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PRC Tax

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China-Korea Free Trade Agreement – One of the most popular potential FTA

The governments of China and Korea initialed a free trade agreement (CN-KR FTA) on 25 February, concluding several years of negotiations. Although both countries still must complete their internal procedures, the CN-KR FTA is expected to be formally approved and signed during the first half of 2015. The CN-KR FTA should benefit the economies of both countries in the area of trade in goods and services, financial services, e-commerce, telecommunications, investment, etc. This analysis will focus on the trade of goods aspects of the CN-KR FTA.

Tariff Concessions

Although details on the tariff concession arrangement still need to be finalized, based on currently available information, the CN-KR FTA will eliminate many tariffs.

Both countries have committed to a schedule of tariff concessions to reduce the tariff rates to zero immediately, or gradually over a period of five, 10, 15 or 20 years. Table 1 provides an overview of the tariff reduction plan:

Table 1

China (Applicable to Korean goods imported into China)	Korea (Applicable to Chinese goods imported into Korea)
• China will eliminate tariffs on 91% of imported Korean products, representing 85% of its total imports from Korea (equivalent to USD 137 billion) over the next 20 years. • Examples: – Textile industry: Knitted goods, functional clothes and baby clothes (note: tariffs on items sensitive for Korea, such as cotton fabrics and pure cotton yarn are to be maintained or partially reduced) – Electronic appliances: Washing machines, refrigerators, medical instruments, electric rice cookers, and electronics components	• Korea will eliminate tariffs on 92% of imported Chinese products, representing 91% of its total imports from China (equivalent to USD 73.6 billion) over the next 20 years. • Examples: – Electronic science and technology industry: motors and electrical transformers – Household items: handbags and golf clubs

For China, goods excluded from the tariff elimination schedule mainly cover automobiles and parts, as well as Korea's 20 main fishery products, such as seaweed, mackerel, abalone, squid and anchovies, imported into China.

Korea maintains a list of 852 highly sensitive items that will not be subject to any tariff cuts, including agricultural products, such as rice, pork, apples, pears, beef, chili, garlic, and tangerines imported into Korea.

Rules of Origin

If the goods fall under the schedule of tariff concessions, mere shipments of goods from Korea to China, or vice versa, would not be sufficient to qualify for a preferential duty rate under the CN-KR FTA. To enjoy FTA benefits, two requirements would have to be met: the goods would have to be as "originating goods" and they would need to be directly transported.

Originating goods

Unless otherwise specified, under the CN-KR FTA, a good would be considered as originating in a party of the FTA (Party) where

- The good is wholly obtained or produced entirely in a Party (WO);
- The good is produced entirely in a Party, exclusively from originating materials; or
- The good is produced entirely in a Party using non-originating materials and it conforms to Annex 3-A (i.e. Product-specific rules of origin).

In the context of scenario (c), the CN-KR FTA adopts the Regional Value Content (RVC)[1] and Change of Tariff Heading rules.[2]

- For the purpose of the RVC rule, the RVC would be calculated as follows: RVC = (FOB-VNM[3])/FOB x 100. Depending on the goods involved, the required RVC percentage would be 40%, 45%, 50% or 60%.
- A change in tariff classification, depending on the goods involved, would include a change to the tariff heading at either the first 2, 4 or 6 digit code.

In addition, CN-KR FTA would enable certain goods made in North Korean factories to be considered as Korean originating and thus enjoy FTA benefits, provided specified conditions are satisfied.

Direct Transport and Non-Party invoice

Similar to some of China's other FTAs, originating goods claiming preferential duty treatment under CN-KR FTA must be directly transported between China and Korea.

Goods that must be transported though one or more third jurisdictions (with or without trans-shipment or temporary storage in such jurisdiction) still would be considered directly transported between China and Korea, provided certain requirements are met. The direct transport requirement will not be deemed not to be met where the following operations are carried out in a third jurisdiction:

- Unloading, splitting up of loads for transport reasons, and reloading, or any operation necessary to preserve the goods in good condition; and
- Temporary storage for a period within three months (six months in the case of force majeure) from the date of entry provided the goods remain under the control of the Customs authorities in that jurisdiction.

To apply for preferential duty treatment under the CN-KR FTA where goods have undergone transit through or temporary storage in a third jurisdiction, relevant supporting documents must be submitted to the Customs authorities of the importing party to substantiate whether the direct transport requirement is satisfied.

Non-Party invoicing[4] is very common in international trade (e.g. Korean-origin goods are shipped directly from Korea to China, but the Korean company first invoiced an intermediary company in Singapore, then the intermediary company invoices a Chinese company) and a key concern is whether this practice is acceptable for purposes of FTA benefits,

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[1] The RVC rule requires a good to have a regional value content of not less than a certain percentage to qualify as a good originating from the region.

[2] The Change in Tariff Heading rule requires all non-originating materials used in the production of a good to have undergone a change in tariff classification for the good to qualify as originating from a region.

[3] Value of the non-originating materials

[4] A Non-Party Invoice is an invoice where the issuer is not located in either of the FTA contracting states.

provided all other requirements under the Rules of Origin are complied with. The CN-KR FTA specifies the acceptance of a Non-Party Invoice, i.e. the importing Party may not reject a Certificate of Origin merely because the invoice was issued by a Non-Party.

Comments and Recommendations

The CN-KR FTA is China's most comprehensive FTA and it covers the highest trade volume for the country and, therefore, the agreement has been eagerly awaited by affected industries.

China has been Korea's largest trading partner since 2004. According to Korean Customs data, trade between the two countries was valued at about USD 228.9 billion in 2013 and USD 215.1 billion in 2012.

Table 2: Top 5 Bilateral Trade Goods in 2014 (By HS Chapter) in Million USD

Main Chinese goods imported into Korea (2014)				Main Korea goods imported into China (2014)			
HS Chapter	Description	Amount	Total %	HS Chapter	Description	Amount	Total %
85	Electrical appliances, Electrical equipment and sound recorders, and parts and accessories	28,431	31.6	85	Electrical appliances, electrical equipment, and sound recorders, and parts and accessories	51,182	35.2
84	Nuclear reactors, boilers, machinery and mechanical appliances and parts thereof	10,459	11.6	90	Optical, photographic, medical or surgical instruments, and parts and accessories	20,351	14.0
72	Iron and steel	8,903	9.9	84	Nuclear reactors, boilers, machinery and mechanical appliances, and parts thereof	14,759	10.2
90	Optical, photographic, medical or surgical instruments, and parts and accessories	4,086	4.5	29	Organic chemicals	13,471	9.3
73	Articles of iron or steel	3,532	3.9	39	Plastic and articles thereof	10,317	7.1

Once the CN-KR FTA is implemented, more than 90% of the goods traded between China and Korea gradually will enjoy zero tariffs, thus benefitting both importers and exporters of the two countries. Trade between China and Korea is expected to increase from USD 235.4 billion in 2014 to USD 300 billion in 2015. In addition to the tariff concessions, the CN-KR FTA promises faster import/export clearances through Customs controls in both countries.

Table 3 shows the industries that are expected to benefit from the CN-KR FTA.

Industries	Exporting country	Products
Electrical	China	Motors; Electrical transformers
Household	China	Handbags; Golf clubs
Chemicals	China	Ion exchange resin; Super-absorbent resin; Polyurethane
Electrical	Korea	Washing machines; Refrigerators; Medical instruments; Electric rice cookers; Electronics components
Textiles	Korea	Knitted goods; Functional clothes; Baby clothes
Iron & Steel	Korea	Cold rolled plates; Hot rolled stainless steel sheets; Universal thick plates

Although the FTA has not yet been signed, potentially affected companies should take the following steps:

- Monitor developments relating to the CN-KR FTA;
- Identify whether their goods/purchases fall under the schedule of tariff concessions (to do that, a company will need to have the correct HS codes);
- Familiarize themselves with the relevant origin implementation procedures (such as application of the Country of Origin and origin claim requirement);
- Train staff to understand the basic logic for determining HS codes of goods and Rules of Origin for each HS code;
- Evaluate the need to re-structure their supply chains (production, sales and purchase) to take full advantage of the preferential duty treatment under the CN-KR FTA;
- Review supply/purchase contracts, in particular with respect to duty clauses relating to the liabilities for origin information and application;
- Assemble the appropriate resources to deal with new requirements associated with implementing FTA (manually and automatically); and
- Establish a regular review mechanism to ensure compliance with relevant FTA requirements.

How Can We Help

Deloitte's Customs & Global Trade Services Groups in Korea and China have extensive experience in maximizing opportunities under FTAs. Specifically, we can assist companies to:

- Determine the correct HS codes of goods to be exported;
- Determine which HS codes fall within the Tariff Elimination Schedules;
- Assess whether exported goods satisfy the appropriate Rules of Origin to determine whether preferential tariffs can be enjoyed;
- If preferential tariffs are not available, identify steps that can be taken to enable the goods to be exported to qualify for preferential duty treatment;
- Obtain advance rulings from Customs that the products to be exported satisfy the criteria for preferential treatment;
- Obtain certified Preferential Tariff Certificates of Origin from the appropriate approval authorities; and
- Defend any challenges by the Customs authorities as to eligibility to claim preferential duty treatment.

For more information, or to discuss how Deloitte can assist your business, please feel free to contact our Customs & Global Trade Services professional teams.

Note: Contents discussed in this Tax Analysis pertain to Deloitte Customs & Global Trade Services.

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