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China Tariff Reduction – Hidden Implications/ Considerations

China Customs and Trade Alerts
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Background of Tariff Reductions

The China Government has announced to significantly cut import tariffs for a large range of goods with effect from 1 December 2017 through the Interim Import Duty Rate (IDR) System. The IDR system generally provides importers with lower tariff rates than the Most-Favoured-Nation (MFN) duty rates (i.e. the WTO bound rates). Hence such goods are subject to lower import tariff rates than those under China's WTO commitments. The intention is to encourage consumer spending and to further open up China's markets. IDR rates are typically reviewed by the China Government every 6 months and revisions are made to reflect changes in the business environment and government policy.

According to the "Notice of the Tariff Commission of the State Council on Adjusting Import Tariffs of Consumer Goods" recently released by the Ministry of Finance, starting from 1 December 2017, China will further reduce tariffs for a total of 187 tariff codes at the 8-digit level, with an average tariff rate reduction from 17.3% to 7.7%. The categories of consumer goods covered by the notice include the following:

- ✓ Food
- ✓ Healthcare products
- ✓ Pharmaceuticals and health supplements
- ✓ Daily chemicals
- ✓ Clothing and footwear
- ✓ Household equipment
- ✓ Sports and entertainment accessories
- ✓ Other general merchandises (such as toiletries, pens, diapers, etc.)

The IDR rates for the majority of the consumer goods listed in the notice would be around or less than half of the MFN rates. For some of the commodities already covered under IDR in the past, the IDR rates are now further reduced or the scope of the commodities covered further expanded under the latest revisions.

Potential Implications/ Considerations

Whilst this obviously is very good news to those companies importing such goods into China, there could nonetheless be implications which may not be as apparent that require consideration:

1. Arm's length pricing for related party transactions

Companies importing and trading in products covered by the tariff reduction may enjoy higher profit margins resulting from lower import costs. However, companies procuring from related parties should pay special attention to updated financial projections and forecasts, and the benchmarking profit margin range stated in the transfer pricing documentation, in order to mitigate the risk of challenges from China Customs in relation to the arm's length nature of the import price.

In line with the principles in Case Study 14.2 recently published by the World Customs Organisation (WCO) Technical Committee on Customs Valuation, China Customs could challenge the arm's length nature of import prices of companies deriving a profit margin above the interquartile range stated in the transfer pricing documentation, and may assess additional import taxes to these companies on the basis that the imported goods were undervalued (please see our other alert on Case Study 14.2 for more information).

Hence, if companies are expecting to derive a profitability resulting from the tariff reduction above its arm's length range, the related customs valuation risks should be reviewed and addressed in order to prevent unexpected additional import tax assessments. If this aspect is not managed properly, any savings from the rate cut could be lost.

2. E-commerce import model still most tax efficient?

There are various types of e-commerce models adopted by companies where different types of import taxes could be applicable to the e-commerce importations. For example, goods imported under the B2B e-commerce model may be subject to import taxes under the so-called “General Trade” customs category. Goods imported under the B2C e-commerce model may be subject to import taxes either under the 70% comprehensive e-commerce tax or under the personal parcel tax rule depending on various conditions of the e-commerce transactions.

The recent tariff reduction may render some models to be more attractive, e.g. the B2B General Trade e-commerce model may be more favourable than say the B2C personal parcel tax model for some businesses. Companies engaging in e-commerce importations may want to review their existing model to see whether it is still the most tax efficient under the latest IDR rates.

3. Applications for tariff reduction under IDR

The general objective of the IDR system is to allow reduced import tariffs to those industries and commodities encouraged by the Central Government in accordance with its policy to improve China's competitiveness, to assist in advanced technological development, to improve the environment, to satisfy demand for certain necessities, etc.

If a company imports a commodity that falls within the context of an encouraged industry or commodity as described above, but the applicable tariff code (HS codes) is not currently covered under the IDR list, there is a chance that the customs classification currently used by the company may not be correct. However, if the tariff code used is correct but the commodity is still currently subject to "unreasonably high" MFN duty rates, an application for IDR may be made with the Customs Tariff Commission of State Council (CTCSC) for their consideration. The CTCSC is a coordination department managed by the Ministry of Finance (MoF) and the members of the CTCSC include various ministries including the MOFCOM, GAC, NDRC and SAT.

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