China – Measures Affecting Imports of Automobile Parts

(DS340)

Attachment to the Rebuttal Submission of the United States:
U.S. Comments on Responses of China to the Panel's Questions to the Parties[1]

Measures at issue and products at issue

Q1. In respect of the criteria set out in Articles 21 and 22 of Decree 125:
. . .
(b) *(All parties)* Are these types of criteria commonly used as standards by customs offices in determining whether parts and components of a product should be considered as a complete product?

1. In its response, China refers to its response to the Panel's question 117. However, the factors that China relies on as justification for classifying the different combinations of auto parts and components is in contradiction to the terms of the Harmonized System and the proper application of the General Interpretative Rules. As demonstrated in the U.S. Response to question 47, customs officials cannot group some assemblies together and claim that they have the essential character of a complete motor vehicle. For example, a single component (e.g., diesel engine sub-assembly A or sub-assembly B as described in Exhibit CHI-3) entered is classified under the terms of a heading that describes that component (e.g., heading 8409). If a group of components are entered together (e.g., diesel engine sub-assembly A and sub-assembly B as described in Exhibit CHI-3) that may form an assembly (e.g., a complete diesel engine), the United States would classify it under the heading that describes that assembly (e.g., heading 8408). If a group of components do not form an assembly, they are individually classified (e.g., a crankshaft and side panel would not constitute an assembly and would be individually classified). None of the assemblies listed in Exhibit CHI-3 ever constitutes incomplete or unfinished motor vehicles within the meaning of General Interpretative Rule 2(a); instead, they would be individually classified in accordance with the terms of General Interpretative Rule 1 (e.g., spark-ignition reciprocating or rotary internal combustion piston engines of heading 84.07, transmission shafts of heading 84.83, chassis fitted with engines of heading 87.06, bodies (including cabs) of heading 87.07).

Q2 *(China)* What were China's bound and applied tariff rates for "CKD and SKD kits", "motor vehicles" and "auto parts" prior to China's accession to the WTO and at the time of China's accession to the WTO?

2. In its response, China explained that immediately prior to its accession to the WTO on

[1] The United States notes that the absence in this document of a U.S. comment on certain of China's responses does not in any way indicate that the United States agrees with such responses of China. To the contrary, the United States takes issue with most positions of China in this dispute.

December 11, 2001, "the average applied tariff rate for 'motor vehicles' was 63.6%, and the average applied tariff rate for 'auto parts' was 24.7%. There were no separate tariff lines for 'CKD and SKD kits' in China's Tariff Code. CKD and SKD kits were classified as complete vehicles according to GIR 2(a) and the applied rates were identical to the tariff rates applicable to the corresponding complete vehicle model." While the United States does not dispute China's statements regarding the applied tariff rates for motor vehicles, it does dispute China's explanation regarding parts and CKD and SKD kits as being both inaccurate and incomplete.

3. From 1992 to 1995, China did maintain separate tariff lines for CKDs and SKDs. As China's exhibit CHI-30 shows, these tariff lines established tariff rates that were the same as the scheduled tariff rates applicable to motor vehicles. However, China normally did not apply these rates. Instead, the applicable rate for CKDs and SKDs was negotiated between an individual auto manufacturer and the Chinese authorities. The key factors in this negotiation were the amount of the auto manufacturer's investment in China and the extent to which the auto manufacturer used local content in the assembly of its vehicles, both at the time of the negotiation and under the auto manufacturer's future plans. Normally, an auto manufacturer with a larger amount of investment and a larger percentage of local content would be able to negotiate a lower tariff rate than would an auto manufacturer with a smaller amount of investment and a smaller percentage of local content. Particularly for the auto manufacturers that the Chinese authorities viewed as committed to China based on these factors, the negotiated tariff rates for CKDs and SKDs were substantially below the tariff rates for motor vehicles. In addition, the Chinese authorities would normally apply the same negotiated tariff rates to parts, as the negotiated tariff rates were often also below the tariff rates for parts set forth in China's tariff schedule.

4. After 1995, China eliminated the tariff lines for CKDs and SKDs, as China's response reflects. However, contrary to China's assertions, China even then did *not* apply tariff rates for CKDs and SKDs that were the same as the scheduled tariff rates applicable to motor vehicles. China continued to apply tariff rates for CKDs and SKDs (and parts) that were negotiated between an individual auto manufacturer and the Chinese authorities, just as it had in the period from 1992 to 1995.

5. These same tariff practices continued through the time of China's accession to the WTO and post-accession until China began to implement the measures at issue in this dispute.

6. From 1992 until the implementation of the measures at issue in this dispute, China pursued these tariff practices because it was focused on building up its capacity for the local assembly of motor vehicles, and it did not have sufficient domestic manufacturers of auto parts to supply domestic auto manufacturers. China therefore welcomed and encouraged imports of CKDs and SKDs (and parts) that could be assembled into motor vehicles in China, particularly by auto manufacturers that demonstrated a commitment to China.

7. China's policy of encouraging imports of CKDs and SKDs (and parts) that could be assembled into motor vehicles locally was facilitated by China's policy of maintaining import quotas on motor vehicles. In this regard, China maintained import quotas on vehicles prior to its accession to the WTO in 2001, and it negotiated the right to maintain import quotas on motor vehicles for three years after its accession, i.e., until 1 January 2005, as reflected in Part I, paragraph 7.1, and Annex 3 of China's Protocol of Accession, as explained more fully below under question 14(b).

8. China's tariff practices relating to CKDs and SKDs (and parts) during the period from 1992 until China's accession to the WTO at the end of 2001 help to explain why paragraph 93 of the Working Party Report accompanying China's Protocol of Accession reads the way it does. As the panel will recall, paragraph 93 provides:

> In response to questions about the tariff treatment for kits for motor vehicles, the representative of China confirmed that China had no tariff lines for completely knocked-down kits for motor vehicles or semi-knocked down kits for motor vehicles. If China created such tariff lines, the tariff rates would be no more than 10 per cent.

9. When negotiating this provision in the years leading up to China's WTO accession, WTO Members, including the United States, knew that China had separate tariff lines for CKDs and SKDs that scheduled tariff rates that were the same as those for motor vehicles from 1992 to 1995, and that China eliminated these tariff lines effective January 1, 1996. WTO Members also knew that the Chinese authorities had nevertheless been applying substantially lower tariff rates for CKDs and SKDs (and parts) than for motor vehicles, both when China had separate tariff lines for CKDs and SKDs and when it did not. In negotiating paragraph 93, therefore, WTO Members wanted to ensure that China would continue to treat CKDs and SKDs essentially as parts for tariff purposes after acceding to the WTO and that China would be unable to re-establish separate tariff lines for CKDs and SKDs, at higher rates, if its policy focus changed as its domestic auto industry evolved.

> **Q9. (*All parties*) Assuming that a country can have an anti-circumvention policy in the context of ordinary customs duties, how much flexibility should a country have in introducing measures to enforce such a policy?**

10. As the United States has explained, China's so-called concern with "circumvention" is that importers might make use of the lower tariff on auto parts negotiated at the time of China's accession.

11. However, the United States does agree with China's general proposition that mechanisms to enforce customs laws must be consistent with a Member's international obligations, including obligations under the WTO Agreement and under the Harmonized System Convention. To this

end, China responded that the "ability to adopt measures to interpret its tariff schedule in accordance with rules of Harmonized System is co-extensive with those rules; any such measure must comport with the requirements of the Harmonized System." However, the substance of China's response to this question is intended to demonstrate a certain "degree of flexibility … in adopting measures to interpret its schedule of Concessions in accordance with the rule of the Harmonized System."

12. China's example of a national measure interpreting a General Interpretative Rule (GIR) fails to demonstrate this alleged "flexibility." The example involves GIR 3(a), which governs goods that are prima facie classifiable under two or more tariff headings. The rule provides that "the heading which provides the most specific description shall be preferred to headings providing a more general description." China's example assumes that a contracting party adopts a measure that advises importers as to which goods it considers prima facie classifiable under more than one heading and advises as to which heading is more specific.[2] Such a measure would be in compliance with the contracting party's obligations under GIR 3(a) only if the products identified were specifically described by both headings.

13. More relevant to the case at hand, there is no degree of flexibility under the Harmonized System that would legitimize the "anti-circumvention" measures that China has implemented for the classification of imported auto parts. It is China's position that "the relevant inquiry would be whether the measure results in classification consistent with the HS [Harmonized System] terms employed in that member's tariff schedule." To this end, China states that the results must be consistent with the requirements of the GIRs. However, China is implementing measures that are not in compliance with GIR 2(a). GIR 2(a) permits the classification of unfinished or unassembled goods as finished goods based upon their condition "as presented." The condition of goods presented for customs clearance is their condition at the time of importation. China's measure that mandates classification of imported auto parts under a tariff schedule heading for a completed automobile is based on the future use of those goods in the production of a completed automobile. Classification on this basis is a flagrant violation of GRI 2(a) because classification based on use after importation is not consistent with the requirement that goods be classified in their condition upon importation.

> **Q12. (*China*) In respect of the alleged problems relating to circumvention of ordinary customs duties for motor vehicles in China:**
> *****
> **(b) How has China dealt with the alleged problem before the introduction of the**

[2] In its response to the Panel question, China states, "Suppose that a Member adopted a measure to advise importers as to which headings it considered to be "prima facie classifiable under two or more headings…." This statement is illogical because a heading is not classifiable under other headings. The United States, for the purposes of its rebuttal to China's response, presumes that China intended to refer to a hypothetical measure that identifies "goods" (rather than headings) that are prima facie classifiable under two or more headings.

measures at issue?

14. The United States disagrees with China's claim that the supposed "circumvention" of ordinary customs duties for motor vehicles in China is simply an example of "a problem of tariff classification that arises whenever there is a significant difference in duty rates between complete articles and parts of those articles." There is not a problem of classification when parts are imported separately and later assembled into a completed article. Under the Harmonized System, it is a longstanding principle that goods are classified, pursuant to General Interpretative Rule 1, under the tariff heading that most specifically describes those goods in their condition as imported.[3] The Harmonized System is made up of 96 chapters grouped into 21 sections consisting of approximately 5,000 article descriptions in the headings and subheadings. The Harmonized System is divided into categories or product headings beginning with crude and natural products and continuing in further degrees of complexity through advanced manufactured goods. As reflected in the United States' response to the Panel's question 47, there are tariff headings that specifically describe automobile parts, and, accordingly, when those parts are imported separately, they are classifiable under those provisions. It is not "circumvention" of the tariff schedule for an auto manufacturer to import parts separately and later assemble them into a completed article in the domestic market.

13. (All parties) Regarding the notion of "circumvention":
(a) Please explain what "circumvention" means; and
(b) Please explain whether, and if so, how, under the WTO law, a Member is allowed to take an anti-circumvention measure. If possible, please support your response with relevant GATT/WTO jurisprudence.

15. In describing its notion of "circumvention" in the context of this dispute, China argues that its concerns reflect a tariff classification issue. China explains: "That tariff classification issue is whether a tariff provision for a complete article (such as motor vehicles) includes the importation and assembly of parts that, in their entirety, have the essential character of that article. This tariff classification issue is governed by General Interpretative Rule 2(a)." China then acknowledges that auto manufacturers "structur[e] their imports of parts and components so that no single shipment has the essential character of a motor vehicle," but it describes this activity as circumvention because these auto manufacturers pay the lower tariff rates applicable to parts instead of the higher tariff rates applicable to motor vehicles. In China's words, this activity is circumvention because "auto manufacturers deprive China of the revenue and market access benefits that it negotiated when it obtained a higher bound duty rate for motor vehicles as compared to parts and assemblies of motor vehicles."

[3] General Interpretative Rule 1 states that "for legal purposes, classification shall be determined according to the terms of the heading and any relative Section or Chapter Notes and, provide such heading or Notes do not otherwise require, according to the following provisions." (Ex. CHI-15).

16. China, however, has no basis for arguing that it is being deprived of the "revenue benefits" that it negotiated in the form of higher duty rates for motor vehicles. The United States and other WTO Members negotiated lower duty rates on parts, and it is they who are being deprived (by the application of China's measures) of their negotiated benefits.

17. China also glosses over the true coverage of the measures at issue by describing them as being aimed at importing parts "in multiple shipments." China's measures cover the importation of parts (1) in multiple shipments, (2) from multiple suppliers, (3) from multiple countries,[4] (4) pursuant to multiple purchase orders, (5) placed as much as one year apart. Moreover, the number of shipments potentially grouped together by China's measures is astounding. Even the simplest motor vehicle contains about 1,500 parts, as is shown in China's discussion in response to question 69. More commonly, motor vehicles have thousands of parts.

18. According to China, the tariff classification issue is "whether a tariff provision for a complete article (such as motor vehicles) includes the importation and assembly of parts that, in their entirety, have the essential character of that article." China specifies that "[t]his tariff classification issue is governed by General Interpretative Rule 2(a)." The United States notes that the concept of parts "in their entirety" is not included in the GIR 2(a). GIR 2(a) provides for the classification of goods "as presented," which is their condition at the time of importation. Consistent with GIR 1, when an imported auto part is specifically described by a heading of the tariff schedule, it is classifiable under that heading notwithstanding that, post importation, the auto part may be used in the assembly of a complete automobile. Even a measure that compels an auto manufacturer to provide proof of the post-importation assembly of many different imported parts, in their entirety, into a complete automobile does not retroactively confer to those parts at the time of importation the "essential character" of an automobile.

Q14. In paragraph 21 its first written submission, China indicates that between 2001 and 2004, the value of imported parts and components increased by 300%.
(b) *(China)* Could China please also indicate the percentage change, if any, in imports of complete vehicles during this same period.

19. In its response to question 14(b), China again makes the point that it found a pattern of "circumvention" during the period from 2001 to 2004 because imports of auto parts increased overall at a quicker rate than did imports of motor vehicles. China also points to a slowing rate of increase for imported motor vehicles in 2003 and 2004 and argues that this trend was "abnormal" because China's import quotas on motor vehicles were being "substantially loosened" during this time period.

[4] China's measures even cover parts that auto manufacturers purchase from suppliers in China if those suppliers had themselves imported those parts.

20. China's response is not convincing. China was doing everything in its power to limit imports of motor vehicles during the years 2001, 2002 and 2003. Only in 2004 did China begin to lift the barriers that it had put in place to limit vehicle imports, and these barriers were only lifted in full by the end of 2004 (with the exception of the high tariff rates that are still applicable to motor vehicles).

21. As explained above (see question 2), during the period from 2001 to 2004, China was pursuing tariff practices that encouraged the importation of parts and even CKDs and SKDs for assembly in China, while it was discouraging the importation of vehicles through an import quota regime. Under the import quota regime, China set an annual import quota for motor vehicles (and two key parts) at a value of $6 billion, with annual increases of 15 percent. At the same time, however, China actively impeded foreign auto companies' attempts to fill this quota, which kept their imports of vehicles even further artificially low.

22. The United States described this situation in the 2002 USTR Report to Congress on China's WTO Compliance, which was issued on December 11, 2002. That report explained:

> From the outset, China's quota system was beset with problems. The State Council did not issue necessary regulations until mid-December 2001. Not only were these regulations late, but they also appeared to be inconsistent with China's WTO commitments in certain respects. Further delay ensued as the administering authorities charged with implementing this system – [the Ministry of Foreign Trade and Economic Cooperation, known as MOFTEC] for some products and the State Economic and Trade Commission (SETC) for other products – struggled with implementation. More problems arose when MOFTEC and SETC finally began allocating quotas. In the case of autos, for example, while MOFTEC issued necessary implementing rules shortly after the issuance of the State Council's regulations, it did not open up the quota application process until February [2002], and it did not begin to allocate quotas until late April [2002]. Because of a lack of transparency, it was difficult to assess whether the quotas were allocated in accordance with the agreed rules. It became apparent, however, that MOFTEC was creating false fill rates by filling the quota for autos with auto parts (other than the key auto parts allowed by China's accession agreement). By mid-year, MOFTEC had also not yet fully allocated the auto quotas, although part of this delay was due to MOFTEC's crackdown on the illegal secondary market for auto import licenses.[5]

The report goes on to recount the efforts of the United States to obtain improvements in the

[5] 2002 USTR Report to Congress on China's WTO Compliance, p. 12.

operations of China's quota system, based on detailed commitments that China had made in its Protocol of Accession regarding applicable rules and procedures. The United States raised its concerns bilaterally with China and during meetings of the Committee on Market Access and the Committee on Import Licensing, as did other WTO Members. The report concluded that "[w]hile it is possible that some of the problems that arose during 2002, such as the missed deadlines, may have been attributable to first-time difficulties in implementing a new system, other problems seemed to reflect protectionist policies, particularly, for example, MOFTEC's filling of the quota for autos with auto parts." *Id*., pages 12-13.

23. One year later, on December 11, 2003, the United States reported little improvement in China's import quota system for vehicles. The 2003 USTR Report to Congress on China's WTO Compliance explained:

> In 2003, the problems encountered with the auto quota system in 2002 continued, and MOFTEC was again late in issuing quota allocations, which resulted in uncertainty and significant disruption of wholesale and retail operations for imported autos. Given the persistence of these problems, it appears that China's poor implementation of its auto quota commitments is not due simply to difficulties in implementing a new quota system.[6]

24. Following sustained pressure from the United States, at the end of 2003, China began to loosen its restrictions on the importation of some motor vehicles. At that time, "China announced that certain U.S. auto companies would be authorized to import sizeable quantities of U.S.-produced autos in 2004 without having to use Chinese enterprises holding quotas. This development effectively ends the auto quota system for these companies as of the end of 2003, one year ahead of schedule."[7]

25. Thus, the import data that China proffers in response to question 14(b) does not reflect China's notion of circumvention. It does not demonstrate that auto manufacturers decided to change their business practices to avoid the higher duty rates on motor vehicles. Rather, the data reflects the Chinese government's own concerted efforts to discourage imports of motor vehicles by manipulating an already restrictive quota regime while promoting imports of CKDs and SKDs and parts through the tariff practices described above under question 2.

55. (All parties) Please explain in detail what customs "clearance" means.

26. According to China, "[t]he relevant consideration is whether the customs procedure to which the goods are subject after they have been released is one that pertains to the satisfaction

[6] *Id*., page 23.

[7] *Id*., page 24.

of a liability that arose by reason of the importation of the goods." For tariff classification purposes, the liability that arises in connection with the importation of the goods is the collection of "Customs duties," which are defined by the revised (1999) Kyoto Convention on the Simplification and Harmonization of Customs Procedures as "the duties laid down in the Customs tariff to which goods are liable on entering or leaving the Customs territory." Therefore, the relevant consideration in this case is whether China's measures enforce the collection of a Customs duty under China's tariff schedule for which an auto part was liable when it entered the customs territory of China by virtue of its importation. While the time or place of the assessment of the charge may vary, that charge cannot be based upon a change in the condition of the auto part that occurred after its entry into the Customs territory of China.

Q62.(China) With respect to CKD and SKD kits, is there any difference between "manufacturing" and "assembling." If so, what is the difference and how is such difference relevant to understanding Rule 2(a) of the General Interpretative Rules?

27. In its response to this question, China stated: "In sum, the notion of 'manufacturing' is not relevant to the application of GIR 2(a) to CKD and SKD kits, as it is beyond dispute that CKD and SKD kits are assembled into finished vehicles by means of the assembly operations specified in the Explanatory Note." The factual question as to whether CKD and SKD kits can be assembled into finished vehicles is indeed disputed by the United States, as spelled out in our response to the Panel's question 47. Further, "manufacturing" operations are not covered by GIR 2(a). See Explanatory Note VII to GIR 2(a), which states in relevant part "[h]owever the components shall not be subjected to any further working operation for completion into the finished state."[8]

Q68. (*All parties*) Please comment on the view that if WTO Members are allowed to resort to the notions contained in Rule 2(a) of the General Interpretative Rules, such as "as presented" and "essential character", in relation to tariff classification, it could have serious implications on the world trading system in light of today's commercial reality that manufacturers import parts and components from different sources and assemble them together.

28. On page 54 of its first submission, China asserts that: "As China has explained to the Panel, the purpose of GIR 2(a) is to deal with the relationship between complete articles and parts of articles." This is a misstatement of General Interpretative Rule 2(a), which deals with the relationship of articles either incomplete or unfinished as well as articles complete or finished that are presented unassembled or disassembled. The notion that this is the only relevant rule ignores the application of General Interpretative Rule 1, which states that: "for legal purposes, classification shall be determined according to the terms of the heading and any relative Section

[8] Ex. CHI-15.

or Chapter Notes and, provide such heading or Notes do not otherwise require, according to the following provisions."

29. For example, the gasoline engine assemblies described in Exhibit CHI-3, are precluded from classification in chapter 87 as "parts" of motor vehicles by the application of General Interpretative Rule 1 and Legal Note 2(e) to Section XVII (which includes chapter 87), and directs classification of this assembly to Heading 84.07 which provides for: "Spark-ignition reciprocating or rotary internal combustion piston engines." This interpretation is supported by EN VIII to GIR 2(a), which provide that "Cases covered by this Rule are cited in the General Explanatory Notes to Sections or Chapters (e.g., Section XVI, and Chapters 44, 86, 87 and 89)." The General EN to Chapter 87 states that this "Chapter also covers parts and accessories which are identifiable as being suitable for use solely or principally with the vehicles included therein, subject to the provisions of the Notes to Section XVII (see the General Explanatory Note to the Section)."

30. Further, China's Footnote 20 also misstates GIR 2(b). That footnote argues: "This is underscored by General Interpretive Rule 2(b), which deals with the closely related issue of the relationship between a material and a mixture or combination that includes that material." To the contrary, GIR 2(b) provides guidance on how to interpret headings that reference a "material or substance." GIR 2(b) simply has no relevance to how customs officials should classify articles and parts.

31. On page 56, China asserts the following: "Thus, the principles of GIR 2(a) do not pose a threat to the international trading system. Customs authorities have been applying the principles of GIR 2(a) for many years, even before the adoption of General Interpretive Rule 2(a) in 1963. These principles are a standard feature of international customs practice." China's selective use of GIR 2(a) does pose a threat to the international trading system, because it ignores the structure of the Harmonized System and General Interpretative Rule 1. The Harmonized System is made up of 96 chapters grouped into 21 sections consisting of approximately 5,000 article descriptions in the headings and subheadings. The Harmonized System is divided into categories or product headings beginning with crude and natural products and continuing in further degrees of complexity through advanced manufactured goods.

32. General Interpretative Rule 2(a) requires that customs officials make a determination as to whether components entered together impart the essential character of a complete or finished article. If not, then the components are to be individually classified. This view is supported by the structure of the Harmonized System itself, which specifically names certain parts in their own headings (e.g., spark-ignition reciprocating or rotary internal combustion piston engines of heading 84.07, transmission shafts of heading 84.83, chassis fitted with engines of heading 87.06, bodies (including cabs) of heading 87.07) and contains headings for parts suitable for use solely or principally with motor vehicles (e.g., heading 87.08 which provides for parts and accessories of the motor vehicles of headings 87.01 to 87.05). To classify all parts eventually

incorporated into complete motor vehicles, as motor vehicles would empty many headings and subheadings of the goods specified therein.

> **Q70. (*All parties*) In light of your response to the previous question, please clarify whether you agree with the European Communities' explanation on CKD and SKD kits in paragraph 267 of its first written submission, including its reference to "all the parts necessary to manufacture not only a vehicle, but also an 'assembly'"?**

33. In its response to this question, China states that it does not consider that a CKD or SKD kit must include all of the parts necessary to assemble a motor vehicle. China explains that "there is some ambiguity in how the automotive industry uses these terms," and that "[w]hile it is generally agreed that a CKD kit includes nearly all of the parts and components necessary to assemble a motor vehicle, the industry sometimes uses the term 'CKD kit' in a way that encompasses a certain proportion of locally-supplied content." The United States agrees that industry uses the term "kit" to describe a wide range of combinations of parts, many of which do not include all of the parts necessary to assemble a motor vehicle. However, the Panel's question is addressed to the measures at issue (not industry usage of the terms). And China's measures, particularly Articles 2 and 21(1) of Decree 125, appear to define CKD and SKD kits as kits that include all of the parts necessary to assemble a motor vehicle.

Nature of the measures

> **Q102. (China) Please explain why the 60% threshold criterion under Article 21(3) of Decree 125 would not constitute a local content requirement.**

34. In its response, China claims: "As China explains in response to question 117 below, the value of imported parts and components in relation to the value of the finished article is one factor that customs authorities consider in applying the essential character test under GIR 2(a). China provides specific examples of this practice in response to question 117. The 60 percent threshold criterion under Article 21(3) of Decree 125 reflects this aspect of the essential character test."

35. This statement by China mischaracterizes the application of Article 21(3) of Decree 125 to importers because it treats value of imported parts as 1 of 3 methods that automatically triggers the conclusion that the parts constitute complete vehicles. This is not an essential character test, but a strict value threshold. Article 21(3) of Decree 125 is not a factor in determining "essential character" but is the sole factor used by China that results in a local content requirement.

36. Further, the examples provided by China in Exhibits CHI-16, CHI-42, and CHI-45, do not support the use of value as a sole criterion for establishing essential character. Exhibit CHI-16 (NY M83114) clearly states that: "[t]he nature of the item, its bulk, quantity, or value

may be looked to in a determination of essential character. It is our belief that the 34-piece Glock 17 model parts kit proposed to be imported, absent the receiver component, constitutes the aggregate of distinctive component parts that establish its identity as what it is, a complete or finished pistol." The United States did not rely on value to determine "essential character" under GIR 2(a), but instead it relied on the fact that the kit was "imported without the frame but with all other necessary parts" as an unfinished, unassembled pistol.

37. In Exhibit CHI-42 (HQ 086555), the United States recognizes, in the context of GIR 2(a), that: "The nature of the item, its bulk, quantity, or value may be looked to [to determine an article's essential character. However, such a determination varies between different types of merchandise. [citing to Explanatory Note (VIII) to GIR 3(b) and not to ENs for GIR 2(a)]." In that ruling, the United States stated that an incomplete or unfinished backhoe excavator would be classified as an excavator, if it has the essential character of an excavator. The incomplete or unfinished excavator must be easily recognizable as an excavator. In that case, the United States concluded that the propelling base of an excavator imparted the essential character because it was substantial enough within the meaning of GIR 2(a). The U.S. did not rely on value to determine "essential character" under GIR 2(a), but examined the nature of the item.

38. In Exhibit CHI-45, a U.S. customs ruling describes an intermodal railway car missing certain components that would make it a stand-alone railway freight car designed to carry certain size truck trailers. As part of its facts, the ruling noted that the percentage value of the imported product compared to the completed article. In its "Law and Analysis" section, the ruling cites to GIR 2(a) and concludes that the article as imported constituted an unfinished railway or tramway freight car. The ruling simply does not provide any reasoning or set forth a basis for its conclusion, and thus does not support China's allegations that U.S. Customs uses value-added tests as a basis for classification decisions.

Q108. China has stated that "the charges that China imposes under the challenged measures relate back to a condition that attached at the time of importation. That condition is that when the auto manufacturer fulfils it stated intention to import and assemble parts and components that have the essential character of a motor vehicle, it will be obligated to pay the applicable duty rate for motor vehicles, just as if it had imported those parts and components in a single shipment" (paragraph 31 of its first oral statement).

(a) (*China*) Could China clarify whether the products at issue cannot cross the border unless the condition as described by China is fulfilled;

(d) (*China*) China has also stated during the first substantive meeting that the "intention" of importers is irrelevant to the interpretation of General Interpretative Rule 2(a) and what is relevant for the purpose of tariff classification is the determination of whether the parts concerned have the essential character of a complete article (i.e. complete vehicle in this case). How does China reconcile this position with its statement cited above that the condition attached at the time of

importation is related to the determination of whether the auto manufacturer fulfils its stated intention to import and assemble parts and components that have the essential character of a motor vehicle.

39. Q108(a): China's response to this question from the Panel suggests that because auto parts may be released into the control of an importer prior to the completion of all customs procedures that the "condition" of the auto parts upon importation may also be determined based on their use in the domestic market after release into the custody of the auto manufacturer. Under the Harmonized System, the condition of the good when the shipment is entered into China is the condition of the good upon importation regardless of when all customs procedures may be completed. Accordingly, the United States disagrees with China's implication that it has a right to classify imported auto parts "without regard to whether the parts and components enter China in one shipment or multiple shipments."

40. Q108(d): In its response, China states: "China has explained in response to previous questions, the purpose of the prior evaluation and verification of specific vehicle models is to establish whether the auto manufacturer has the practice or intention of importing multiple shipments of parts and components that, in their entirety, have the essential character of a motor vehicle. As explained, the auto manufacturer is obligated to pay the applicable duty rate for motor vehicles for these imports. Under the customs procedures that China has established for this purpose, the auto manufacturer pays the applicable customs duties after it has assembled the multiple shipments of parts and components into the registered vehicle model."

41. This practice by China ignores the proper application of the Harmonized System, which provides that merchandise should be classified in its condition as presented without regard to what occurs to the merchandise after importation.

Article II of the GATT 1994

Q110. (All parties) Rule 2(a) of the General Interpretative Rules states, inter alia, that " Any reference in a heading to an article shall be taken to include a reference to that article incomplete or unfinished, provided that, as presented, the incomplete or unfinished article has the essential character of the complete or finished article." Please explain what "as presented" means as referred to in Rule 2(a)?

42. China defines the term "as presented" under GIR 2(a) as meaning, "in light of the facts or circumstances surrounding the import transaction." For the purposes of China's "anti-circumvention" measures, these facts and circumstances include the post importation assembly of imported auto parts into finished motor vehicles. This proposed interpretation of the term "as presented" undermines the very uniformity that the Harmonized System was designed to protect because China disregards the actual form of the shipment of the goods in favor of a future condition of the goods as integrated into a whole motor vehicle. This future condition does not

exist at the time of importation of the auto part.

43. The United States disagrees with China's claim that the term "as presented" is not limited to single shipments because of the language of the Harmonized System "decision" described in paragraph 10 of Annex IJ/7 to Doc. 39.600.[9] This "decision" is not entitled to any additional weight based on Article 31(3)(a) of the Vienna Convention, which provides that in the interpretation of a treaty, there shall be taken into account "any subsequent agreement between the parties regarding the interpretation of the treaty or application of its provisions." The original comment was by the Nomenclature Committee, which was responsible for the interpretation of the Customs Cooperation Council Nomenclature (the predecessor to the Harmonized System). As the "decision" was only reflected in the report of the Committee and no amendments were made to the Explanatory Notes nor was a Classification Opinion adopted, paragraph 10 has little weight, as it is not an enforceable decision of the Harmonized System Committee.

44. Furthermore, the "decision" was not adopted by the WCO. The "decision" also does not not mean that a member customs administration can abrogate the requirements of the General Interpretative Rules by regulation at the domestic level. Nor is the "decision" an interpretation of the meaning of "as presented." In fact, the "decision" does not in any way address the phrase "as presented."

45. Indeed, China's theory of the meaning of "as presented" is contrary to a decision of the Nomenclature Committee during its 42nd session in 1979. This decision adopted the proposal of the Danish Delegation that "the word "imported" in the English version of the nomenclature of the Harmonized System be replaced by "presented" in order to align the French and English versions and so that the English version would also be applicable to exported goods when necessary.[10] This substitution was also made in the context of GIR 2(a) for purposes of consistency. "As presented" means the condition of the good when it is imported, and the reason why "as presented" replaced "imported" in the context of GIR 2(a) is editorial, not substantive.

46. This interpretation is, in fact, supported by a letter issued by the Nomenclature and Classification Directorate in October of 1989, wherein it explained that "the replacement of 'imported' by 'presented' was in fact an editorial amendment, adopted to make it quite clear that the provisions of the Rules concerned apply for a given article in the state in which it is presented for Customs clearance."[11]

47. Goods are presented for customs clearance at the time of importation. Even if customs clearance is not completed until some time thereafter, assembly that occurs after the presentation

[9] Ex. CHI-29

[10] *See* Annex F/2 to Doc. 25.300E (Ex. US-1).

[11] Letter from Nomenclature and Classification Directorate dated 2 October 1989, with annexes (Ex. US-1).

is not a condition that existed when the goods were presented for customs clearance (at the time of their importation). Accordingly, China's interpretation of "as presented" (which includes post-importation assembly in the domestic market) is incorrect. For the aforementioned reasons, "as presented" is the condition of the good upon importation..

Q111. (Complainants) Please comment on China's statement in paragraph 160 of its first written submission and in paragraph 13 of its oral statement in relation to the WCO affirmed decision concerning Rule 2(a) of the General Interpretative Rules. In particular, please clarify the legal status of this WCO decision, including whether it is binding on the parties to the WCO or the WTO Members.

48. In its first sentence of its response, China claims that: "The Decision [Exhibit CHI-29] of the Harmonized System Committee is, by its terms, an interpretation of General Interpretative Rule 2(a)." This is not an accurate interpretation of what Exhibit CHI-29 actually represents. As the United States noted in its initial response to this question, there were two "decisions" taken by the WCO as reflected in Annex IJ/7 to Doc. 39.600 (HSC/16- Report). The first "decision" taken was an agreement by the Harmonized System Committee (HSC) to remove the reference of "simple assembly" to the Explanatory Note to General Interpretative Rule 2(a). In regards to the first "decision", the United States Customs Service gives this decision considerable weight and has classified in accordance with the WCO's decision to remove the reference of "simple assembly".

49. In its response to this question, China states that: "As a consequence of these provisions, the decision of the HS Committee is an authoritative interpretation of GIR 2(a) adopted by the members of the WCO. It reflects the WCO's official interpretation of GIR 2(a) as applied to the classification of articles that are assembled from multiple shipments of parts and components. The decision of the WCO is that this particular application of GIR 2(a) is a matter 'to be settled by each country in accordance with its own national regulations.' This interpretation of GIR 2(a) dates back to a decision taken by the Nomenclature Committee when GIR 2(a) was first drafted in the early 1960s." This statement is not accurate. At its 16th Session, the Nomenclature Committee specifically decided that the Explanatory Notes for the new GIR that: "No provision would be made for application of the Rule to parts and split consignments of unassembled or disassembled articles."[12]

50. China further states: "[S]ince at least 1995, that the Harmonized System allows Members to classify multiple imports of parts and components in accordance with the principles of GIR 2(a)." In short, the portion of the document that China builds its case around is nonbinding on HS contracting parties and deserves little or no weight in the WTO proceeding. The basic "decision" is a comment by the Nomenclature Committee interpreting the Customs Cooperation

[12] *See* Annex E to Doc. 13.450 E (NC/16/Apr. 1966) (Ex. US-2).

Council Nomenclature, to which the U.S. was never a party. The incorporation of that comment in the HSC/16 report merely indicates that neither the status of split consignments nor the classification of goods assembled from imported goods of various origins are within the jurisdiction of the HS Convention nor the HS Committee. The "decision" taken in the HSC does not interpret GIR 2(a). In fact, it is taken in the midst of a discussion on how simple assembly and further manufacturing relate to the application of GIR 2(a).[13] In subsequent sessions, the HS Committee stated that industrial production with the use of machine tools was beyond the scope of allowable assembly contemplated by GIR 2 (a).[14]

51. Thus, the "decision" that China relies on has no direct impact on the interpretation of GIR 2(a). It in no way diminishes China's obligations under the HS Convention. China must still classify goods as presented, using the entire nomenclature, rather than classify goods by effectively eliminating from use many headings of chapters 84 and 85. China cannot abrogate its responsibilities to an international agreement through domestic regulation.

Q112. (All parties) How should General Interpretative Rule 2(a) be interpreted in light of this decision?

52. Please see the above comments on China's response to question 111. Contrary to China's claim in its response that "[i]n light of these decisions, GIR 2(a) must be interpreted to allow national customs authorities to apply the principles of GIR 2(a) to goods that are assembled domestically from multiple shipments of imported parts and components," the only impact of the HSC/16 report is that the reference to "simple" for assembly should be removed. Any other interpretation would be contrary to the proper application of the Harmonized System.

Q117. (All parties) The European Communities explains in paragraph 262 of its first written submission that a situation foreseen under Article 21(2)(a) of Decree 125, namely importation of both an engine assembly and a body assembly together, is far away from the categories foreseen by the Chinese tariff schedule examined in the light of the general Explanatory Notes for Chapter 87 whereby an incomplete or unfinished vehicle may be classified as the corresponding complete or finished vehicle provided it has the essential character of the latter.

(a) Do you consider that the two examples of incomplete or unfinished vehicles in the General Notes for Chapter 87 correspond to any of the criteria set out in

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[13] The United States notified the public regarding its position on the various Harmonized System documentation that is available through the WCO. See T.D. 89-80, 54 FR 35127 (1989) (Ex. US-4). Within that notice, the United States indicated that a decision by the HSC that is memorialized merely by a reference in an HSC report is accorded little weight. That T.D. is routinely cited in Headquarters rulings issued by the United States.

[14] *See* Annex H/25 to Doc. 40.600E (HSC/18- Report), citing to paragraph 15 of Doc. 40.447 (HSC/18) (Ex. US-3).

Article 21 of Decree 125?; and

(b) In your view, what auto part products, other than those referred to in the general Explanatory Notes for Chapter 87, would qualify as an "incomplete or unfinished vehicle having the essential character of a complete or finished vehicle"? Please explain by referring to specific examples.

53. Response to Q117(a): In examining the examples in the General Explanatory Notes to Chapter 87, China asserts that: "With respect to the second example, 'a motor vehicle not equipped with its engine or with its interior fittings,' this would likely correspond to Article 21(2)(b) of Decree 125, as it constitutes a 'body … plus at least three other assemblies.' " The United States submits that this conclusion is unsupported because China has not established which types of assemblies would constitute an incomplete or unfinished motor vehicle.

54. Response to Q117(b): China cites to three examples of U.S. customs practices in Exhibits CHI-42, 43, and 44. Of the three examples, only one (Exhibit CHI-43) is directly on point to the panel's question, which asks for examples of auto parts products that would qualify as an "incomplete or unfinished vehicle having the essential character of a complete or finished vehicle." Exhibit CHI-43 was also identified by the United States along with several other rulings in its original response to this question.

55. China also asserts in its response that "Value" should be taken into consideration. In regards to whether "value" criterion constitutes the essential character of these assemblies, the United States respectfully refers the Panel to the above U.S. comment on China's response to Panel question 102.

Q134. Does China consider that how imported products are going to be used can be considered for the customs classification purpose? If so, how do you reconcile your position that the measures are "border" measures with the fact that a consideration of factors such as how products are used in the domestic market is related to events that take place in the importing country's internal market after importation?

56. China's practice of determining the identity of an imported good based on its post importation use is not a border measure. According to China, its process of "establish[ing] the relationship among multiple shipments of parts and components for assessing duties that apply to the completed article" is permissible because "[I]t seeks to establish what was imported, not how it was used." However, for tariff classification purposes (and under GRI 2(a) specifically) the identity of the good that is imported must be demonstrable by the good in its condition "as presented" for entry into the customs territory, that is, at the time of importation. Shipments of other parts and components with which the good will be assembled in the importing country's internal market cannot be considered in the classification of the good because there is no assembly of the good and the other parts and components at the time that the good is imported.

57. Even though customs formalities may not be completed until some time period after imported goods have entered the country's customs territory, any domestic assembly, which transpires during this interim period between importation and completion of customs formalities, is not a basis for classification under the Harmonized System.

58. China postulates that the United States has the authority to implement similar measures while United States customs formalities are ongoing. Specifically, China asserts that the United States could conduct administrative reviews after the importation of goods to determine "whether multiple shipments of parts and components were actually assembled into the completed article." The United States, howver, does not conduct such administrative reviews, for the simple reason that the United States does not classify multiple shipments of different parts and components as a completed article for the purpose of assessing duties that apply to the completed article.

Q138. (All parties) The Harmonized System Committee Decision on the interpretation of General Interpretative Rule 2(a) (Exhibit CHI-29) refers to the questions of "split consignments" and "the classification of goods assembled from elements originating in or arriving from different country" in paragraph 10. Please explain differences between these two situations.

59. The United States does not agree with China's definition of "goods assembled from elements originating in or arriving from different countries" in the context of the Harmonized System Committee decision on GIR 2(a) contained in Exhibit CHI-29. According to China, this phrase means "the classification of goods assembled from imported parts and components (or 'elements) that arrive in the customs territory in multiple shipments." China's definition is mere conjecture given that decision identified in paragraph 10 does not include a definition of this phrase and China has not identified any other documents promulgated by the Committee which would support its interpretation.

60. China's interpretation also disregards the Committee's reference to "different countries" and claims that this reference "cannot mean that the decision of the HS Committee applies only in the case of goods assembled from more than one exporting country" because this issue would be relevant only in the context of the application of the Rules of Origin. We agree with China that the Rules of Origin are beyond the scope of GIR 2(a). Consistent with this position, the HS Committeee's decision in paragraph 10 is an indication that matters involving goods of mixed origin are beyond the scope of GIR 2(a).

61. Finally, the decision of the Harmonized System Committee cannot be used by China as a tool to abrogate its obligation to comply with the GIRs under the HS Convention. China must still classify goods as presented, using the entire nomenclature, rather than selectively applying the nomenclature (headings of the HS) to goods (auto parts) based on a condition that is not existent (assembly into motor vehicle) until after the goods are released into the domestic market.

SCM Agreement

159. (China) With respect to "revenue foregone" under Article 1.1(a)(1)(ii) of the SCM Agreement, could China please:
(a) Clarify the specific factual basis for its argument that the 10 per cent rate and the 25 per cent rate of import duties and charges have separate and independent scopes of application and operation, such that the 25 per cent is not the default rate, as alleged by the complaining parties; and
(b) Indicate what would be the appropriate normative benchmark in its view.

62. In its response to question 159, China does not dispute the basic formulation laid down by the Appellate Body in US- FSC (Article 21.5 – EC) that the term "otherwise due" in the context of Article 1.1(a)(1)(ii) of the Agreement on Subsidies and Countervailing Measures (SCM Agreement) "implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation." China also does not seem to directly dispute the U.S. position set forth in response to question 157, to the extent that the United States argues that (1) a government foregoes revenue when it imposes a 10 percent internal charge on an imported part if it is used in the assembly of a vehicle with insufficient local content but imposes no internal charge on that same imported part if it is used in the assembly of a vehicle with sufficient local content or, alternatively, that (2) a government foregoes revenue when it imposes 25 percent duties on an imported part if it is used in the assembly of a vehicle with insufficient local content but imposes only 10 percent duties on that same imported part if it is used in the assembly of a vehicle with sufficient local content. Instead, China argues that neither of these scenarios accurately portrays how the measures at issue in this dispute operate. According to China, the measures at issue are border measures that simply apply the duty rates set forth in China's Schedule of Concessions. In other words, China insists that its measures properly classify imported parts as motor vehicles (and apply 25 percent duties) if they will be assembled into a vehicle with insufficient local content within one year, and its measures properly classify imported parts as parts (and apply 10 percent duties) if they will be assembled into a vehicle with sufficient local content.

63. The United States, of course, disagrees with China's view that the measures at issue are border measures that properly apply China's Schedule of Concessions. But the United States would agree in general that in the case of true border measures properly applying a Member's Schedule there may well be no "revenue foregone" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.

64. But since China's measures are internal measures or border measures that misclassify parts as motor vehicles for tariff purposes, the Chinese government foregoes revenue under the measures at issue, as the United States describes above and explains more fully in response to question 157(a).

Other claims

161. *(China)* Could China please clarify whether the alleged customs circumvention is also related to the importation of CKD/SKD kits? If so, could China please reconcile its response with the statement in paragraph 39 of China's first written submission that "major car manufacturers have imported CKD/SKD into China and declared these imports as complete vehicles, both before and after the challenged measure took effect" (emphasis added).

65. The United States disagrees with China's statement in response to this question that China's classification of CKD and SKD kits as motor vehicles "has never been contested by importers." As the United States explained above under question 2, from 1992 until China began to implement the measures at issue, China normally did not apply the motor vehicle tariff rates to CKDs and SKDs. Instead, the applicable rate for CKDs and SKDs (and parts) was negotiated between an individual auto manufacturer and the Chinese authorities. The key factors in this negotiation were the amount of the auto manufacturer's investment in China and the extent to which the auto manufacturer used local content in the assembly of its vehicles, both at the time of the negotiation and under the auto manufacturer's future plans. Normally, an auto manufacturer with a larger amount of investment and a larger percentage of local content would be able to negotiate a lower tariff rate than would an auto manufacturer with a smaller amount of investment and a smaller percentage of local content. Particularly for the auto manufacturers that the Chinese authorities viewed as committed to China based on these factors, the negotiated tariff rates for CKDs and SKDs (and parts) were substantially below the tariff rates for motor vehicles. But, for an auto manufacturer that the Chinese authorities viewed as insufficiently committed to China, as may have been the case for one manufacturer,[15] it is very possible that the Chinese authorities would insist on applying higher tariff rates.

[15] *See* China's First Written Submission, pages 15-16.