Deloitte.

Dbriefs

Impact of US trade policies in Asia Pacific: The changing landscape

The Dbriefs Indirect Tax series

Sarah Chin / Robert Olson / Meng Yew Wong

19 December 2018

Agenda

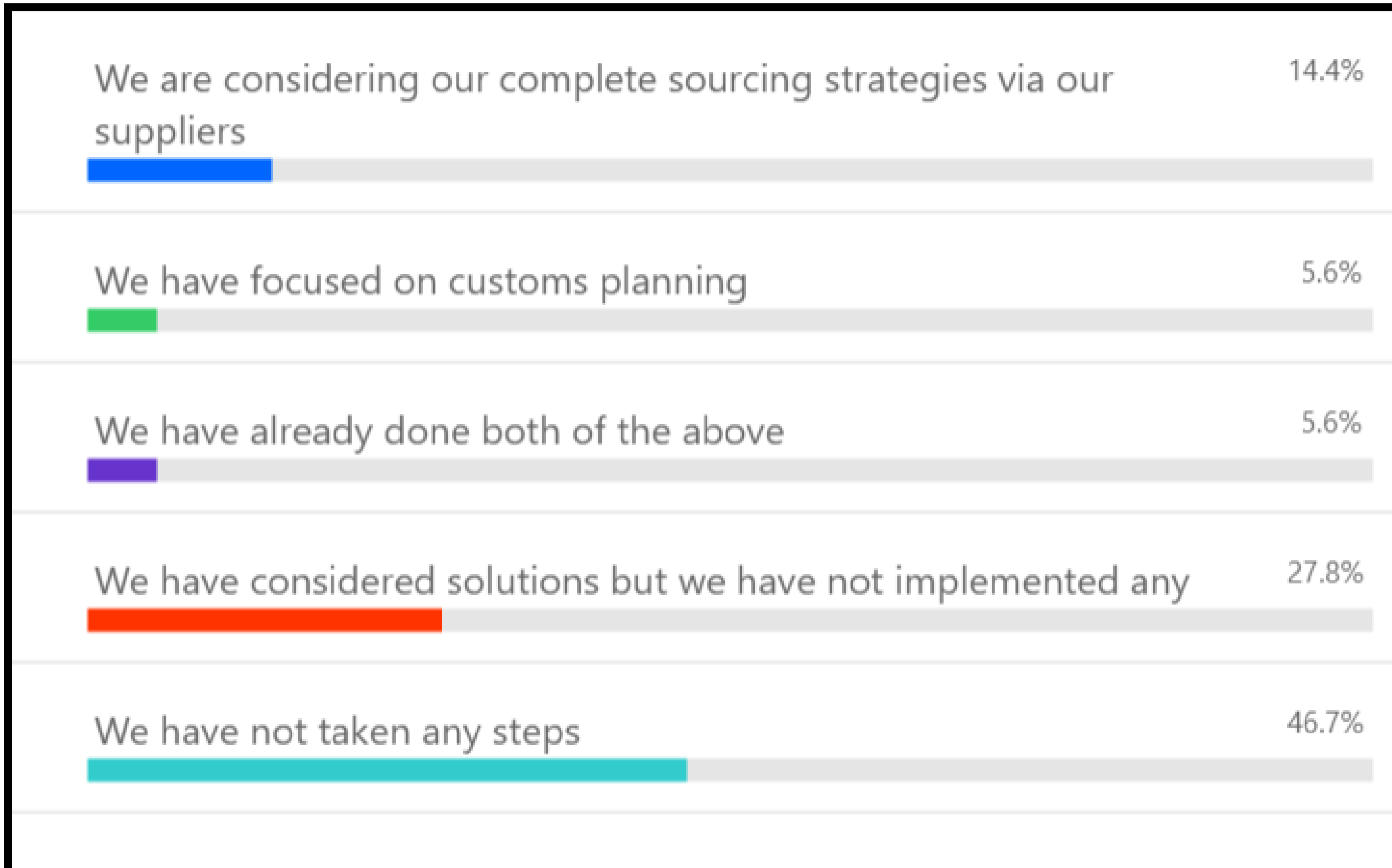
- Recent events surrounding US and China trade relations
- Impact on Asia Pacific region
- Strategies for managing tariff expenses
- Key takeaways
- Questions and answers

Polling question 1

What step is your company taking regarding the effect of the China-U.S. trade discussion?

- We are considering our complete sourcing strategies via our suppliers
- We have focused on customs planning
- We have already done both of the above
- We have considered solutions but we have not implemented any
- We have not taken any steps

Polling results from Dbriefs webcast on 18 September 2018



Recent events surrounding U.S. and China trade relations

Recent events surrounding U.S. and China trade relations
The 90 day truce

Background

- On 1 December, Presidents Xi and Trump met on the sidelines of G20 meeting in Buenos Aires
- It was announced that U.S. and China had agreed to pause the trade discussion for 90 days

What was agreed?

1. 90 day freeze on additional or increased tariffs (U.S.)
2. Ends on 1 March 2019 (U.S.) or ends on 1 April 2019 (China)
3. China to purchase substantial amounts of agricultural, energy, industrial, and other products
4. Immediately begin negotiations on structural changes with respect to forced technology transfer, IP protection, non-tariff barriers, cyber intrusions and cyber theft, services, and agriculture
5. China agreed to designate fentanyl as a controlled substance, which would allow for China to impose the "maximum penalty under the law,"

The 90 days truce

- On 19 December, the U.S. published an official delay to the planned increase in tariff rates on $200 billion worth of Chinese imports from 10 per cent to 25 per cent to permit further negotiations
- If there is no deal at the end of the 90-day period, the rates will automatically increase on 2 March 2019

Lead negotiator Robert Lighthizer has said

- Negotiations must produce structural changes in China that protect U.S. technology and intellectual property and increase market access for American companies
- "It's not just a dialogue strategy. It's a strategy of tariffs and taking hard lines"
- "We need an open market or a more open market. More access by American companies. We need protection of intellectual property. We need to stop cyber theft. We need to stop forced technology transfer, that is to say giving your technology in order to do business in China"

The 90 days truce (Cont'd)

On 14 December 2018, China announced CTCSC Bulletin [2018] No. 10 which suspends, for a period from **1 January 2019 to 31 March 2019**, imposition of the additional tariff on cars and car parts originated from the U.S.

Suspension list	Number of HS code items	Corresponding previous announcement	Original additional tariff rate	Effective date of original additional tariff
Suspension List 1	28	CTCSC [2018] No.5	25%	6 July 2018
Suspension List 2	116	CTCSC [2018] No.7	25%	23 August 2018
Suspension List 3	67	CTCSC [2018] No.8	5%	24 September 2018

On 14 December, China also announced the purchase of 1.13 million tonnes of U.S. soybeans for January delivery.

Additionally, China has made moves related to IP reforms in December

- **4 December** – China released a document announcing an array of punishments for patent infringement, including restrictions on access to loans and government funding by the National Development and Reform Commission and People's Bank of China
- **5 December** – Draft amendments to the Patent Law were approved by the State Council for submission to the National People's Congress for deliberation

Strategies for managing tariff expenses
New agreements under CEPA

On 12 December and 14 December 2018, Mainland China signed new agreements for the liberalization and facilitation of trade in goods and services under the Closer Economic Partnership Arrangement ("CEPA") with Hong Kong and Macao.

Key point

- Implement a zero duty rate from 1 January 2019
- Introduce a general rule of origin
- Stipulate commitment to facilitating trade

Potential opportunity

- Review the origin to see whether the goods satisfy the rules of origin and can enjoy zero rate of duty under CEPA
- Adjust current supply chains to enable the imported goods to qualify under CEPA

Recent events surrounding U.S. and China trade relations

In the news: effect on global supply chains – leaving China

China Electronics Mfr

- Maker of Apple accessories
- Profits down 38% at mid-year
- Moving production from Shandong, China to Vietnam

Japan/South Korea LED Panels Mfrs

- Both companies had LED display factories in Hangzhou, China
- One announced plant closure in mid-2018
- The other followed recently

Taiwan Electronics Mfr

- Company adding final assembly lines in the U.S. state of Illinois
- Company will also expand sales offices in U.S.

Taiwan Bicycle Mfr

- World's largest maker of bicycles based in Taiwan
- Diversifying production away from China to Eastern Europe

Source: Nikkei Asian Review

Recent events surrounding U.S. and China trade relations

In the news: effect on global supply chains – new opportunities

South Korea Network Equipment Mfr

- Leading consumer and business electronics manufacturer
- New opportunities in telecom market
- Additional opportunities if U.S. expands 301 tariffs to cover all Chinese products

Taiwan Semiconductor Mfr

- Taiwan based chip packaging and testing company
- Customers include Toshiba, Micron, Western Digital, and Intel
- Seeing substantial increase in business as customers shift away from China

Singapore Agribusiness Firm

- Agribusiness conglomerate based in Singapore
- Large increase in almond shipments from Australia to China based on tariffs
- Large increase in soybean shipments from Brazil to China based on tariffs

Hong Kong Logistics Provider

- Global logistics company based in Hong Kong
- Benefiting from accelerating shift in production away from China (electronics, apparel, household items, toys, and other products)
- 27% increase in revenue during first half of 2018

Source: Nikkei Asian Review

Polling question 2

What has been your reaction to the 90 days truce?

- We are very excited and have already started reordering some products that won’t be charged with a 25% high rate
- We are cautiously optimistic
- Uncertain/need more information
- Don’t know/not applicable

Impact on Asia Pacific region

Impact of recent U.S. trade policies on APAC

Highlights

1. Restructuring of supply chains
2. Impact on trade agreements – renegotiations and terminations
3. Trade remedy actions – rise of "safeguard" actions

Impact on Asia Pacific region

Highlights – reset of regional manufacturing supply chains

India

- Trade surplus of $19bil with the U.S.
- India exports of chemicals, pharmaceuticals, electrical parts ("not yet a beneficiary")
- Issue with expanding capacity
- Subject to increased duties in the U.S. on steel & aluminium products
- Subject to GSP review of Indian products entering U.S. market

Malaysia

- Trade deficit of $21.9bil with the US
- Likely to be major beneficiary of "import substitution", with some benefits from "manufacturing destination"
- Top exports include E&E, components, machinery, chemical and petrochemical products sector, medical sector
- Trying to regain foreign investor confidence under new Government

Singapore

- Trade deficit of $4.4bil with the U.S.
- Beneficiary of "import substitution" and also for access into US Government Procurement market (SG is party to the WTO Agreement on Government Procurement, and has an FTA with the U.S.)
- Major products exported include chemicals, machinery, E&E products, optic & medical devices

Korea

- Trade surplus of $15bil with the U.S.
- China and U.S. accounted for 24.8% and 11.9% respectively of South Korea's total exports
- Top exports include consumer electronics, semiconductors, automobiles, other intermediate goods
- Likely to benefit from "import substitution" to China, (e.g., semiconductor)

Vietnam

- Trade surplus of $33bil with the U.S.
- Most successful in attracting manufacturing out of China
- Lower costs, tax incentives, free trade zones, customs facilitation
- E&E equipment, machinery, apparel, footwear, furniture
- FTA connectivity increasing, 2nd ASEAN country to sign with EU

Indonesia

- Trade surplus of $13.2bil with the U.S.
- Top exports include commodities (coal, rubber, palm oil, steel, aluminium, and iron)
- Less impact on 'import substitution' but as an added 'manufacturing base' due to its large population size exceeding 200 million
- Historically, fewer FDIs into manufacturing due to the eco-system

Japan

- Trade surplus of $56bil with the U.S.
- Top exports include automobiles, machinery, computers, iron and steel
- Benefit from "import substitution" by exporting more products to the U.S. and China respectively

Thailand

- Trade surplus of $20bil with the U.S.
- Top Thai exports to the U.S. include electrical machinery, rubber, precious metals, stone/jewellery, vehicles and agriculture.
- Tariffs in U.S. and China may see Thai exports benefit from "import substitution"

Philippines

- Trade surplus of $3bil with the U.S.
- Less exposure to U.S. and China market compared to ASEAN
- Key exports include agriculture products and electronics
- Push by Government to modernize laws to attract FDI

Australia

- Trade deficit of $12.5bil with the U.S.
- Top exports include LNG, will benefit from U.S.-China trade discussion due to tariffs on U.S.-origin LNG into China
- US tariffs on steel imports from China could affect iron ore and coal exports
- Australia's agriculture sector stands to gain - exports of Australian tree nuts to China grew from $6 million in 2010-11 to $63 million in 2015-16

Impact on Asia Pacific region

Highlights – impact on free trade agreements

1. Impact of the TPP 'pull-out' by the U.S. on APAC countries

- On 23 January 2017, Trump signed an executive order to withdraw US from the TPP. Parties to modified TPP-11 signed the CPTPP on 8 March 2018 (expected entry into force in 2019)
- TPP no longer the "model agreement" for U.S. to enter into bilateral or enforce "high-standard provisions" under the TPP related to IP, labour standards, disciplines on SOE and Government Procurement, e-commerce, competition, environmental protection, to existing and incoming countries (Thailand, Korea, Indonesia previously mulling joining the TPP)
- CPTPP still contains "high-standards" and affords greater market access than without the agreement. Structural reforms under the TPP will benefit further FDI into relevant APAC markets, (i.e., Vietnam and Malaysia in particular)
- Even without the US, the TPP will be able to help signatories (including incoming member) to reduce dependency on major economies for a successful trade agreement

2. Renegotiation of FTA's

- Only 3 countries in APAC currently have FTAs with the U.S., (i.e., Spore, Australia, and Korea). KORUS has recently been renegotiated with additional concessions being given by Korea to the U.S. in the automotive and agriculture space
- With new NAFTA signed between the US, Canada, and Mexico on 30 November 2018, this may form the new "Model Trade Agreement" used by the U.S. for its FTAs moving forward

Impact on Asia Pacific region

Highlights – trade remedy use

1. Increased trade disputes and actions

- Section 232 of the Trade Expansion Act 1962 provides the President with the ability to impose restrictions on certain imports based on an affirmative determination by the Commerce Department that the product under investigation is imported into the U.S. in "such quantities" or "under such circumstances" as to threaten to impair the national security
- President's imposition of tariffs on steel and aluminium imports (as well as exemption of certain countries) may have implications for the U.S. at the WTO level (c.f. challenge by China in this regard)
- Crosshairs between the US and India surrounding (i) export subsidies given by India alleged by U.S. to be tied to export promotion programmes, special economic zones and duty-free imports for exports; and (ii) high duties imposed by the US on steel and aluminium products exported by India into the U.S. (i.e., whether WTO compliant)

2. Impact on APAC

- Above could impact sourcing chains generally - diversion of steel orders to SEA (e.g. Korea and Japanese companies have set up steel mills in Vietnam, Malaysia, Indonesia, Thailand, etc.). These countries could benefit
- Related concerns surrounding dumping of excess capacity from China due to additional tariffs into the U.S. This may result in increased investigations from authorities within APAC. India, Australia, Malaysia, historically active users of anti-dumping investigations (note: period of 1 to 3 years usually required to gather evidence/statistics of dumping to substantiate action. Alternatively, country may invoke rights under WTO (security exception) to increase tariffs on dumped products)

Strategies for managing tariff expenses

Strategies for managing tariff expenses

Four primary “levers” for managing customs duties owed

Duties owed

1 +

Customs value
Provides basis for duty calculation in most cases (except when rates are based on weight or other unit of measure)

2 +

HTS classification and duty rate
Determines general and special duty rates for specific goods

3 +

Country of origin
Determines which rate for a specific good applies

4 =

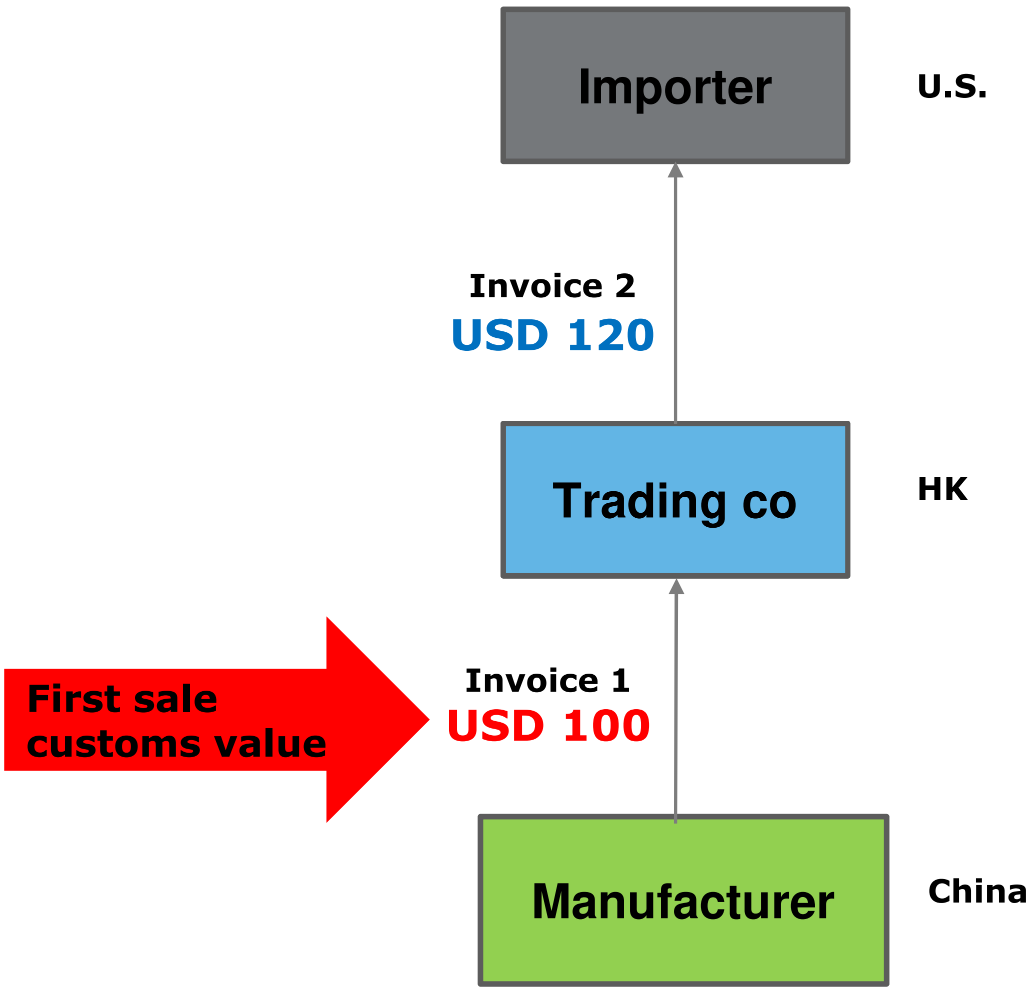
Duty relief and refund programs
Relieve or recover all or part of duties normally owed

$

Just like other taxes, duties can be managed using the 4 levers that feed into it

Strategies for managing tariff expenses

First sale for export example



- Customs duties are commonly assessed on the value of imported goods, which is traditionally based on the price paid by the importer
- Companies that import under a multi-tiered distribution structure can significantly reduce duty costs by employing the "First Sale" valuation method
- The "First Sale" valuation method can be used for importations into the United States
- Under this method, customs duties are assessed upon the "manufacturer-to-middleman" sales price, which may be significantly lower than the traditional assessment based on the "middleman to importer" sales price

Strategies for managing tariff expenses

First sale for export requirements

FSFE Requirements

CLEARLY DESTINED

- Product identifiers to indicate that the goods are made for the U.S. market

ARMS LENGTH

- The FSFE value must be at arm’s length, fully costed price where the vendor is related to the manufacturer
- For related party sales, an analysis must be completed to demonstrate arm’s length prices, (e.g., negotiations, operate as unrelated parties, profitability)

BONA FIDE SALE

- At least two bona fide sales must exist, first from the manufacturer to the vendor, and second, from the vendor to the U.S. importer

Other requirements

- The value declared must be auditable by the Authorities
- Reasonable care is a standard established by U.S. customs
- Importer is responsible to ensure that the FSFE value is valid with documentation to support

Strategies for managing tariff expenses

Case study: first sale for export

Typical import transaction

- U.S. importer purchases an item from a middleman at $12 per unit
- The original purchase price from the manufacturer is $9
- Assume duty rate of 15%
- If importing 30,000 units at the **second sale** price of $12, the importer pays duties of $54,000

Product qualifying for first sale transaction

- U.S. importer purchases the same item from the middleman at $12 per unit
- The original purchase price from the manufacturer is $9
- Assume duty rate of 15%
- If importing 30,000 units at the **first sale** price of $9, the duties paid are reduced to $40,500, a savings of $13,500, or 25%
- Across $100 million in annual purchased goods, the first sale duty reduction of 25% translates to a savings of $3.75M

Strategies for managing tariff expenses
FTA overview

- Prominent feature of global trade for WTO member countries
- International agreements to grant preferential market access to its members
- In many cases lower than the prevailing applicable general rate of duty (the MFN rate)
- Two major types of FTAs
  - Multilateral
  - Bilateral
- Goods can only qualify for preferential duty rates if they meet the Rules of Origin (ROO) employed by the particular FTA
- The ROO determines whether or not an item qualifies for free trade benefits, or is considered as “originating”

Strategies for managing tariff expenses

FTA overview (Cont'd)

U.S list of regional Trade Agreements in force

- North American Free Trade Agreement (NAFTA) – Canada; Mexico; United States of America
- Dominican Republic – Central America – United States Free Trade Agreement (CAFTA-DR)
- United States – Australia
- United States – Singapore
- United States – Republic of Korea
- United States – Bahrain
- United States – Chile
- United States – Colombia
- United States – Israel
- United States – Jordan
- United States – Morocco
- United States – Oman
- United States – Panama
- United States – Peru

Strategies for managing tariff expenses

How is origin determined for these special tariffs

Non-preferential origin

- Section 301 of The Trade Act of 1974 does not include a specific definition of country of origin. We therefore default to U.S. Customs' standard for non-preferential origin: **substantial transformation**
- Under this standard, the origin of an imported item is the last country in which the goods were substantially transformed into a new and different article of commerce
- This is distinct from preferential origin rules

Origin

Preferential origin

- For special duty programs, (e.g., generalized system of preferences) or trade agreements, (e.g., NAFTA), specialized sets of rules exist to determine whether items qualify for the tariff benefit. These types of rules include
  - Local content requirements
  - Regional content requirements
  - Tariff shift rules
- These are not the rules that apply to imports into the U.S. that are subject to Section 301 tariffs

Strategies for managing tariff expenses

Case Study: preferential vs non-preferential origin

U.S. customs reconsiders ruling on NAFTA and Section 301 tariffs

- Company requested ruling from U.S. Customs
- Moving production from China to Mexico
  - Electric motors will be assembled in Mexico from China origin parts
- Mexico production qualifies product as MX originating under NAFTA
- **Does qualification as MX originating under NAFTA shield product from Section 301 tariffs?**
- **Is the product "substantially transformed" so that Section 301 tariffs do not apply?**

Product qualifies for NAFTA, but is still subject to Section 301 tariffs

- **No. Not in this case.** the planned production in Mexico does not substantially transform the China origin parts
- NAFTA and Section 301 tariffs are governed by different origin rules
  - NAFTA is governed by specific preferential rules or origin
  - Section 301 tariffs are subject to general rule or origin, (i.e., substantial transformation)
- Company will need to localize more production to meet substantial transformation test to avoid application of Section 301 tariffs
- **Companies need to consider both sets of rules**

Key takeaways

Key takeaways

- In this Dbriefs we have highlighted the most recent developments in the U.S.-China trade discussion and some of the impacts on the broader Asia Pacific region
- The U.S. and China trade discussions may be at an inflection point, but could easily continue further into the future if the "pause" generate a feeling of progress
- Making changes is BIG decision, however there are quick and relatively simple steps that can be taken to ensure that optimizing your duty spend
- If the "pause" does not lead to improving trade relations between China and the US, we expect to see continued changes the duty environment, and a possible shift beyond tariffs that could include issues with residents, business travelers, and intellectual property. We could even see the US begin to pull away from global institutions that it helped found, such as the WTO
- Look through a wider lens
- We have both technical and automated solutions (data analytics – Global Trade Radar, Classification Automation Tool) that can help you to analyze the impact of these changes on your current supply chain and help model changes

Questions and answers

Thanks for joining today’s webcast.

You may watch the archive on PC or mobile devices via iTunes, RSS, YouTube.

Eligible viewers may now download CPE certificates. Click the CPE icon at the bottom of your screen.

Registrations for the 2019 Q1 (January – March) Dbriefs Asia Pacific webcast program will be available in early January.

For more information, visit www.deloitte.com/ap/dbriefs

Contact information

Sarah Chin
Tax Partner
Deloitte Hong Kong, China
sachin@deloitte.com.hk

Robert Olson
Tax Senior Manager
Deloitte Hong Kong, China
robolson@deloitte.com.hk

Meng Yew Wong
Tax Partner
Deloitte Singapore
mewong@deloitte.com

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the “Deloitte Network”) is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.