

## Tax

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# Tax Analysis

## Chinese Customs will apply new requirement on declaration of dutiable royalties from 1 May 2019

On 27 March 2019, China's General Administration of Customs (GAC) issued guidance (Bulletin 58) on the declaration of dutiable royalties (i.e. royalties that must be included in the dutiable value of imported goods), an area that has been scrutinized by the Chinese customs authorities and fraught with uncertainty. Bulletin 58 will apply as from 1 May 2019.

### Background

According to China's customs valuation rules, royalties that the buyer must pay, either directly or indirectly, must be included in the dutiable value of imported goods (i.e. being dutiable) if both of the following conditions are fulfilled:

- The royalties are related to the imported goods; and
- The payment of the royalties is a condition of the sale of the import of the goods into Chinese territory.

In recent years, Chinese customs authorities have enhanced their monitoring of dutiable royalties by conducting post-import audits or investigations, and pursuing underpaid import taxes by adding back dutiable royalties to the dutiable price of imported goods because, in practice, royalties are often separately charged from the purchase price of goods. However, until the issuance of Bulletin 58, there was no formal guidance on how importers should make voluntary self-declarations of dutiable royalties and practices were inconsistent.

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## Highlights of Bulletin 58

### Scope

Bulletin 58 applies only to the declaration and payment of dutiable royalties. Other adjustments to the transaction value (such as commission and brokerage expenses, container expenses, packing material expenses, packing service fees, assistance fees, proceeds of subsequent resale, etc.) are not governed by Bulletin 58.

The term "royalties" is defined in the Chinese customs valuation rules as the fees paid for the right to use or transfer patents, trademarks, copyrights, know-how, and distribution or selling rights. It should be noted that the definition of royalties for customs valuation may not be same as the definition for other taxes; for example, royalties under an income tax treaty may include payments for leasing equipment or certain technical services, whereas these payments would not be considered royalties for customs valuation purposes.

### "Confirmation of royalty payment"

When preparing a customs declaration form (CDF), an importer must fill in a column "Confirmation of royalty payment." Bulletin 58 revises the requirements for completing this column as follows:

Before 1 May 2019	After 1 May 2019
<p>State "yes" in the following situations:</p> <ul style="list-style-type: none"><li>The buyer must pay the royalties directly or indirectly to the seller or related parties where the royalties are not included in the price paid or payable for the imported goods and the royalties are related to the imported goods.</li><li>The buyer must pay the royalties directly or indirectly to the seller or related parties where the royalties are not included in the price paid or payable for the imported goods, but the taxpayer is unable to determine whether the royalties are related to the imported goods.</li></ul> <p>State "no" in the following situations:</p> <ul style="list-style-type: none"><li>The buyer must pay the royalties directly or indirectly to the seller or related parties where the royalties are not included in the price paid or payable for the imported goods and the taxpayer determines that the royalties are <i>not</i> related to the imported goods.</li><li>The buyer must pay the royalties directly or indirectly to the seller or related parties where the royalties are included in the price paid or payable for the imported goods.</li><li>The buyer does not have to pay royalties directly or indirectly to the seller or related parties.</li></ul>	<p>State "yes" if the buyer must pay dutiable royalties directly or indirectly to the seller or related parties, regardless of whether the royalties are included in the price paid or payable for the imported goods.</p> <p>State "no" if the buyer does not have to pay dutiable royalties, directly or indirectly, to the seller or related parties.</p> <p>A taxpayer generally is not required to complete the item for exported or customs-bonded goods.</p>

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The focus of the current guidance is on determining whether the royalties are "related to the imported goods" as opposed to whether they are "dutiable." Even if the royalties are related to the imported goods, they may not necessarily be dutiable if the payment of the royalties is not a condition of the sale of the imported goods into China ("condition-of-sale test").

The rules under Bulletin 58 may shift more responsibility to the taxpayer, since the taxpayer will have to determine whether the royalties are related to the imported goods and meet the condition-of-sale test to ascertain whether the royalties are dutiable. In practice, many disputes arise between importers and the customs authorities as to whether the payment of royalties is a condition of the sale of imported goods.

Another key difference between the current guidance and Bulletin 58 is the treatment of royalties that already are included in the import price paid or payable. Currently, a taxpayer is required to state "no" on the declaration form for all such royalties, but Bulletin 58 requires the taxpayer to state "yes" or "no," depending on the dutiability of the royalties.

Due to the changes in how taxpayers are to file their declarations, affected businesses should review their filing practices for royalties and consider whether any changes are needed.

#### *Self-declaration of dutiable royalties*

#### **A. Dutiable royalties paid before a customs declaration is made for the imported goods (Case A)**

When a taxpayer declares the imported goods and completes the corresponding CDF, any dutiable royalties that were paid before the declaration must be included under "Miscellaneous expenses" rather than "Total value" in the CDF. The relevant work flow process can be illustrated as below:



#### **B. Dutiable royalties are not paid before declaring the imported goods (Case B)**

In most cases, taxpayers pay the dutiable royalties after the imported goods are declared. Bulletin 58 will require taxpayers to make a separate self-declaration of dutiable royalties after the royalties are paid. To self-declare, the taxpayer will have to file a separate CDF (under the customs supervision code 9500, which applies to post-import dutiable royalties), along with a "Declaration form for dutiable royalties." The relevant work flow process is as follows:

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The deadline for making a declaration of post-import dutiable royalties is 30 days after each payment.

When filing the CDF to declare post-import dutiable royalties under the customs supervision code 9500, the taxpayer will need to include the name and HS code of the originally imported goods. In addition, the taxpayer must complete a "Declaration form of dutiable royalties" and provide the following information:

- The number of the original CDF that was filed when the goods were imported;
- The contract/agreement and invoice and evidence that the royalties were paid;
- A withholding tax clearance certificate issued by the tax authorities for the royalty payment; and
- Written explanations documenting that the royalties are related to the imported goods and that the payment is a condition of the sale of the import of the goods into the Chinese territory.

The separate post-import declaration of dutiable royalties requires much information relating to the original import of the goods. This may create challenges for taxpayers since, it is often difficult to match the payment of royalties with various flows of imported goods.

#### *Duty rate and foreign exchange rate*

For Case A taxpayers, Bulletin 58 requires the customs authorities to use the duty rate and foreign exchange rate prevailing on the day customs accepts the declaration of the goods to assess import taxes on the dutiable royalties.

For Case B taxpayers, Bulletin 58 requires the customs authorities to use the duty rate and foreign exchange rate prevailing on the day customs accepts the declaration of dutiable royalties (rather than the rate on the day customs accepts the declaration of import of the original goods) to assess the import taxes on the dutiable royalties. This approach is simple and practical, since it likely will be difficult for taxpayers to match the royalties with various flows of imported goods.

#### *Late payment surcharges*

Bulletin 58 provides that a daily 0.05% late payment surcharge will be imposed on any outstanding import taxes if the taxpayer fails to declare the dutiable royalties within the prescribed timeframe. The charging period will differ, depending on the situation:

- If the taxpayer incorrectly inserts "no" in the "Confirmation of royalty payment" column when declaring the imported goods, the charging period will commence on the date the import taxes on the goods were paid or the goods were released from customs and end on the date customs discovers the violation.
- If the taxpayer inserts "yes" in the "Confirmation of royalty payment" column when declaring the imported goods, but then fails to declare the dutiable royalties within the prescribed timeframe, the charging period will commence on the deadline for the declaration of dutiable royalties and end on the date the taxpayer actually declares the dutiable royalties or when customs discovers the violation.

Two examples illustrate the duration of the charging period:

1. On 1 May 2019, Company A imports goods and pays import taxes. The goods are released by customs on the same day. When declaring the goods, Company A states "no" in the CDF "Confirmation of royalty payment" column. On 10 October 2019, Company A pays royalties to an overseas seller, and on 30 December 2019, customs discovers that the royalties should have been included in the dutiable value of the imported goods, thus resulting in underpaid import taxes. The charging period for the late payment surcharge starts on 1 May 2019 and ends on 30 December 2019.
2. On 1 May 2019, Company B imports goods and pays import taxes. When declaring the goods, Company B states "yes" in the CDF "Confirmation of royalty payment" column. On 10 October 2019, Company B pays the dutiable royalties to an overseas seller, but later fails to declare the royalties. On 30 December 2019, customs discovers that the royalties should have been declared and included in the dutiable value of the imported goods, thus resulting in underpaid import taxes. The charging period for the late payment surcharge starts 30 days after 10 October 2019 and ends on 30 December 2019.

Before the issuance of Bulletin 58, it was unclear whether the customs authorities would impose a late payment surcharge on underpaid import taxes due to a taxpayer's failure to include dutiable royalties. In practice, customs seldom imposes late payment surcharges in these situations, but this may change once Bulletin 58 becomes effective. Taxpayers should adopt a technical position and make timely and accurate declarations in cases where they believe the relevant royalties are dutiable. Otherwise, there may be exposure to surcharges. Where the risk of late payment surcharges arises, taxpayers may consider applying for an exemption or a reduction of the surcharges (if eligible) by voluntarily disclosing the noncompliance to the customs authorities.

#### *Transfer pricing considerations*

When affected businesses are assessing the customs risk in relation to royalties, they also should consider potential transfer pricing implications. The Chinese tax authorities have been stepping up their scrutiny and investigation of service fee and royalty payments made to overseas related parties by Chinese companies. In October 2012, the State Taxation Administration expressed its views on royalties in the "China Country Practice" session of the UN Practical Manual on Transfer Pricing for Developing Countries. In one of the cases discussed, where a Chinese affiliate was paying royalties to overseas related parties at a fixed rate for 10 years, the administration pointed out that factors such as technological advancements and the local affiliate's contribution to the intangibles should be taken into account in determining whether and how to change the royalty rate. The taxation administration has been closely examining whether foreign affiliates make contributions to intangibles in their transfer pricing investigations. Royalties paid to foreign affiliates by loss-making companies or royalties paid to foreign affiliates that are registered in tax havens or low-tax jurisdictions and merely hold the legal ownership of intangible assets without contributing value to the assets are likely to trigger the attention of the tax authorities.

Taxpayers may wish to consider assessing both the customs and transfer pricing risks and possible changes to existing business arrangements. For example, a group may want to look at whether to charge a separate trademark licensing fee to the Chinese subsidiary acting as a product reseller in China or to factor the licensing fee into the import price of the relevant products. Specifically, a group may consider the following actions:

- Review the economic substance of the royalties to identify whether any duplicate payments exist;
- Consider the withholding tax implications associated with the royalty payment; and
- Evaluate the current transfer pricing policy of royalties and the associated changes to the business environment and functions/risks of relevant entities and decide whether pricing changes are necessary.

## Recommendations

The issuance of Bulletin 58 should be welcome as it provides guidance on how to complete the self-declaration of dutiable royalties and may help to standardize the practices of the customs authorities. However, questions still may arise in determining whether certain royalties are dutiable and how much duty should be imposed, and it may be difficult for taxpayers and customs to reach a consensus on these issues in certain cases.

Some companies have been using the customs supervision code of 9700 to declare the dutiable royalties, where, unlike the voluntary self-declaration under Bulletin 58, the declaration must be completed after a dutiable price audit is initiated and concluded by the customs authorities. Technically, Bulletin 58 does not eliminate this declaration approach, so potentially affected companies may need to confirm with the customs authorities whether they need to switch to the voluntary self-declaration mechanism under Bulletin 58 after 1 May.

Taxpayers should consider taking the following actions:

- Thoroughly study the new guidance and fully understand the relevant compliance requirement in relation to dutiable royalties. To correctly declare dutiable royalties in a timely manner, a taxpayer may need to coordinate the relevant internal departments such as logistics, customs affairs, finance, legal, etc. and ensure the sharing of information among the departments.
- Regularly review business and pricing arrangements in relation to the royalties and other non-trade payment, collect relevant documentation or information such as import agreements, technical data, etc. and assess the risk of them being dutiable.
- To increase certainty, consider applying for advance rulings in relation to the dutiability of certain royalties, especially before significant changes are made to a business model.
- Carefully prepare the relevant materials to support the desired technical position in relation to the dutiability of royalties, and actively communicate with the customs authorities to ensure the position is understood and accepted by the authorities.
- Where noncompliance (such as failure to declare dutiable royalties) is discovered through self-reviews, consider utilizing the volunteer disclosure program to apply for a possible exemption or reduction of late payment surcharges or other penalties, or an exemption from receiving a downgraded customs compliance rating.
- Review and improve the relevant business and pricing documents from a transfer pricing perspective, review the legal and economic ownership of relevant intangible assets, and prepare supporting documents to substantiate the contributions by each party to the value creation to the intangibles.

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