



CHINA

China Customs Focuses on Royalties & Related Party Transactions in 2010/11

We have welcomed the year of the Tiger and all that it will bring to the business community in China in 2010. In 2009, we witnessed the increase in enforcement actions by the State Administration of Taxation ("SAT"), with the changes in transfer pricing legislation and the requirement for self audits by named companies. We also witnessed increased enforcement by China Customs of those companies enjoying privileges provided under the rules and laws of the processing trade. In 2010/11, the focus for China Customs is likely to be on related company transactions and royalty payments.

With the increasing number of top brand-named products jostling for space in China, it seems inevitable that royalties and the related revenue would attract the attention of China Customs, especially with regard to the possible inclusion of royalty payments in the valuation of goods for customs duty purposes. In fact, there have already been several cases of China Customs looking into the royalty payments of manufacturers operating under the processing trade or Customs handbook schemes and selling their products into the Chinese domestic market.

Clarification of a Common Misconception About Royalties

We often hear financial officers state that, because they report royalty payments in the company's financial reports and pay corporate tax or withholding tax on such payments, they do not have to include royalty in the import value of their goods. The reality is that royalty payments are subject to question and possible taxation from both the direct and indirect tax authorities in most countries. Even if royalty is only payable on an annual or other basis, it is not precluded from being included as part of the customs value of the goods. Companies must be fully aware of obligations to both the direct and indirect tax authorities and must be fully compliant with those responsibilities.

Treatment of Royalties by China Customs

The *Rules of the General Administration of Customs of the People's Republic of China for the Determination of the Dutiable Value of Import and Export Goods* ("Rules") is the key legislation governing customs valuation of goods. The provisions in the Rules relating to the inclusion or exclusion of royalties and license fees in the customs value are based on the World Trade Organization ("WTO") Agreement on Customs Valuation ("ACV").

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i. Definitions for Customs Purposes

Two key terminologies are defined under the Rules:

- “Royalties and license fees” means any fee paid by the buyer to intellectual property right-holders or persons duly authorized by the right-holders for authorized use or transfer of patents, trademarks, know-how, copyrights, distribution rights, or selling rights.
- “Know-how” means any undisclosed knowledge, experience, methods, techniques and skills concerning technological process, formula, product design, quality control, examination and test, marketing management, etc., expressed in forms of blueprints, models, technical data and standards.

ii. Inclusion or Exclusion of Royalty

Articles 11(c)(i), 11(c)(ii) and 13 of Section III “Adjustable Items of Transaction Value” of the Rules detail the situations under which royalty or license fee may be included or excluded from the customs value of a good. Specifically, royalties and license fees that a buyer must pay to the seller or a relevant party, whether directly or indirectly, must be included in the customs value, except where the royalties and license fees:

- Are not related to the imported goods; **or**
- Are not paid as a condition for the sale of the goods to China.

We note that the WTO ACV approaches this from the opposite direction, i.e., royalties are included if they are related to the goods **and** is a condition of the sale for export to the country of import.

Companies should take note that royalties paid to the seller or to a relevant party are applicable. The reference to “a relevant party” is quite significant. This means that, besides royalty payment made directly or indirectly to the seller, payment made to a completely independent third party outside of the actual sale of the good may also be considered a part of the value for customs purposes.

iii. Royalty Related to Goods

The legislation is quite specific in describing the various situations in which a relationship is deemed to exist:

- (1) When royalty is paid for the right to or the right to use a patent or know-how and the imported good:
- Contains the patent or know-how;
 - Is produced using patented methods or patented know-how; or
 - Is specially designed or manufactured to perform the patented process or know-how.



(2) When royalty or license fee is paid for the right of to use a trademark, and the good

- Bears that trademark;
- Can be sold directly with the trademark affixed after importation; or
- Already has the right to the trademark when imported and can be sold with the trademark affixed after minor processing.



(3) When royalty or license fee is paid for the copyright and the good:

- Contains software, words, music, pictures, images and other similar contents which are in the form of magnetic tapes and disks, CDs and other similar media; or
- Contains other copyrighted content.



(4) When royalty or license fee is paid for the right to distribute or resell or other similar rights and the good:

- Can be resold directly after importing; or
- Can be resold directly after minor processing.



iv. Royalty as Condition for Sale of Goods to China

Article 14 of the Rules identifies two instances whereby royalty is deemed a condition for the sale of goods to China:

- Where the buyer cannot buy the imported goods without payment of royalties and license fees; or
- Where the sale transaction cannot be concluded without payment of royalties and license fees.

v. Franchise Fees

If a company is paying franchise fees, then there is a need to determine whether such fees fall within the conditions mentioned above and as such, form part of the value for customs purposes.

Customs Audit of Related Party Transactions

China Customs is also likely to increase enforcement and audit efforts on related party transactions in 2010/11, especially in light of the upsurge in direct tax audits of related companies by the SAT. With the new reporting and documentary requirements of SAT, China Customs will expect ample paperwork to be available for its audits.

Customs valuation rules for related party transactions are quite different to those for direct tax. Under the WTO ACV, customs valuation focuses on the actual cost of the goods plus profit, and there are several methods available to determine the actual value.

There are several scenarios for which a company in China has to carefully examine its transactions with a related overseas party.

- If the company transacts the movement of goods with the related overseas entity at cost or less, or at a price not reminiscent of a sale to an unrelated company, then it needs to “test” the transaction value.
- If the value that the company is declaring to China Customs for a sale from a related overseas party is subject to other conditions and possible further payments, there is a need to determine whether such conditions and payments have an effect on the value declared to Customs.
- If a management fee is paid to or for the benefit of the seller of the imported goods and that seller is the foreign parent company or a related overseas entity, the company may need to check these fees to ensure that they can legitimately be excluded from the customs value.
- If the transaction value between the company and a related overseas entity is based on the direct tax transfer pricing methodology as outlined under the OECD rules, there is a need to look at the way the transfer price was achieved and whether it is fully compliant with customs rules on valuation in China.

If you are not currently including royalty payments as part of the customs value of imported goods or goods you are manufacturing in China, or if you have not considered transfer pricing from the customs perspective, it may be timely to give your operations in China a thorough health check to ensure that you are fully compliant with China Customs laws.



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