Managing Trade & Customs in China

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Managing the China Trade & Customs environment

Customs rules can present complex challenges in any jurisdiction. However, if these rules are understood and managed, they can enable organisations to reduce operational risks, manage costs, improve their bottom line and gain favourable recognition in the market. In China, the size of the country can create further uncertainty due to variations in practices or interpretations at different ports of entry. Although these challenges can be met, they do require a commitment of time, resources and strategic planning.

This brochure introduces some of the intricacies of import, export and customs management in China. The starting point is a clear understanding of the regulatory environment, including the structure of government authorities. From this position, companies can move towards strategic planning options that can significantly enhance their competitiveness. These strategies can be applied either when products are imported into China, or are produced in China using imported components.

Structure of government agencies

The General Administration of Customs (GAC or China Customs), a ministry level organisation under the State Council, has authority and responsibility over all the Customs Districts and Offices throughout the People’s Republic of China (PRC or China). All imports and exports from the PRC are subject to the supervision and control of the GAC. The organisational structure of the GAC can be found as an Appendix on page 26.
There are 46 customs districts or agencies and offices that report directly to the GAC. These consist of 41 customs districts, two customs educational institutions, two supervising offices located in both Tianjin and Shanghai, and the Guangdong Sub-administration of Customs that is in charge of the seven customs districts located in Guangdong Province. On the ground, the GAC administers a total 580 customs houses or offices and nearly 4,000 customs clearance control stations manned by roughly 50,000 personnel (including Customs anti-smuggling police).¹

Cross-border trade with China can either be done under General Trade or Processing Trade. General Trade is the regular import channel where import duties and Value Added Tax (VAT) are levied upon importation. Processing Trade, on the other hand, is a special operating model whereby materials to be used in export production are imported into China under bonded status (i.e. free from import duties and VAT).

Customs environment for general trade

Basic importation into China requires the payment of the proper duties and taxes. Payment of the correct amount depends on an accurate declaration of a product’s value, tariff classification and country of origin.

- Types of duties and taxes

China Customs levies duties and taxes in accordance with the Customs Law of the PRC and the import/export tariff schedule. Currently, total revenue collected by China Customs comprises mainly the following:

<table>
<thead>
<tr>
<th>Duties/Tax</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customs duties</td>
<td>Varies on type of product</td>
</tr>
<tr>
<td>Value Added Tax</td>
<td>17%</td>
</tr>
<tr>
<td>Consumption Tax</td>
<td>5% to 40% depending on product</td>
</tr>
<tr>
<td>Vessel Tonnage Tax</td>
<td>RMB 0.45 to RMB 9.3 per ton</td>
</tr>
</tbody>
</table>

Following China’s accession to the World Trade Organisation (WTO) in 2001, the overall average rate in China has been reduced from 15.6 percent in 2000 to 9.8 percent in 2010. The average tariff level for agricultural products was 15.2 percent, while that of industrial goods was 8.9 percent in 2010.²

- Customs valuation

China’s Customs authorities follow the valuation principles set out in the WTO Agreement on the Implementation of Article VII of the General Agreement on Tariffs and Trade (GATT) or the WTO Agreement on Customs Valuation.

The current regulation on customs valuation in China is the Measures of Customs of the People’s Republic of China for Assessing and Determining the Dutiable Value of Imported and Exported Goods i.e. GAC Order [2006] No.148, which was published on 28 March 2006. According to the Valuation Rule, the dutiable value of imported goods should be assessed based on the transaction value, which is defined as the complete actual price of the goods, including both direct and indirect payments made by the buyer to the seller.

For cases in which there is no transaction value (e.g. no-sale situations), or where the transaction value is deemed unacceptable (e.g. due to conditions attached to the sale of the product), China Customs would employ, in hierarchical order, another five methods of appraisal. The table below summarises the WTO appraisement hierarchy:

¹ Source from GAC official website: http://english.customs.gov.cn/publish/portal191/Annual Report--2009 China Customs
² China Customs Today, 2010, Public Relations brochure (Beijing, General Administration of Customs)
### Method

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Transaction value</td>
</tr>
<tr>
<td>2.</td>
<td>Transaction value of identical goods</td>
</tr>
<tr>
<td>3.</td>
<td>Transaction value of similar goods</td>
</tr>
<tr>
<td>4.</td>
<td>Computed value</td>
</tr>
<tr>
<td>5.</td>
<td>Deductive value</td>
</tr>
<tr>
<td>6.</td>
<td>Fall-back value</td>
</tr>
</tbody>
</table>

Customs valuation is a common area of difficulty between Customs authorities and importers. More details about issues regarding this area may be found later in this brochure.

- **Tariff classification**

The determination of the correct Harmonised System (HS) Code for tariff classification purposes is important since the applicable customs duty rates and import licences/certificates for specific imported goods are determined according to their HS Code. In China, these HS Codes typically consist of eight to 10 digits.

#### Sample

**HS Code**

<table>
<thead>
<tr>
<th>1234.56.7890</th>
</tr>
</thead>
<tbody>
<tr>
<td>National sub-headings assigned by China</td>
</tr>
</tbody>
</table>

The first six digits of these codes are similar to those used by other members of the World Customs Organisation (WCO). However, the final two to four digits may differ from those used by other countries. These potential inconsistencies, if left unchecked, may lead to disputes or non-compliance issues.

To gain more certainty on the tariff classification of a product to be imported into China, the importer may apply to China Customs for a pre-determination on the appropriate HS code. Such an application should be made 45 days before the actual importation of the goods.

It is important to note that HS codes are also relevant to export VAT refunds since a product’s tariff classification determines the refund rates of exports, and hence the amount of refundable input tax, which in our experience, can be substantial.
• Country of origin

It is important for both importers and exporters in China to properly identify their product’s country of origin due to the potential impact this would have on the customs duty rate that may be imposed on their product either in China or in its country of destination.

China is involved in various preferential trade agreements such as the Generalised System of Preferences (GSP) and free trade agreements (FTA) with several countries in Asia (e.g. Thailand, Vietnam, New Zealand) that granting lower rates of duty for products that originate in China. These FTAs in particular also provide reciprocal treatment in China for goods that are imported from other countries that are members of the specific FTA. The FTAs available to companies in China will be discussed further in the Strategic planning and savings section of this brochure.

• The rules of origin

To determine whether a product originated in China or in other FTA member countries, companies must ensure their compliance with the Rules of Origin (ROO). The ROO generally defines the country of origin as the place where the “last substantial transformation” took place. Compliance with this criterion usually requires meeting a minimum regional value content (RVC) or undergoing a change in tariff classification (e.g. a change in the first four digits of the HS code) from raw/intermediate material to a finished product.

A Certificate of Origin will be issued as proof of compliance with the ROO, which must be presented to the Customs authorities in order to enjoy the preferential rate of duty. In China, Certificates of Origin for preferential purposes are issued by the Bureau of Commodity Inspection and Quarantine. Companies would have to register in advance with the said Bureau to apply for Certificates of Origin. For the ASEAN-China FTA, the Certificate of Origin used is also known as a Form E.

Customs environment for processing trade

Manufacturers involved in the production of goods for export may realise substantial savings upfront by importing their raw materials through a Processing Trade arrangement. Each Processing Trade application, however, would require a thorough evaluation by China Customs. In order to qualify for operations under Processing trade, manufacturers are required to comply with requirements pertaining to the materials to be imported, the type of processes to be undertaken, and the sophistication of their inventory management system, among others.
There are normally two types of processing trade models that can be adopted by a Chinese manufacturer:

1. **Import Processing model (or Contract Manufacturing model)**

   - **Company**
   - **Customer**
   - **Overseas**
   - **China**
   - **Contract Manufacturer**

   Under the Import Processing model, a Chinese manufacturer is allowed to purchase raw materials from overseas suppliers free of import duty and VAT. It then performs manufacturing functions and exports the finished goods to an overseas party. The title to the imported raw materials is transferred from the overseas supplier to the Chinese manufacturer.

2. **Contract Processing model (or Toll Manufacturing model)**

   - **Company**
   - **Customer**
   - **Overseas**
   - **China**
   - **Contract Manufacturer**

   The Contract Processing model is an alternative to importing raw materials with duties and VAT suspended. Under this model, the overseas supplier would provide raw materials free of charge to the China manufacturer for processing. The finished goods will then be exported to the overseas party. In contrast to the Import Processing model, there will be no transfer of title to the raw materials under Contract Processing. The manufacturers will only be compensated by the overseas party with a processing fee.

   If any of the bonded materials under Processing Trade are diverted for domestic consumption, China Customs would collect the corresponding amount of duties and VAT.
Import and export licensing

A number of products are regulated by the Chinese government and require special licenses prior to their import into or export from China. These include pharmaceuticals, encryption technologies, chemical fertilisers, and products containing “homegrown” technologies.

These permits are normally issued by the Ministry of Commerce, while the actual policies are formulated and enacted by the State Council. Importers and exporters are required to make accurate declarations and submit the requisite import or export licenses to Customs for examination. In the absence of necessary import or export licensing documents, goods subject to import or export restrictions shall not be released.

If bonded materials subject to import licensing were imported under Processing Trade and later sold locally, such a sale would only be allowed if the proper amount of customs duties and VAT is collected and the appropriate import licenses are secured and presented to Customs.

Foreign exchange controls

China’s regulations on foreign exchange controls have progressively relaxed to accommodate the rapid expansion of its trade with the rest of the world and the rising economic significance of the renminbi (RMB). Gradually more transactions are being settled in RMB. An RMB Trade Settlement simplifies tax and customs documentation in that (i) foreign exchange verification documents can be waived for customs declaration and export VAT refund (exemption) purposes, and (ii) the export tax refund (exemption) policy shall apply to export trades settled in RMB. Companies are encouraged to review their current documentation with a view to strengthening their compliance from a customs and tax viewpoint to ensure that these aspects are considered as part of the project implementation.

Export controls

Many Chinese companies use the Hong Kong Special Administrative Region (SAR) as their trading gateway to and from the rest of the world.

However, although Hong Kong is a free port, it enforces strict controls on the import and export of so-called “strategic commodities” or products which have both military and civilian applications. This includes all goods from the US or products containing US technology that are subject to the US Export Administration Regulations (EAR). Examples of these products are electronic devices, integrated circuits and aerospace products. It is important for US companies to ensure that import and export licenses for these products are obtained when these are brought into or transshipped from Hong Kong to a third country. Failing to comply with these requirements could lead to heavy penalties for both the Hong Kong company and the US-based headquarters. US companies in Hong Kong should verify the applicability of any US export controls on their products and make certain that the proper licenses are obtained for these goods before these are imported into/ exported from Hong Kong. Please note that Hong Kong has the most stringent export licensing requirement in the region as the Southern China gateway.
Strategic planning, savings and efficiencies

Amidst the complexities of the China Customs landscape, companies can explore a number of strategies to reduce their costs of importing and exporting in China. These include special customs supervision areas, value unbundling, tariff engineering and third party logistics management.

Special customs supervision areas

As a complement to the Processing Trade arrangement, China has also established export processing zones and various other special customs supervision areas to promote itself as a world-class manufacturing hub. Following China’s accession to the WTO, China Customs has expanded the scope of permissible bonded operations from manufacturing to include logistics operations.

Customs special supervision areas include Bonded Ports (BP), Bonded Logistics Parks (BLP), Bonded Logistics Centers (BLC), Free Trade Zones (FTZ), Export Processing Zones (EPZ), Bonded Warehouse (BW) and Export Supervisory Warehouses (ESW). The common denominator among these special areas is that materials may be imported into these zones free from import duties and VAT under Customs’ supervision. However, each of them has unique characteristics that afford different sets of advantages and limitations to different types of businesses.
<table>
<thead>
<tr>
<th>Type of customs supervision area</th>
<th>Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonded Port (BP)</td>
<td>• No limitations</td>
</tr>
<tr>
<td>Bonded Logistics Park (BLP)</td>
<td>• No Processing Trade activities</td>
</tr>
<tr>
<td>Bonded Logistics Center (BLC)</td>
<td>• No Processing Trade activities</td>
</tr>
<tr>
<td>Free Trade Zone (FTZ)</td>
<td>• Goods must be physically exported out of China to claim export VAT refund</td>
</tr>
<tr>
<td>Export Processing Zone (EPZ)</td>
<td>• No Processing Trade activities</td>
</tr>
<tr>
<td></td>
<td>• No inland transfers</td>
</tr>
<tr>
<td></td>
<td>• No price adjustments</td>
</tr>
<tr>
<td>Export Supervisory Warehouse (ESW)</td>
<td>• No inland transfers</td>
</tr>
<tr>
<td></td>
<td>• No price adjustments</td>
</tr>
<tr>
<td>Bonded Warehouse (BW)</td>
<td>• No Processing Trade activities</td>
</tr>
<tr>
<td></td>
<td>• No inland transfers</td>
</tr>
<tr>
<td></td>
<td>• No price adjustments</td>
</tr>
<tr>
<td></td>
<td>• Goods must be physically exported out of China to claim export VAT refund</td>
</tr>
</tbody>
</table>

Customs is also encouraging more high-value added activities to be performed inside these areas. To facilitate this, Customs has established special supervision centres and computerised networking systems, such as high-tech research and development centres, product inspection and maintenance centres, logistics centres and regional operation settlement centres to provide support to enterprises producing high value-added commodities.

**Unbundling**

Under the WTO Customs Valuation Agreement, the final price actually paid or payable for goods by an importer is the value that must be declared to Customs. This includes universal additions to the price such as royalties, as well as legal deductions.

However, certain cost elements included in the final price can be stripped out, thus lowering duty costs, and potentially other indirect tax costs.

Non-dutiable cost elements include after-sales or post-implementation services such as training, assembly, maintenance and warranty services. Other cost elements such as finance charges, inspection fees, sales and marketing costs, and certain types of commissions can also be deducted based on a review of the supplier agreements and payment structure.

**Free Trade Agreements**

There are more than 100 regional and bilateral FTAs offering preferential duty rates for trade between Asian states as well as global trade. The question is whether the benefits of these preferential duty rates outweigh the internal administrative costs of complying with the country of origin and documentation requirements.

Exploring the FTA landscape can reveal significant reductions in duties and import-related costs, and even if a company is already claiming FTA benefits, closer examination of practices and procedures may reveal that critical compliance requirements are not being met. Early identification of non-compliance can help companies make the changes necessary to help avoid costly customs penalties.
Currently China has FTAs with the following regional groupings:

<table>
<thead>
<tr>
<th>Regional FTA</th>
<th>Member countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia-Pacific Trade Agreement (APTA)</td>
<td>China, Bangladesh, India, Laos, Republic of Korea, Sri Lanka</td>
</tr>
<tr>
<td>ASEAN-China Free Trade Area (ACFTA)</td>
<td>China, Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam</td>
</tr>
</tbody>
</table>

It also has bilateral FTAs with the following countries/territories:

- Chile
- Pakistan
- New Zealand
- Singapore
- Hong Kong
- Macau
- Taiwan.

**Tariff engineering**

Tariff classification, based on the physical form of the goods, determines the rate at which duty is payable on import. Therefore, changing the state in which goods are imported offers the potential to change the tariff classification of declared goods and reduce the associated duty cost. For example, breaking down fully assembled goods into components, sub-assemblies or individual parts could result in the goods being subject to different tariff classification numbers which confer more favourable tariff rates. There are certain restrictions on this type of tariff planning, so it is important to pay close attention to the rules pertaining to specific industries and tariff heading when considering this opportunity.

**Case:**

<table>
<thead>
<tr>
<th>Client</th>
<th>Leading manufacturer of high-end consumer goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Engagement</td>
<td>Tariff engineering</td>
</tr>
<tr>
<td>Services</td>
<td>Client assessed by Customs as having improperly declared its imports under an HS Code with a duty rate of 10 percent instead of one with a duty rate of 20 percent. The 10 percent difference amounted to millions of dollars worth of back duties and tax. Following an analysis of the product’s characteristics and its manufacturing process, KPMG China made a determination that the original classification was more correct under the classification principles set forth under the HS Convention. Based on KPMG China’s technical analysis and assistance, Customs agreed with KPMG China’s analysis and withdrew the requirement for payment of additional duty and tax.</td>
</tr>
</tbody>
</table>
Management of third party service providers

Many companies rely heavily on third parties such as customs brokers and freight forwarders, particularly in the early stages of their market entry. As such, a lot of responsibility is entrusted to these third parties, particularly involving functions that could have administrative, risk management or strategic ramifications. It may be more cost effective to turn these responsibilities over to in-house resources, or at the very least, to assess the cost-benefit ratio of paying a third party to perform all these services.

If a company uses multiple customs brokers or agents, it may be wise to reduce the number of service providers and leverage better economies of scale on filing fees and administrative charges. It is also beneficial to install insiders in the customs management role, as they will have a broader understanding of the company’s business processes. This can prove critical for strategic planning and proactive risk management in the future.

First sale for export

When a China manufacturer sells to the US or the EU through a middleman in Hong Kong, the profit earned by the middleman may be excluded from the customs value of the goods when declared to US or EU customs. It is called the “first sale for export” principle, because it refers to the imposition of customs duties on the selling price between the China manufacturer and the Hong Kong middleman or the “first sale” as opposed to the selling price of the goods on the “second sale” i.e. the Hong Kong middleman to the US importer.

In order to qualify under this scheme, four conditions should first be met and proved to US or EU Customs:

• **There is a bona fide sale between the seller and the middleman:** The circumstances and documentation demonstrate that all parties function as ‘proper’ buyers and sellers under the First Sale for Export Principle.

• **The transaction is at arm’s-length:** The importer must substantiate that the manufacturer’s prices to the related middleman are at arm’s-length.

• **The goods should be clearly destined for the particular end market:** The goods must be clearly destined for the US or EU at the time of the sale.

• **There is full documentation and recordkeeping of the transaction:** The importer must provide to Customs, and make available upon request, all documentation that supports the above requirements and clearly establishes the role and purpose of each party in the transaction.
Common trade and customs management issues faced by companies

The complexity of rules in China may lead to challenges in the management of a company’s customs function. Based on our experience, issues most commonly arise in the areas of customs valuation and Processing Trade.

Customs valuation

Customs valuation is a hot topic for companies operating import and export businesses. In practice, there are dedicated departments focused on investigation of customs valuation cases. To ensure the payment of proper duties and taxes despite these special circumstances, Customs has increased their attention on validating the transaction value of related parties and investigating potential duty liabilities on non-trade payments such as royalties and service fees.

• Valuation with related-party transactions

Many multinational companies sell goods or material-related subsidiaries in China. China Customs may scrutinise these related-party sales more carefully to verify that these sales are at arm’s length (i.e. the transaction value is reasonable and not influenced by the relationship between the parties).
Average value benchmarking

China Customs uses a database of average benchmark values to test the acceptability of related-party prices. Although these benchmarks are intended for reference purposes only, it is not uncommon for China Customs to use these values as a substitute for transaction value – a practice which other customs jurisdictions regard as inconsistent with WTO principles. Notably, even if the database yields no comparable price information, China Customs still has the authority to question the acceptability of the declared value without the need to provide evidence. Thus, it is important for the importer to take responsibility for collecting the relevant evidence to prove that their relationship does not influence the transaction value.

Disputes

When Customs raises a price query regarding a related-party transaction, the importer should submit a written explanation letter and provide evidence to prove that the invoice price or contract price approximates the price of the same or a similar product sold to a third party buyer that has been accepted by PRC Customs. During this period, Customs will detain the imported goods whose transaction value is considered unreasonable, or request that the importer pay a guarantee deposit. If the importer cannot provide any explanation or the contents of the explanation letter submitted are deemed insufficient by Customs, Customs will determine a new import price based on their own valuation methodology, which will almost certainly result in higher duty and import tax liabilities.

- Non-trade payments

In recent times, Customs has also become more scrutinising about non-trade payments such as royalties and service fees.

Royalties

According to the Valuation Rule, “royalties” refer to the charges paid by the buyer of imported goods for obtaining permission to use or transfer the patents, trademarks, know-how, copyright, distribution rights or selling rights of the owner or its valid agent of intellectual property. The royalties that the buyer needs to pay to the seller or the relevant party directly or indirectly should be included in the dutiable value, unless it is under either of the following circumstances:

1. the royalties are irrelevant to the imported goods (condition 1)
2. the payment of royalties does not constitute the conditions for the imported goods to be sold within China (condition 2).

If royalties are paid, the buyer takes responsibility to prove to PRC Customs that Condition 1 or 2 have been met, otherwise, the royalties will be dutiable. Otherwise the royalties will be dutiable. In practice, it is difficult for the buyer to prove to PRC Customs that Condition 2 has not been met. Thus, in order to persuade PRC Customs that the royalties are non-dutiable, the buyer needs to prove that Condition 1 has not been met.
Case:

<table>
<thead>
<tr>
<th>Client</th>
<th>Leading personal care product distributor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Engagement</td>
<td>Customs valuation – Royalties</td>
</tr>
<tr>
<td>Services</td>
<td>Client assessed by Customs as not having paid customs duties and taxes on royalty payments it had remitted to a trademark owner for the distribution of products bearing the said trademark. The total liability amounted to around RMB 8 million. KPMG China conducted a detailed analysis on the nature of the royalties and the characteristics of their arrangement. This was combined with in-depth research of China’s Customs laws and regulations, WTO valuation rules, and case rulings on royalties. Ultimately, KPMG China was able to assist the Company in reaching an agreement with Customs that the royalty payments were not part of the dutiable value, thus successfully reversing the Company’s liability.</td>
</tr>
</tbody>
</table>

Service fees

There are no published rules regarding the dutiability of service fees. The service fees are generally paid for various reasons. In determining the dutiability of service fees, PRC Customs will see whether they are relevant to the production, research and development, and sales of the imported goods by conducting a review of the relevant service agreements and the actual nature of the services. If found to be relevant to the imported goods, Customs will include the service fees in the dutiable value of the imported goods; otherwise, no additional duties and import taxes will be imposed.

Other non-trade payments

During the Customs audit, PRC Customs will request that the importer provide audit reports, payment breakdowns and other information for their review. If Customs uncovers any non-trade payments, the importer should provide an explanation letter to PRC Customs to prove that the payments are not connected to the imported goods. If the importer cannot provide any explanation or the explanation letter is found to be unsatisfactory, Customs will determine the non-trade payments as related to the imported goods and impose customs duties and VAT on the said amounts.

Valuation of spare parts under warranty and customs risk management

Another common issue faced by multinational companies pertains to the valuation of replacement parts for products that are covered by warranty. Often these replacement parts are provided free of charge and thus cannot be valued under the transaction value method. In these situations, Customs may value these replacement parts based on average market prices, which would then be used as the basis for import duties and VAT. Customs would also use average market pricing in an effort to avoid price fixing for related party transactions. Nevertheless, if the intercompany prices approximate the average market prices, Customs may accept the actual prices declared in the invoices.
Processing Trade and customs risk management

The implementation of Processing Trade arrangements has caused various issues not only for many companies, but also for Customs authorities. The basic logic for bonded treatment under processing trade is relatively simple i.e. all imported raw materials shall be re-exported after being processed into finished goods, or will otherwise be subject to Customs Duties (CD) and VAT. However, it is practically very difficult to demonstrate or verify in exact terms whether the imported raw materials have all been consumed for the production of the exported finished goods.

It is normal practice for Customs to quantify the overall exposure of a processing trade company through inventory reconciliation. If there is a shortfall in the inventory of bonded materials that should have been used for the production of the exported goods, Customs would often assume that these have been diverted for domestic consumption and thus, subject to CD/VAT. However, if there is a surplus of these bonded materials, their Customs treatment would be more ambiguous. In the past, most companies could get Customs’ approvals to carry forward surpluses and avoid paying CD/VAT. Nowadays, however, Customs authorities may subject these surpluses to additional probing for possible underlying non-compliance issues. It is no longer uncommon for big multinationals to pay back millions of RMB worth of back duties and VAT on surplus bonded materials. Sometimes Customs may even impose penalties and/or downgrade the company’s customs rating. Therefore, companies would have to clearly explain to Customs the reasons why these surpluses were incurred.
• Bills of Materials

The main reason for surpluses and shortages that immediately attract the attention of Customs can be traced to the Bill of Material (BOM). The BOM is shared by both the company and the Customs authority to measure how much of the imported raw materials are consumed to produce the exported finished product. However, the information in the BOM held by Customs is different to that contained in the company’s internal BOM. The Customs BOM contains leftover information while most internal BOMs do not. Furthermore, most companies make declarations that are not directly based on internal part numbers that are labelled in their BOM. Therefore, it is often necessary to first convert the internal BOM into more items or models with more high-level descriptions for Customs to appreciate.

For Customs, it is a fundamental requirement to declare accurate BOM according to actual data. However, this may not be that straightforward from the point of view of companies who would find it challenging to identify the “actual BOM” and ensure that this is accurate information. This is because many companies use Engineering BOM or Standard BOM with quantities that may vary from those that are actually consumed at the production line. Even if a company can provide actual consumption for Customs declaration purposes, it is still necessary to ensure the prompt conversion of units from the internal to the Customs BOM whilst updating the Customs BOM in case of any engineering/design change.

• Internal Controls

Another important area to manage in a Processing Trade set-up is the internal control of warehouse and inventory management. Without adequate control, companies will find it impossible even to complete proper inventory reconciliation. Furthermore, the mismanagement of warehouses and raw material inventory will normally result in unjustifiable shortages and surpluses, which could cost companies significant back duties, VAT and penalties.

The importance of sound internal controls has been highlighted by China Customs’ issuance of the revised Processing Trade Supervision Measures (General Administration of Customs’ Decree, No. 195, dated 1 Nov 2010). Under the new measures, China Customs clarified that processing trade companies should separate their bonded and non-bonded material physically. Now swaps and commingling without Customs’ pre-approval is no longer allowed between bonded and non-bonded material, and also between different bonded materials.

China Customs has also recently issued another notice3 stipulating that for companies in certain industries and large companies that utilise integrated inventory and logistics management systems, Customs will also evaluate their internal Enterprise Resource Planning (ERP) system to verify the companies’ ability to segregate data related to processing trade from that which is not. Upon positive verification, the Customs authority will recognise the entity as being compliant with the requirements of separate management. It is becoming clearer that China Customs is shifting its focus from an outcome-orientated approach to a more pre-emptive one that strives to verify whether the company has the right internal controls in place to ensure compliance.

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3 Circular on the Implementation Issues of Administrative Measures of Customs on the Supervision of Processing Trade Goods (GAC Circular No.93, issued by GAC on 31 December 2010, effective from 31 December 2010)
Why and how we can help

• We offer holistic, regional customs solutions

KPMG’s Trade & Customs practice is built upon a broad network of customs professionals in all key markets in China and throughout the region. We are able to deliver customs-related advice to our clients on a country, regional and global level. We coordinate closely with other key service lines within the KPMG network, such as Transfer Pricing, Corporate Tax and Advisory. As a result, we are able to offer comprehensive, relevant customs advice.

• We understand your business

KPMG has a strong track record of delivering quality services to multinational corporations, governmental organisations and other entities either directly or indirectly engaged in the cross-border trade of physical goods. In short, any enterprise whose goods must clear customs at any point along a supply chain can benefit from our assistance.

• We live and breathe the regulatory environment

Our experienced professionals come from a variety of backgrounds and include former Customs officers, lawyers, accountants, economists and executive managers from the private industry. In addition to having strong customs backgrounds, many staff members have years of experience in corporate and indirect taxation.

In China, we have specialised Trade & Customs teams in Beijing, Guangzhou, Hong Kong, Shanghai and Shenzhen, consisting of 16 full-time professionals and technical specialists with backgrounds in economics, finance, accounting and government.
Our professionals include highly experienced former senior Customs officials who are able to effectively represent and articulate our clients’ concerns to the Customs authorities. We maintain a close working relationship and conduct frequent technical consultations with the General Administration of China Customs in Beijing and various local Customs authorities.

• **Our services**

We help our clients reduce customs-related costs and expenses and enhance trade processes and strategies. We help to clarify customs rules and regulations, develop strong working relationships with local Customs authorities and provide guidance regarding the proactive management of customs compliance.

Our team in China is highly experienced and maintains a positive track record in assisting clients before, during and after an enforced customs audit. Our competencies are highlighted by comprehensive industry-specific knowledge and experience that allows us to provide relevant, practical and meaningful advice across various industry clusters. Our other fundamental service offerings include:

- qualification for and benefit from free trade agreements
- duty reduction through “unbundling” of non-customs costs
- strategic tariff planning
- coordination of transfer pricing and customs valuation
- anti-dumping duty reviews and assistance
- utilisation of Free Trade Zones, Logistics
- parks and Customs Bonded Zones
- duty reductions through tiered sales and commissionaire structures
- implementation of customs policies, procedures and internal controls
- compliance reviews
- third party cost analysis
- preparation of a wholly contained Internal Compliance Program (ICP) to meet Export Control requirements

• **Call us if you or your company:**

1. are interested in reducing its customs and cross-border costs through various strategic trade planning strategies.
2. would like to undertake a proactive assessment of potential customs risks concerning your operations.
3. encounter any of the following issues:
   - Transfer Pricing documentation, methodology or year-end adjustments questioned by Customs
   - tax issues on the transfer of bonded goods for further processing
   - potential double taxation due to royalty payments
   - receiving conflicting requirements from tax and Customs authorities
   - challenges by Customs regarding customs value, tariff classification and country of origin
Our credentials and past achievements

The following is a limited list of the notable consulting achievements we have delivered to our clients.

<table>
<thead>
<tr>
<th>Client</th>
<th>Leading global electronics manufacturer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Engagement</td>
<td>Efficiency and internal controls enhancement</td>
</tr>
<tr>
<td>Services</td>
<td>KPMG China analysed the client’s existing efficiencies and its compliance with China Customs rules. This involved the review of royalty agreements, cross-border logistics arrangements and regional trading agreements to identify possible cost-saving opportunities.</td>
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</tbody>
</table>

In the course of the review, KPMG China identified areas for improvement in the client’s management of bonded materials, use of bonded equipment, and pointers for effective customs broker management, which resulted in substantial savings for the company.
<table>
<thead>
<tr>
<th>Client</th>
<th>Major Korean electronics manufacturer</th>
</tr>
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<tbody>
<tr>
<td>Engagement</td>
<td>Free trade agreement advice</td>
</tr>
<tr>
<td>Services</td>
<td>Client sought KPMG China's advice on options to reduce its duty burden on its exports of anti-static boots imported into China. KPMG China advised that since Korea and China are members of the Asia-Pacific Trade Agreement (APTA), they can enjoy reduced duty benefits, provided that their product meets origin requirements. After confirmation of the country of origin, it was found that 40 percent of the company's products sold to China could enjoy the conventional tariff rate, which was two percent lower than the MFN rate. It that same year, the company was able to realise at least RMB 1 million savings in duty and VAT.</td>
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<table>
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<tr>
<th>Client</th>
<th>A global service provider of leasing/maintenance</th>
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<tbody>
<tr>
<td>Engagement</td>
<td>Customs supervision area advice</td>
</tr>
<tr>
<td>Services</td>
<td>A global service provider of leasing/maintenance wanted to expand its business in China by setting up a service/maintenance centre in a Special Customs Supervised Area (SCSA) and engaged KPMG China to provide advisory services for preliminary SCSA planning. KPMG China provided the company with an analysis and recommendations relating to the location of the centre, the arrangements on the flow of goods, cash and information, and the impact of different operation models on their financial statements.</td>
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<table>
<thead>
<tr>
<th>Client</th>
<th>Fortune 500 electronics manufacturer</th>
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<tr>
<td>Engagement</td>
<td>Internal controls enhancement</td>
</tr>
<tr>
<td>Services</td>
<td>Client sought KPMG China's advice to identify the causes and avoid a recurrence of a shortage in bonded materials which cost them over USD 1 million in customs penalties. After KPMG China's investigation, analysis and in-depth interviews with personnel from various departments, more than ten reasons for the bonded material shortage were identified. These areas related to six departments within the company. To strengthen internal controls relating to these areas, KPMG assisted the company in developing an integrated customs operations manual. In addition, KPMG China helped the company develop a revised ERP system, which was designed to include customs-related internal controls.</td>
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<table>
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<tr>
<th>Client</th>
<th>A leading electronic consumable manufacturer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Engagement</td>
<td>Customs training</td>
</tr>
<tr>
<td>Services</td>
<td>Client requested KPMG China's help to develop and implement a comprehensive training programme for its customs team. Through close coordination with the company, KPMG China developed a training programme and actively assisted the company in the recruiting and training of its customs team.</td>
</tr>
</tbody>
</table>
Our local, regional and global Trade & Customs network

China

Broad coverage
Across 13 cities in China

Dedicated resources
16 full-time, experienced staff members
Regional (Asia Pacific)

Broad coverage
Coverage in 16 territories

Dedicated resources
Over 50 full-time, experienced staff members
Global

- Broad coverage
  Coverage in over 100 countries

- Dedicated resources
  Over 175 full-time, experienced staff members
The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

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