



# Navigating challenges of China customs audit

Nov 2013

 **ERNST & YOUNG**  
安 永

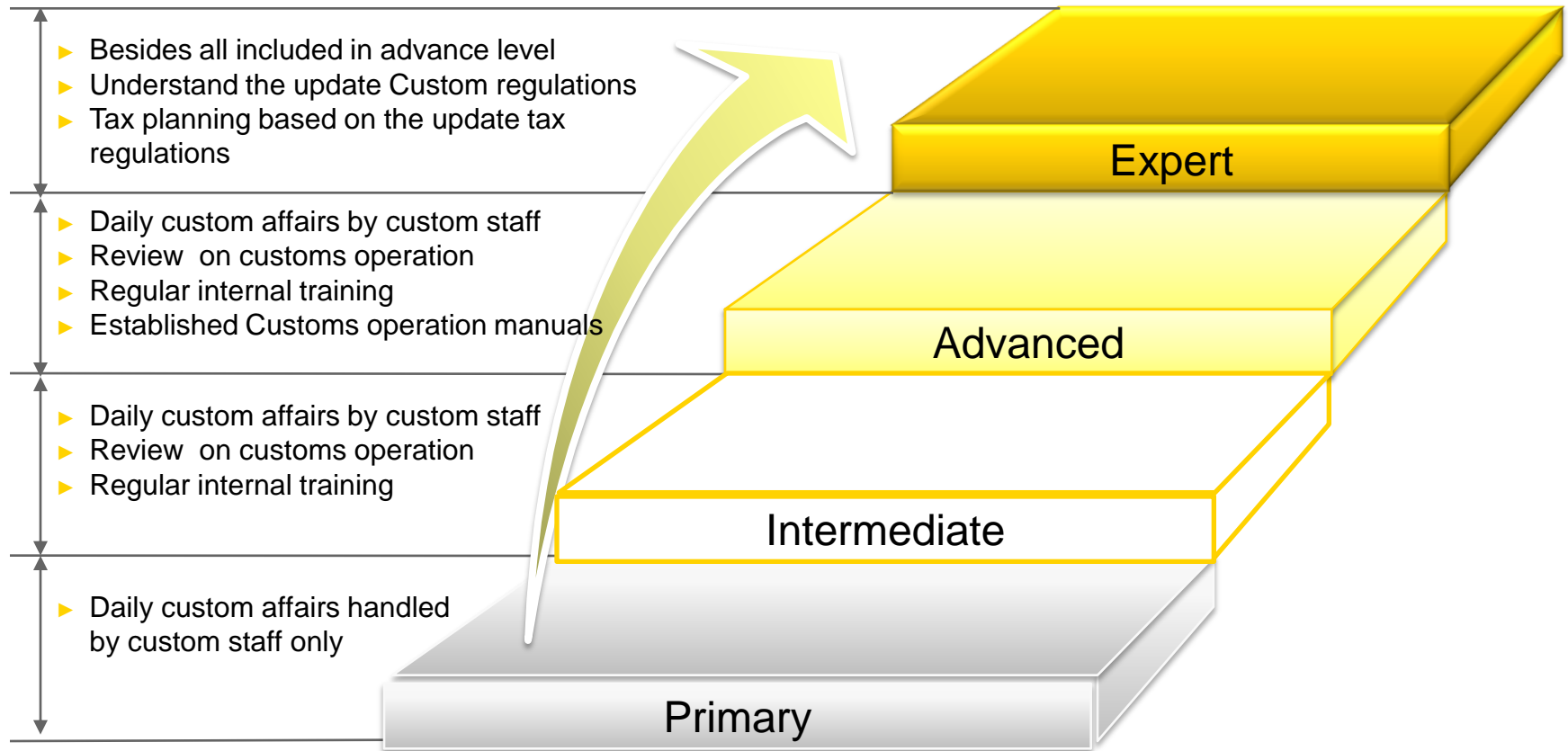
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# Today's agenda

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- ▶ China Customs Organization
- ▶ Hot Topics of China Customs
  - ▶ Processing Trade
  - ▶ General Trade
  - ▶ Customs Audit
- ▶ China VAT Pilot
- ▶ Q & A

# Which level are you in?



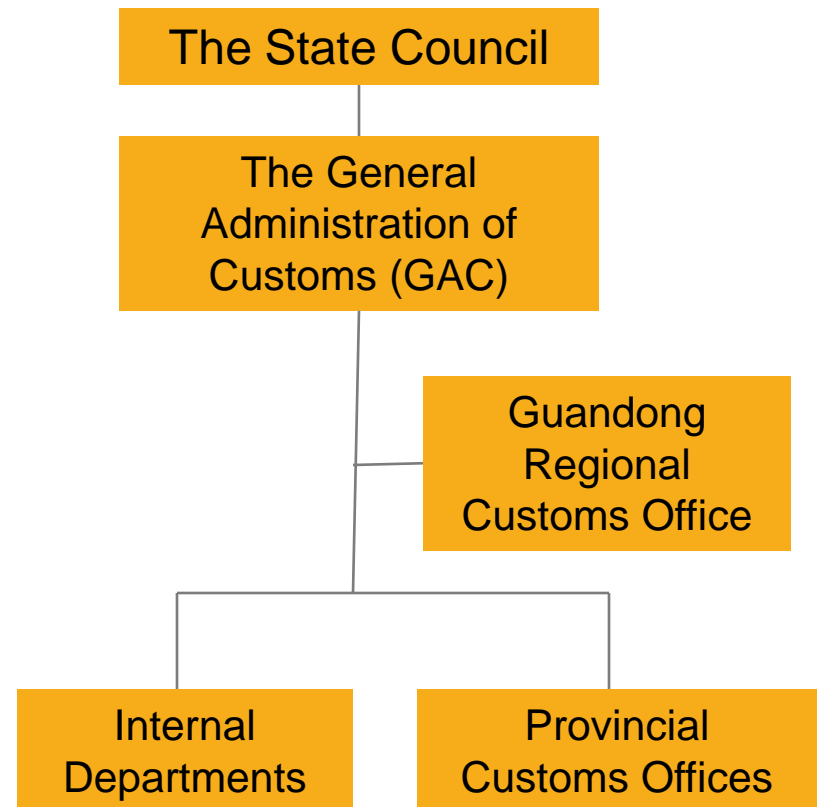
# China customs organization



# China customs organization



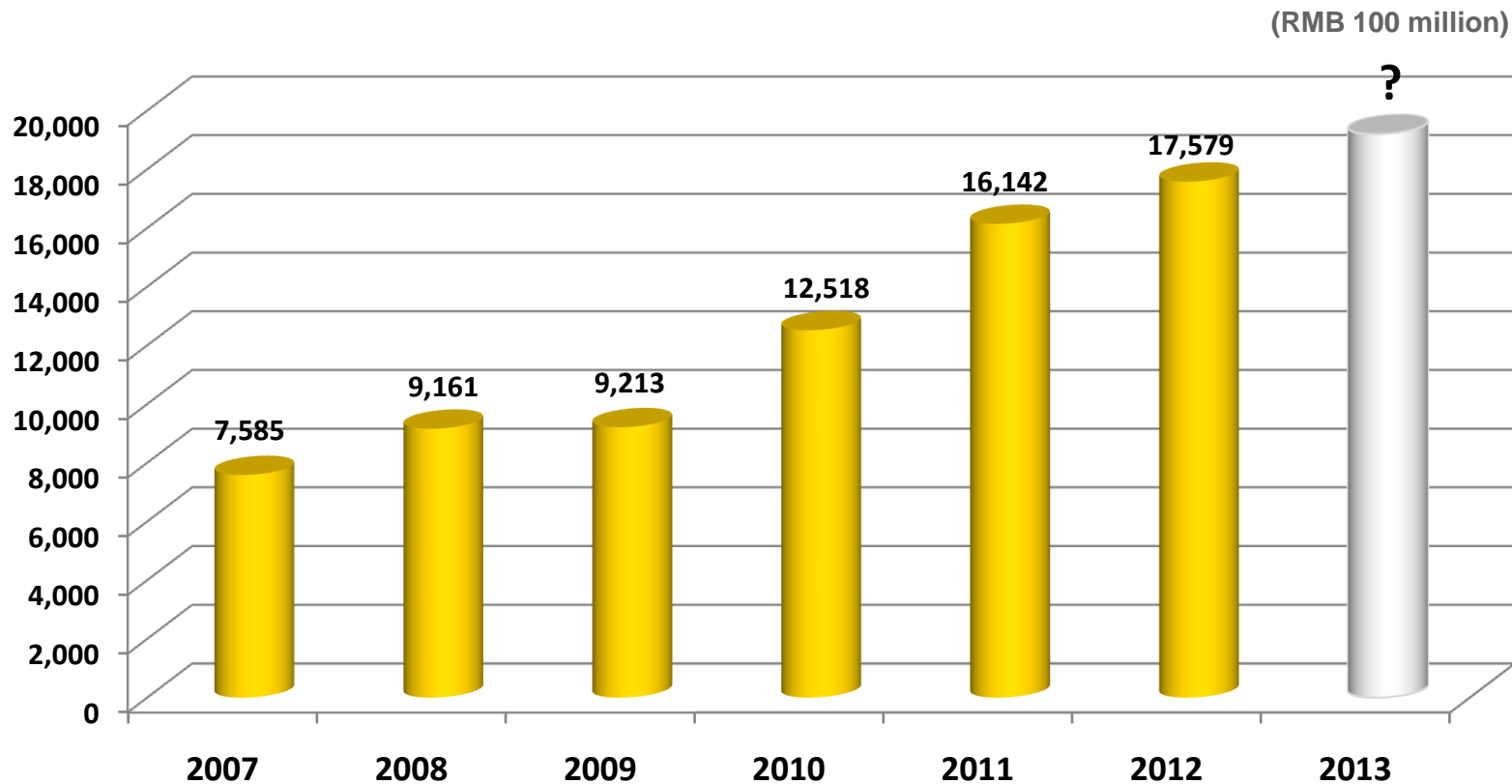
(Source from GAC official website)





# Taxation collection continues to grow

## ► Taxation revenue in the period of 2007-2013



As of every 31 December  
Resource: The website of Ministry of Finance of China

# Hot Topics of China Customs





# Processing trade – general flow



- 1) Processing trade certificate (type/capacity)-MOFCOM
- 2) HB registration
  - ▶ BOM(HS code/ grouping / unit consumption)
  - ▶ Issue HB - in charge customs

- 1) Preparation (HS code, unit price, license and so on)
- 2) Goods reach port
- 3) Import declaration
- 4) Customs examination, if required
- 5) Additional documents if required
- 6) Release
- 7) RM enter WH
- 8) FX verification and write-off (contract manufacturer)

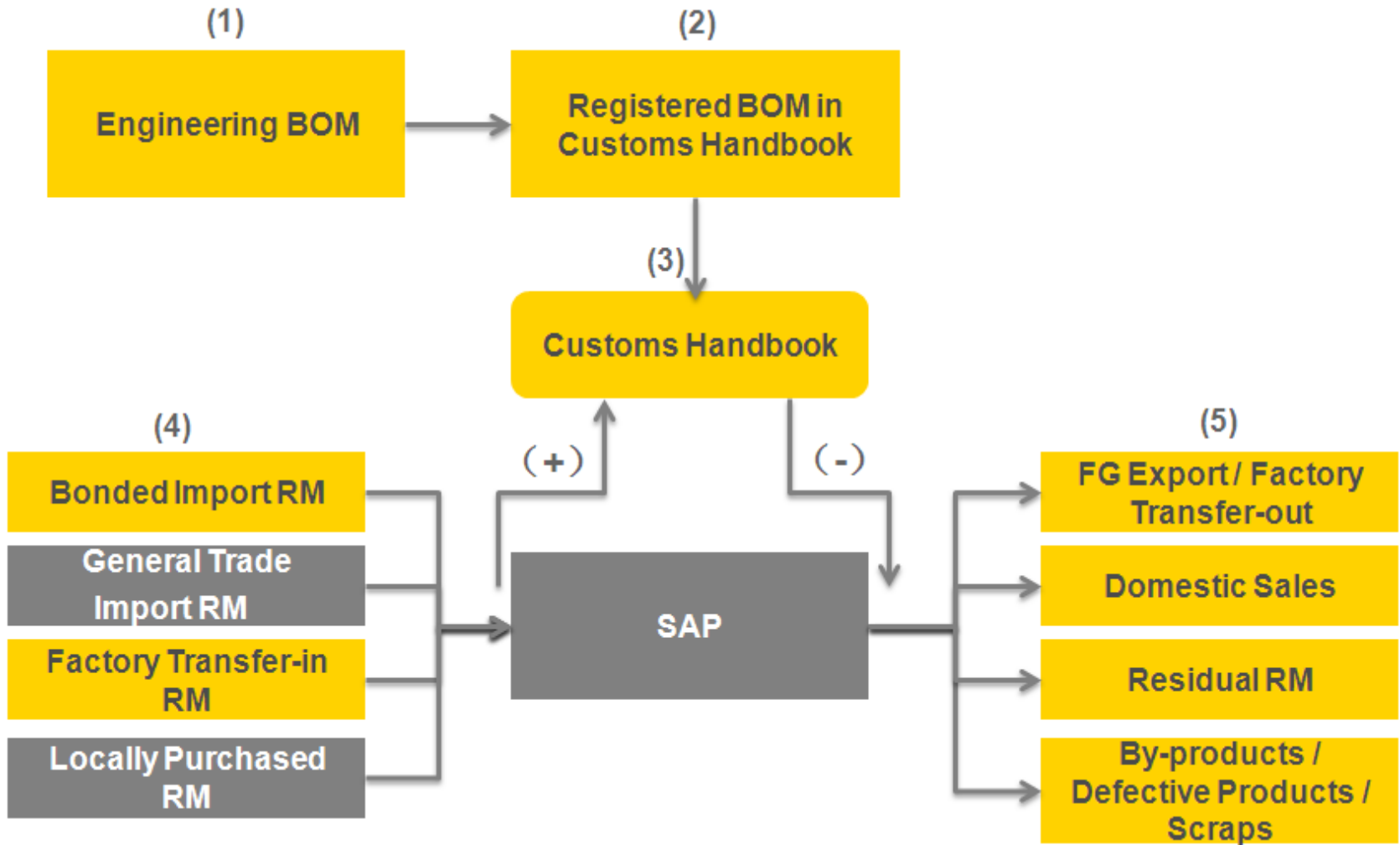
- 1) RM delivery out of WH
- 2) FG production
- 3) FG / WIP / defective products / scraps and so on



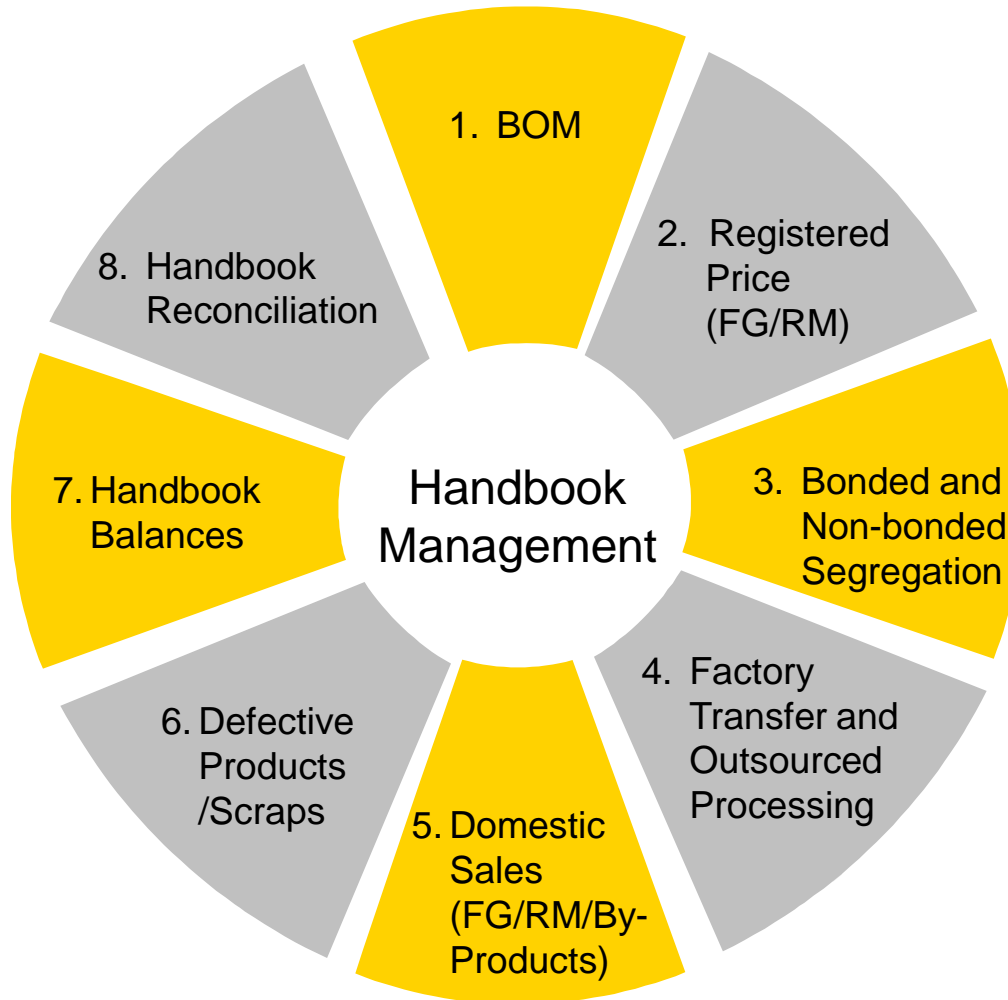
- 1) Preparation
- 2) Export declaration
- 3) Customs examination if required
- 4) Additional documents if required
- 5) Release
- 6) FX verification and write-off (contract manufacturer)

- 1) Stock take
- 2) Calculate discrepancy
- 3) Identify root causes for discrepancy
- 4) Submit supporting documents for discrepancy
- 5) Pay taxes
- 6) Transfer remaining RM to next HB (approved by Customs)
- 7) Complete HB reconciliation

# Processing trade – general flow (cont'd)



# Processing trade – common pitfalls



# General trade - customs valuation

## ▶ Transfer Pricing vs. Customs Valuation

	TP Methods	Customs Methods
Traditional Methods	CUP Resale Minus Cost Plus Profits Based	Transaction Value
	CUP	Identical / similar goods
	Resale Minus	Deductive Value
	Cost Plus	Computed Value
	Profits Based	No direct comparable

Companies try to be here

- ▶ TP trend is more towards using the profits based methods due to availability of public information and comparables

# General trade - customs valuation (cont'd)

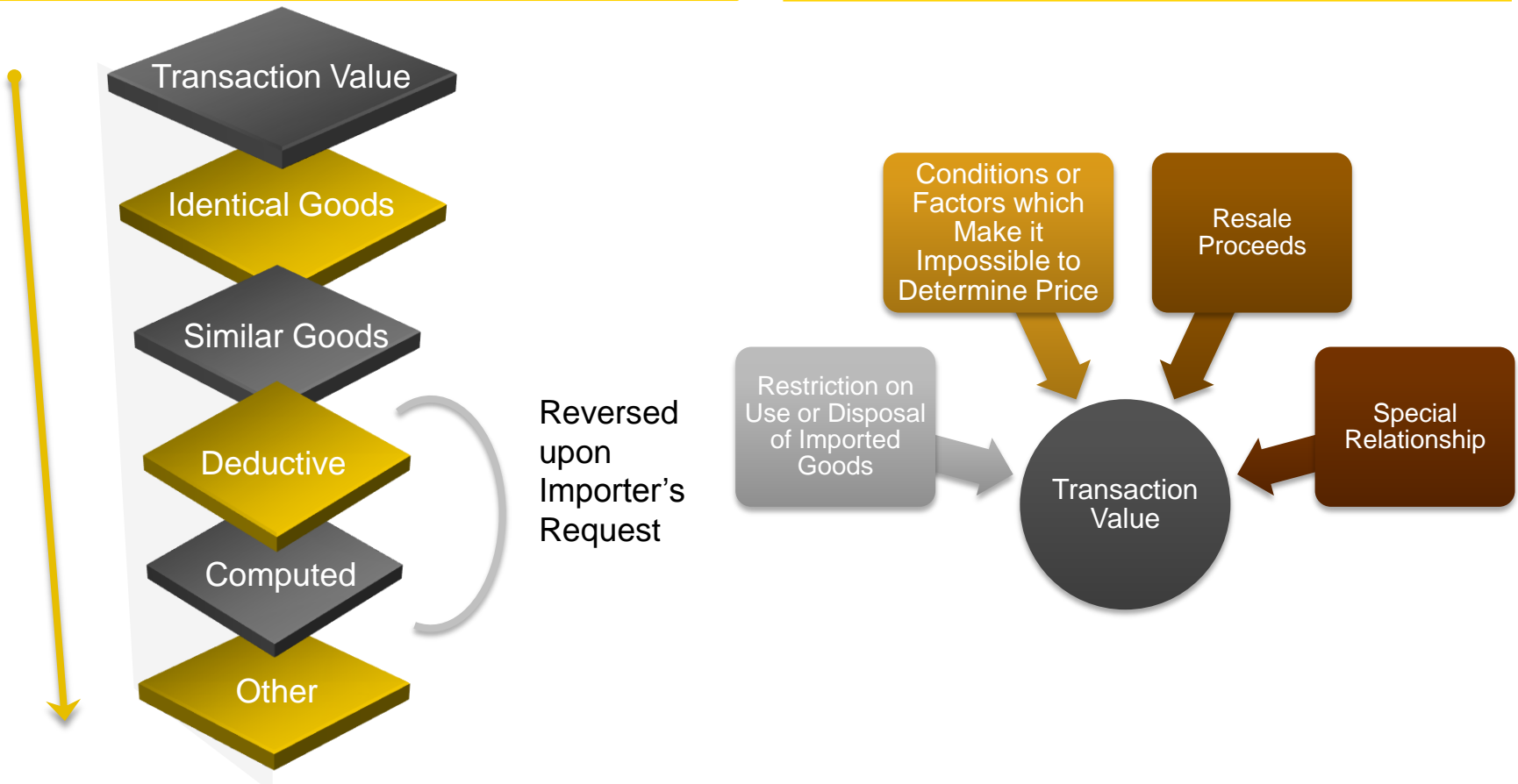
## ► Transfer Pricing vs. Customs Valuation

	Transfer Pricing	Customs Valuation
Governing body	OECD	WTO / GATT
What is taxed?	Annual net taxable income	Individual import transaction values
How do they do that?	Entity level annual tax filing	Declaration on a product basis for every import transaction
Implication for transfer prices?	Arm's length profit for the year → able to "net profit and losses"	Relationship did not influence price for each individual transaction → no netting = each transaction should stand on its own
How are they tested?	Entity comparables	"Test values" product by product
Import country concerns?	Prices high → profit low → tax low	Price low → values low → duty low

# General trade - customs valuation (cont'd)

## Hierarchy of Customs Valuation Methods

## Elements affecting Transaction Value



# General trade - customs valuation (cont'd)

## ► Adjustments to Transaction Value

Dutiable	Non-dutiable
Commissions or Brokerage (except for buying)	In-country Delivery Costs
Containers (treated as one)	In-country Duties
Packing	Buying Commissions
<b>Assists</b>	Interest Charges
<b>Royalties and license fees (see a separate manual)</b>	Other - per WTO Valuation Agreement
Warranty Fees	Other - per National Valuation Rules
Subsequent Proceeds	
<b>International Insurance &amp; Freight</b>	
Other - per WTO Valuation Agreement	
Other - per National Valuation Rules (Bonded Zone Costs)	

# Customs Valuation Rules on Royalties

## ▶ WTO valuation rules V.S. China customs valuation rules

- ▶ Pursuant to stipulation of WTO Technology Committee, royalty should be added into the import price for customs valuation purpose if:
  - ▶ Royalty paid directly or indirectly to seller is related to the imported goods being valued; and
  - ▶ Royalty payment excluded from the purchase price is a sales condition of the goods being valued.
  
- ▶ Pursuant to prevailing China Customs valuation regulations (“Decree 148”), royalty that the buyer pay, either directly or indirectly, to the seller or a related party should be dutiable **except** in either of the following cases:
  - ▶ Royalty is NOT related to the imported goods being valued; **or**
  - ▶ Royalty is not paid as a condition for the sales of the goods to the territory of China.

	China Customs	WTO
Viewpoints	Assuming royalty payment is dutiable unless demonstrating either of aforementioned “NOT” conditions is satisfied.	Assuming royalty payment is NOT dutiable unless both of the conditions set by technology committee are satisfied.
Proofing liability	Enterprise	Customs



# China Customs Audit

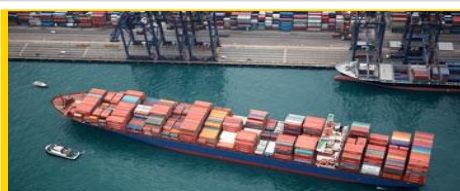


# China Customs supervision

## ▶ Customs Supervision (front, middle and back count)



Front Court



Middle Court



Back court

- ▶ categorized management
- ▶ risk supervision and control
- ▶ risk analysis
- ▶ risk control assignment

- ▶ categorized customs clearance
- ▶ centralized declaration
- ▶ examination
- ▶ release with guarantee

- ▶ duty reduced and exempted goods inspection
- ▶ bonded goods inspection
- ▶ Customs audit
- ▶ anti-smuggling investigation

# Types of customs audit

## ► How Customs issues to be found?

	Certificate Audit	General Audit	Focused Audit
Audit Target	Enterprises applying for A/AA category	All Enterprises	Specific Enterprise
Risk for Enterprises	Low	Medium	High
Stock Take	Referring to SAP/ERP	Sample Testing / Focused Testing	Full stock take

# Customs audit procedures



# Customs audit – Legal documents

中华人民共和国 海关  
**稽查通知书**  
(正本)

关稽查通 ( )

根据《中华人民共和国海关法》、《中华人民共和国海关稽查条例》的有关规定，我关自 2005年 8月 18日起对你单位实施海关稽查。请接到本通知书后按下列范围准备相应账簿、单证等有关资料。海关稽查人员到你单位时，单位法定代表人或其授权的代表应到场配合海关工作，并提供必要的办公条件。


稽查范围：

请接到本通知后 3 天内回复海关。

联系人：

特此通知。

2005年 8月 18日




此联交被稽查人

中华人民共和国 海关  
**稽查结论**  
(正本)

关稽查结 ( )

根据《中华人民共和国海关法》、《中华人民共和国海关稽查条例》的有关规定和 关稽查通 ( ) 号稽查通知书，我关自 2006年 3月 22日至 2006年 7月 2日对你单位进行了稽查，稽查结论如下：



此联交被稽查人

# Possible outcome of customs audit

Audit passed	<ul style="list-style-type: none"> <li>▶ Comprehensive mechanism for customs declaration and document management;</li> <li>▶ Management books and accounting practices in accordance with Customs requirements; and</li> <li>▶ No violating activities.</li> </ul>
Internal improvement required	<ul style="list-style-type: none"> <li>▶ Issue was caused unintentionally ;</li> <li>▶ Issue shall not trigger liability of tax and import/export license; and</li> <li>▶ Issue was minor and not deemed as violating rules and regulations</li> </ul>
Tax collected	<ul style="list-style-type: none"> <li>▶ Tax under-paid;</li> <li>▶ Tax under payment was caused by violating customs rules/regulations; and</li> <li>▶ Not necessary to be transferred to Anti-smuggling Bureau.</li> </ul>

	Fault Liability	Retroactive Period	Potential Risk
Tax pursued	Company	3 years	Tax liability and late surcharge
Tax collected	Customs	1 year	Tax liability

# Customs audit transferred to Anti-Smuggling Bureau (ASB)

Case transferred	<ul style="list-style-type: none"> <li>▶ Bonded goods sold domestically, transferred, disposed without Customs pre-approval;</li> <li>▶ Unexplained handbook discrepancy</li> <li>▶ Inaccurate declaration (e.g. value, quantity, classification, origin, trade mode, etc.);</li> <li>▶ Subcontracting without Customs' pre-approval</li> </ul>
Down grade	▶ AA/A→B, AA/A/B→C, AA/A/B→D

Customs Audit	ASB	Procuratorate	Court
<ul style="list-style-type: none"> <li>▶ Order to correct</li> <li>▶ Recover tax</li> <li>▶ Transfer to ASB</li> </ul>	<ul style="list-style-type: none"> <li>▶ Recover tax</li> <li>▶ Administrative penalty</li> <li>▶ Transfer to Procuratorate</li> <li>▶ Return to Customs Audit</li> </ul>	<ul style="list-style-type: none"> <li>▶ Return to ASB</li> <li>▶ Transfer to Court</li> </ul>	<ul style="list-style-type: none"> <li>▶ Confiscate illegal gains</li> <li>▶ Penalty</li> <li>▶ Sentence</li> </ul>

# Customs Audit – Risks

- ▶ Preferential measures of customs clearance cancelled
- ▶ Increase of field inspections
- ▶ Decrease of customs clearance effectiveness



- ▶ Large resources to handle
- ▶ Downgrade
- ▶ New handbook rejected
- ▶ Impact on TP
- ▶ Disclosure of business secrets

- ▶ Smuggling / offense
- ▶ Personal legal responsibilities, including legal representative, responsible staff, and other personnel
- ▶ Duty / VAT
- ▶ Late payment surcharges and interest
- ▶ Penalty
- ▶ Large amount of guarantee



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# Customs audit focuses in 2013

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- ▶ Restructuring of processing trade inspection and customs audit
  - ▶ Inspection → Customs Audit
  - ▶ Inspection Division → Unit Consumption Division
- ▶ Differentiated audit (“差别化稽查”)
  - ▶ Certificated audit/general audit/focused audit
  - ▶ Large scale audit on AA/A grading companies (>30%)
  - ▶ Challenge indexes for auditors
- ▶ 3<sup>rd</sup> party CPA firm audit (“第三方中介稽查”)
  - ▶ Pilot expansion
  - ▶ Certificated audit → General audit
  - ▶ Tax collection oriented
- ▶ Self-disclosure (“自查自报”)
  - ▶ Theoretically, no regulation support yet
  - ▶ Practically, encouraged by regional Customs

# How are you handling an indirect tax audit?

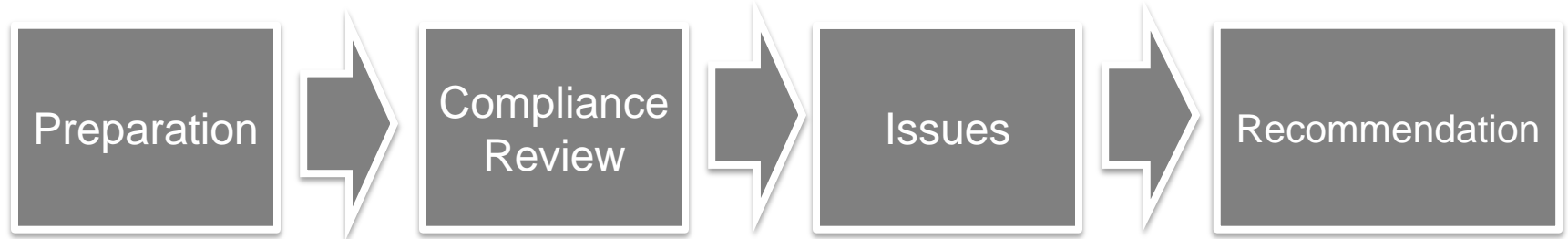


OR



- ▶ How can companies begin to transition from fighting fires to more strategic management of handling an indirect tax audit?

# Periodical self assessment



- ▶ Exercise plan
- ▶ Responsibility of relevant department
- ▶ Documents collection
- ▶ Professional assistance

- ▶ Documents review
- ▶ Factory tour
- ▶ Data analysis
- ▶ Discrepancy identification

- ▶ Issues summary
- ▶ Root causes investigation
- ▶ Tax/compliance risk assessment
- ▶ Improvement plan

- ▶ Self assessment
- ▶ rectification
- ▶ Building up procedural manual
- ▶ Periodically review
- ▶ Apply for AA/A category with Customs

# Strategically handling a tax audit



- ▶ Assigning a focused team and engaging professionals, where appropriate
- ▶ Understanding the tax audit background
- ▶ Assessing potential tax risks and exposure
- ▶ Coming up with audit handling strategy

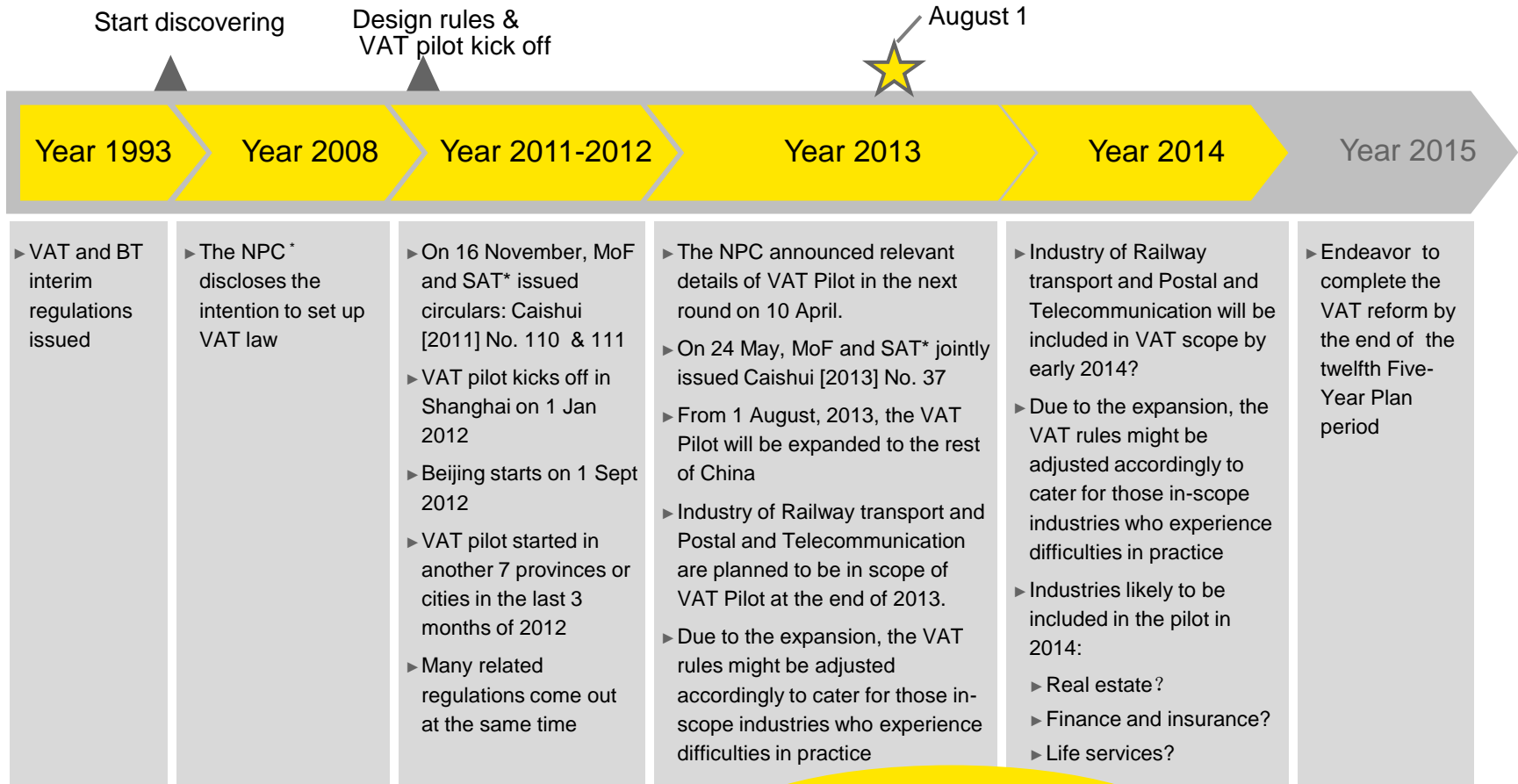
- ▶ Pro-actively engaging with tax authorities
- ▶ Justifying the incompliant activity without intention of evasion.
- ▶ Strategically providing submission to tax authorities
- ▶ Strategically responding to tax authorities' queries
- ▶ Assessing strategies for each step on a timely basis

- ▶ Applying for administrative reconsideration
- ▶ Settling tax payment/penalty on a timely basis
- ▶ Pro-actively communicating with tax authorities and ensuring input VAT recoverable
- ▶ Settling the identified tax issue(s) and reporting to tax authorities if necessary
- ▶ Maintaining a higher grading with Customs i.e. AA, A.

# China VAT Pilot



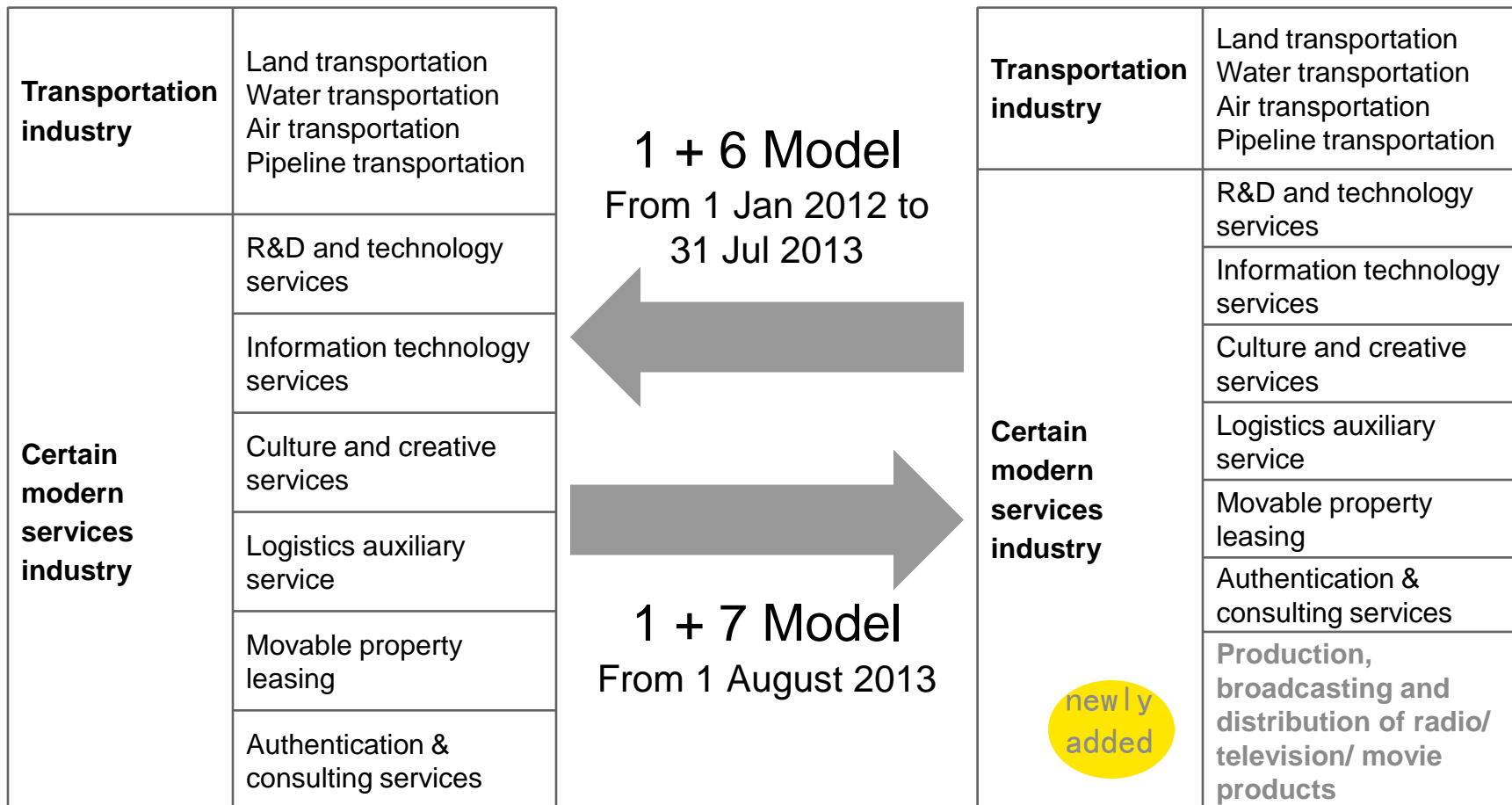
# VAT pilot reform timeline



The relevant regulations for railway transportation and telecommunication are yet to be announced.

\*NPC: National People's Congress  
 \*MoF: Ministry of Finance  
 \*SAT: State Administration of Taxation

# Expansion of pilot service scope



State Council has announced railway transport, postal and telecommunication should be in scope of the upcoming round of VAT Pilot expansion. The exact date is not announced yet.

# 2 types of VAT taxpayers and applicable tax rates

## BTable items

BTable items	Tax rate
Transportation service	3%
Finance and Insurance service	5%
Service	5%
Culture and Sport service	3%
Transfer of intangible service	5%



## VATable services in VAT pilot

<b>General VAT taxpayers</b>	Movable property leasing	17%
	Transportation services Postal and telecommunication services?	11%
	R&D and technology services, Information technology services, Culture and creative services, Logistics auxiliary services, Authentication & consulting services, and Radio, TV & Film broadcast services Postal and telecommunication services?	6%
<b>Small scale VAT taxpayers</b>	All VAT pilot services	3%
<b>Special</b>	Other taxable services stipulated by MoF and SAT	0%/ VAT exempt

The Chinese government understands the difficulties that taxpayers encounters with respect to the many different applicable VAT tax rates. It is possible that tax rates will be integrated in the future and they can go up or down. For those entities that have not separated the taxes from its prices, it is a good opportunity to take action.



# Recap: Circular 37 VAT exemption

## Services rendered outside the territory (6 items)

Engineering survey services with the engineering, mineral resources outside the territory  
Conference and exhibition services with conference and exhibition place outside the territory.  
Warehousing services with storage location outside the territory.  
Tangible personal property leasing services with the subject used outside the territory.  
Advertising services with advertising places outside the territory  
Distribution and Broadcasting of radio, TV & film programs (works)

## International transportation services (2 items)

International or Hong Kong, Macao and Taiwan transportation services provided by entities or individuals without international transportation licensing certificate

## Other services provided to overseas entities (11 items)

Technology transfer services, Technology consulting services  
Contractual energy management services (excluding those with contract targets outside the territory)  
Software services, Circuit design and testing services, Information system services  
Business process management services, Trademarks and copyrights transfer services, Intellectual property services, Logistics supporting services (excluding Warehousing services)  
Authentication, attestation and consulting services (excluding those providing services to overseas goods and real estate)

Long waited  
Detailed  
Implementation  
rules for VAT  
Exemption...

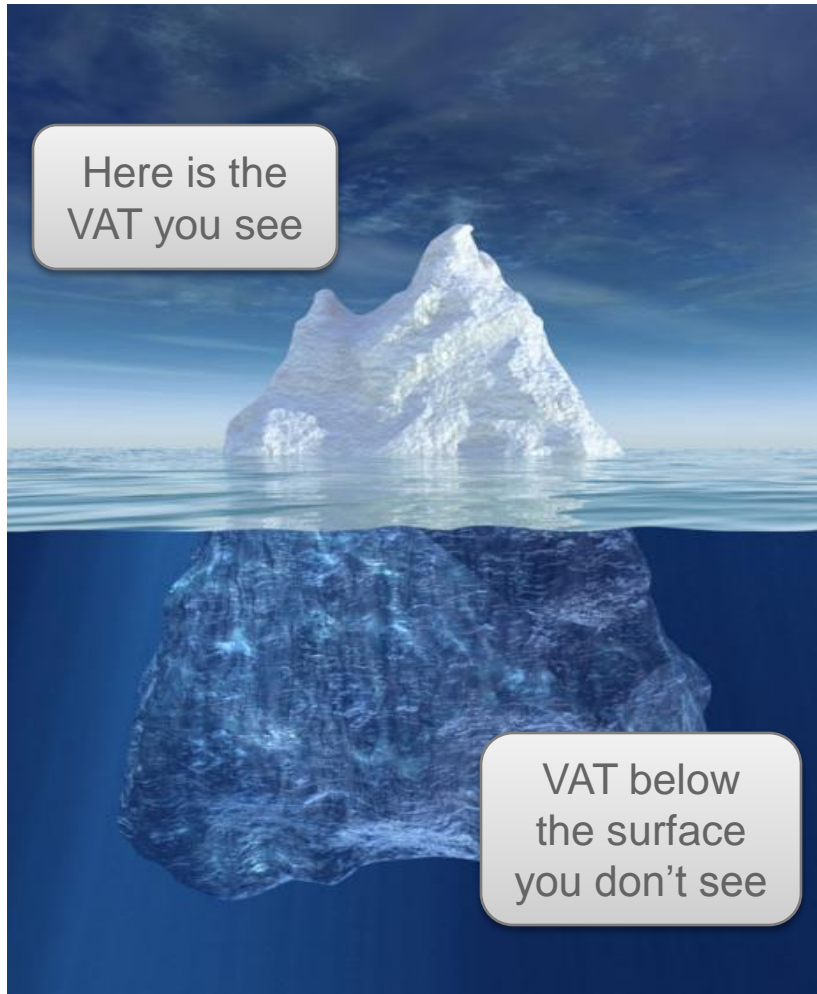
# Conditions to be fulfilled in order to be qualified for VAT exemption

Conditions	Details on the conditions
Signing of contract	▶ A service contract signed by both the service provider(s) and the service recipient(s) must be in place.
Payment of service fees	▶ The entire service fees correspond to the supply of services provided to overseas should be collected from overseas.
Specific accounting of VAT exempt revenue and input VAT transferred out	▶ Taxpayers should separately account for their VAT exempt service revenue and transfer out the input VAT associated with the supply of VAT exempt services.
Requirements on invoice issuance	▶ Special VAT invoices are not allowed to be issued for VAT exempt services.
Requirements for VAT exemption registration	<p>▶ Taxpayers shall register with their in charge tax bureaus. Taxpayers are required to prepare a submission package to support the registration.</p> <p>▶ Please see Note 3 for further details on the documents to be included in the submission package.</p>
Changes/amendments made to service contracts or to the services which have already been registered	▶ For the service contracts already registered with the tax bureaus for VAT exemption purposes, any change(s) to the contract or change(s) to the nature/ scope/ on the delivery of services shall be re-registered with the tax bureaus.
Requirements on record keeping	▶ The materials submitted for the purposes of the VAT exemption registration should be kept properly and completely.

# Actions for companies to consider / How EY can help?

Action steps	Description of the action steps
Detailed review service contract(s)	Review the service contract(s) in accordance with the details set out in Article 2 of Circular 52. The review would include an analysis of the nature the services provided with reference to the precise scope of VAT exemptible services set out in Circular 52. Other considerations such as the location of the service recipients, details of payments as well as the supportive evidences that could be made available to support the VAT exemption registration process.
Assess the status of the VAT exemption “temporarily” allowed by the tax authorities	<p>For the taxpayers who have adopted VAT exemption treatments based on the “temporary” VAT exemption allowed by their tax bureaus, they should assess whether they should be eligible for the VAT exemption based on the Circular 52 rules.</p> <p>If such taxpayers cannot fulfill the Circular 52 requirements, they should consider computing their VAT underpaid. Depending on the outcome of the assessments, taxpayers should decide whether and how they should approach their tax bureaus.</p>
Preparation of documents to support the VAT exemption registration	Taxpayers should study the documentation requirements set out in Circular 52 and assess whether they can fulfill the requirements. It is anticipated that taxpayers could face varying practical difficulties over the course of document preparations. For instance, it could take time for the contract translations to be completed and to be agreed by the contractual parties. During the process, taxpayers would be required to pay VAT before their services contracts have been registered with their tax bureaus.
Develop follow up plan to follow up closely on the VAT exemption registration process	<p>As Circular 52 is a newly issued circular, tax officials across China may need time to understand the administrative measures and could develop some local adaptations/ interpretation of the Circular 52 rules.</p> <p>It is anticipated that a high volume of VAT exemption registration requests would be raised by taxpayers. In order to ensure their registration requests would be handled in a timely fashion, taxpayers would need to develop a robust plan with clear time line, roles and responsible set up to follow up with their tax bureaus.</p>

# VAT Management



- ▶ It is relatively easy to see the VAT data shown in financial statements, GTS report and VAT returns. But this is only the surface.
- ▶ It is difficult to identify root causes of the variances and get behind the source data.
- ▶ Reconciliations can help to uncover the “hidden” costs and risks lying below the surface.
- ▶ Not all the variances are errors or reconciling items. Many are pure timing differences. But in China timing differences can turn into permanent differences.



# What type of VAT reconciliations?

There are many reconciliations that must be done to ensure accuracy and completeness in the VAT returns. The following are some examples:

▶ Actual revenue (export/domestic) per accounting books Vs. Revenue per VAT returns

▶ Input VAT per accounting books Vs. Input VAT per return

▶ VAT adjustments (red letter invoice, input VAT transfer-out, deemed sales, etc) Vs. Accounting books

▶ AR  VAT invoice issuance  Payment collection

There are many other types of reconciliations that can be conducted to refine and improve VAT management to proactively identify issues and opportunities.

# “Discovery” can help

- ▶ An analytical tool to perform VAT data analysis and high-level reconciliations to financial data.

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**Discovery - China VAT Analysis Tool**  
*'Revealing the hidden truth behind your VAT'*

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**VAT Return Analysis**

- Trends
- Red Tests
- Charts
- Number of invoices

**High Level reconciliation to financial data**

- Sales
- Purchases
- Discounts & Rebates
- VAT Payables/Receivables
- Fixed Assets

**Detailed data transactional level analysis**

- VAT invoice Analysis
- Aging
- A/P & A/R Analysis

**Detailed end-to-end process walkthrough**

- Interview relevant staff on VAT roles
- Step-by-step process analysis
- Internal controls for VAT
- Develop VAT process flowcharts
- Identify gaps with recommended approaches
- Formulate future strategies

**Preferred Language**

- English
- Chinese

**EXIT**

# Discovery: VAT return analysis

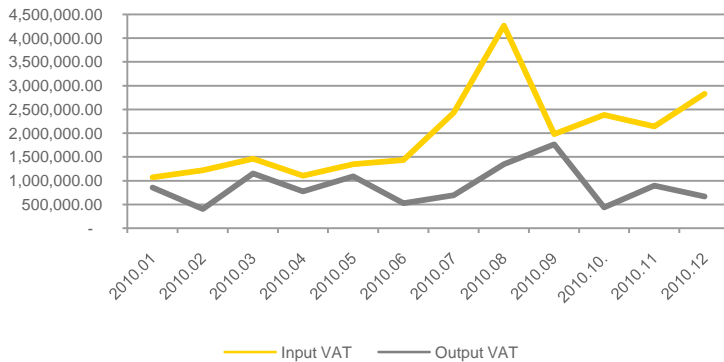
Return Analysis	Explanation of Analysis	Benefits of Analysis
<b>Red Checks</b>	<p>Discovery has been preprogrammed with automatic mathematical checks over hundreds of data fields to test whether manual data entered into the VAT returns have been calculated correctly. In addition, certain information on the VAT returns comes from the Appendices and these checks traces and vouches data from Appendices to the main VAT return forms.</p>	<p>Since much VAT return data is processed manually these red checks will automatically highlight mathematical input errors.</p> <p>Data from appendices link to the main VAT returns and these checks would verify if variances exist.</p>
<b>Red Flags</b>	<p>Discovery has been programmed with red flag tests gathered from general accounting treatment as well as those viewed by the Tax Bureau as areas for further exploration.</p>	<p>Identify key areas where the Tax Bureau may focus when a red flag is raised.</p> <p>Identify items that may be flagged as anomalies from an accounting perspective.</p> <p>Flags typical items that just do not seem like a reasonable outcome or make sense for the company's VAT profile.</p>

# Discovery: VAT return analysis

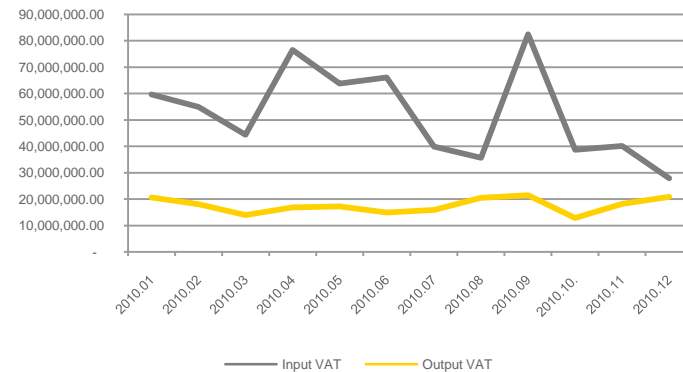
## – Trending charts: Input vs. output VAT

- ▶ The following graphs illustrate the input and output VAT on a trended basis to identify periods of peaks and valleys upon which to focus.

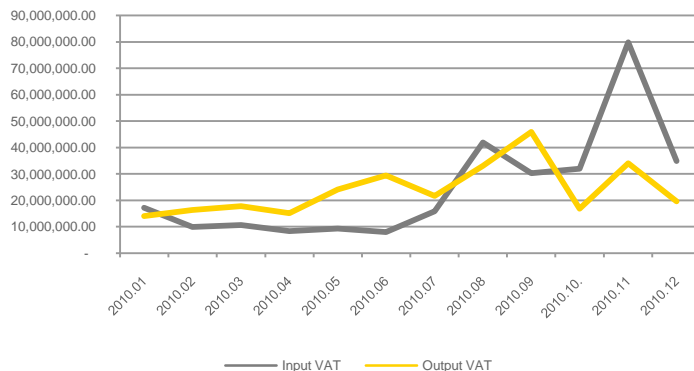
Company A



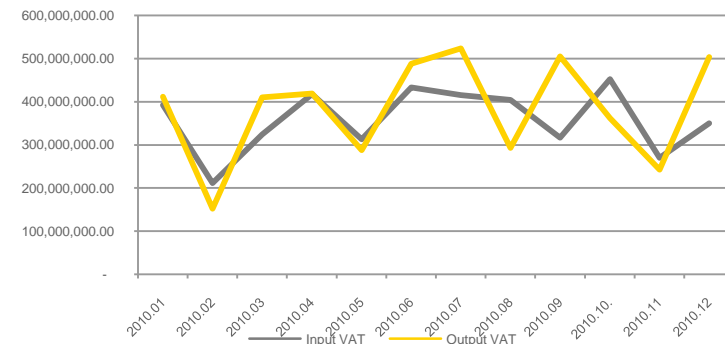
Company B



Company C



Company D





# Q & A



# Indirect Tax contacts

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## Hong Kong and Southern China Indirect Tax Partner



**Michael Lin**  
Partner (Shenzhen)  
+86 21 2228 3006  
[Michael-cs.lin@cn.ey.com](mailto:Michael-cs.lin@cn.ey.com)

## Hong Kong



**Joanna Chow**  
Senior Manger  
+852 2629 3438  
[joanna.chow@hk.ey.com](mailto:joanna.chow@hk.ey.com)

## Shenzhen



**Ivy Chen**  
Senior Manager  
+ 86 755 2502 8379  
[ivy-j.chen@cn.ey.com](mailto:ivy-j.chen@cn.ey.com)

## Guangzhou



**Steven Lin**  
Senior Manager  
+86 20 2881 2744  
[steven-zf.lin@cn.ey.com](mailto:steven-zf.lin@cn.ey.com)



**Charlie Sun**  
Senior Manager  
+86 20 2881 2796  
[charlie.sun@cn.ey.com](mailto:charlie.sun@cn.ey.com)



**Xiaoqiang Yang**  
Senior Manager  
+86 20 2881 2854  
[xiaoqiang.yang@cn.ey.com](mailto:xiaoqiang.yang@cn.ey.com)



**David Xu**  
Manager  
+86 20 2881 2900  
[david.xu@cn.ey.com](mailto:david.xu@cn.ey.com)

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