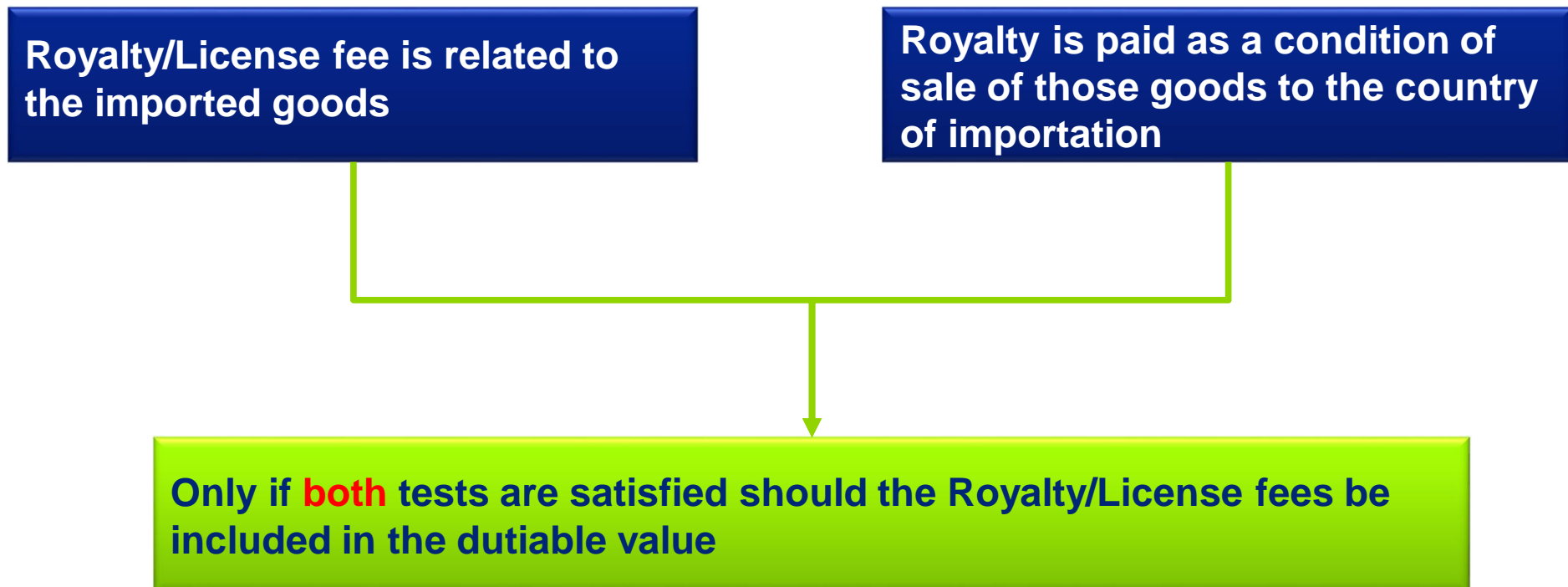
- Foreign exchange control: Legal import/export supporting documents, settlement and sale management on foreign exchange
  - ü Difficulties in remittance
  - ü Troubles in receipt
- Customs could challenge that the import price is manipulated and chase on the import taxes underpaid.
- Impact on VAT deduction
- Tax authority's consideration
  - ü additional business tax/VAT
  - ü Cost deduction before tax

# Key focuses of Customs valuation

## Royalty

### Introduction

- Royalty / License fees shall only be included in the value for duty purposes when:



# Case Study 3

## Royalty

### Background

- Company B is a domestic electromechanical product manufacturing subsidiary and imports raw material, intermediate goods and key components from overseas parent company (“Company C”) for further assembling and manufacturing.
- In 2007, company B signed Royalty agreement with its parent company, according to which company B can use the transferred technology within the expiry date, including mainly the following two aspects:
  - ü A: Patent and knowhow - for the importation of key parts containing the patent.
  - ü B: Corporation internal management experience: including the manufacturing technology, procedure, method, finance management system, pricing and sales system etc. - for the production of finished goods.
- According to the agreement, the royalty fee is calculated based on the total sales revenue multiplied by a certain ratio.
- The Customs challenged that all the royalty should be dutiable.

# Case Study 3

## Royalty

### Analysis

- Analyze what the royalty is actual paid for;
- Whether there is any party of royalty could be dutiable;
- How to split the royalty

### Our insights

- Royalty is always a hot topic scrutinized by the Customs, as most of the royalties are paid separately from the import price.
- The Royalty case normally will not be settled easily by the Customs, which may take long time. Companies should be well-prepared.
- Large amount of supporting documents are required, which may involve many departments. Before the official meeting with the Customs, companies need to internal coordinate well through the different departments and control the risks.
- Wisely choose the appropriate Customs valuation method, as the different methods may lead to very different results.



# Effective Management on Customs Valuation

# Effective Management on Customs Valuation

## Strategy for Addressing Customs' Challenge

| Prepared before Customs challenge   | When challenged by Customs  |
|---|---|
| <ul style="list-style-type: none"><li>• Assessment and control of Customs Valuation risk associated with:-<ul style="list-style-type: none"><li>ü changes to import transaction model or import price</li><li>ü transfer pricing policy</li><li>ü non-trade payment</li><li>ü free of charge imports</li></ul></li><li>• Securing formal or informal pre-Valuation advice from Customs;</li><li>• Supply chain planning</li></ul> | <ul style="list-style-type: none"><li>• Understand which level the challenge has been raised at</li><li>• Understand Customs' focus and key concern;</li><li>• A well-structured explanation letter, with the appropriate supporting paperwork, will be critical to a successful closure of the case;</li><li>• Understand if there are business units within your company that also maybe affected</li><li>• Understand how one answer provided may affect future operations</li></ul> |

# Effective Management on Customs Valuation

## Art to keep the balance between Tax and Customs

- When preparing the transfer pricing policies, comparable analysis and TP planning, Customs valuation should be also considered in order to maintain a balance between tax authorities and Customs;
- Review and assess the transfer pricing documentation from Customs valuation perspective;
- Obtain approval from tax authorities and Customs for pre-valuation, formula pricing, explanation and record for price adjustment;
- Review and assess whether the TP policies within the group are compliant with the local tax, Customs and forex regulations;
- Conduct regular review on the transaction price and profit to make sure compliant with tax authorities and Customs' requirements.



# Effective Management on Customs Valuation

## Art to keep the balance between Tax and Customs

- When challenged by tax authorities or Customs, the impact(s) for financials, taxes, import/export management should be fully considered;
- Review and analyze companies' profits in short/ middle/ and long-term;
- Cooperate with the tax authorities and Customs and proactively solve the gap in between (if any);
- Utilize the communication channel and the consulting mechanism under the prevailing regulations;
- Seek the advice and assistance from professional firm.



# Questions & Answers

**Deloitte.**