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Indirect Tax Alert

US and China reach Phase One Agreement on trade

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Executive summary

On 13 December 2019, the United States (US) and China reached a framework for a formalized agreement to address the ongoing trade tensions between the two countries that has resulted in a series of tariff actions during the past two years.[1] Key components of the deal, referred to as the "Phase One Agreement" (Agreement or Phase One), was first agreed to in principle in October 2019 when the two nations announced an initial accord whereby the US indicated that China was expected to purchase up to US$50b[2] in US agricultural and farm products.[3]

However, ongoing negotiations have taken place since that time and the recently announced Agreement now includes concessions by both parties. The US has agreed to indefinitely postpone, but not cancel, the List 4B tariffs that were already scheduled to take effect 15 December and to reduce the current punitive tariffs already imposed on approximately $120b on China by 50%, on a date still to be announced. China in turn has agreed, in principle, to increasing purchases of US-origin goods and services, reported to be $200b in goods and services imports over the next two years, specifically in the agriculture and energy industries, although a formal announcement by China has not been made yet. Additionally, China has agreed to other items including addressing numerous areas of intellectual property (IP) concerns, agreeing to end certain technology transfer conditions required for obtaining market access,

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removing barriers to entry in the financial services sector, and refraining from devaluating their currency.[4] China has also agreed to a temporary suspension of additional tariffs planned for US-origin goods under China List 4[5] and US automotive goods.[6] Finally, both parties agree to the implementation of a dispute resolution agreement.

Detailed discussion

In August 2017, US President Trump directed the US Trade Representative (USTR) to investigate whether China's laws, policies or practices were damaging to American IP rights, innovation, and technology developments under the authority of Section 301 of the *Trade Act of 1974* (Section 301).[7] The findings were announced in March 2018 and it was determined that China's laws, policies and practices did in fact inflict harm to US Commerce, as laid forth under Section 301, and that the US was subsequently entitled to take action, including retaliation, to eliminate the imbalance.[8]

Based on the findings, President Trump instructed the USTR to take a full range of action responding to China's acts, policies and practices involving unfair and harmful acquisition of US technology. The USTR subsequently proposed 25% punitive duties on $34b worth of Chinese-origin goods (List 1).[9]

This action set off subsequent, incremental actions by both countries, with multiple rounds of negotiations. The US ultimately imposed three additional rounds of tariff actions on Chinese-origin goods: 25% punitive tariffs on another $16b and $200b of Chinese-origin goods (List 2[10] and List 3,[11] respectively), as well as 15% punitive tariffs of $300b (List 4A and List 4B[12]). China retaliated for each of the four rounds of the US tariffs with its own tariff increases, implementing 5% to 25% of additional duties on $185b of US-origin goods.

On 11 October 2019, President Trump and China's Vice Premier Liu held a joint press conference announcing that a Phase One agreement had been reached in principle and indicated that an additional Phase Two agreement, and potentially a Phase Three agreement, would subsequently occur as the two nations continue to negotiate additional areas beyond what was outlined in the Phase One framework.

During the course of the last two months the two nations continued to work through the details of the agreement, culminating in the final deal announced on 12 December.

The newly announced iteration of the deal includes:

- US agrees to indefinitely postpone List 4B, that was set to take effect 15 December.
- US agrees to reduce tariffs on List 4A to 7.5%, approximately $120b of Chinese-origin goods, date to be determined.
- US will maintain 25% tariffs on Lists 1, 2 and 3, approximately $250b of Chinese-origin goods.
- China agrees to import no less than $200b of US goods and services in the next two years, including US manufactured goods, food products, agriculture and seafood products, and energy products.
- China allows for certain financial access relaxations.
- China agrees to address IP concerns, specifically as they apply to pharmaceutical-related IP, company trade secrets, geographical indications, trademarks, and enforcement against pirated and counterfeit goods.
- China agrees to end technology transfer conditions required for market access.
- China agrees to actions regarding relaxing currency restrictions and devaluation.
- China suspends certain tariffs scheduled to take effect 15 December for goods under China List 4 and automotive goods.
- Both parties agree to enforcement and dispute provisions.

The State Council Information Office of China held a press conference about the US-China trade talks on 13 December 2019. During the conference, Chinese officials confirmed that China and the US had agreed on the text of a phase one economic and trade agreement and that both sides agreed to complete their necessary procedures including legal review, translation and proofreading as soon as possible, and to discuss the detailed arrangements for officially signing the agreement. The officials also stated that the US has promised to eliminate tariffs on some Chinese products and will increase the tariff exemption for Chinese exports to the US.

On 15 December 2019, China's Customs Tariff Commission (Commission) announced it would temporarily suspend additional tariffs on certain US-origin goods that were scheduled to take effect on 15 December 2019.[13] This will include 5,207 US-origin goods valued at $75 billion that were announced under China List 4 and US-origin vehicles and parts.

The agreement, now formally outlined and being drafted into formal text, is expected to be signed in January by both parties and would be expected to go into force the same month.

What's Next?

Despite the progress of Phase One, the original Section 301 investigation from the USTR noted five main areas of discriminatory and unfair practices by China, not all of which are fully addressed in the newly announced agreement. These items are expected to be addressed in subsequent negotiations (e.g., Phase Two and potentially Phase Three). These outstanding areas include:

- **Unfair technology transfer regime,** including foreign ownership restrictions such as certain joint-venture requirements
- **Discriminatory licensing restrictions**, forcing foreign companies to license IP and technology ownership rights to domestic Chinese entities
- **Outbound investment practices**, including certain Chinese government funding of foreign direct investment for certain industry sectors, such as technology, as well as barriers in place for US foreign investors to entry into the Chinese market
- **The theft of IP and sensitive commercial information** by conducting cyber-attacks on US corporations
- **"Other" policies and practices related to technology transfer, IP and innovation**

Actions for businesses

Companies involved in US-China trade should actively monitor the enforcement of the currently announced deal, as well as subsequent negotiations of Phase Two and beyond.

Despite the significant reduction in tariffs by the US, punitive tariffs remain on four lists of products, making mitigation and planning critical. Immediate actions companies can take include:

- Reviewing contracts with suppliers and with customers to understand who has liability for increased duties and if there are opportunities for negotiation.
- Mapping their complete, end-to-end supply chain to fully understand the extent of products impacted, potential costs, alternative sourcing options, alternative manufacturing options including relocation of production outside of China, and to assess any opportunities to mitigate impact such as country of origin planning to address potential increases in 301 tariffs.
- Identifying strategies to defer, eliminate, or recover the excess duties paid under Section 301 such as bonded warehouses, Foreign Trade Zones, substitution drawback, Chapter 98, and equivalent programs under China customs regulations.
- Exploring strategies to minimize the customs value of imported products subject to the additional duties under either 301 tariffs, re-evaluating current transfer pricing approaches, and for US imports, considering US customs strategies, such as First Sale for Export.

Additionally, US distributors who purchase from related parties will almost certainly have transfer prices impacted by the imposition of 301 duties. Along with the strategic importance of mitigating duty impact while aligning the income tax and customs approaches, mechanics for reporting any transfer pricing adjustments to US Customs should also be reviewed. This process may be particularly complex when duties are present for only a portion of the year, and in many cases, actions need to be taken in advance of importations.

US Customs has very specific rules for reporting adjustments to prices made after importation, such as transfer pricing adjustments. These rules require that the importer take specific actions before importation of goods for which prices may be adjusted, including adding customs specific language to transfer pricing policies.

Companies importing Chinese origin goods which are granted exclusions should take action to seek refunds on any punitive duties previously paid by submitting the necessary Post Summary Correction. Companies also should retain all data and records needed to continue to see maximum refunds through exclusions.

Endnotes

1. See USTR press release "United States and China Reach Phase One Trade Agreement."
2. Currency references in the Alert are to US$.
3. See White House transcript *Remarks by President Trump and Vice Premier Liu He of the People's Republic of China in a Meeting*.
4. See USTR Fact Sheet "AGREEMENT BETWEEN THE UNITED STATES OF AMERICA AND THE PEOPLE'S REPUBLIC OF CHINA".
5. "Announcement of the Customs Tariff Commission of the State Council with regard to Increasing Additional Tariffs on Certain Imported Goods Originating from the United States" Customs Tariff Commission Announcement 2019 No 4, 23 August 2019.
6. "Announcement of the Customs Tariff Commission of the State Council with regard to the Reinstatement of Additional Tariffs on Imported Autos and Automotive Parts Originating from the United States" Customs Tariff Commission Announcement 2019 No 5, 24 August 2019.
7. See 82 FR 39007.
8. See USTR Report "FINDINGS OF THE INVESTIGATION INTO CHINA'S ACTS, POLICIES, AND PRACTICES RELATED TO TECHNOLOGY TRANSFER, INTELLECTUAL PROPERTY, AND INNOVATION UNDER SECTION 301 OF THE *TRADE ACT OF 1974*, Executive Summary."
9. See 83 FR 28710.
10. See 83 FR 40823.
11. See 84 FR 26930.
12. See 84 FR 45821.
13. "Announcement of the Customs Tariff Commission of the State Council with regard to the temporary suspension of Certain Imported Goods Originating from the United States" Customs Tariff Commission Announcement 2019 No 7, 15 December 2019, available at http://www.gov.cn/xinwen/2019-12/15/content_5461332.htm.

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