

# Attaining Customs Valuation compliance after implementation of your new Transfer Pricing Documentation



# Introduction

Ever since the new Chinese corporate income tax law (CIT law) came into effect on 1 January 2008, Chinese transfer pricing documentation (TPD) has been a major topic for multinational companies across the globe. Now, after much anticipation, the State Administration of Taxation (SAT) has released the final version of the 'Implementation Measures of Special Tax Adjustments (Trial)' (the Measures) including the requirements for transfer pricing contemporaneous documentation (TPD Requirements).

The development and release of the Measures and the TPD Requirements has been monitored by the customs authority. Given the close and often conflicting relationship between arm's length pricing for tax and customs purposes, multinational companies with significant import/export operations are strongly encouraged to ensure that they can meet the respective standards of both revenue collection authorities.

## Key Issues

The tax and customs authorities have different rules for testing an arm's length price. Contrary to popular belief, the transfer price for corporate tax purposes and declared value for customs purposes are not necessarily the same. The World Trade Organisation (WTO) based customs valuation rules and Organisation for Economic Co-operation and Development (OECD) transfer pricing guidelines are different.

For example, the customs authority test an arm's length price based on a transaction and product specific comparison at a Gross Margin, rather than Net Margin level. The definition of comparables is quite different to that applied for transfer pricing purposes. Sales below cost at a cross-border level are generally unacceptable for customs valuation purposes. The tax authority have regard to the taxable income and profitability of an operating entity when taken as a whole over a period of time, whereas the customs authority focus on fixing the dutiable value of imported goods on a transaction-by-transaction basis.

Whilst it is the objective of both the tax and customs authorities to ensure that related parties are trading on an arm's length basis, companies can find themselves being pulled in opposite directions. The customs authority is seeking higher transfer prices so as to maximise customs duty collections whilst the tax authority is seeking lower transfer prices so as to maximise corporate income tax collections.

Additionally, the new TPD forms (see Form 2 and 3) provide far more information about the transfer pricing methodology and the status of intangibles. Intangibles such as royalty payments for trademark fees are often dutiable for customs valuation purposes, yet many companies currently fail to declare these in the dutiable value. Going forward, the Customs authority is likely to ask for TPD when conducting customs valuation audits.

## Impact to Business

A company can pass a transfer pricing audit today but fail a customs valuation audit tomorrow.

When a company fails a customs valuation audit the following scenarios arise:

- **Additional costs for customs duty and import VAT due to a higher dutiable value.**

Goods imported in 2009 will be subject to an average customs duty of 9.8%, valued added tax (VAT) of 17%, and consumption tax, in certain

situations. For some multinational companies duties assessed on imported goods can amount to a higher liability than corporate taxes. Customs may make a retrospective assessment for goods imported over the past 3 years as well as collect additional duties on future imports.

- **Additional costs due to financial penalty**

Customs may impose financial penalty – up to 3 times the amount of underpaid duties assuming administrative smuggling – which is a further cost burden for the company.

- **Additional costs due Enterprise Category downgrading**

Customs may downgrade enterprises from say Category A to Category B which results in delays in clearance for incoming goods, additional documentary and physical inspections, all of which increases operational costs and reduces supply-chain efficiency.

## Action Items

Many companies establish a transfer pricing methodology solely from a corporate tax viewpoint. Duties on imported goods are sometimes overlooked. However, more robust strategies for managing customs valuation compliance are now available, such as advance rulings with respect to the customs valuation of imported goods.

In view of the foregoing, multinational companies with significant import/export operations are strongly encouraged to undertake the following:

- i. Check in advance of a customs audit whether or not the transfer price can be defended as being arm's length to the customs authority.
- ii. Prepare documentation that evidences the transfer price as being arm's length for customs valuation purposes. The documentation should focus on an assessment of the acceptability of the transfer prices per the customs valuation rules and practice in terms of (a) Transaction Price as the Method of Valuation and evidence to support arm's length pricing and (b) adjustments to the Transaction Price, if any.
- iii. Ensure consistency in documentation exists in terms of what is presented to the tax and customs authorities respectively.
- iv. Develop standard procedures and strategies for responding to customs valuation audits.

- v. Consider obtaining advance rulings with respect to the customs valuation of goods.

Overall, the challenge for many companies is how to meet the competing expectations of the direct and indirect tax revenue collection agencies. That said, the WTO-based customs valuation rules and the OECD transfer pricing guidelines nevertheless converge into one fundamental concept: inter-company transactions between related parties should be carried out and treated as if they were between unrelated parties.

## Benefits

Completion of the above activities has the following benefits:

- Avoid the additional costs that arise due to customs valuation non-compliance
- Save costs where instances of overpayment of customs duties are identified
- Obtain a level of comfort that the company is in compliance with the valuation rules
- Save time when responding to a customs audit as defense documentation will be already in place

## Summary

The development and release of the Measures and the TPD Requirements has been monitored by the customs authority. Contrary to popular belief, the transfer price for corporate tax purposes and declared value for customs purposes are not necessarily the same. Overall, the challenge for many companies is how to meet the competing expectations of the direct and indirect tax revenue collection agencies.

The GAC has recognised that collections in 2009 will be more challenging due to the economic climate and local Customs have been exercising greater effort to ensure the revenue collection. Customs may well ask for TPD when conducting customs audits. Multinational companies with significant import/export operations are strongly encouraged to undertake action to ensure customs valuation compliance in advance of being audited.

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