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Indirect Tax Alert

US and China reach initial accord towards trade agreement on agricultural purchases, tariff delays and next steps on framework for intellectual property and technology transfers

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Executive summary

On 11 October 2019, the United States (US) President Donald Trump and Chinese Vice Premier Liu He announced that the two nations had reached an initial accord, referred to as the Phase One Agreement (Agreement or Phase One). In a joint press conference at the White House following a week-long negotiation process, the US has indicated that the Agreement will be the first step towards a more comprehensive trade agreement to ultimately address key concerns regarding China's discriminatory and unfair trade practices as sought by the Trump Administration under Section 301 of the *Trade Act of 1974*.[1]

Phase One features include increased purchases by China of US agricultural products, suspended punitive tariff increases by the US, certain Chinese concessions on currency manipulation, as well as the framework for next steps on other issues such as intellectual property (IP) and technology transfer matters, arguably the most complex and longstanding issues subject to the negotiations.

The President indicated the Agreement in principle is pending formal write-up, which could take up to five weeks to complete, and may be signed at or around the time President Trump and Chinese President Xi Jinping attend the Asia-Pacific Economic Cooperation meeting in Santiago, Chile next month on 16-17 November. Despite this progress, US$550 billion[2] worth of annual US imports of Chinese-origin goods remains subject to tariffs ranging between 15% and 25%, and $185b[3] worth of US goods imported into China remain subject to tariffs ranging between 5% and 25%.

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Notably, while China appears to be committing to up to $50b in US-origin agricultural purchases and the US has stated that the 5% tariff increase planned for 15 October has now been suspended indefinitely but not cancelled, the 15% tariffs scheduled for 15 December were not formally addressed in this initial phase.

Detailed discussion

On 14 August 2017, President Trump directed the US Trade Representative (USTR) in a Presidential Memorandum 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).[4]

The USTR conducted an investigation and on 22 March 2018, published a report of their findings. The report determined 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.[5] In their findings, the USTR noted five main areas of discriminatory and unfair practices by China:

- **Unfair technology transfer regime**, including foreign ownership restrictions such as certain joint-venture (JV) 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 (FDI) 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**

Following the issuance of their 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 worth of Chinese-origin goods (List 1).[6]

This action began a back and forth of punitive tariff actions between the two counties, intermittent 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[7] and List 3,[8] respectively), as well as 15% punitive tariffs of $300b (List 4A and List 4B[9]). China retaliated on each of the four rounds of the US tariffs with its own tariff increases, implementing 5%-25% of additional duties on $185b of US-origin goods.

On 11 October 2019, following a round of negotiations in Washington DC, President Trump and Vice Premier Liu held a joint press conference announcing a Phase One agreement had been reached and indicated that an additional Phase Two agreement, and potentially Phase Three agreement would subsequently occur as the two nations continue to negotiate. While there is limited information surrounding the specific terms of the agreement, the primary aspects of the Phase One agreement as announced are as follows:

- The US agrees to suspend the 15 October scheduled increase of Lists 1, 2 and 3 tariffs from 25% to 30% as the agreement is finalized
- China agrees to increase US agricultural purchases scaled up to $40-$50b annually within the next two years
- China agrees to open markets to US financial services firms
- China agrees to concessions regarding currency manipulation
- China agrees to unspecified, but limited, concessions around technology transfer
- Both parties agree to establish a formal enforcement and escalation provisions

Absent from this deal is any relief regarding US sanctions on Huawei,[10] reduction of existing tariffs currently in place by both sides, and many specific concerns regarding technology transfer as outlined in the USTR's Section 301 report, such as addressing Chinese JV and cooperative agreement regulations and licensing restrictions. Additionally, the Phase One agreement is silent on Chinese human rights violations and abuses, important issues to the US as illustrated by the 7 October actions taken by the US Department of Commerce, Bureau of Industry and Security (BIS) by adding 28 Chinese organizations to the Entity List, as further described in EY Global Tax Alert, *US Bureau of Industry and Security adds 28 Chinese entities to the Entity List*, dated 10 October 2019.

President Trump stated in the White House press conference that the aforementioned components not covered under Phase One may be addressed in subsequent phases after additional negotiations with both parties. Timing surrounding next steps for the indicated Phases Two and Three has not been announced, except that negotiations for Phase Two will begin once the Phase One agreement is signed.

It is important to note that at this time, the agreement is not formally drafted and has not been signed by either the US or China.

Actions for business

Companies impacted by the tariffs in place (and planned) by both sides as well as those impacted by the broader China-US dispute should closely monitor developments in the coming months, as the Phase One agreement has not yet been formally drafted and will require signatures and steps for implementation by both parties. Terms of this preliminary deal, and any subsequent deals reached are likely to contain specific provisions that may impact certainty, and possibly duration, of outcome and will need to be closely analyzed once made available.

Despite the progress in bilateral negotiations, uncertainty remains and US tariffs pursuant to Lists 1, 2, 3 and 4A are expected to remain in place. List 4B's implementation remains scheduled but somewhat less certain. Companies impacted by the current and planned tariffs should continue to assess impact and take actions to mitigate any impact to business.

Immediate actions for such companies to consider 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, and to assess any opportunities to mitigate impact such as tariff engineering 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.

Endnotes

1. See White House transcript Remarks by President Trump and Vice Premier Liu He of the People's Republic of China in a Meeting.
2. Currency references in the Alert are to US$.
3. Pending official announcement from the China regarding dollar amount breakdown for China List 4.
4. See 82 FR 39007.
5. See USTR 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.
6. See 83 FR 28710.
7. See 83 FR 40823.
8. See 84 FR 26930.
9. See 84 FR 45821.
10. See EY Global Tax Alert, *Huawei and affiliates added to the Bureau of Industry and Security's Entity List effectively barring US exports to the company*, dated 22 May 2019.

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