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ATO Guangzhou takes a crack at fixing China's flawed Customs valuation system

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Report Highlights:

Summary: Inconsistent and unpredictable tariffs are being levied on U.S. agricultural products as they enter Mainland China ports. Port officials often base their tariff calculations on their unique assessment of the commodity's value as opposed to the contact price or many other factors that are usually determinative of fair market prices around the world. U.S. wood exports to China, for example, are being valued at prices 30-50% in excess of legitimate contract prices. Understandably, these sort of incorrect valuations throw local traders off their game and cause them to seek lower grade wood from markets other than the U.S. As the port authority in charge of setting all of China's valuations for most agricultural products, Shenzhen Customs holds the key to resolving these types of trade distortions. Guangzhou's Agriculture Trade Office (ATO) is coordinating with industry groups and Shenzhen officials to arrange seminars and other training to improve the flow of reliable market data to

Shenzhen's ports and provide a more objective basis for valuations of agricultural commodities. End summary.

General Information:

Complaints About Valuations: ATO Guangzhou as well as the other ATOs located in China's coastal cities have received numerous complaints from local traders that they have been forced to pay higher tariffs and value added taxes (VAT) on imported U.S. agricultural products as a result of flawed price valuations applied by Customs inspectors. These complaints were again raised at an all-China USDA Cooperators Conference (USDA Cooperators are U.S. producer associations receiving congressional Market Access Program support funding) in Xi'an in early September 2012. After analyzing the issue further, Post determined that the flawed valuations would have a much broader implication on several other U.S. agricultural commodities imported into China --namely, wood, cherries, wine, seafood, and alfalfa. Our initial research revealed that among all of the commodities aforementioned, U.S. wood emerged as a commodity group which had consistently received unfavorable and inconsistent tariff treatment due to flawed product valuations.

Wood Imports – A Case Study: Over the past several years, wood has come into focus as a growing U.S. export to China. The slowdown in U.S. housing development projects freed up many varieties of U.S. wood that were not previously available to the surging China market. With ample supply, prices for many of these commodities have also become more affordable in recent years.

All woods are not alike. For example, for the same species of wood, such as U.S. red oak lumber, there are five aspects that could determine the market price: 1) production region, 2) suppliers, 3) grading of quality, 4) purchasing volumes, and 5) season. U.S. domestic wood prices are market-driven, and given all these variables, we thought it likely that Customs inspectors had difficulty in determining fair market prices for wood shipments.

Instead of considering all of these factors to determine the market price of a commodity like wood, we understand that Customs officials are only taking historical price information from the previous collections of transactions. This methodology can lead to situations where global or regional price fluctuations based on supply and demand fundamentals, as well as a host of other variables, can be completely ignored. In short, the methodology perpetuates a vicious cycle of flawed price valuations and subsequent tariffs that are assigned inconsistently port by port. Flawed valuations can be considered trade distorting as tariff rates add unforeseen costs and cut into the profitability of the trade. An additional complication -- inspectors in Shenzhen have reportedly taken advantage of uncertainties of valuation and have inflated the prices of imported shipments as well as played favorites to agencies with special relationships with Customs Shenzhen.

The tangible result of all this is that imported U.S. woods are being taxed based on valuations that are 30 to 50 percent higher than the stipulated contract price regardless of the quality and trustworthiness of the documents presented at port that state the shipment is of lesser in value. According to one trader, there is an average price increase of 50-70 percent irrespective of invoices, bill of lading, or contracts that traders provide. For example, a shipment of U.S. red oak was purchased at $800-850 per thousand board feet, but the assigned value for this type of product at Shenzhen Customs was set at $1,200 per

thousand board feet. While importers tried to provide copies of contracts to reflect the actual transaction, these were rejected by Customs inspectors.

Some traders have attempted a number of strategies to circumvent improper valuations. One such strategy involves requesting U.S. exporters to mix different grades of wood (i.e., add low grade to the sought after high grade wood) together to hedge against the artificially bloated prices being applied at port. So, if the contract stipulates "A" grade wood, two-thirds of the shipment would then have "B" grade wood added. This strategy has backfired, however, as Shenzhen Customs officials have caught on to it, and have subsequently punished those traders by increasing their rates in future transactions. Traders and port officials acknowledge, in their own ways, that there is a vast breach of trust between the local trade and Shenzhen Customs port inspectors.

Shenzhen Customs – The Arbiter of Agricultural Tariffs: The Valuation Division of the Shenzhen Customs Office has been designated by China Customs as the office responsible for developing valuations for most agricultural products, regardless of actual port of entry. To do this, Shenzhen conducts market research and price monitoring of these products. (Note: Shenzhen handles valuations for all imported commodities listed under the *International Harmonized Commodity Coding and Classification System* (HS) chapters 1-46. About 95 percent of agricultural products are covered in chapters 1-25. End note). Shenzhen has this responsibility as a result of the Central Government's attempt to divide the labor in managing the treatment for thousands of imported products. To do this, six Customs port offices were designated to gather market information for specific groups of commodities and develop value formulations that will be used throughout China's ports. For example: Guangzhou Customs handles daily chemicals (HS Chapter 5); Shanghai Customs handles finished apparel and textiles (HS 47-71); Tianjin Customs handles mechanical equipment, vehicles and electronics (HS 84, 85, and 90-97); Ningbo Customs handles iron and steel (HS 71-83), and Harbin Customs handles transportation equipment (HS 86-89).

Seeking better coordination between Customs and U.S. industry: To create on opening for U.S. agricultural industry associations to discuss valuations and educate Customs inspection managers on the various aspects of wood pricing, ATO Guangzhou has been coordinating with the two U.S. wood industry associations to develop seminars, training modules, and corralling expert speakers that can help officials develop a fair, transparent, and predictable formula to accurately determine current prices. These two associations are the American Hardwood Export Council (AHEC) and American Softwoods (Amsoft). From their perspective, pricing is a difficult area of marketing to address as most producer associations are forbidden from discussing pricing with non-members, since this issue could infringe on the privacy of certain producers and even be misconstrued as promoting unfair competition. Despite these concerns, the issue of flawed price valuations has become a serious irritant to local traders who are also stakeholders in developing supply and distribution channels for U.S. agricultural products in Mainland China. Keeping these traders happy is critical for US wood exporters. Even marginal fluctuations in their costs due to improper tariff assessments can make the purchase of U.S. wood unprofitable for them, leading them to purchase from other suppliers such as Canada and New Zealand, even if this meant purchasing lower quality wood.

On September 27, ATO Guangzhou Director and staff met with Shenzhen Customs' Valuation Division to discuss tariffs being levied on U.S. agricultural products. To ensure smooth trading practices, ATO Director offered assistance to the Shenzhen Customs by expressing our willingness to arrange individual

meetings with U.S. producer associations, collect pricing documents, and provide training for Customs' Valuation staff as well as frontline inspection officers on designating fair market prices to U.S. agricultural products as they enter Mainland China ports.

During the meeting, Li Zhenxian, Director of the Pricing Division of Shenzhen Customs, claimed to strictly follow the World Trade Organization's guidelines on processing duty issues and said that that importers have the right to disagree or apply for reviews when there was a concern of the import price set by the Division is in question. Director Li added that there were plenty of "liars" in the trade that recreate prices and that his Division paid close attention to false contracts and price claims. Director Li added that because many importers used local agents to handle the Customs declaration and clearance processes, in many cases, these agents would declare import values at a lower price, especially when the agents already have a special connection ("兄弟关系") with the importer.

ATO Director asked Director Li to break down the price formulation review/appeal procedures conducted by his staff. According to Director Li, if an importer disagrees with a tariff valuation anywhere in China and the following conditions are present, then a price review can proceed:

1. The contract was not recognized by Customs or the original contract was not provided.
2. Customs inspectors suspect a special connection between the importer/customs clearance agent and/or the exporter
3. Special fees associated to intellectual properties were not aggregated, and thus required a second evaluation, i.e. logos and trade marks
4. Insurance fees, transportation costs, and prices after taxes were not properly prepared or declared

Justice Delayed is Justice Denied: When an importer disagrees with Customs over the shipment's valuation of price, the legal procedure is timely and can be costly. When an appeal is processed, the container is held at port and the importer is forced to incur daily storage, warehousing or demurrage fees. The length of time needed to complete an appellate review can be about seven working days. According to the traders, China Customs usually sides with the port inspection official. Several traders told us they had all tried to appeal the inflated price valuations at some point in the last three years, but they had never heard of anyone receiving a favorable ruling. As a result, most importers choose to accept the arbitrary valuations established by Shenzhen Customs' staff or inspection officials. Given the unpredictability of the valuation process, traders can only infrequently pass on the added costs to their customers further down the supply chain in order to recover or make up for these losses.

In other ports, the tariff and legal treatment are inconsistent – sometimes to the relative benefit of the traders, sometimes not. One Shanghai wood importer has had two successful appeals within the last two years. Although the procedure took over a month to resolve, he mentioned one of the shipments was considerably large and the buyer was not in a hurry to receive the product. Tianjin traders did not indicate Customs valuations were a problem, but told us there was little criteria available to appeal an incorrect valuation and that if the contents of a shipment were substandard, not only was there was no recourse to appeal to the U.S. exporter, there was no legislation on how to process a duty drawback. Customs payments are final, and traders cannot open the containers at port to inspect the merchandise. This particular trader contended that current Customs practices implicitly trusted U.S. exporters over

local traders in an unfair manner.

According to one trader who is also a certified National Hardwood Lumber Association (NHLA) inspector, the appeals process only raises your profile as a "trouble maker" and added that "to make up for this trouble is also expensive." The trader referred to informal bribes that long-term Shenzhen Customs' inspectors expect after every transaction. Although he was reluctant to touch on this issue in great detail, he did say that such illegal payments were typically based on a percentage of the value of a shipment.

Private Custom Clearance "Agencies" Stack the Deck: Local traders with longer histories tend to allow clearance agents to handle the painstaking clearance process. These agencies are often composed of former Customs officials or have other informal relationships with Customs. One such company is "Seabond", an entity our contacts have told us is owned and operated by former Customs officials. This company is one of the oldest of its type in operation and charges about US$400 (RMB2,500) in consultation fees per shipment. We made a cold call to Seabond and learned from someone who identified himself as "Director Chen" that Seabond "understood" Customs procedures better than any other company because many former Customs Shenzhen employees consulted for them on a regular basis. Chen said Seabond would guarantee saving time and money, but when asked if the agency was claiming a lower price, he said that the rate depended on how much Customs was charging on a particular day. According to Chen, Seabond had developed its own internal database that tracks recent Customs price valuations and they could advise importers when it was most adventitious to clear the shipment. He added that the difference in pricing can make all the difference for larger shipments. Later in the call, Chen would not admit that the company was owned by a former Customs official and instead claimed it was owned by a larger corporate logistics and shipping group in Hong Kong.

China is Different: According to industry contacts, traders do not experience Customs valuation problems in nearby markets like Japan, Taiwan and Vietnam. In those countries, tariffs are not assessed until after the products are sold to a third party. The duties are derived as a percentage of the profit that was made in the sale. Imported woods in those countries clear inspection freely, although Customs officials there keep an electronic record indicating the value, volume, grade and other distinguishing characteristics. By taxing a shipment's profit value after the sale is made instead of on the value of the shipments at the ports of entry, Customs practices in these three countries seem more business-friendly as they reduce the risk of losses to importers who cannot sell products.

In China, however, value added taxes (VAT) are collected up front, so when shipments arrive at port, a payment must be made before these shipments can be cleared. As a result, a higher China Customs Value per shipment means importers need to tie up cash for the VAT payment irrespective of when a subsequent sale takes place. This type of system tends to limit the size of wood shipments and incentivize lower quality and lower priced purchases overall. Local importers told us that they believed that the 17 percent VAT was reasonable only if it were applied to the actual transaction price. Although this is the way China Customs has operated for over 30 years, local traders impacted by the global financial crisis, and the subsequent slowdown in south China's export-driven manufacturing sector, importers are finding it harder to commit to new purchases of U.S. wood products as the 17 percent non-refundable rate on an arbitrarily inflated valuation is a tough pill to swallow.

Optimistic about Engagement with Customs: ATO Guangzhou Director assured Shenzhen Customs

that price discovery factors can be provided periodically to assist them in preparing accurate and timely assessments that reflected market prices. In addition, ATO Guangzhou would be calling on industry experts to offer educational sessions on how to derive cost formulations with open market information. Overall, Shenzhen Customs' had a good disposition toward the ATO's offer of assistance and requested regular meetings with the ATO and U.S. agricultural industry associations. One key outcome - Shenzhen Customs agreed that importers could seek ATO Guangzhou's support when they encountered a price discrepancy issue. Shenzhen Customs seems willing to adjust the pre-determined valuation factors provided by the industry groups. ATO Guangzhou reached an agreement with Shenzhen Customs that "wood" products would the first trial project to tackle together and the next meeting to discuss next steps will be held in November.