China

Recent experiences on interaction between transfer pricing and customs valuation

If your company imports goods into China from related parties then you may have already, or likely will in the future, receive a request from China Customs to provide information in support of the declared import prices. There are new developments in the China customs valuation regulations (i.e., Decree No. 211 and 213) and continued discussions at a global level between the World Customs Organization[8] (WCO) and the Organisation for Economic Co-operation and Development (OECD) about the relevance of how/whether a transfer pricing documentation report (TPD Report) could be used by importers to support the arm's length nature of the import prices through the "circumstances surrounding the sale" test.[9] Although it is still early days for this topic in China, the China authorities are starting to evaluate whether the TPD Report contents can be used to support declared import prices.

Companies need to be ready to respond to requests for information from China Customs. When doing so, it is important to understand that any submitted information, such as a TPD Report, can either support a position or may result in additional questions about the pricing that can lead to potential assessments of import taxes and penalties. Ernst & Young (China) has seen an increase in such risks during the last few months.

A majority of China import taxes (i.e., customs duty, import VAT, import consumption tax, anti-dumping and others) are based upon ad-valorem rates and the tax revenue collected by China Customs is directly affected by the declared customs values. China Customs are concerned that related parties may have declared lower import prices and as a result underpaid related import taxes. Consequently, China Customs has the authority and right to ask importers to explain and defend why their import prices should be acceptable and in compliance with the customs valuation regulations. How can the import prices be supported?

One question frequently asked of late is: "Can a TPD Report prepared for corporate income tax purposes be used in front of China Customs to support import prices?" While WCO Commentary 23.1 points out that "the TPD Report submitted by an importer may be a good source of information," it also goes on to state it "may not be relevant or adequate in examining the circumstances surrounding the sale because of the substantial and significant differences which exist between the methods in the agreement to determine the value of the imported goods and those of the OECD Transfer Pricing Guidelines." So what should a company do if requested to submit their TPD Report?

First of all, it is important to note that a TPD Report is prepared under the arm's length principle under the Implementation Measures for Special Tax Adjustments (Trial) (Circular 2), and the China Customs applies a different regulatory frame of mind when reviewing the same document. For example, China Customs will review the import prices by applying the new customs valuation regulations, which are fundamentally different. Since the basic regulatory framework for transfer pricing and customs valuation is not the same, there may be differing views by the China authorities when interpreting the same TPD Report information. The conclusion in WCO Commentary 23.1 states that the use of a TPD Report "as a possible basis for examining the circumstances of the sale should be considered on a case-by-case basis" and "could be one source of such information." Hence, companies need to be particularly sensitive to the implications of providing a TPD Report in an attempt to support the import prices in front of China Customs.

8. See WCO Commentary 23.1 on: Examination of the expression "circumstances surrounding the sale" under Article12.(a) in relation to the use of transfer pricing studies.
9. This is a customs valuation related concept for companies to help them support that the relationship did not influence the price and that the prices are "arm's length."

There are numerous fundamental differences between the transfer pricing arm's length principle and the customs valuation principle, and China Customs' perspective on circumstances of sale makes some of these differences difficult to reconcile. For the purpose of this article, we have listed a few key comparisons important to China Customs:

Issue	Transfer pricing	Customs valuation
General basis	Typically, this is conducted on an entity-level basis for a year or other period of time.[10]	Typically, this is conducted on a transaction level for each good or service; China Customs gathers a range of detailed transactional level prices that can be used to compare against the importer's declared prices.
Concerns	There are concerns that import prices are overstated to erode China profits.	There are concerns that import prices are understated to avoid import taxes.
Characterization	For transfer pricing purposes, a company is characterized as limited risk, full-fledged, etc. according to their functions, risks and assets. The analysis and characterization is a pre-step to identify comparable companies and benchmark profit levels.	Customs valuation principles do not characterize companies in a similar manner. Nevertheless, these are still important factors in trying to assess how the import prices were determined and what level of margins or profits are reasonable.
Comparables	There is a need to identify a set of companies that have similar functions, risks and assets; the search process requires comparable companies with significant related party transactions to be eliminated. since their results will likely distort the benchmark profit levels. The sample of comparable companies could include companies from outside China.	It is not necessary to remove related parties with significant related party transactions from comparable analysis. Companies selected from countries outside China are not considered by China Customs for customs valuation purposes.
Profit-level indicators	TPD Reports are usually focused on testing the net margins of the China subsidiary and less frequently at the gross margin level.	China Customs tends to focus more on gross margin, believing it is where the import price is most relevant in the financial statements. The use of a net operating margin makes connecting the TPD Report analysis to transactional level import prices quite challenging.

10. Some TPD Reports may analyze prices of goods and services at the transactional level. A majority focus the TPD Report analysis on the profit performance of the entire entity.

Companies are now encountering the risk where China Customs is reaching conclusions on customs valuation matters directly from data/information contained in the TPD Report. Such conclusions can be confusing to importers that are not familiar with the different principles applying to transfer pricing and customs valuation. It is not straightforward and unlikely that a transfer pricing analysis will adequately satisfy the customs valuation regulatory criteria.

We would recommend importers consider the following four actions to prepare for China Customs challenges in relation to the transfer pricing analysis:

1. Review your existing TPD Reports from a customs valuation perspective to identify whether certain customs valuation related risks may already be imbedded.
2. Research, document and be prepared to explain and support the actual pricing methodology utilized to calculate the import prices of individual goods from a customs valuation perspective and using customs language.
3. Conduct an additional comparable search, or revisit the initial search conducted during preparation of the TPD Report, to make it more relevant to the customs valuation regulations.
4. Prepare an "off-the-shelf" document that explains the company background, transaction flows, import pricing mechanism and other relevant matters related to customs valuation. This type of document can be the first line of response when an importer receives a valuation query from China Customs.

Conclusion

China Customs has succeeded in the past to make a case for customs valuation using transfer pricing analysis and we are seeing an increasing trend recently. We believe this is a concern to importers and the risks should be managed proactively. If a request to submit the TPD Report has been received from China Customs, then consider involving knowledgeable and experienced internal resources or external advisors who are able to address the situation from both a transfer pricing and a customs valuation perspective. What importers should not do is to simply provide the TPD Report to China Customs hoping, or assuming, that it would be a sufficient response to satisfy all their import price questions.

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