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Asia Pacific Industrials, Manufacturing & Transportation Webinar Series

9 June 2022 | 10:30 - 11:30 am (CHT)

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1

Welcome & Introduction

Yaeko Hodaka
Co-chair, Asia Pacific IMT Industry Group
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Agenda

1	Welcome & Introduction	Yaeko Hodaka
2	Customs audits and export controls in China ▪ Introduction to Customs Audits ▪ Key Customs Audits Trends ▪ Customs Audit Management Strategy ▪ China's Export Control Law and dual-use controls ▪ Q&A	Tina Li & Weng Keong Kok
3	Closing & Wrap Up	Yaeko Hodaka

Speakers

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2

Customs audits and export controls in China

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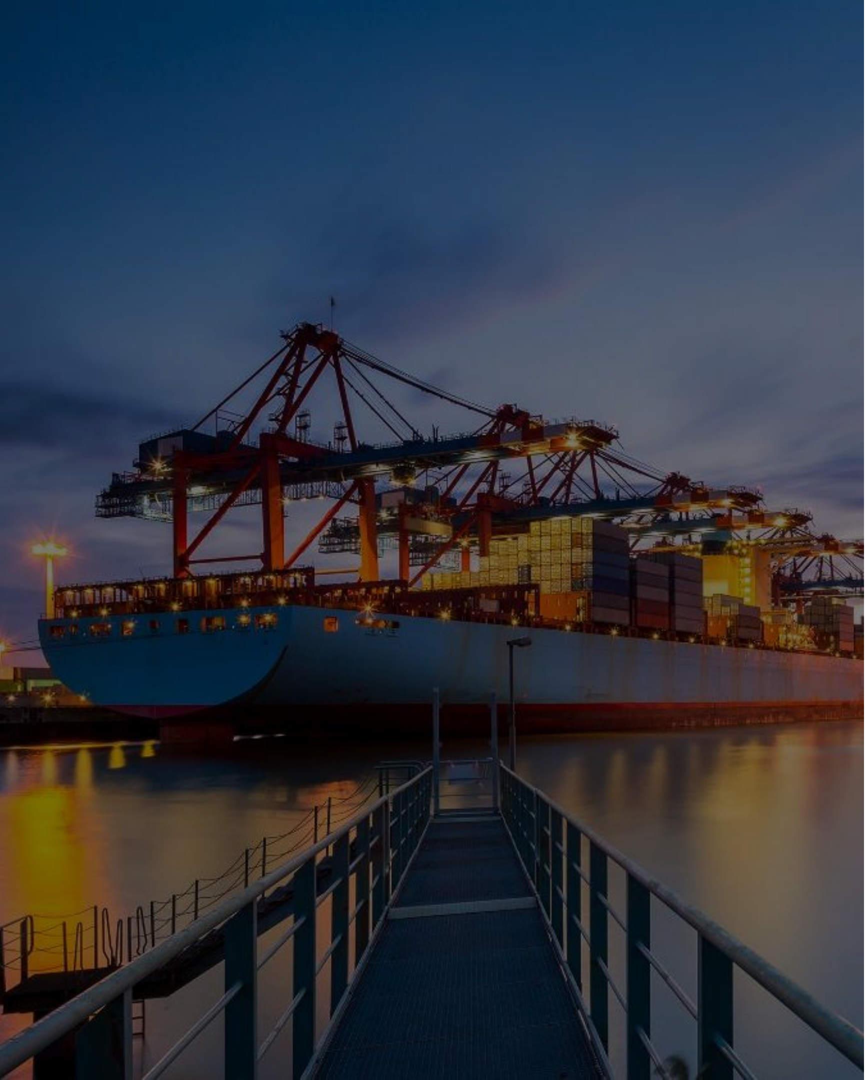


Introduction to Customs Audits

What are Customs Disputes

Customs disputes are matter that involve non-compliance with PRC Customs laws and regulations

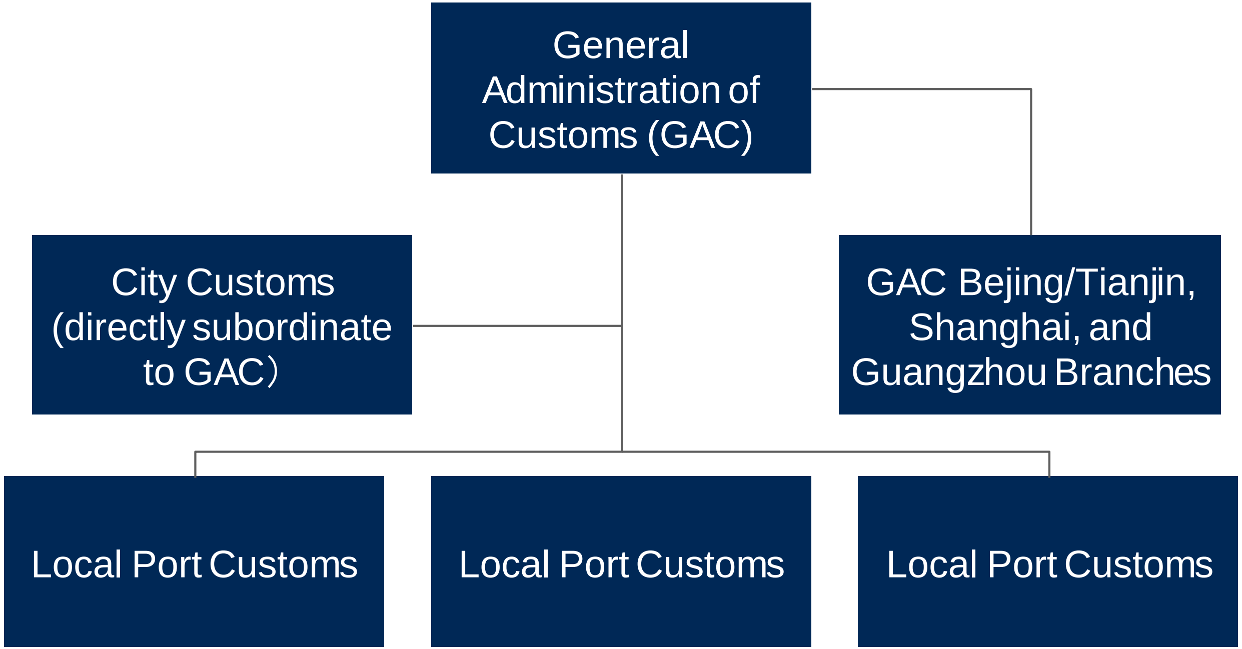
Customs in seeking to enforce compliance may impose penalties, from fines to imprisonment

Clients seek expertise in legal analysis, matter management and negotiation experience with PRC Customs

Organization of Customs in China

Departments at City- and Local- level Customs

1. Enterprise Administration Department
2. Valuation Department
3. Audit Department



Common Areas of Disputes

1 Customs valuation

- Measures of Customs on Determining the Dutiable Value of Imports and Export (GAC Order 213)
- Common Areas of Disputes
  - Transfer pricing
  - Royalties

2 Customs classification issue

- Regulations of Customs for the Administration of the Classification of Imported and Exported Goods (GAC Order 252)
- Common Areas of Disputes
  - Classification of parts v. complete equipment
  - Classification of products in set

3 Origin of goods

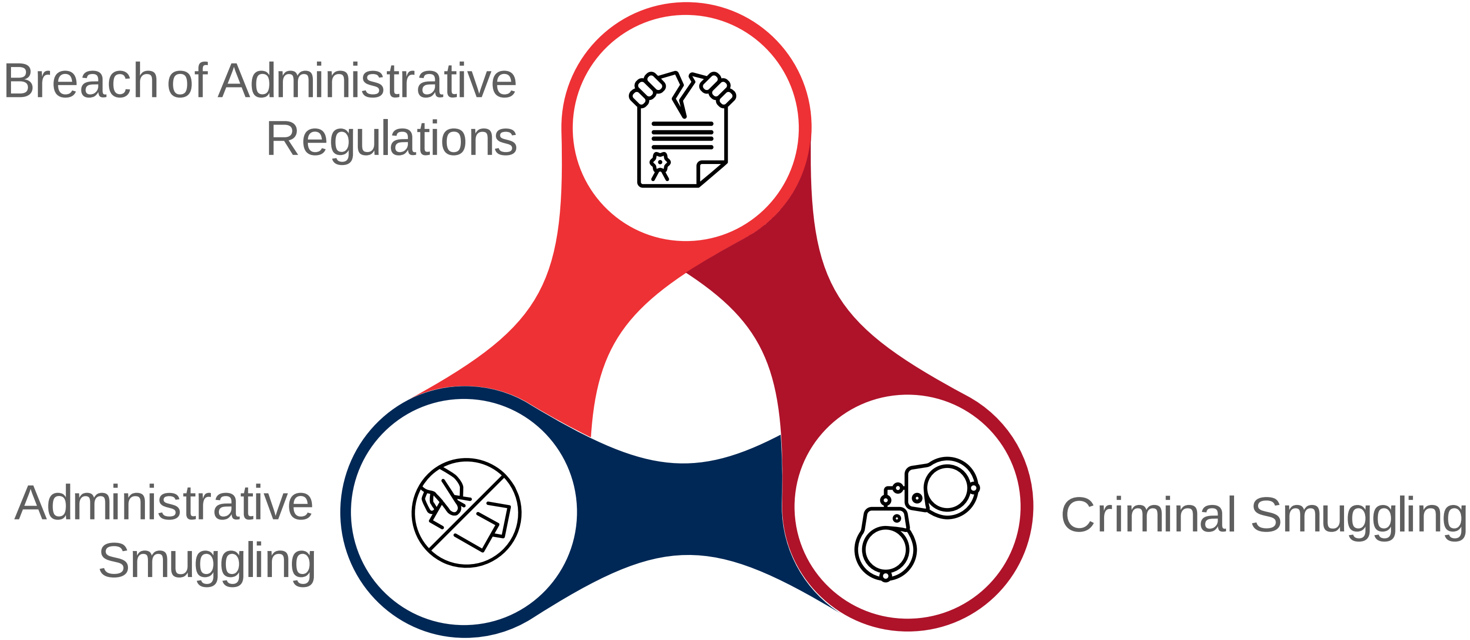
- Non-preferential origin rules, regulated by Regulations on the Origin of Imported and Exported Goods (State Council Order 709)
- Preferential rules of origin, set out in the Free Trade Agreements and the implementing rules of China Customs
- Common Areas of Disputes
  - Origin marks
  - Preferential treatment

4 Contract Manufacturing Issue

- Measures of Customs for the Supervision and Administration of Processing Trade Goods (GAC Order 247)
- Common Areas of Disputes
  - Unit consumption management
  - Mixing bonded materials with non-bonded materials
  - Domestic sale without Customs approval
  - Others

Penalties

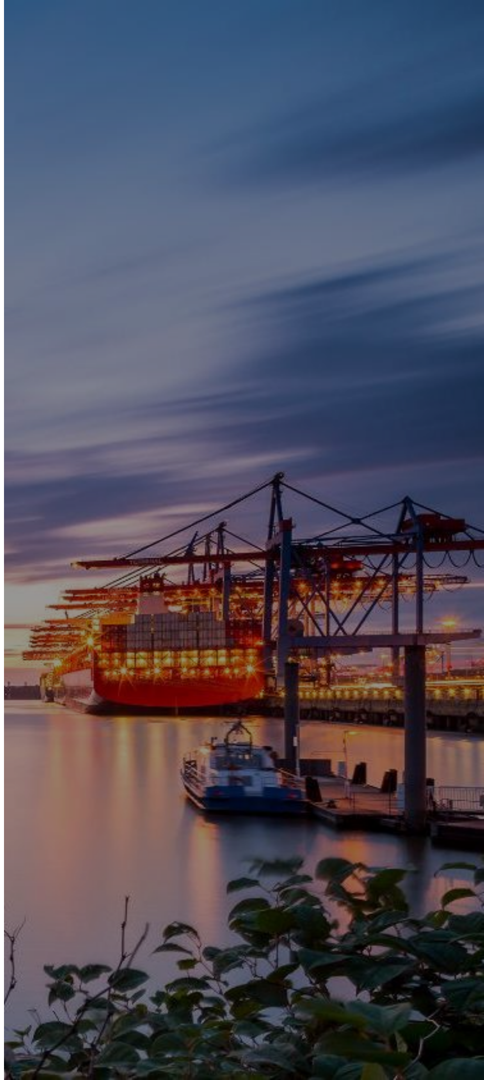
Summary of penalties

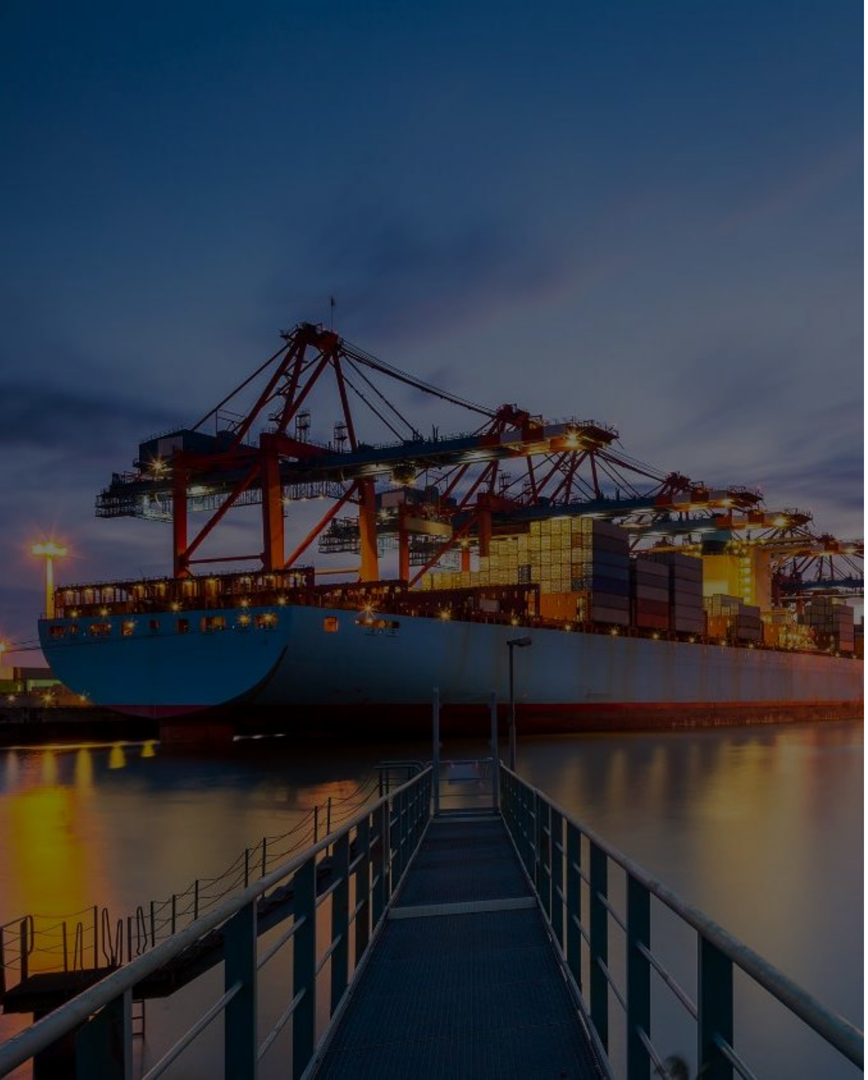


Voluntary Disclosure

Announcement on Matters relating to the Handling of Voluntary Disclosure (Bulletin 2019 No. 161)

- Penalties would be waived if a voluntary disclosure is made, provided that:
  - If the voluntary disclosure is made within 3 months after the date of violation, remedial actions are voluntarily taken to eliminating the harmful consequences, or
  - If the voluntary disclosure is made after the 3 months window after the date of violation, (1) the underpaid amount of duties and taxes is under 10% of the total duties and taxes liabilities, or under RMB 500,000, and (2) remedial actions are voluntarily taken to eliminating the harmful consequences.
- In any situation, if a voluntary disclosure is made, and the monetary penalty ultimately assessed by China Customs is less than RMB 500,000, such penalty would not impact the credit rating of the company.
- The above waiver is only applicable in breach of administrative regulations





Key Customs Audit Topics and Trends in China

Change in the Focus of Customs Valuation Audits and Investigations

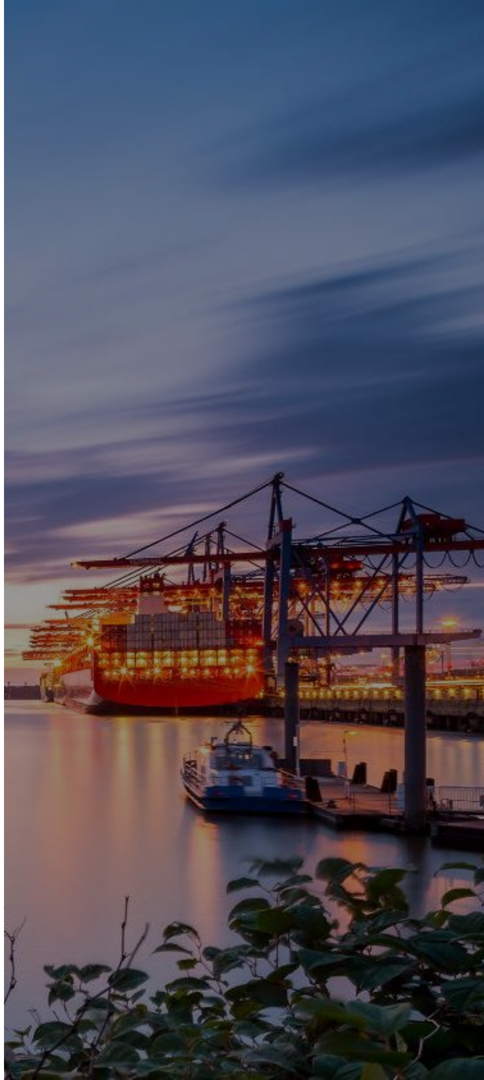
	Focus of customs valuation audits and investigations prior to 2021	New trend of enforcement since 2021
Trading companies	Has the special relationship between the buyer and seller influenced the transaction values (i.e., transfer prices)? Key challenge: difficult to ensure that the actual profit is always closely aligned with the target profit margin or the profit margins of the benchmarks.	Trademark royalties paid for distribution of the imported finished goods in China are more frequently targeted by Customs Key challenge: difficult to argue that such royalties are unrelated to the imported goods or not paid as a condition of sale of the imported goods
Manufacturers	Has any royalty payment satisfied the conditions for customs dutiability? Key challenge: China Customs would generally impute at least part of the technology royalty paid for the manufacturing technology to the imported components, if such parts are "specially designed".	The transfer prices of the imported raw materials are more frequently scrutinized Key challenge: difficult to justify the transfer prices based purely on the company-level transfer pricing studies or documentation

Triggers of a Customs Valuation Audit or Inquiry

Customs conducts regular audits on both transfer prices or royalties (note, however, that an upward adjustment to the transfer price and an addition to the import price for a dutiable royalty are **two mutually exclusive approaches** for a same import transaction)

Other common triggers:

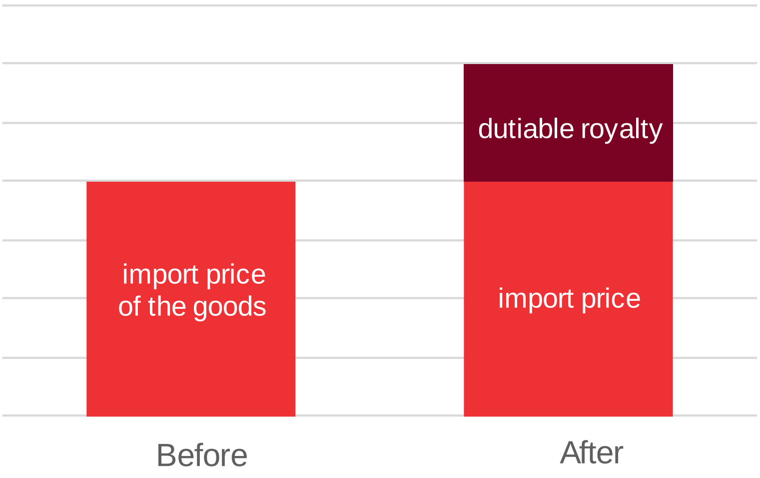
- Significant increase or decrease in the import prices
- Significant outbound remittance of royalties
- "Royalty paid" box on the customs entry forms checked for the first time



Technical Challenges - Example

Challenges of imposing new royalties, increasing existing royalty rates or adopting a variable royalty structure

New royalties

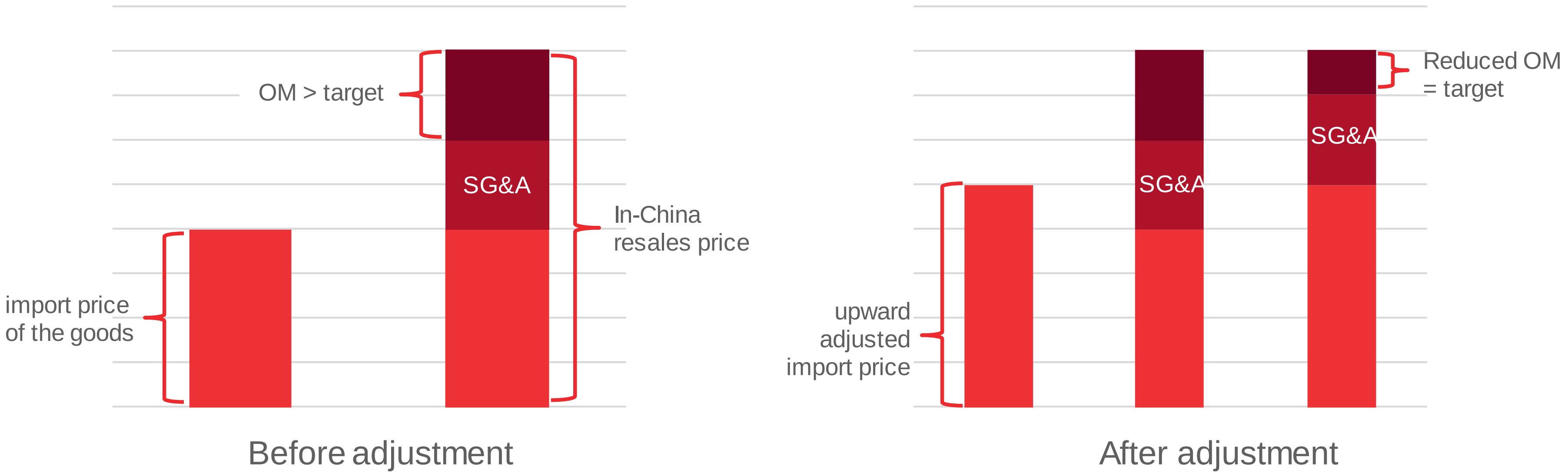


Variable royalties

- x% of the OM be paid as royalties
- OM < target, No royalty payment

Technical Challenges

Aligning the company's actual profit margin with the range of the benchmarks specified by the TP studies through a retrospective year-end TP adjustment



Technical Challenges

No formal procedures to follow, but opportunities to negotiate with Customs on a case-by-case basis

Once the process kicks off, the firm will need to undergo the same process on a yearly basis

Key steps:

- Negotiate with Customs on the TP method and the (favorable) benchmarks
- Negotiate with Customs on the basis for making the year-end adjustment (e.g., the median of the interquartile range of the benchmarks, the target profit margin specified by the TP policy, etc.) and the frequency of updating the related TP studies
- Negotiate with Customs on the import prices (preferably lower than the level that would otherwise allow the company toachieve the target profit margin), at which the goods are allowed to be imported during the course of the year, without triggering any customs challenges
- Negotiate a timeline for making the retrospective adjustment, which is aligned with the firm's tax filing and accounting practices – e.g., year-end vs. mid-year adjustments
- Discuss the feasibility of repatriating the cash out of China for the adjusted import prices (which would require coordination with the port level customs authority to retrospectively amend the customs entry forms)
- Aligning the approach accepted by Customs with the other stakeholders -- e.g., tax authority, CPA, port authority, and the related in-house teams

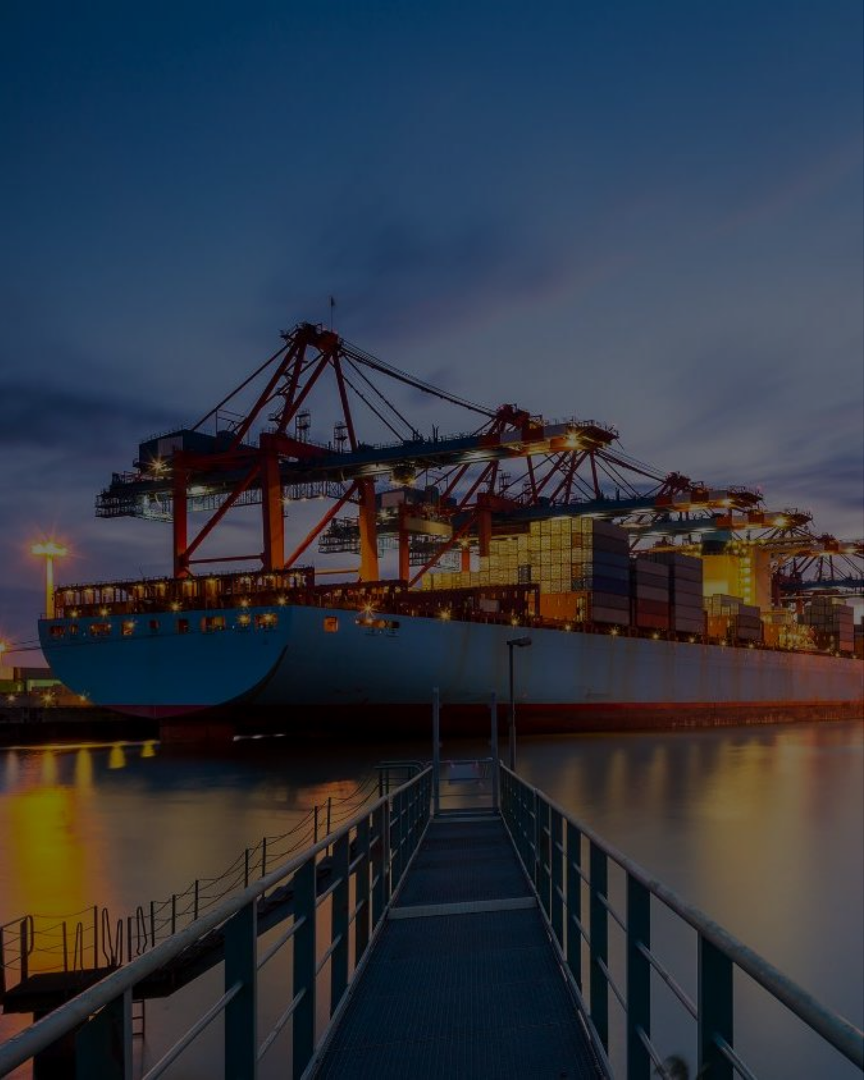
Suggestions

Assess the customs implications before making any decision on transfer pricing changes

Incremental, prospective transfer pricing adjustment is still preferred from a Customs perspective

Analyze whether it is in the firm's interest to proactively engage customs beforehand, by taking into account the technical strength of the case and the liability exposure, and decide the right course of action

Retrospective transfer pricing adjustment may be an option, but requires certain commitments from the company, including the disclosure of the company's TP to Customs on a continued basis



Customs Audit Management Strategy

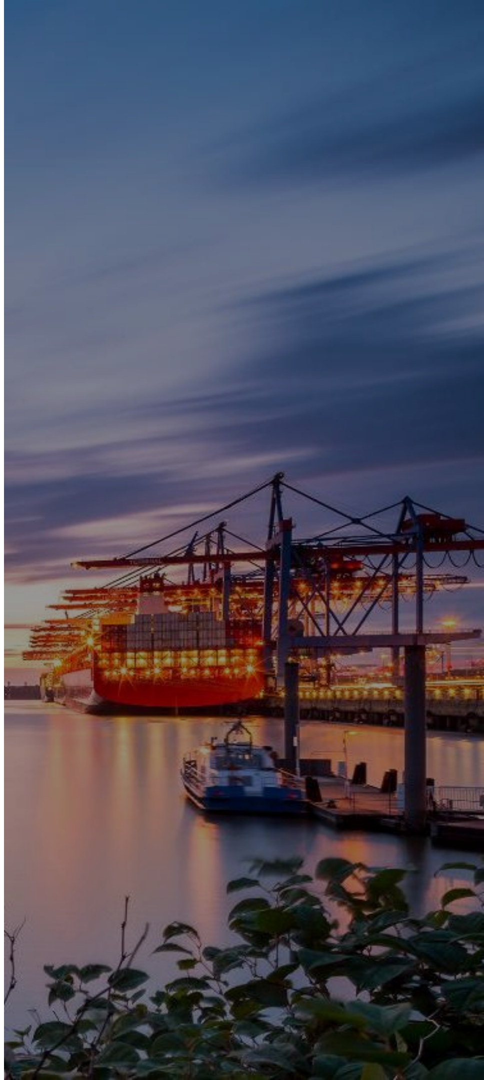
Common Mistakes

Insufficient Planning / Systems

No or little control over dispute process

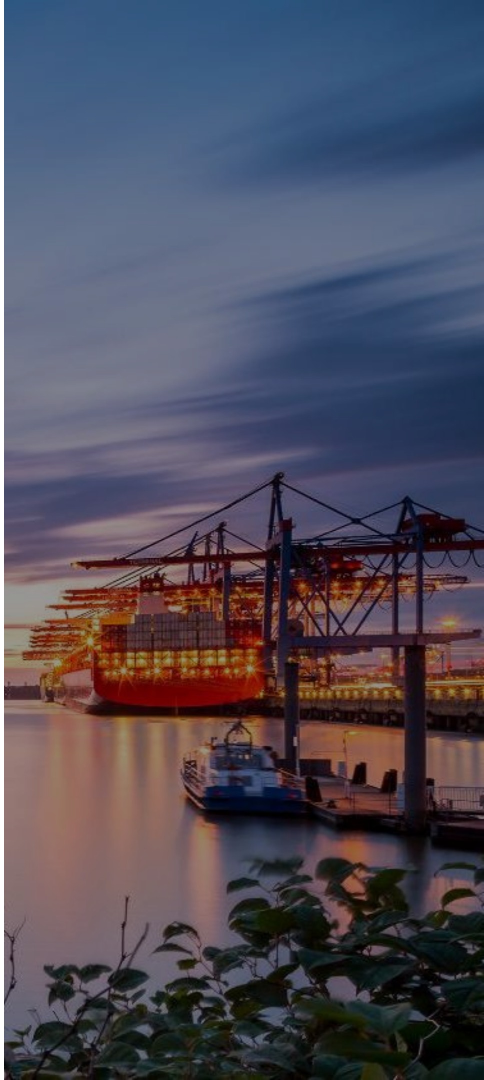
Accepting independent agents' 'assistance'

Over-reliance on customs brokers / import-export agents



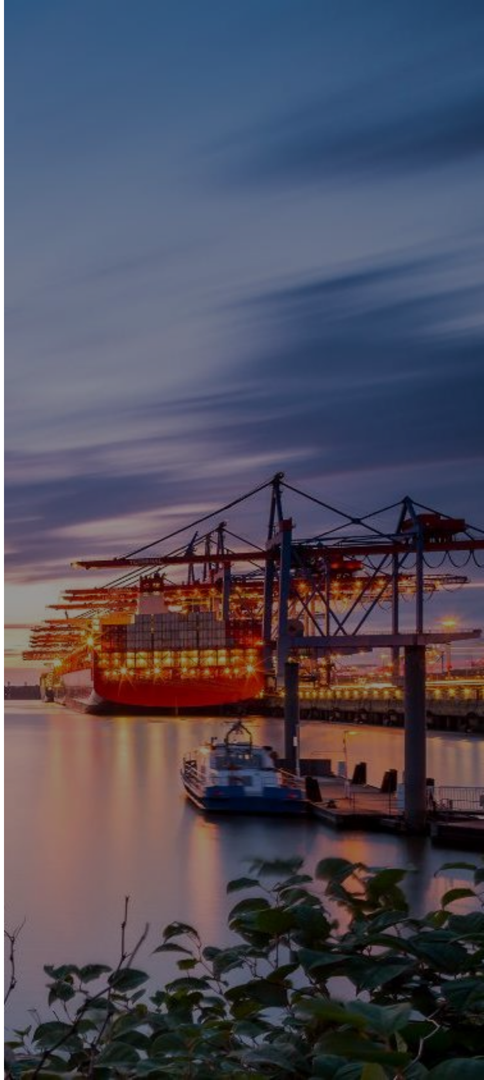
Managing Disputes

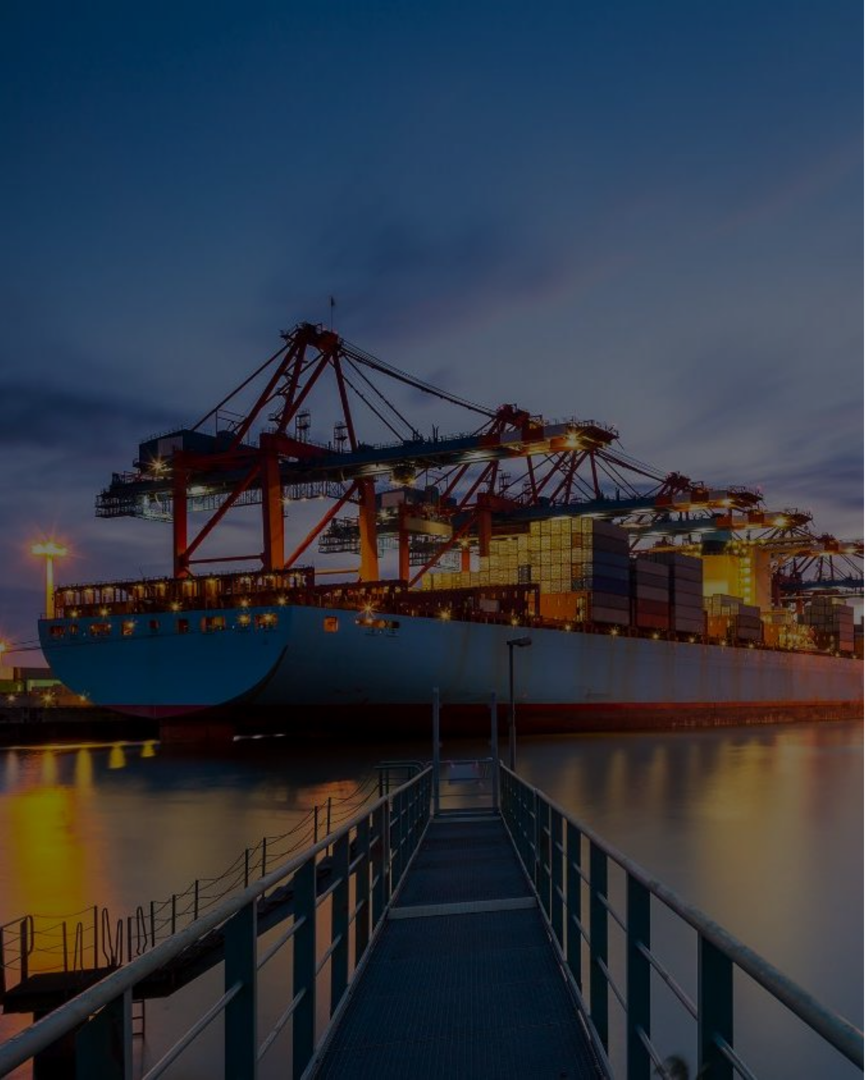
- Internal Communications Protocol
- Control of External Communications Flows
- Technical Basis
- Navigating Customs Requests / Demands
- Negotiations
- Corrective Action



Issue Spotting

- Goods stuck at Customs
- Notice of Price Query / Investigation
- Customs Audit Team Visits
- Customs Request for Information
- Disgruntled Employees
- Whistleblowers





China's Export Control Law and dual-use controls

China's Export Control Law – Key Concepts

Controlled items

Controlled items include dual-use, military, nuclear and other goods, technologies, services and items that relate to fulfilment of international obligations and national security. Encryption listed under structure similar to Wassenaar List

Deemed export

Include "deemed export" concept which can apply to in-country transfer to non-Chinese persons

Catch-all provision

National security, weapons of mass destruction, and terrorist activities

Licensing Considerations

Include (a) international obligations and commitment, (b) national security, (c) type of export, (d) sensitivity of item, (e) destination, (f) end-use and end-user, (g) credit record of the exporter and (h) other factors provided under law

Prohibitions & Temporary Measures

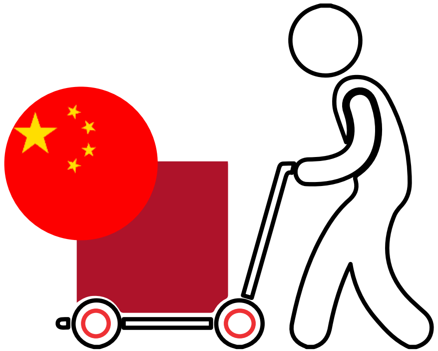
Power to prohibit the export / supply of controlled items to specified countries, regions and persons. Additional power to impose temporary controls on goods, technologies and services that are not prescribed.

Black-listing control

Provides black-listed control for importers and end-users who fail to fulfil their end-user or end-use commitments, may pose threats to national security or use the items for terrorist purposes.

Internal compliance program

Encourages enterprises to establish internal compliance program ("ICP") for export control, and may grant licensing facilitations to enterprises which adopt ICP

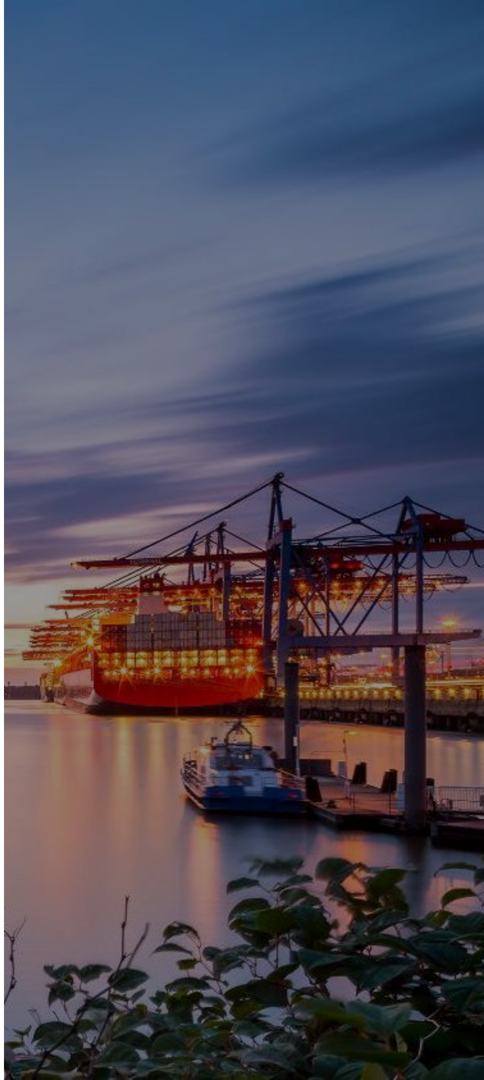


Effective 1 December 2020

MOFCOM Draft Export Control Regulations

More than one year since China's new Export Control Law ("ECL") became effective, MOFCOM has released long-awaited Regulations on Dual-use Item Export Control ("Draft Regulations") draft for public comment on 22 April 2022.

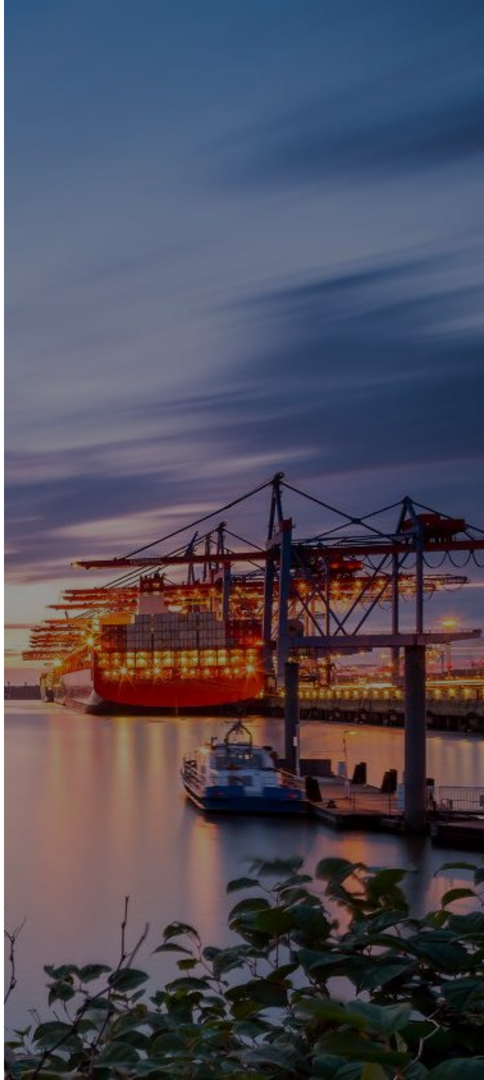
- Scope of control: Although the Draft Regulations focus on dual-use item controls, they also include a provision that allow the regulators to apply the rules to the export of non-dual-use items controlled by China, where the relevant regulations leave gaps to be filled.
- Such non-dual-use items may include the export of technologies that are currently regulated under a separate legacy technology import and export control regime, which sits alongside the ECL.



Classification and Destination Based Controls

Currently, MOFCOM and GACC publish and update a consolidated "dual-use" list on an annual basis. These are based on technical descriptions as well as the accompanying tariff classification codes for the items.

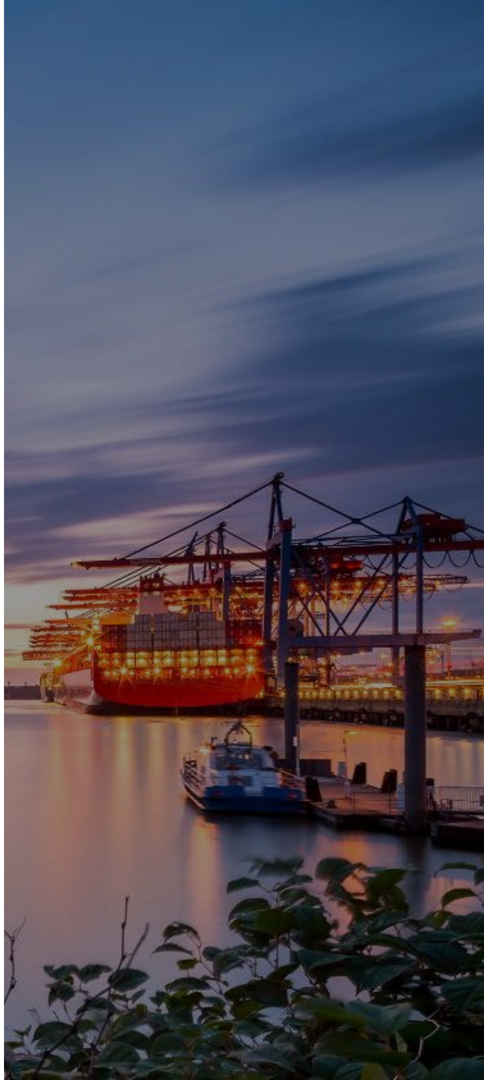
- The Draft Regulations contain references to the establishment of "export control classification codes" and "country of destination risk grading system"
- This suggests China may eventually adopt systems similar to Export Control Classification Number ("ECCN") and Country Chart under the US Export Administration Regulations ("EAR") regime. This approach will be in line with MOFCOM's overall objective to promote adherence with international export control regimes.



Prohibition to Accept Investigations by Foreign Authorities

Draft Regulations specifically prohibit Chinese individuals and companies from cooperating or committing to cooperate with agents of foreign governments in on-site export control interviews or investigations conducted in China without MOFCOM's approval.

- These could include, for example, end-use or end-user checks.
- It is unclear how MOFCOM's approval may be obtained under this requirement, and how such restriction may impact compliance and ability to secure export permits under foreign export control regimes.



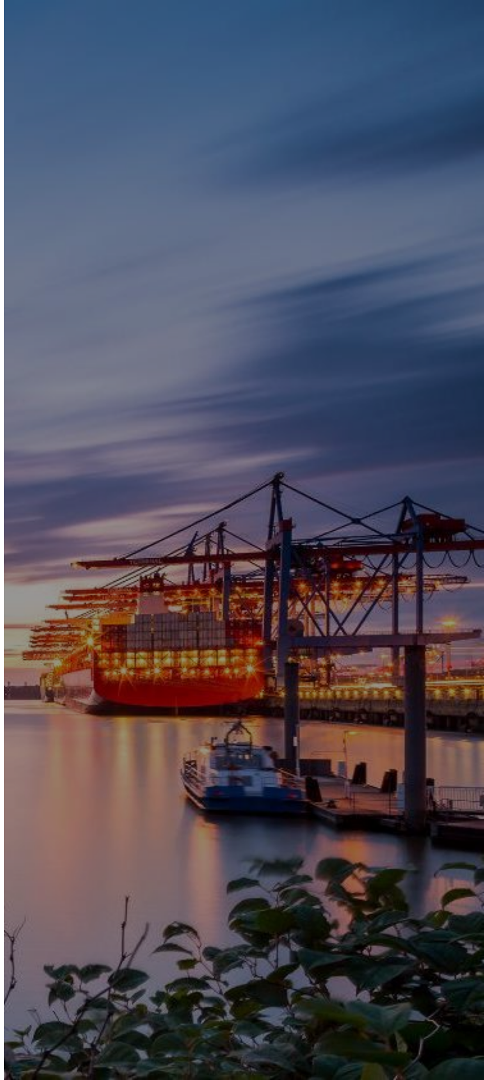
General Licensing Regime

The Draft Regulations provides for two licensing options:

"Specific license" regime, which pursuant to which an export license issued can be used for the export of specific item to a specified end-user.

"General license" regime, pursuant to which an export license issued can be applied to the export to multiple end-users with respect to multiple items within a period of two years.

- Availability of the "general export license" will depend on various factors.
- This includes the export control compliance status and the implementation of the internal compliance program ("ICP"), exporter's export records and the historical license application record for the past two years, relevant transaction flows and sales channels, etc.

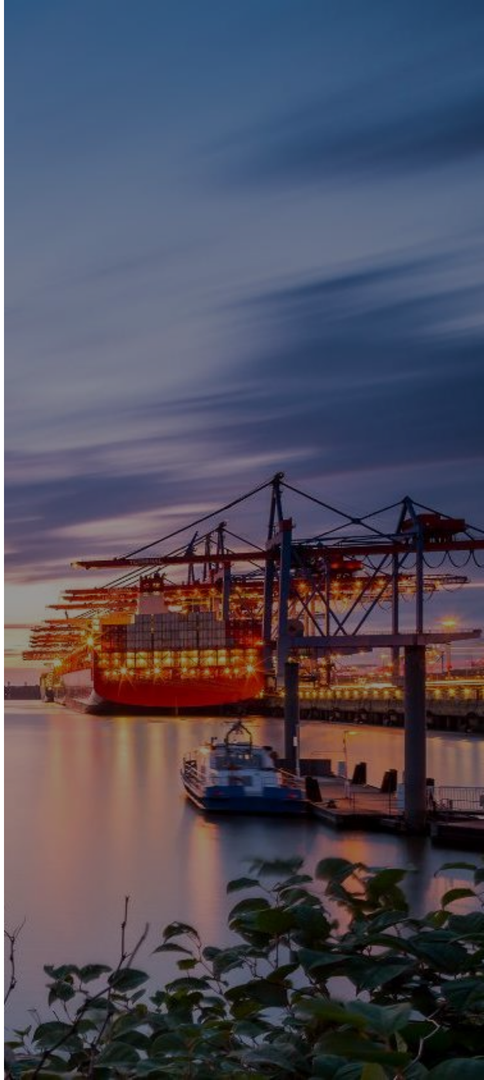


License Exceptions

The Draft Regulations provides for license exceptions and are expected to facilitate business operations:

- Re-export of goods brought into China for maintenance, testing or inspection back to the country of export within a reasonable period of time
- Re-export of goods brought into China for the purposes of exhibitions held in China, to the country of export immediately after the exhibition ends
- Export of civil aircraft parts and components for maintenance purposes
- Other circumstances prescribed by MOFCOM

An exporter who believes that its export is exempted from licensing requirement under the above-mentioned circumstances may register with MOFCOM before exporting.



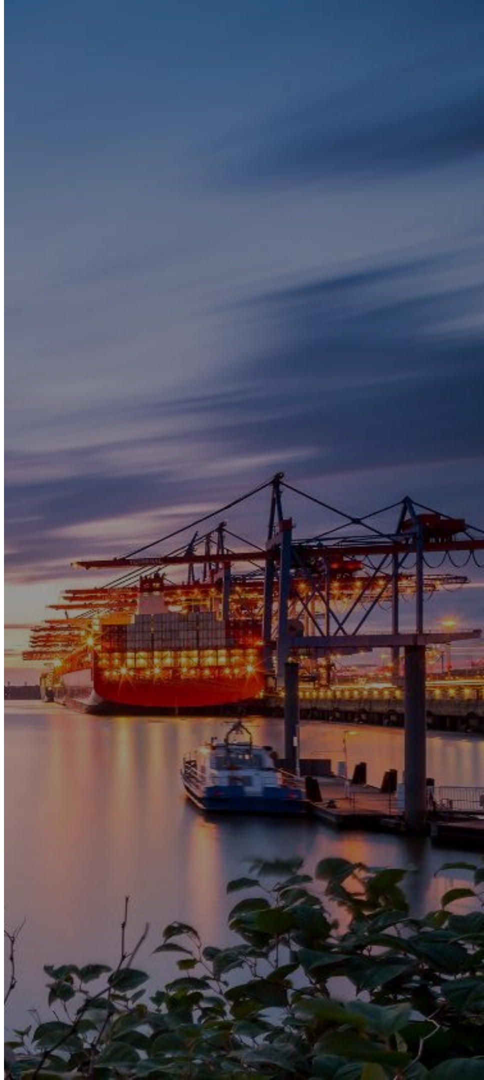
End-use Controls

Where there is a change in the end-use of an exported item, obligation is placed on the foreign end-user of the exported items to apply to MOFCOM (through the Chinese exporter) for approval of the anticipated end-use change.

Catch-all Controls

Items falling outside of control lists may still be subject to catch-all controls.

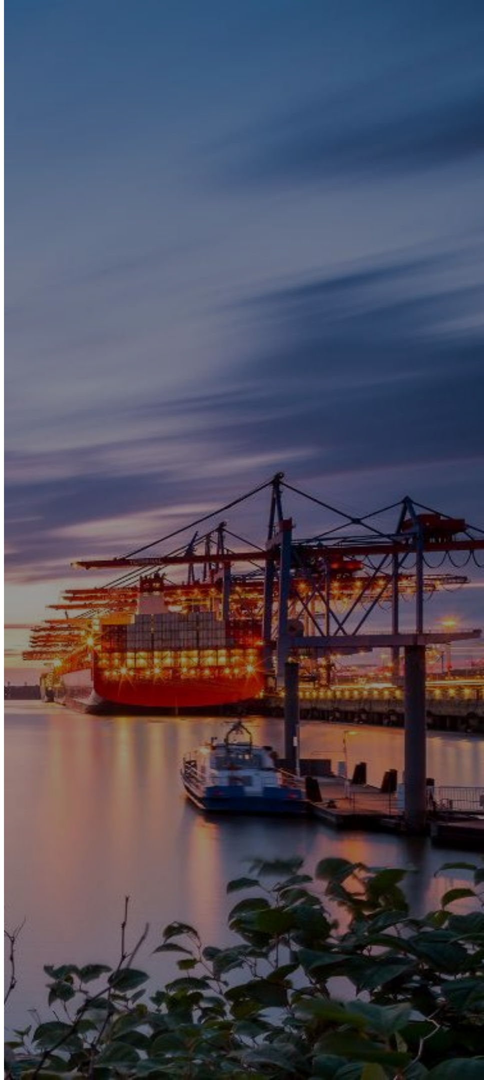
The exporter as well as the foreign importer are obliged to report to MOFCOM any risks to national security and interest, risk of involvement in weapons of mass destruction and risk of terrorism with respect to the use of the item within three years after the date of exportation.



Blacklisting

The Export Control Law authorizes the Chinese government to prohibit export of goods, technologies or services to specifically designated countries, entities or individuals either unilaterally, or as a retaliatory measures or under the framework of the UN Security Council Resolutions.

- Draft Regulations outline more specific provisions for importer or end-user "blacklisting", providing for denial of general license and license exceptions where the item is exporter to any blacklisted importer or end-use.
- Draft Regulations also outline procedures for seeking delisting.



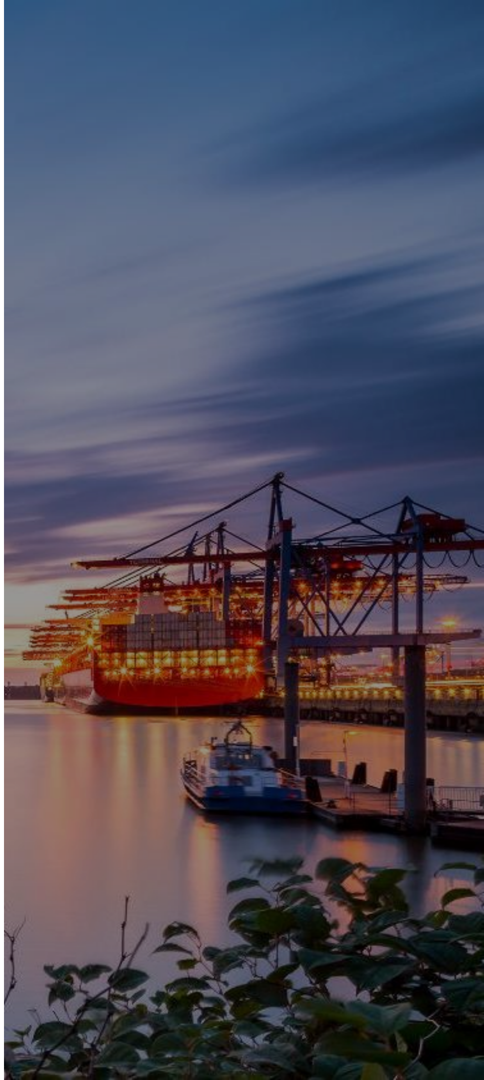
Third Party Responsibilities

Upon discovery of any exporter engaging in export control violations, any third party person or company engaged in the provision of agency, freight, delivery, customs declaration, third-party e-commerce trading platforms, and financial services shall:

- immediately cease such activities and
- report the same to MOFCOM.

Who are third parties?

Parties involved in the supply chain, such as brokers, agents, forwarders, e-commerce platforms, financial service providers, etc.

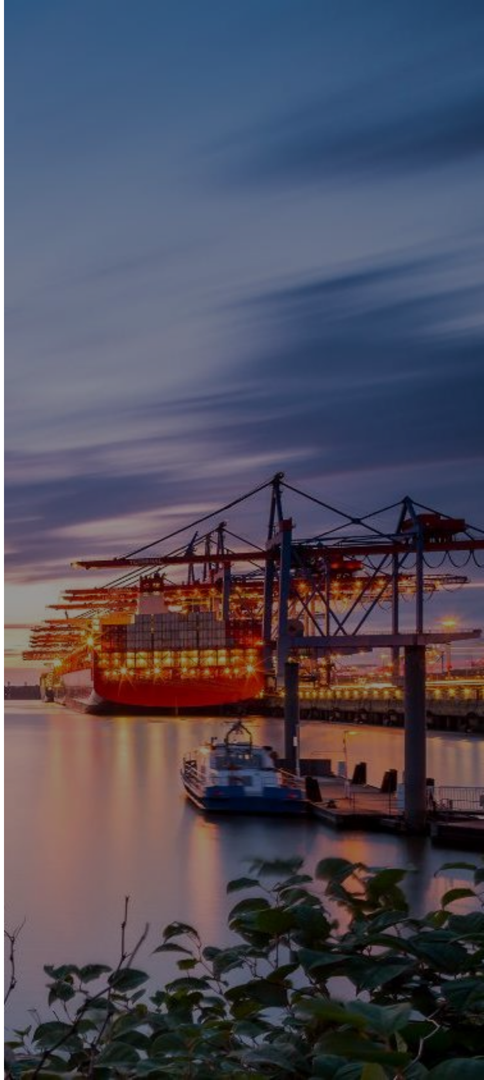


Multi-agency Collaboration Regulatory Regime

The Draft Regulation, which is slated to be issued by the State Council (i.e., China's cabinet), once formally adopted will put in place a mechanism for MOFCOM to work with other governmental agencies, in enforcement actions.

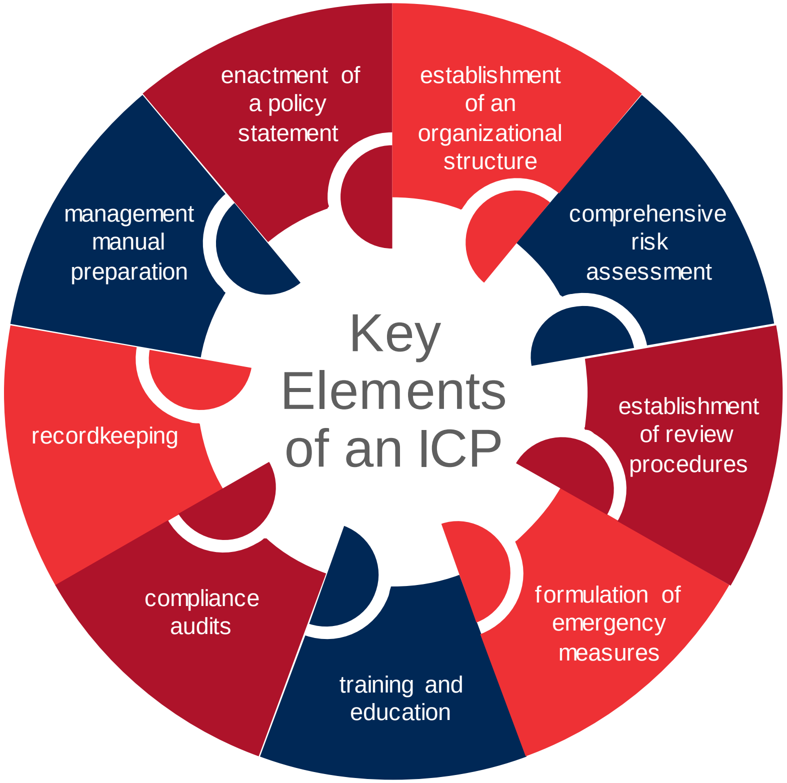
Government agencies include:

China's top agencies in charge of public security, national security, financial regulation, market regulation, customs, and public transportation.



Internal Compliance Guidelines on the Export of Dual-Use Items

The implementation of an Internal Compliance Program ("ICP"), while not mandatory, is encouraged to accord the exporter certain benefits including the grant of general export license and penalty mitigation in case of violation.




Questions

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Closing & Wrap-up

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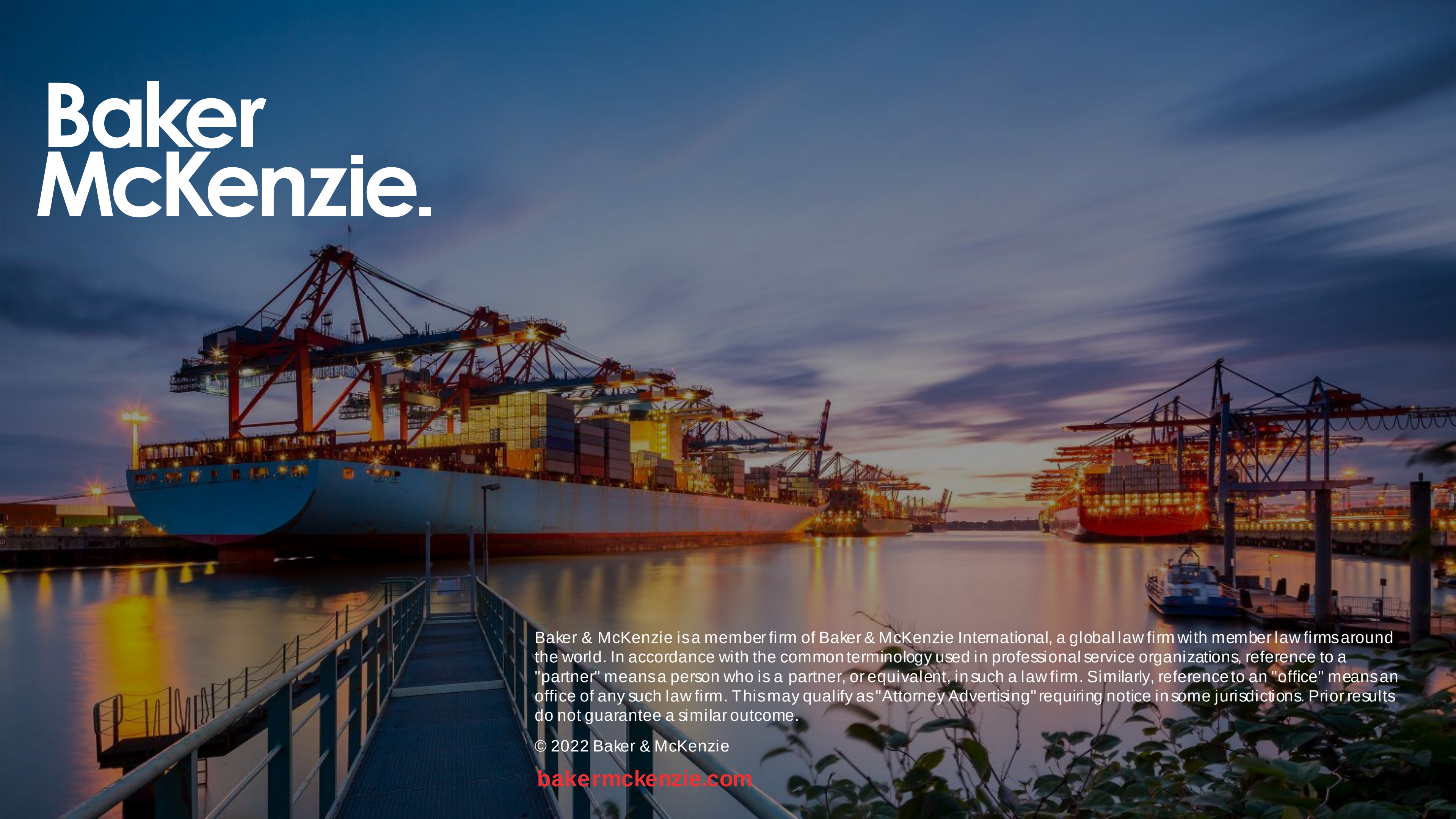

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