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Global Tax Alert

US and China sign Phase One Economic and Trade Agreement though tariffs remain

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Executive summary

On 15 January 2020, the United States (US) President Donald Trump and Chinese Vice Premier Lui He signed the Phase One Economic and Trade Agreement (Agreement or Phase One) negotiated between their respective nations and designed to rebalance trade and address unfair trade practices asserted by the US.[1] The Agreement, initially concluded in principal in October 2019, was announced to be formalized in December 2019 following additional negotiations which included translation and final agreement of key provisions.

The 96-page agreement is comprised of a preamble and seven chapters on specific provisions as follows:

- Intellectual Property (IP)
- Technology Transfer
- Agriculture
- Financial Services
- Macroeconomic Policies and Exchange Rate Matters (Currency)
- Expanding Trade
- Dispute Resolution

Building a better working world

These chapters address a number, but not all, of the discriminatory and harmful policies conducted by China as set forth in the initial Section 301 report conducted by the US in 2018 and subsequently presented to the US Congress.[2] An additional eighth chapter regarding final provisions that address future amendments, negotiations and termination procedures is also included.[3]

The agreement provisions are scheduled to enter into force on 14 February 2020, 30 days after the 15 January signing. Current punitive tariffs of 15% applied on certain Chinese-origin products will be modified to 7.5% and will become effective on that same day. Signing of the Phase One Agreement effectively suspends the cycle of escalating tariff increases and provides a framework for a continued, multifaceted process of ensuing negotiations.

While Phase One includes concessions by both nations as a means to restore the balance of trade, such as Chinese buying commitments in many sectors including manufacturing, agricultural, energy and financial services, as well as the cancellation of US List 4B tariffs, outstanding and complex items remain to be addressed in future negotiations.

The US released the full agreement text on 15 January 2020 along with 16 Fact Sheets that provide further details on actions and expectations across the specific industries. Also, on 16 January 2020 (Beijing time), China's Ministry of Finance and Ministry of Commerce both released the full text of the Agreement[4] in English and Chinese.

Detailed discussion

In August 2017, 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).[5] 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.[6]

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 US$34b[7] worth of Chinese-origin goods (List 1).[8]

This action set off incremental duty imposition actions by both countries with intermittent 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[9] and List 3,[10] respectively), as well as 15% punitive tariffs of $300b (List 4A and proposed List 4B[11]). 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.

In October 2019, President Trump and 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.

Two months of continued negotiations followed before the two nations announced the formalized agreement had been reached in December 2019. Based on the signing date of the Agreement, Phase One will go into force 30 days following the signing, per Article 8.3(1) of the agreement's final provision, on 14 February 2020.

It should be further noted that the Agreement permits termination following 60 days after formal written notice is provided by either party, per Article 8.3(2). Both countries have also agreed to further negotiations as warranted (i.e., Phase Two) and to provide a public comment period on proposed measures for implementing the Agreement.

The final text of the Phase One agreement includes seven specific chapters, addressing many of the US's primary concern areas regarding China's discriminatory and harmful policies and practices as determined by the USTR in their Section 301 investigation, including:

- **Intellectual Property**: addresses areas of trade secrets, pharmaceutical-related IP, geographical indications, trademarks, and enforcement against pirated and counterfeit goods. Further, the chapter discusses:
  - US and China's agreement to address data protection for pharmaceuticals, unauthorized camcording of motion pictures, and copyright protection for sporting event broadcasts in future negotiations (e.g., Phase Two)
- **Technology transfer**: addresses certain acts, policies and practices as determined by the Section 301 investigation, including prohibition of:

- Forced technology transfer for companies as a condition of market access
- State-directed or outbound investment with the intent to acquire foreign technology in targeted sectors and industries

- **Agriculture**: addresses non-tariff barriers to US agriculture industry, specifically those pertaining to meat, poultry, seafood, rice, dairy, infant formula, horticultural products, animal feed and feed additives, pet food, and products of agriculture biotechnology. Specifically, items in this chapter include, among others:
  - China's agreement to purchase and import on average at least $40b of US food, agricultural, and seafood products annually for a total of at least $80b over the next two years
  - China's commitment to comply with World Trade Organization obligations by making specific improvements to its administration of wheat, corn, and rice tariff-rate quotas
  - China opening up market access to US rice exporters, which could result in US rice exports reaching $300 million on an annual basis in the future, per a US Department of Agriculture estimate
  - China providing new market access to US meat, poultry and live breeding cattle by removing restrictions on imported meats and expanding the allowable product scope for beef and pork products
- **Financial services**: provides for the elimination of foreign equity caps in the securities, fund management and insurance services industries, as well as opening up new opportunities to the US financial institutions. Further specifics in this chapter include:
  - China ensuring that regulatory authorities will operate an improved and timely licensing process for US suppliers of electronic payment services to facilitate access to China's market
  - China's allowing US credit rating companies to acquire a majority stake in existing joint ventures with Chinese companies
- **Macroeconomic Policies and Exchange Rate Matters**: provides for the requirements of high-standard commitments to refrain from competitive devaluations and targeting of exchange rates, while increasing transparency and providing mechanisms for both accountability and enforcement. Specifically, both parties agree to:
  - Be bound to the International Monetary Fund (IMF) Articles of Agreement to avoid manipulating exchange rates
  - In the event of a dispute, the US Secretary of the Treasury or the Governor of the People's Bank of China may request formal consultations with the IMF
- **Expanding trade**: includes commitments from China to import US goods and services exceeding the corresponding 2017 baseline amount by no less than $200b, over the next two years, covering four broad categories:
  - Manufactured goods, such as machinery and chemicals, will total at least $32.9b in 2020 and at least $44.8b in 2021
  - Agricultural products, such as soybeans and cotton, will total at least $32b over the next two years, with China striving to purchase an additional $12.55b of agricultural products in 2020 and $19.5b in 2021
  - Energy products, such as liquefied natural gas and crude oil, will total at least $18.5b in 2020 and at least $33.9b in 2021
  - Services, such as financial services, insurance services, cloud services, and travel services, will total at least $12.8b in 2020 and at least $25.1b in 2021

  The increase amounts are defined in the Agreement through Annex tables by each Product Category, but specific subcategory amounts remain confidential and will not be shared with the public.[12] Further, the Agreement provides that in the event China's ability to fulfill its obligations under the Expanding Trade provision is being affected by an action or inaction by the US or by other circumstances in US, China is entitled to request consultations with the US. Definitions of what will qualify for such action or inaction are not provided.
- **Dispute resolution**: lays out the arrangements for both parties to ensure the effective implementation of the Agreement, as well as allow the parties to resolve disputes in a fair and expeditious manner, including regular bilateral consultations at both the principal level and the working level.

In addition to the terms ultimately outlined in the text of the Agreement that was finalized for signing, the USTR previously suspended indefinitely the imposition of punitive tariffs on List 4B, set to take effect 15 December 2019. China reciprocated by suspending additional tariffs set to be imposed as of 15 December 2019 on $75b worth of US-origin goods under China List 4 and US-origin vehicles and parts.

Concurrent with the Agreement signing, the US has committed to reduce the 15% punitive tariffs on List 4A by 50% to 7.5%, effective 14 February 2020 per a USTR Notice released 15 January 2020.[13]

China's action

Following the US publication of the Agreement and accompanying Fact Sheets, China's Ministry of Finance and Ministry of Commerce released the full text of the Agreement on 16 January 2020 (Beijing time). The Ministry of Commerce's website published both the English and Chinese version of the Agreement. The Chinese version of the Agreement is 88 pages and contains a Preamble, seven chapters that align to the US-specific chapters, plus an eighth chapter on final provisions, which are consistent with the English version of the Agreement published by the US.

China has reacted positively to the signing of the Agreement. Chinese President Xi jinping said that the Phase One trade deal "is good for China, US and world." On 15 January, China's official newspaper, People's Daily published an article discussing how each aspect of the Agreement facilitates China's long-term economic development needs. In a press conference held for Chinese news organizations in Washington DC, Chinese Vice-Premier noted that the signing of the agreement would have a positive impact on China 's future scientific and technological development and the cooperation between the two countries. He said that China's economic development depends to a large extent on technological progress and protecting IP rights is conducive to safeguarding technological progress.

What remains

Despite the progress of Phase One, the US Administration has indicated there remains outstanding areas of concern and these areas are expected to be addressed in further negotiations (e.g., Phase Two). The parties have agreed to form a Trade Framework Group with a mandate to address the outstanding areas of concern. Most notably, the outstanding areas include:

- Information and communications technology policies
- Subsidies
- State-owned enterprise disciplines
- Cyber Intrusions
- Anti-Monopoly Law Enforcement
- Services to include data localization, cloud computing and express delivery

These areas are many of the structural issues tied to China's development model and were difficult to address in the Phase One negotiation. The Trade Framework Group is expected to begin meeting several times over the course of the coming year. It remains unclear if progress before the US election will take place.

What to expect

The Phase One Agreement addresses many non-tariff barriers to entry for US companies doing business in China, as well as longstanding concerns about doing business within China. However, the Agreement does not address the current tariffs that remain from both the US on Chinese-origin goods, as well as from China on US-origin goods.

President Trump stated that the current tariffs for products on Lists 1, 2 and 3, as well as the residual tariffs after the upcoming reduction for products on List 4A, will remain in place for purposes of ensuring fair and equitable negotiations. The President also indicated that they will be removed should the negotiations result in a successful Phase Two Agreement. While the agreement is silent as to whether China will reduce its retaliatory tariffs, for China to meet its purchase commitments it most likely will need to adjust tariff levels on US imports.

Actions for businesses

Companies involved in US-China trade should thoroughly review the text of the Agreement to understand and assess business impact. Companies equally are encouraged to review the relevant Annex 6.1 Attachment for specific subcategories of products to determine if they apply to their business. Doing so will allow companies the ability to assess which, if any, products are affected by the proposed increased purchase commitments from China and subsequent business impact. Additionally, companies that export US-origin goods to China should monitor news coming out of Beijing that may pertain to tariff changes.

Despite the suspension of tariffs on List 4B 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.

Further, companies that are currently in fiscal year end should consider and understand the implications that Section 301 duties have had on their financials. This includes ensuring accruals for duty drawback refunds are correctly assessed and considering 301 duty impact on end of year transfer pricing adjustments.

US distributors who purchase from related parties will almost certainly have transfer prices impacted by the continuation 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. Companies should address the impact of duties on transfer prices proactively.

Endnotes

1. See White House Fact Sheet, "President Donald J. Trump is Signing a Landmark Phase One Trade Agreement with China."
2. 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."
3. See "Economic and Trade Agreement between the Government of the United States of America and the Government of the People's Republic of China."
4. See http://www.mofcom.gov.cn/article/ae/ai/202001/20200102930845.shtml.
5. See 82 FR 39007.
6. 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."
7. Currency references in the Alert are in US$.
8. See 83 FR 28710.
9. See 83 FR 40823.
10. See 83 FR 26930.
11. See 84 FR 45821.
12. The "Economic and Trade Agreement between the Government of the United States of America and the Government of the People's Republic of China", Chapter 6, Annex 6.1 provides the formal increases per Product Category. We note that the USTR website Fact Sheet for "Expanding Trade" erroneously provided differing ranges.
13. See USTR Notice "Notice of Modification of Section 301 Action: China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation."

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