

# CLIENT ALERT

## China Customs Targets Key Industries in Latest Transfer Pricing Enforcement Initiative

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Transfer pricing is a major enforcement priority of China Customs in 2020. In April 2020, China Customs launched a national enforcement action to investigate and audit import transactions between related companies. More than 1000 multinational companies have received notices from China Customs requesting information on their transfer pricing policies and activities.

### 1. Who will be impacted?

China Customs has initially targeted certain industries including companies in the automotive, auto parts, electronics, mechanical, and medical devices industries. China Customs may expand the scope of this enforcement action if it finds similar transfer pricing issues in other industries.

In 2016, China Customs initiated a similar national enforcement action on dutiable royalty payments by companies operating in China to overseas licensors.<sup>1</sup> China Customs started with audits and investigations of companies in the automotive and auto parts industries, and then expanded to electronics, pharmaceutical, machinery, luxury products, and many other industries. This enforcement action lasted for more than two years. Our experience has been that companies that were prepared and organized in their responses to government inquiries associated with the enforcement action were generally able to mitigate damages and penalties.

China Customs initiated a series of reforms beginning in 2018, which included establishing three centralized Tax Collection Centers (TCCs) in Shanghai, Beijing and Guangzhou to scrutinize all import and export transactions across China. The establishment of the TCCs gives China Customs access to broader price data sources to be used to identify high-risk entries for further investigation and verification. Companies that declare a price lower than the average price for the goods across the country, based on information collected by the TCCs, are more likely to be selected by China Customs as targets for audit and investigation.

### 2. Importers have the burden to disprove the influence of the relationship between importers and exporters on the import price

Consistent with the WTO Customs Valuation Agreement, China enacted customs valuation regulations that regard “transaction value” as the primary method of establishing the customs value of imported goods. An important caveat, however, is that the transaction value method applies only if the buyer and seller are not related, or if the buyer and seller are related, the relationship did not influence the import price. This is a key issue for multinational companies that send goods to their related affiliates or subsidiaries operating in China.

A related party import does not, by itself, make the transfer price unacceptable. China Customs, however, may conduct a further [inquiry with the importer about](#) a declared import price if it has reason to doubt that “the [transfer] price may have been

influenced by the relationship between the importer and exporter.” (Article 44 of the Measures of the Customs of People’s Republic of China on Determination of Dutiable Value for Imported and Exported Goods). According to the PRC Customs Audit Regulations, China Customs is entitled to carry out an audit on the acceptability of declared import prices within three years from the date of release by Customs of the goods. (Article 2 of the PRC Customs Audit Regulations).

If China Customs challenges an importer’s declared transfer price, the importer has the burden to prove that such price has not been influenced by the relationship between the importer and its related multinational exporter and therefore constitutes an acceptable basis for China Customs valuation purposes. (Article 17 and Article 18 of the Measures of the Customs of People’s Republic of China on Determination of Dutiable Value for Imported and Exported Goods). Generally, the importer may disprove the influence of the relationship in the following two ways:

- a. The transfer price closely approximates one of the “test values” including the transaction value of identical or similar goods, the deductive value and computed value for identical or similar goods. The test provides importers an opportunity to demonstrate that the transfer price closely approximates a value that has been previously accepted by China Customs and is therefore acceptable for China Customs valuation purposes; or
- b. The transfer price satisfies the “circumstances of the sale test.” No further guidance is provided on the application of the test under China Customs’ valuation regulations. Based on our experience, the test is satisfied if (1) the price is settled in a manner consistent with the normal pricing practices of the industry in question; (2) the price is settled in a manner consistent with the way the exporter settles prices for sales to unrelated buyers; or, (3) the price is adequate to ensure recovery of all costs plus a profit that is equivalent to the exporter’s overall profit realized over a representative period of time in sales of goods of the same class or kind.

On its face, the circumstance of sales test in China is consistent with the standards set forth in the World Trade Organization Valuation Code and the U.S. valuation laws and regulations. However, Chinese importers should seek expert guidance if their transfer prices are questioned because China Customs’ actual practice in analyzing the arm’s length nature of transactions may differ from U.S. and EU customs authorities.

### **3. Importers that fail to disprove the influence of the relationship between related parties may be subject to additional duty liabilities and/or penalties**

If an importer fails to prove that a transfer price between related parties has not been influenced by the relationship between the importer and exporter, China Customs may reject the transfer price declared by the importer and re-appraise the customs value of the goods with another alternative method. This generally results in a higher appraised value and assessment of additional import taxes. More importantly, a change in valuation is not just a one-time event for previous transactions; the new valuation method determined by China Customs will also be used for future imports.

Before 2016, the primary China transfer pricing Customs risk was reassessment of the subject goods to a higher price. China Customs rarely assessed any penalties on an importer unless there was evidence of intentional misconduct. In 2016, however, China Customs amended its Import and Export Declaration Guidelines by requiring importers to fill in the corresponding columns in the declaration form with a simple “Yes” or “No” answer to confirm the existence of affiliated relationship between the importer and exporter and the influence of such relationship on the import price. If China Customs finds the declaration to be

inconsistent with facts discovered in an audit or investigation, China Customs may impose administrative or criminal penalties on the importer.

#### **4. Now is the time to prepare for potential transfer pricing customs audits or investigations**

In the light of the increased China Customs transfer pricing enforcement risk, multinational companies who frequently import goods and components into China from their affiliated companies operating outside of China should review their intercompany import prices and prepare for a China Customs audit or investigation.

Below are defensive strategies that multinationals should consider in anticipation of a China Customs audit or investigation.

First, prepare arguments based on China Customs' valuation rules. China Customs valuation rules are separate and distinct from the transfer pricing rules applied for income tax purposes. The fact that a transfer price is acceptable to the income tax authorities (China State Administration of Taxation) does not necessarily mean it is also acceptable to China Customs<sup>22</sup>. In practice, many multinationals rely on their transfer pricing studies and/or contemporaneous documents prepared for income tax purposes to justify their import price to the customs authorities. Although China Customs regularly requests transfer pricing studies and contemporaneous documents as part of its investigations and audits, such studies can be insufficient or even damaging to the importer. For example, information in transfer pricing studies<sup>33</sup> can be used against the multinational companies by China Customs. Some companies use such studies to set their profit margin in the upper quantile range of prices used by comparable companies to establish a benchmark of "arm's-length" pricing for products sold between related companies. From a China Customs perspective, however, this could be interpreted as *prima facie* evidence that the price has been influenced by the relationship between the importer and exporter. As such, it is important for multinationals to address the inherent tension between China Customs and income tax authorities related to transfer pricing and make sure your arguments are based China's customs valuation rules.

Second, in China, it is important to understand common practices and work effectively with China Customs. When China Customs considers using an alternative valuation method to establish the dutiable value, it should properly consult with the importer. Having the ability to understand and negotiate with China Customs about their proposed approaches should be based on recent trends and China Customs practices. Of course, such consultations should always be conducted in a manner consistent with corporate compliance policies.

Third, multinational companies should carefully assess and manage the risks of escalation of the customs audit or investigation. The scope of a China Customs audit or investigation is not static and restricted by administrative law. China Customs may expand the audit or investigation to other products or entities of your company at any time in the course of the ongoing process. China Customs may also transfer the case to the China Anti-Smuggling Bureau for further administrative or criminal investigation if any noncompliance or violations are identified. Companies should carefully manage the risks of escalation and consider voluntary self-disclosures where necessary.

It is important to note that the decision to make a voluntary disclosure to Chinese authorities is complex and is significantly different from considerations involved in making a voluntary disclosure to U.S. authorities.

Fourth, multinational companies should be careful when making transfer pricing adjustments as a result of the COVID-19 pandemic and/or U.S.-China trade war. Multinational companies may find themselves making new and larger-than-usual transfer pricing adjustments to reflect the impact of the COVID-19 pandemic and/or the increased tariff costs as a result of the U.S.-China trade war. Typically, these adjustments are made to bring transfer prices within arm's length ranges for tax purposes. We recommend that companies review these adjustments to make sure they are also consistent with China Customs' valuation regulations.

Please contact us with any questions.

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<sup>1</sup> Royalties are a major source of transfer pricing disputes in the income tax arena in many countries. Companies should implement procedures to coordinate the reporting of these royalties, and resolution of any controversy, with their income tax department.

<sup>2</sup> In the U.S., Internal Revenue Code Section 1059A provides for coordination between the customs value reported on an import, and the basis or cost of goods sold that the taxpayer can use in computing its income from sales. This requires taxpayers to address the natural tension between the desire for a low customs import price and the desire to reduce income subject to U.S. tax. However, no similar coordination mechanism between the customs and tax authorities exists in China.

<sup>3</sup> For U.S. income tax purposes, income tax studies, and/or advance pricing agreements (APAs), are essentially required by the IRS and other tax administrations. It will be important for the customs experts in the company to understand the content and implications of transfer pricing studies and APAs.

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