



Epidemic Prevention and Response to COVID-19 in the Automobile Industry

Series Issue 1 – China Tax, Legal and Customs Issues

The Coronavirus outbreak in China has forced players in the automotive industry to revisit their medium-to-long term plan, which could mean accelerating the transformation of the industry. In this article, PwC China Automotive Industry Team examines some of the key tax, legal and Customs issues which automotive companies should be aware during and after the epidemic.

Managing contractual obligations

Contractual obligations under any existing enforceable contracts should be carefully reviewed to determine whether any special contractual obligations will be triggered or if the epidemic could result in any expanded obligations under the contract for both parties, and if it would, whether and how the relevant risks could be effectively managed.

Force majeure provisions are commonly included in procurement, sales and supply contracts executed by OEMs and components/parts suppliers. Force majeure is defined as an objective situation that is unforeseeable, unavoidable and insurmountable under PRC law. If a contract cannot be performed due to a force majeure event, the party may be relieved from liabilities in whole or in part depending on the impact of the force majeure, unless otherwise provided by law. It can be observed from the statements recently made by Chinese legislative and judicial authorities that the COVID-2019 outbreak has embraced all the three main characteristics of force majeure. If a party is unable to perform its obligations under the contract due to a force majeure event,

it should promptly notify its counterparty in a timely manner to minimize the potential loss that may be incurred by the counterparty, and should provide evidence to prove that it is infeasible to perform the contractual obligation within a reasonable period. It is worth noticing that no matter under the PRC law or international practice, a force majeure event does not directly relieve an obligor from its liability or render a contract automatically terminated, unless otherwise agreed by the parties.

In case of exporting complete built units ("CBU") or components and parts by Chinese domestic manufacturers, the contracts in question may not be governed by PRC laws. Laws of other countries often focus on whether the event is beyond the '(reasonable) control of the parties', and do not require the event to be unforeseeable, unavoidable and insurmountable at the same time. What circumstances can be treated as force majeure and how to allocate risks and losses in the event of force majeure depends on the agreement between the parties. If 'plague' or 'epidemic' is not explicitly listed as force majeure in the contract, then the party claiming force majeure and requesting exemption of liability should provide proof and evidence.

From a China corporate income tax ("CIT") perspective, reasonable losses that are actually incurred and are related to the generation of income, including losses incurred due to a force majeure event in the production and operation of the enterprise, are deductible. In practice, the losses incurred due to a force majeure event shall be supported with documentary proof, including the relevant contract, and a statement of explanation for the loss, for the purpose of securing the deduction. The documentary proof may be examined by the tax authority in due course. Thus if there are losses incurred due to the outbreak, the taxpayer enterprise should get prepared in advance by reviewing the contractual clauses and collecting the relevant documentary proof of losses.



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Temporary change of production and adjustment of supply chain

2.1 Obtaining the required qualifications and certification

As the routine manufacturing operations cannot be carried out during this period, many automotive manufacturers are actively participating in the prevention and control of the epidemic. For example, SGMW, GAC, BYD, and Changan Automobile have announced one after the other their plan to support the production of face masks to help win the war against the coronavirus.

It should be noted that under the prevailing PRC laws and regulations, medical masks, protective clothing, and disinfection products may be classified as medical devices. China implements classification administration on medical devices. Class I medical devices are subject to "record filing" administration (somewhat like notification), which should be performed with the local drug administration at the municipal level at where the filing applicant is located. Class II and III devices are regulated under the product registration regime, where the applicant should apply to the provincial and national drug administration respectively for the registration.

Manufacturers of Class II or Class III medical devices should apply for a manufacturing license issued by the local provincial-level drug administration. If a company expands its business scope to include the production of medical devices, it should also register with the competent administration for market regulation

Although the drug and market regulatory authorities may provide special fast tracks when processing the related record filings and applications, to avoid any unnecessary compliance risk, automotive companies seeking to (temporarily) divert their production into manufacturing "medical devices" should not bypass any required qualifications and permits in accordance with the relevant laws and regulations.

2.2 Advance reporting for using equipment under Customs supervision

If CBU or automotive components/parts manufacturers are using the existing equipment for the production of urgently needed supplies for epidemic prevention and control, the manufacturers should pay attention if these equipment includes any import duty-exempt equipment that is still under Customs' supervision. According to Customs laws and regulations, import duty-exempt equipment could only be used for the purposes as approved by the Customs and cannot be used for other purposes without approval, otherwise, Customs has the right to recover the exempted taxes or impose administrative penalties. Therefore, it is suggested for the manufacturers to communicate and report to the in-charge Customs office in advance if any import duty-exempt equipment would be used for other purposes (such as production of urgently-needed medical supplies) and not to start the production until after obtaining the approval.

2.3 Switching to import — additional duty cost and Customs requirements

If the domestic upstream suppliers are not resuming production, it would cause a chain effect to the domestic CBU and components/parts manufacturers. OEMs may choose to temporarily import components and parts or raw materials from overseas as an alternative, where the following considerations should be taken from a Customs and tax perspective:

- Increased cost due to import duty
- Different import duty rates caused by different country of origin ("COO"), for example, certain components and parts originated from U.S. might be subject to additional tariff, while some originated from ASEAN countries could enjoy lower conventional rate or even 0 tariff
- Import license may be required for certain components and parts or raw materials
- For components and parts or raw materials purchased from related parties, Customs valuation and transfer pricing should be considered when setting import price, so as to mitigate the risk of challenge by the Customs and tax authorities
- Losses due to abnormal production — if the OEM anticipates that it can be compensated by the upstream suppliers, e.g. in cash or goods, the relevant CIT and Value Added Tax ("VAT") implications should be considered in advance so as to better negotiate and determine the compensation amount.

A balanced approach in dealing with profit decline

3.1 How General Distributors react to profit decline

Impacted by the epidemic, the automotive market which is already suffering decline in sales, may be facing another blow in 2020. To cope with the significant decrease in CBU sales during and after the epidemic, the various cash flow difficulties, the general distributor of imported CBU may consider the following measures:

- Downward adjustment of MSRP
- Lower wholesale price or increase sales discount
- Offer dealers with more sales rebates
- Roll out more sales boosting initiatives

When setting the import price with its overseas affiliates, the general distributor of imported CBU would normally factor into the current year sales and expenditure budget forecast with an objective to achieve its targeted Return on Sales ("ROS") as a "routine distributor" (transfer pricing terminology). During this abnormal period, the above-listed measures may decrease the average sales revenue per vehicle or increase the marketing expense of the general distributor. As a result, the general distributor may not be able to achieve the routine distributor targeted ROS with the preset import price. To cope with this situation, the normal practice would be lowering the import price to protect the ROS, in an attempt to mitigate potential transfer pricing risks. As the downward adjustment of import price is likely to catch the immediate attention of the Customs, the general distributor should be well prepared to justify the proposed downward adjustment and where possible communicate with the Customs in advance. It is not uncommon that the Customs does not necessarily agree to adjusting the import price (downward especially) fully or partially, in such case one-off adjustment compensation payment from the overseas affiliates may become necessary.

China implements foreign exchange controls, so any transfer pricing adjustment compensation payment from overseas would be subject to "reasonableness review" by the recipient's (the general distributor's) bank in China. The reasonableness review focuses on the validity of the transaction and more importantly consistency with the prevailing foreign exchange control regulations. The prevailing foreign exchange control regime does not anticipate transfer pricing adjustment compensation inbound payment from an overseas affiliate. In practice,

It means the reviewing bank would not be able to categorise the payment into any existing permissible type of "reasonable transactions". There are also regional differences in the practice, but in general, companies seeking to receive inbound transfer pricing adjustment payments are facing both uncertainties in compliance and tax risks. These risks can be better managed by proactively communicating with the bank, the State Administration of Foreign Exchange ("SAFE") and its local branch, and the tax authority (see the last paragraph in this section) with adequate documentary proof. There have been a couple of exceptions granted by SAFE in different regions allowing one-off transfer pricing adjustment inbound remittance; albeit not related to the automotive industry, these cases could be good references for general distributors of imported CBU seeking to solve the problem down the same route.

General distributors of imported CBU may also consider relieving its liquidity pressure by increasing its registered capital or borrowing loans from their overseas affiliates. China has completely changed its cross-border loan borrowing administration regime. Companies can choose the most beneficial mode in determining their foreign loan borrowing quota under the following mechanisms: 1) the borrowing cap is calculated based on the difference between the total investment and registered capital of the company; or 2) the borrowing cap is calculated according to the "Macro Prudential Policy". This has greatly increased the flexibility for China companies (including domestic enterprises) seeking to utilize overseas funding.

Regardless of what measures general distributors may take to react to its profit decline situation, it is pertinent that the potential CIT and VAT impact should be assessed comprehensively taking into consideration the contractual rights and obligations, business substance, goods flow, cash flow, etc. General distributors should plan in advance to ensure compliance with tax regulations and to optimize tax efficiency.

3.2 How parts suppliers react to profit decline

Most of the multinational parts suppliers in China source raw materials locally and sell their products to domestic customers, while paying royalties on technologies and technical support service fees to overseas related parties. During this period, suppliers may suffer losses from interruption of business operations or decrease in volume/orders, while still be required to make royalty payments and service fees. This could be later challenged by the tax authorities.

The epidemic has affected the global supply chain of many automotive companies. If Chinese suppliers could not enhance their competitiveness, the OEMs may adjust the supply chain and choose suppliers from other countries. In the meantime, considering the impact of the epidemic and the potential transfer pricing issues, it is recommended that the companies which suffer may build up more connections with the tax authorities in order to seek their understanding on the impact of the epidemic. We also hope the tax authorities can fully consider the difficulties faced by companies while assessing their transfer-pricing risks.

3.3 Making compensation payments or receiving incentive payments

It is anticipated that compensation payments for breach of contract would likely occur among companies during this period. Specific stipulations in contracts which pertain to the obligation to compensate and the mutually agreed computation method of the compensation would be important to provide legal protection for both parties, and also to a very large extent supports CIT deductibility of the compensation payment.

In cross-border businesses, liabilities pertaining to various kinds of failure in the fulfilment of the purchase or sales contract between domestic and overseas entities, e.g. refund of payment for goods import and export, deduction of guarantee deposit, payment of penalty and late payment interest etc., could occur on a fairly frequent basis especially during and after the epidemic. To ensure a smooth execution of inbound or outbound remittance, understanding foreign exchange control rules and the silent practices will be very helpful. Complying with foreign exchange control rules or getting around them legitimately requires a clear and comprehensive plan, effective execution strategies, hands on experience and knowledge. Working closely with professionals — banks, tax experts, lawyers — will optimise the formulation and execution of a good plan.

CBU manufacturers and general distributors may provide additional incentives to dealers or customers based on current sales policies, e.g. discount, allowance, rebate and etc. in the form of cash, or in kind, to promote the dealers' confidence and mitigate the short-term impact of the epidemic on sales. For different types of sales incentive policies, companies should carefully evaluate each one against the relevant tax implications by reference to both the business substance and contractual arrangement, especially for different VAT treatments (e.g. implications of issuing of VAT special invoice and red-letter invoice, deemed sales and etc.) and CIT deductibility criteria.

Local government may also grant subsidies to companies to help in their recovery of production. Appropriate accounting and tax treatments should be adopted according to the specific form of government subsidies. For taxable government subsidies, tax should be accrued properly and settled timely; for non-taxable subsidies, relevant approval documents shall be obtained from the government and well maintained to support the tax position taken.



Compliance amid innovations

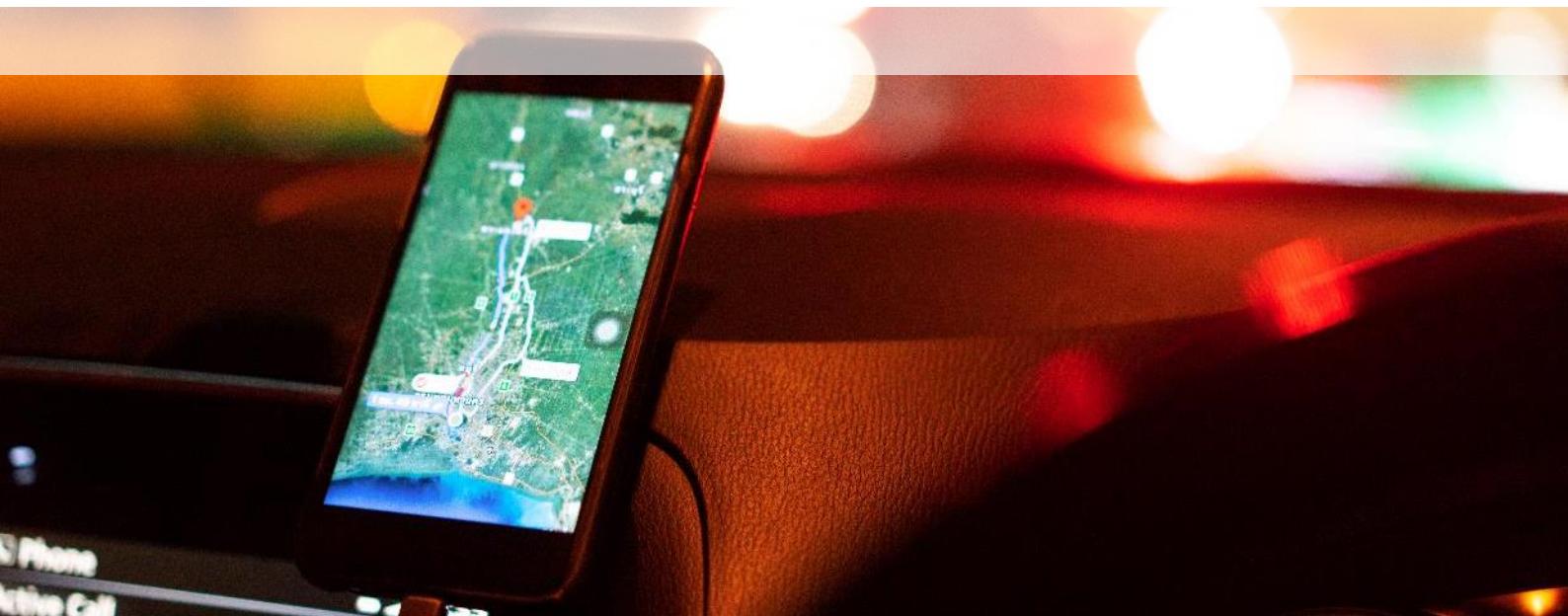
Shadowed by the local government control on activities during the epidemic, automobile offline sales has completely suspended. Major automotive companies embarked on their trial runs of online sales platforms, helping dealers attract and gather customers through virtual reality panoramic car viewing and online inquiries.

Automotive dealers collect a lot of potential customers information either directly via their online platforms or purchasing from third-party information collection platforms, or more recently, procuring leads through content operators, promoting brand stories, professional surveys, or KOL/KOC. Such methods inevitably involve the gathering of personal information and data of the potential customers. When obtaining personal information from a third party, dealers or OEMs should confirm that the third party is an institution or individual properly authorized to collect the data, and that it has taken measures to ensure encrypted transmission of the data to protect the confidentiality, integrity and availability of the information. If the personal information of potential consumers is collected directly from a potential consumer, the dealer must notify the customer (data subject) the purpose, method, scope, protocol, etc. for the personal information in accordance with the Cyber Security Law and the Personal Information Security Specification to seek their authorization and consent, and to inform them of the purpose and scope of using the collected information. It is prohibited to collect any personal information in a fraudulent, deceptive, misleading manner or beyond the minimum necessity. All those require automotive players to comply with laws and regulations in the design of related apps and websites.

With the coronavirus outbreak, many automotive companies pay more attention to the functions of vehicles air quality and health protection. For example, a new car brand featured a "high temperature antibacterial" function during this critical moment. Users can remote control the air conditioner through a mobile phone App to carry out high temperature purification and suppression of germs to enhance safety within the vehicle. Another domestic brand claimed that it has developed an "industry-leading intelligent air purification system" which can allegedly block bacteria and viruses from entering the vehicle.

Automotive companies are entitled to develop and promote new functionality of their vehicles and to create differentiations. Nonetheless, they need to abide the laws and regulations on publicity and advertising, such as the Advertising Law and the Anti-Unfair Competition Law. During the epidemic, the administrations for market regulation in Beijing, Nanjing and other cities have issued specific documents requiring advertisers, advertising operators, advertising publishers, and advertising spokespersons not to design, produce, represent, publish, or endorse false or illegal advertisements, and prohibiting release of any advertisements on the prevention, control, treatment, and cure of new coronavirus. Observing from the recent published cases, law enforcement authorities seem more likely to impose "stricter" penalty on illegal acts during the epidemic. Therefore, we would suggest that companies should be more cautious in their promotion of new products and functionalities during this period, and to avoid crossing the regulatory red line.

When developing the above new functions, companies should plan for reasonable utilization of R&D related tax preferential treatments. It is also recommended that companies already enjoying R&D tax preferential treatments should periodically revisit if they are still in compliance with the requirements of the more stringent R&D tax regime.





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