Transfer pricing vs. Customs valuation – A practical approach and perspective in China

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In brief

In recent years, the heated discussions around harmonising customs valuation and transfer pricing methodologies had never ceased in World Trade Organisation member countries. The World Customs Organisation (WCO) has broken silence and published a guide on the subject matter this year in an attempt to address long-existent conflicts.

Timely for the China customs regime, the WCO Guide sheds new lights and interest on interpretation and application of transfer pricing related information on customs valuation matter in China. A practical way to gauge such interpretation is to cross-reference the recently revised Circular 2 – "Implementation Measures of Special Tax Adjustment" which incorporates the Organisation for Economic Co-operation and Development (OECD)'s transfer pricing documentation (TPD) requirements into the Chinese regime. It is crucial for enterprises in China to diligently understand how Circular 2, alongside with other developments, would potentially create benefits or pose disadvantages to its current customs valuation methodologies adopted.

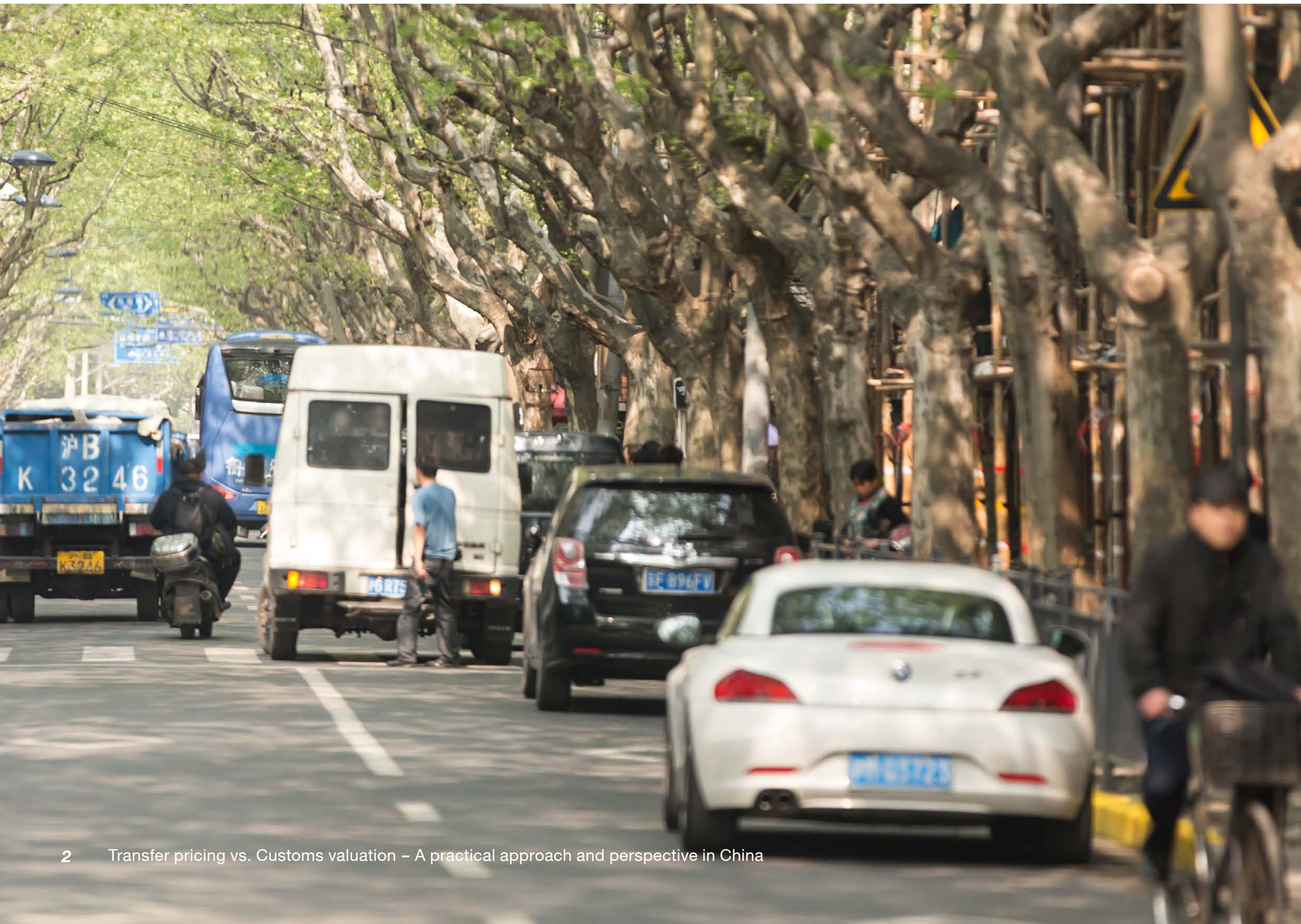
PwC observations

Overview of the WCO Guide

The WCO Guide is a 101-page reader on customs valuation and transfer pricing topics encompassing methodologies, assessments, related party transactions, legal framework of the OECD transfer pricing principles, etc.

The last three chapters outline mechanism in resolving conflicts between customs valuation and transfer pricing from a more practical angle, such as stating the relationships between customs valuation and transfer pricing, introducing how customs authorities would adopt transfer pricing information in assessing related party transactions and providing recommendations to enterprises, customs and tax authorities on implementing the WCO Guide (with a few examples). Full texts are available at the WCO official website below:

http://www.wcoomd.org/en/media/newsroom/2015/june/new-wco-guide-to-customs-valuation-and-transfer-pricing.aspx



Circular 2 TPD content requirements – implications to China Customs valuation

In China, TPDs are often mandatory documents filed for income tax purpose. That said, such documents are also routinely requested by China Customs for review in relation to import price inquiry. Taking into account the commentary provided under the WCO Guide and the revised Circular 2, we summarise as follows the customs focal points that should be considered with some of the most common contents found in a TPD:

Content	Subcontent	Customs focal points
1. Report summary	**1.1 Scope and purpose** **1.2 Functions and risk analysis summary** **1.3 Financial analysis summary** **1.4 Economics analysis summary**	A description of the company to assist in understanding its business operation
2. Company overview	**2.1 Group overview** **2.2 Group holding structure overview** **2.3 Local entity overview** (business activity, management structure, employees, products, clients, etc.) **2.4 Description of related parties**	The company's structure, its relationship with overseas sellers and its product scope
3. Related party transactions	**3.1 Major related party transactions** **3.2 Transfer pricing policy** (related party purchases, royalty payments, technical service fee, sales support service fee, etc.) **3.3 Other related party transactions** (related party purchase of equipment, etc.)	The transfer pricing policy adopted, dutiability of royalty and other intangibles that may be related to the imported goods
4. Industry analysis	**4.1 General industry overview** **4.2 Specific industry overview** **4.3 Market prospect** (future market trends, challenges and the corresponding implications on the company)	The company's understanding towards the industry it is in, the market condition of the industry and how the company is positioned in the industry
5. Functions and risks analysis	**5.1 Overview** **5.2 Functions analysis** (R&D, procurement, production, quality control, logistics/warehousing, sales, after-sales support, general management, etc.) **5.3 Risks analysis** (market risks, credit risks, inventory risks, foreign exchange risks, warranty risks, R&D risks, production risks, etc.) **5.4 Assets** (tangible assets and intangible assets) **5.5 Positioning**	The degree of functions and risks the company bears; if any intangibles bear a relationship with the imported goods
6/7. Financials and economics analysis	**6. Financials analysis** **7. Economics analysis** **7.1 Overview** **7.2 Selection basis of transfer pricing methodology** (Comparable Uncontrolled Price method, Resale Price method, Cost Plus method, Profit Split method, TNMM, etc.) **7.3 Selection basis of parties subject to benchmark testing** **7.4 Application of transfer pricing methodology** (searching of external comparable companies, profit levels of comparable companies, etc.)	The methodology applied in benchmark testing; the relevance (in terms of product) of comparable companies selected

BEPS considerations and impact on customs valuation

The State Administration of Taxation Circular 2 Guoshuifa [2009] formulated general anti-tax avoidance administrative procedures and localise Base Erosion and Profits Shifting (BEPS) actions in China. The revisions and new requirements embedded in Circular 2 will have the following far reaching implications to customs valuation matters in China:

Circular 2 requirements	Customs implications
Three-tier documentation	• China customs authorities will routinely request to review files disclosed under Circular 2 for customs related valuation issues. Information prepared in local and master files will enable Customs to check the extensive supply chain of goods imported into China, which may not be available from before. • The additional information could be sensitive information in terms of roles of foreign related parties and its pricing practice (mark up and intangible), which will increase the complexity and/or reduce flexibility of explaining the customs valuation basis to customs authorities.
Special issues file	• The special issues file is required to be prepared and may cover "special issues" such as inter-group services, cost-sharing arrangements, etc. • It will be relevant to customs valuation review on dutiability of intangibles (royalties, assists, trademark, patents, etc.)
Transfer pricing principles and methodologies	• In addition to arm's length principle, "other fair and reasonable profit allocation principles" could be adopted in forming the transfer pricing basis of inter-company transactions. • This profit allocation may encompass a basket of factors or considerations which may lead to Customs to use the "Fallback Method" to finalise valuation assessments. • The "value chain analysis" may expose sensitive details and attract customs challenges upon customs audits. • If for BEPS consideration, a reallocation of profit is engineered through adjustment of import price, such action will likely be assessed by China Customs.

Conclusion

As contemplated above, a change of regulatory regimes within customs and tax in China has taken place. A silo approach to customs valuation management will likely trigger or invite more inquiries. Simply put, there has been an administrative practice in place to review the compliance of customs valuation declarations through reference to tax related document and information. The new TPD requirement under Circular 2 which embedded BEPS consideration should lead to a substantial impact on customs valuation in the future. Hence, when preparing TPD or setting transfer pricing policy in general, it is of utmost importance to adopt a balanced approach and ensure consistency towards customs and tax concerns.

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