

PRC General Administration of Customs Issues Circular on Duty Treatment of Royalty Payments

China's General Administration of Customs (GAC) has published a new circular to clarify the customs duty treatment of royalty payments, an issue of considerable concern to foreign companies with operations in China. The new circular, which came into effect on 1 July 2003, represents one of the most sweeping changes to PRC Customs legislation since China's accession to the WTO.

The circular (which supersedes the Customs Interim Provisions of Tax Levy and Exemption of Software Charges of Import Goods (1993 No. 15)) defines royalties and the conditions under which royalties or like payments will be subject to or exempt from customs duty.

Definition of Royalties

Royalties are defined in the circular as payments made by buyers of imported goods (*i.e.* finished goods, components and materials) for the right to use patents, trademarks, copyrights and proprietary technology. The provisions of the circular also extend to payments by importers/buyers of rights to distribute, retail and resell goods. Notably, the circular states that "other similar charges" are also covered, although that phrase is not further defined. As a result, management fees and other technical support charges paid by overseas companies to their China-based affiliates for commercial knowledge potentially may be captured by the circular.

Inclusion in Dutiable Value of Imported Goods

In accordance with the WTO Customs Valuation Agreement, royalties paid in respect of the above will now only be included in the value for customs duty purposes if (1) the payments are related to the imported goods, *and* (2) the royalties are paid as a condition of their sale for export to the PRC.

Definition of "Related to the Imported Goods"

The GAC circular stipulates the specific circumstances under which the PRC Customs authority will deem various royalty payments as being related to the imported goods.

Patent rights or proprietary technology rights will be related to imported goods in the case of:

- Goods with embodied patent rights or proprietary technology;
- Goods produced by using patented methods or know-how; and

- Machinery and equipment specially designed or manufactured for implementing patented or proprietary technology.

Of particular note is that patents and proprietary technology imported by tape, floppy disk, CD or other carrier mediums, or transmitted via the Internet or satellite are considered related to imported goods.

Payments for trademark rights will be related to imported goods in the case of:

- Imported goods bearing the trademark;
- Imported goods that can be resold directly with the trademark attached after import; and
- Imported goods that include a trademark right and that can be sold immediately or after slight processing and the trademark is included.

Payments for copyrights rights will be related to imported goods in the case of:

- Imported goods that contain software, words, music, pictures or other similar contents, including tapes, floppy disks, CDs or similar mediums; and
- Imported goods with other content that is copyrighted.

Payments for the rights to retail or resell granted to the seller of the goods in the PRC will be related to imported goods if the goods are:

- Sold directly after import; or
- Sold after light processing, *i.e.* simple handling operations such as dilution, mixing, simple assembly, repacking or other similar processes.

There is scope to argue to the PRC Customs authorities about the degree of processing that is undertaken on imported goods, and therefore, whether the royalty payment is subject to duty.

Definition of "Condition of Sale for Export to PRC"

The WTO's Technical Committee on Customs Valuation attempted for many years to provide guidance to Customs administrations on the meaning of the phrase "condition of sale" but abandoned this initiative because it was reluctant to define a term of the Valuation Agreement in the context of other terms not used in the Agreement.

The new circular indicates that the condition of sale part of duty liability test is satisfied where the transaction for the goods can only be concluded by the payment of the royalty. It appears that the PRC Customs authorities will determine whether a royalty is a precondition of sale. It remains to be seen on what basis the Customs administration will make this determination and to what extent the decision is reviewable.

Exemptions from Duty Liability

The circular recognizes that, subject to certain evidentiary and documentary requirements being fulfilled, payments made for the reproduction of imported goods within the PRC, and for technical training or overseas inspection expenditure will not be subject to customs duty.

Declaration of Royalty Payments

In other countries, importers generally self-assess customs duty liability for royalty payments and, if in doubt, seek a written ruling from the Customs authorities. From a risk management perspective, importers into China need to be aware that under the new circular, there is a requirement to declare all royalty payments when making import declarations. Importers will need

to be in a position to provide supporting documentation relating to the payment of royalties, particularly when the importers do not believe that the payments should form part of the customs value for duty purposes.

Conclusion

Although the new circular is welcome in that it provides greater clarity on how royalty payments should be treated by the China Customs authorities nationally, concern remains as to how the new rules will actually be implemented by local customs offices and how some of the provisions of the Circular will be interpreted. Many businesses are justifiably concerned that payments which hitherto have not been considered dutiable under the old legislation will now be captured under the new rules.

It may be possible in certain circumstances to persuade the PRC Customs authorities about the appropriate treatment of royalties based on "international precedents." This will be important to ensure that China conforms to the generally accepted WTO principles regarding the treatment of royalties.

Companies that are currently paying customs duties on royalty and similar payments should critically review their arrangements to determine whether the new circular gives rise to potential additional duty exposure and what arguments can be advanced to demonstrate to Customs that the payments do not relate to the imported goods and are paid as a condition of sale of such imported goods.

Companies that are considering implementation of royalty/license fee or similar arrangements will need to re-evaluate the arrangements to ensure they are structured in a tax-efficient way. Consideration should be given to seeking written rulings from the Customs authorities as to whether royalty payments are dutiable to reduce delay in clearing goods through the border controls.

This issue should be addressed immediately because indications are that PRC Customs are about to embark on a detailed audit program, and royalty and similar arrangements are likely to be at the forefront of their enquiries.

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