

Case Study No.3 from China

Valuation Matters

Shenzhen pilots a scheme to coordinate tax and customs pricing for imported goods from related parties

Introduction

When it comes to valuation for imported goods between an onshore company and a related offshore company, two sets of rules will come into play simultaneously, one from tax administration and the other from customs administration. However, tax administration tends to focus on whether or not the price of the imported goods is higher than the arm's length price, potentially eroding the tax base of the underlying income tax, while customs administration concerns more about whether or not the price of the imported goods is lower than the arm's length price, potentially eroding the tax base of the underlying customs duties. These two conflicting perspectives often leave the importer in a dilemma, complying with one will make it at odds with the other. Both the World Customs Organization and the OECD have acknowledged that this predicament is a universal problem¹.

At the request of a taxpayer, Shenzhen Tax Office and Shenzhen Customs worked together and found a solution successfully for the challenge. Then they proceeded to establish a scheme to coordinate tax and customs pricing, with the guidance from the State Taxation Administration (STA) and the General Administration of Customs, offering fairness and certainty to taxpayers. It is the first similar scheme in China, setting a precedent welcomed by the business community.

The Case

- **Facts**

XCo, a tax resident of country X, sells recreational goods to YCo, a low risk distributor in Shenzhen, China. Both XCo and YCo are wholly-owned subsidiaries of ACo, a multinational enterprise (MNE) in country A and the brand-owner of the recreational goods. YCo imports more than 1000 items of recreational goods from XCo and sells them to third parties, wholesale or retail. The marketing strategy for the sales of those goods in China as well as their selling prices are established by ACo. ACo has invested heavily in developing valuable intangible assets associated with the goods, so it assumes the research and development risks while YCo assumes the market risk and inventory risk with respect to the goods sold in China.

¹ *Practical Manual on Transfer Pricing for Developing Countries*. New York: United Nations, 2021: 119 - 3.6.6.7 points out that "There has been a great deal of focus internationally on the interplay between transfer pricing and customs valuation methods. Following two joint World Customs Organization (WCO) – OECD conferences in 2006 and 2007, it became clear that harmonization of the two systems was not a realistic proposition."

- **Issue**

YCo was challenged by Shenzhen Customs because the latter found that the declared price of some items imported from XCo was lower than comparable goods. If YCo increases the import price and pays extra import duties, it will raise the corresponding cost and reduce its profit, exposing itself to potential transfer pricing risk with Shenzhen Tax Office. So it turned to Shenzhen Tax Office for a solution.

- **Solution**

Teaming up. Shenzhen Tax Office and Shenzhen Customs acknowledged that the dilemma of YCo is a legitimate concern, and they decided to explore the possibility of collaboration on the pricing of the import between related parties, finding a middle ground between them. The two authorities accepted application documents from YCo, compared relevant data against both internal data such as tax/customs database and external data such as industry reports and publicly available information. Additionally, they conducted function interviews with staff in YCo as well as on-site facts-finding in the company.

Deciding on Pricing Method. Although both customs and tax authority evaluate the import price of related-party based on the arm’s length principle, the customs usually evaluates the price of **an individual item** in the customs declaration, while transfer pricing analyzes the rationality of **a whole transaction**. Due to the wide variety of goods imported by YCo and the lack of “price of the same or similar goods” in practice, it is not feasible to value those goods item by item. In the end, Shenzhen Customs came to agree that the pricing should be based on the valuation of the overall transaction.

Then they moved on to the pricing method. There is a strict application order in customs valuation with the Transaction Value Method as the top priority. However, there is no strict order in the selection of transfer pricing methods (Table 1). In this pilot case, because the imported goods of YCO are entirely sold to third parties in China, both customs and tax authorities accepted the rationality of the sales revenue of YCO and treated it as the basis of calculation of import price. After rounds of discussions, the two authorities finally settled on the Resale Price Method with the following:

Fair transaction price = Resale price to uncontrolled party x (1 - Gross margin of comparable uncontrolled transaction).

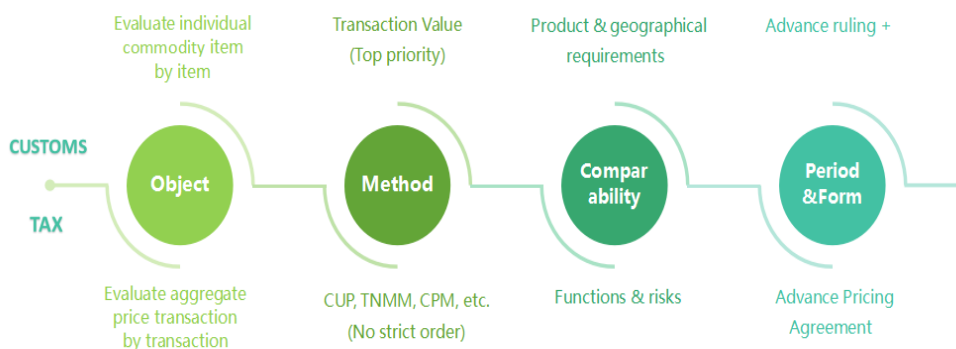
Table 1

Customs		Tax	
Transaction Value Method		Comparable Uncontrolled Price Method (CUP)	
Identical Goods Method		Resale Price Method (RPM)	

Similar Good Method	Cost Plus Method (CPM)
Computed Value Method	Profit Split Method (PSM)
Deductive Value Method	Transaction Net Margin Method (TNMM)

When the two authorities did the benchmarking analysis, the customs valuation focuses on the comparability of products and the geographical requirements for comparable enterprise groups. And tax authority mainly considers the functions and risks such as supply, marketing, research and development. In this pilot case, given that there is a large difference between the gross profit margins of wholesale and retail, and that the change of their proportion would influence the overall gross margin, the two authorities selected wholesale and retail comparable enterprises respectively and adjusted the price according to the median of the comparable enterprises. In the end the two authorities achieved agreement on benchmarking analysis.

Tripartite Consensus. The two authorities and the YCo signed a memorandum of understanding, requiring that during the applicable period of coordinated management, YCo shall submit an annual report on the implementation of transfer pricing coordinated management to Shenzhen Customs and Shenzhen Tax Office within 6 months after the end of each year. Shenzhen Customs and Shenzhen Tax Office shall conduct follow-up supervision respectively.



The Scheme

Goal: It is expected to reduce tax burden associated with cross-border trades and improve tax certainty, simplify the subsequent tax and customs supervision and compliance requirements, and change from management ex post to management ex ante.

Policy Basis: Promoted by the success of this pilot case, Shenzhen Tax Office and Shenzhen Customs proceed to issue jointly *The Notice on Related Issues Concerning the Collaborative Management of Transfer Pricing of Related-Party Imported Goods and its Supporting Documents (the Notice)* on 18 May, 2022, establishing a

unified approach of combining the customs valuation and transfer pricing to provide certainty to MNEs.

Procedure: The Notice outlines the following four-step-procedure: application and acceptance, evaluation and consultation, signing of memorandum, implementation of memorandum.



Applicable Period: The Memorandum will be valid for 3 years, after which it will automatically expire. Taxpayers may apply to the Customs and the Tax Authorities for renewal within 90 days of the expiration date.

The Message

This case study offers an interesting and insightful example of how tax administration or even government administration works in general in China. It is widely known that China has a central government and many reforms are conducted in a top-down manner. Not all of them apparently. In the above case study, Shenzhen Tax Office and Shenzhen Customs took the initiative to find a solution to a long and wide-spread problem, by working collaboratively and creatively. Its success may be studied and modeled by other cities or provinces, paving the way for a nation-wide solution. In a sense this is a bottom-up approach. The State Taxation Administration and the General Administration of Customs, the respective central organ for tax and customs, will monitor, review and facilitate the process of establishing a national framework to collaborate on tax and customs valuation. It is fair to say that the Chinese model is a mutual learning, self-evolving one, with players from the top and local contributing their share to a maximum result.

The collaboration between Shenzhen Tax Office and Shenzhen Customs is another example of China's whole-of-government approach to make its doing-business environment more competitive. Tax-wise, the State Taxation Administration is teaming up with Business Registration authority, banks, social security institutions and other government bodies/third parties to exchange information. Taxpayers are experiencing a significant reduction of compliance cost by not having to file the same information to different administrations. More cooperation among government bodies is expected in the process where China strives to optimize its E-government.

Shenzhen ranked first in innovation capacity among major Chinese cities in 2021, according to a report endorsed by China's Ministry of Science and Technology. It seems that the innovation momentum in technology sector is spilling over to government administration. For example Shenzhen Tax Office completed the first case of simplified procedure for unilateral advance pricing arrangement in China, focusing on helping enterprises achieve tax certainty and improving China's business climate. In addition, Shenzhen Tax Office pioneered in advanced ruling practice, which is not officially available across the country.