**Foreign Economic Policy | Customs**

**GEMEINSAME ERKLÄRUNG I THEMA**

Anlage: Positionsentwurf EU-China-Zollbeziehungen

**Requirements Regarding Customs Inspections in China from the Perspective of German Industry**

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Introduction

In the context of customs audits in China, there is currently no legal certainty regarding international WCO/WTO standards in China from a customs valuation perspective. Chinese subsidiaries of German enterprises are increasingly confronted with disproportionate demands for evidence and in part, incomprehensible interpretation and tax assessment practices in the context of customs audits in China.

# Summary

The Chinese customs authorities have recently been intensively examining customs valuation issues. A standardized procedure has been defined with regard to audit methodology, interpretation practice and duty determination for customs valuation in China.

On the basis of the following examples, we consider the risk to be very high that, despite a comparable legal basis in China, the interpretation of certain facts may deviate from the usual assessment practice of WCO-/ WTO standards and manifests itself for the future.

For this reason, the following requirements for the audit behavior of the customs authorities in China are a fundamental prerequisite for the future activities of German companies in China. An improvement of the associated framework conditions is of central importance.

* The customs valuation should take current market conditions into account and accept the prices actually paid.
* Customs authorities should accept standard commercial practices to substantiate the order.
* The principle of proportionality should be respected when requiring evidence. Certificates from independent third parties should be accepted as evidence in the formation of transfer pricing.
* When determining gross margins for customs purposes, transparent determination and timely communication should take place.
* The customs valuation of royalties should be examined in accordance with WCO/ WTO standards. Contractual content and written comments from third parties should be accepted as evidence.
* The customs valuation should consider the relevant WCO comments on indirect payments and accepted guarantee costs.

# Background

A key basis for determining customs duties is the so-called customs value for imported goods. In this context, the WTO has defined international standards on the costs to be taken into account for customs valuation. Based on this, China has also formulated a national customs valuation law. In the event of a customs inspection, the respective national customs authority will check whether the customs value requirements are being complied with by the importing company.

In the course of the current customs audits at various companies in China, it can be ascertained that the procedure of the Chinese customs authorities – in terms of legal interpretation and inspection procedures and the associated acceptance of the evidence provided – differs from the approach of customs authorities of other countries. This leads to incalculable risks for the Chinese subsidiaries.

# Facts and Appeals

The following examples delineate the relevant facts and resulting general requirements for customs inspections in China.

## 1. Assessment of Common Commercial Practices

Generally accepted commercial practices are placed in a customs valuation context. This leads to the fact that, according to general assessment, facts not relevant to customs value are included in the assessment basis for customs duties.

**Example 1:**

The authority establishes the idea that the same goods are always sold at the same price for all customers and all markets, regardless of the number of units and the time of sale. They do not recognize different prices due to economies of scale, rationalization effects and the different market power of different customers.

**Appeal:**

Current market conditions (e.g. customer and country specific price differences, price fluctuations etc.) should be taken into account and accordingly the prices actually paid should be accepted. It cannot be assumed that the same goods will always be sold at the same price to all customers and all markets, regardless of quantities and time.

**Example 2:**

* Contrary to common belief, the following actions are currently considered as a transfer of know-how relevant to customs value:
* The issuance of a specification sheet (character of a “wish list” and not a “construction manual”) with requirement criteria when ordering a machine without passing on manufacturing know-how.
* The issuance of a drawing/material specification for the order of standard materials/ catalogue goods to specify standard measures or other quality assurance features without passing on manufacturing know-how.
* Change of dimensions/ measures

Supplier has DIN screws M4\*25mm in standard offer.

M4\*23 mm screws are ordered.

**Appeal:**

Customs authorities should accept customary business practices to specify orders, allowing the possibility to make available specifications and specifications without IP. Accordingly, this should not be considered as transfer of manufacturing know-how for customs purposes without making any distinction.

## 2. Influence on Prices Through Affiliation

Particularly in the case of purchases from affiliated companies, the correct calculation of the customs value of imported goods is regularly questioned.

From a customs valuation point of view, it is crucial that the relationship between the seller and buyer of the goods has not influenced the price of the goods. This is ensured by compliance with the OECD standards, which follow the “arm’s length principle”.

**Example 3:**

As part of customs audits, companies are required to provide appropriate evidence. In this context, the respect of the principle of proportionality is of great importance. Currently, the Chinese customs authorities regularly request evidence of the correct transfer pricing at item number/transaction level for the entire import volume of affiliated companies. With a high import volume and a significant number of part numbers, this can translate to years of manual checking on the company side. Furthermore, these verifications are only accepted to a limited extent, as they are created by the company itself.

If independent certificates are presented (e.g. by external auditing companies), companies are faced with the requirement to have the correct TP and thus customs valuation for their complete import volume from affiliated companies verified by independent certificates on a case by case basis.

**Appeal:**

The principle of proportionality should be respected when requiring evidence. Certificates from independent third parties, such as opinions from external audit firms, on compliance with OECD standards should be accepted as evidence in transfer pricing.

**Example 4:**

In the context of car imports from affiliated companies, the Chinese customs authorities also question whether there is any price influence due to affiliation. To investigate this matter, the Chinese customs authorities have been setting permissible gross margins for Chinese importers themselves since 2014. In our opinion, the procedure described below is not transparent and does not comply with WTO rules.

Once a year, the Chinese customs authorities retrospectively determine the gross margins of all passenger car importers in China (affiliated and non-affiliated companies, of which the affiliated companies are by far the majority) by means of a so-called “pricing investigation” and then set a range of “permissible” gross margins. If importers’ gross margins are below or within this range, the transaction values are recognized. If they are above the range, the transaction values are considered to be influenced – and therefore too low – until proven otherwise by the importer. Counter-evidence of non-interference even if theoretically possible, can hardly be provided in practice and is hardly recognized by the authorities. We have the following serious reservations about this approach:

* The “permissible” gross margins are generated from a pool of largely related importers. Since the determination of margins is fundamentally different from the transfer price perspective (RoS determined from benchmark studies with only non-affiliated companies), there are logical conflicts here; a result that is appropriate from a tax/TP perspective may still be too high from a customs point of view.
* The “permissible” gross margins are determined by customs in a non-transparent procedure (there are no studies by external consultants as in TP).
* The “permissible” gross margins are not announced in advance at the beginning of a planning period so that the margins/prices can be controlled accordingly, but only after a closed period, when the corresponding imports have taken place.
* Whether or not an importer is confronted with a “pricing investigation” depends from year to year on the results obtained by other market participants. This means that even a conservative gross margin achievement may retrospectively be considered too high, if poor results of numerous other importers push down the margin average.

**Appeal:**

The determination of gross margins for customs purposes by the Chinese customs authorities should be transparent, communicated timely (one quarter of the lead time) and be coordinated with the tax authorities.

## 3. Reference of Special/Setting off Payments on Imported Goods

In the case of imports of goods in general, the question arises as to whether the price of the goods is complete at the time of import or whether the buyer of the goods has incurred further costs (e.g. development costs, license fees, etc.) which relate to the imported goods but are not included in the price of the goods.

**Example 5** **(customs value relevance of royalty payments):**

If the importing Chinese legal entity is subject to royalty payments, the question arises whether these payments relate to imported goods and are therefore customs value-relevant.

As part of the checks carried out by the Chinese customs authorities to determine whether licenses paid are related to imported goods,

* a detailed price breakdown of imported parts and components is often requested. However, according to international customs law, price breakdowns are not decisive in determining whether there is a link with the imported goods. A written statement by the manufacturer that the goods were sold at full cost plus a certain profit margin is insufficient according to the Chinese customs authorities. We are critical of the sending of detailed price breakdowns from the company’s point of view and on the basis of existing antitrust law.
* it is intended that all imported goods should indicate for which goods technology or patents are embodied, irrespective of the requirement of licenses for those technology or patents. The compilation of such lists is very costly and disproportional for large import volumes, considering that on the basis of international customs law, this information is not relevant for indicating whether or not licenses are related to imported goods.

**Appeal:**

The customs valuation of royalties should be examined in accordance with WCO/WTO standards. Contract contents and written comments from third parties should be accepted as evidence. The principle of proportionality should be respected when requesting evidence.

**Example 6:**

The Chinese unit bears costs for extended warranties (due to national regulations in CN) and for compensations as a gesture of goodwill. According to WCO Commentary 20.1, these are not relevant for customs value. The Chinese customs authority is generally of the opinion that these costs are relevant to customs value.

**Example 7:**

In the replacement of a defective component in case of warranty by local retail company, the local retail company will be reimbursed for this by the Chinese wholesale distribution unit.

The Chinese wholesale distribution unit is reimbursed for its acquisition costs by the principal in the third country under the guarantee agreement. The difference between the reimbursed acquisition costs and the reimbursement to the retail company (local sales price of the Chinese unit to retailers) is usually borne by the Chinese unit. According to the Chinese customs authorities, this difference in value is relevant for customs valuation.

**Appeal (for examples 6 and 7):**

The customs valuation should take the relevant WCO comments on indirect payments and guarantee costs covered into account.

# Impressum

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