TRANSFER PRICING IN CHINA 2016

(3rd Edition)

I. What is Transfer Pricing?
II. Understanding Taxation in China
III. Overview of Transfer Pricing Methods
IV. Transfer Pricing Compliance
V. Preparing Transfer Pricing Documentation
VI. Transfer Pricing Analysis of Intercompany Services
VII. Transfer Pricing for Intangibles
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IX. Transfer Pricing Audits and Enforcement in China
X. AdvancePricing Agreement ("APA"s)
XI. Current Transfer Pricing Issues in CHina
XII. Base Erosion Profit Shifting ("BEPS") Project and its Impact on China

Produced in association with
DEZAN SHIRA & ASSOCIATES

Disclaimer

This edition of Transfer Pricing in China was produced by Sowmya Varadharajan of IC Advisors Pte Ltd in consultation with China Briefing and Dezan Shira & Associates. Samuel Wrest served as the managing editor. Creative design of the guide was provided by Jessica Huang and Estela Mi.

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Introduction

Transfer pricing is a reality for any multinational company. As a result of a globalized economy and increasing complexity in business models, tax authorities around the world are actively protecting their revenue base through the introduction of transfer pricing regimes, which focus on the taxation of profits that stem from related party transactions. These transfer pricing regimes will typically provide guidance to taxpayers on how related party transactions should be priced and how taxpayers can discharge the burden of proof that their transfer pricing arrangements comply with the arm's length standard.

If designed and implemented early in a business life, a transfer pricing system can complement and support an MNC's business model and commercial objectives, as well as optimize its global effective tax rate.

The Chinese tax authorities have embraced this growing trend of introducing transfer pricing regimes. In 2009, China formally introduced comprehensive transfer pricing regulations. Since then, China has also been a key player in the development of the United Nations Transfer Pricing Guidelines for Developing Countries, as well as the Organization of Economic Cooperation and Development ("OECD")'s initiative and action plan on Base Erosion and Profit Shifting ("BEPS").

Transfer Pricing in China 2016, written by Sowmya Varadharajan in collaboration with Dezan Shira & Associates and Asia Briefing, explains how transfer pricing functions in China. It examines the various transfer pricing methods that are available to foreign companies operating in the country, highlights key compliance issues, and details transfer pricing problems that arise from intercompany services, intercompany royalties and intercompany financing.

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Dezan Shira & Associates is a pan-Asia, multi-disciplinary professional services firm, providing legal, tax and operational advisory to international corporate investors. Operational throughout China, India and ASEAN, our mission is to guide foreign companies through Asia's complex regulatory environment and assist them with all aspects of establishing, maintaining and growing their business operations in the region. With more than two decades of on-the-ground experience and a large team of lawyers, tax experts and auditors, in addition to researchers and business analysts, we are your partner for growth in Asia.

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What is Transfer Pricing?

- Transfer pricing at a glance
- Arm's length principle
- Transactions entered into by multinational corporations
- The increasing prominence of transfer pricing

1.1 Transfer pricing at a glance

Transfer pricing concerns the prices charged between associated enterprises established in different tax jurisdictions for their intercompany transactions. By determining the price that is charged between associated parties, transfer pricing indirectly affects either the level of income or the level of expense in a particular tax jurisdiction and therefore the taxable profit that may be booked in each related entity.

Due to globalization and the need to operate in different markets, multinational enterprises are growing in number and complexity. As a result, they transfer large quantities of goods and services among related companies in different countries, as well as engage in a range of transactions relating to services, intangible property and financing activities.

The pricing system for such transfers across borders within multinationals creates considerable managerial and tax problems. This is mostly due to the direct effects on the profits of both parties and the taxable revenue of all countries involved in the transactions.

Transfer pricing is not only a critical issue for taxpayers. From the perspective of revenue authorities, tax auditors are increasingly looking at transfer pricing as akin to tax avoidance. Scrutiny on transactions that have potentially been transfer priced is consequently on the rise.

Ideally, the transfer price should not differ from prevailing market prices, which would be reflected in a transaction between independent companies. However, business transactions between associated companies may not always reflect the dynamics of market forces.

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1.2 Arm's length principle

Taxpayers rely on the arm's length principle in order to demonstrate that transactions among group / affiliate companies are appropriate. According to the arm's length principle, a transfer price is acceptable if all transactions between related parties are conducted at the arm's length price, which is the price which would have been determined if such transactions were made between independent entities under the same or similar circumstances. In other words, the application of the arm's length principle requires a comparison between what the taxpayer has done and what an independent party would have done under the same or similar circumstances.

The arm's length principle has a long history, dating back to the League of Nations Model Tax Conventions that formed the international consensus in the first half of the last century. In 1963, the arm's length principle made its way to Article 9 of the OECD Model Tax Convention. In 1980, the United Nations also adopted the arm's length principle, which is reflected in Article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries. As a result, the arm's length principle has universal application today. It forms the basis of an extensive network of bilateral income tax treaties between OECD member countries and between OECD member countries and non-OECD economies.

There are several reasons why countries (irrespective of whether they are an OECD member or not) have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for members of multinational groups and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, it is believed that the arm's length principle promotes the growth of international trade and investment.

When applying the arm's length principle, a firm may encounter companies within a corporate group that engage in transactions that independent enterprises would not. An example of such a transaction is the provision of intercompany loans. A cash-rich group company would be willing to lend funds to a group company, but such a transaction will not occur between third parties that are not in the business of borrowing and lending money.

There may be other cases where entities within a group may price their transactions differently from third parties. Such transactions may not necessarily be motivated by tax avoidance but may occur because, in routine business transactions with each other, members of a group face different commercial circumstances than independent enterprises. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not in itself mean that it is not arm's length.

Another key difficulty with the application of the arm's length principle is the fact that it is a separate entity approach. Such an approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. Within the arm's length principle, there is currently no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises.

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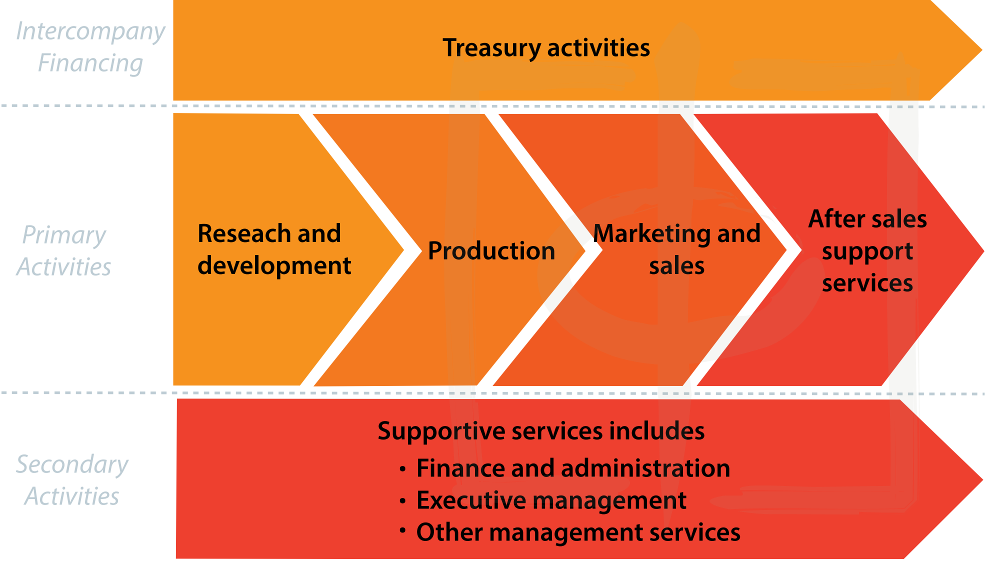
For further information on transfer pricing, please visit our Knowledge Sharing Platform hosting a wide range of resources from our experts at Dezan Shira & Associates

EXPLORE DETAILS

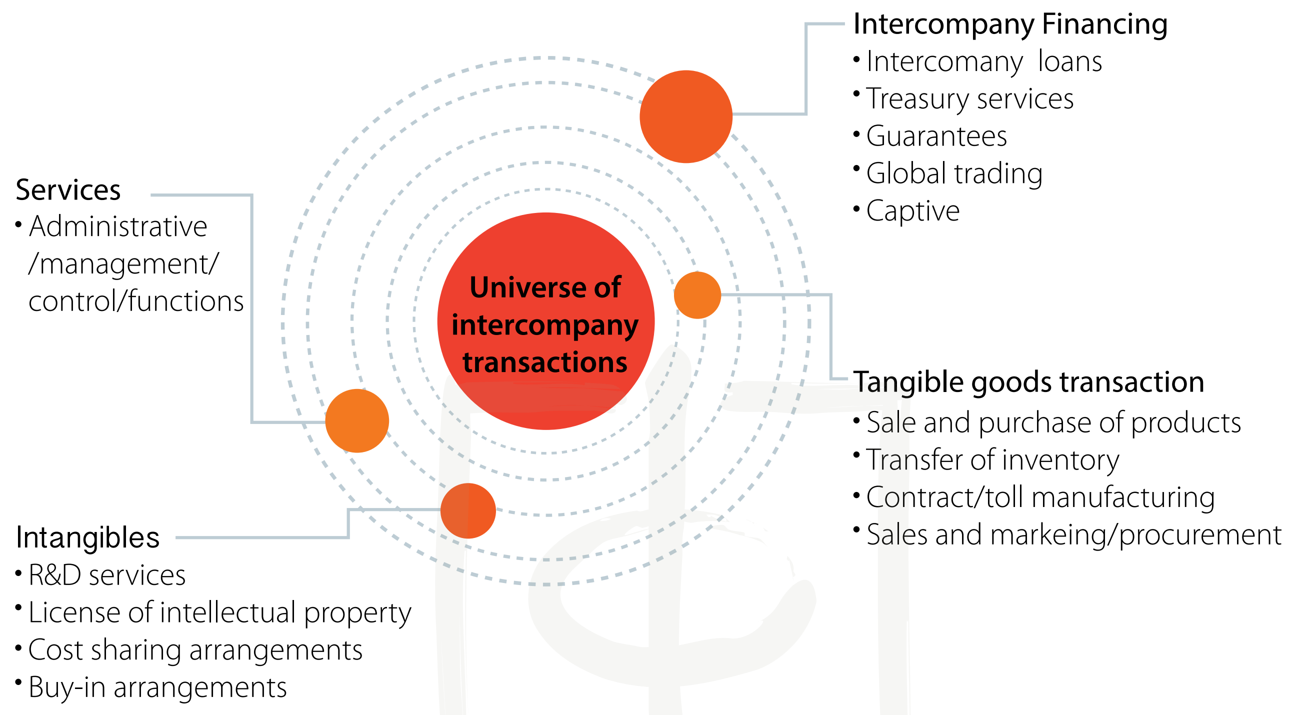
1.3 Transactions entered into by multinational corporations

The following diagram describes a simplified value-chain of a typical multinational corporation and demonstrates the range of activities that a typical company would carry out. Based on the specifics of the industry, e.g. digital economy, the actual value chain may differ.[1]



With the differing product / invoice and legal flow that can occur amongst various companies in the group, a significant number of related party transactions may occur between each and every entity. From a transfer pricing perspective, the various transactions carried out by a multinational corporation can be broadly categorized as follows.

1. In the digital economy, production in a traditional sense of procurement and manufacturing will not occur.



A closer look at the Chinese Transfer Pricing Regulations specifically provides guidance on each of these categories of transactions.

1.4 The increasing prominence of transfer pricing

Transfer pricing and the ability to adjust profits arising from intercompany transactions has been around for several decades. The OECD introduced its first transfer pricing guidelines in 1979. International taxation principles were introduced in these guidelines which serve the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimizing conflict between tax administrations and promoting international trade and investment.

The OECD's primary motive in developing robust guidelines was to help tax authorities and taxpayers deal with international aspects arising from the pricing of goods and services. These international aspects are more difficult to deal with because they involve more than one tax jurisdiction and therefore any adjustment to the transfer price in one jurisdiction implies that a corresponding change in another jurisdiction is appropriate. However, if the other jurisdiction does not agree to make a corresponding adjustment, the MNE group will be taxed twice on this part of its profits. In order to minimize the risk of such double taxation, an international consensus is required on how to establish transfer prices on cross-border transactions for tax purposes.

At a country-by country level, the first interest in transfer pricing came from the United States, which wanted to protect its tax base from erosion. This was in view of the increasing presence of Japanese MNCs establishing distribution operations in the U.S. Japan soon reciprocated and Australia and other countries closely followed with transfer pricing legislation and investigation.

The issue then gained wider recognition in Europe, with several countries introducing legislation and enforcement regimes. Asia, with the exception of Japan, has been a little slower to recognize transfer pricing as a significant issue, which is partly a reflection of its level of economic development and need to attract foreign investment. However, in the last decade, this position has changed dramatically. Most Asian countries (including Singapore, Malaysia, Thailand, Vietnam, India and South Korea) now have pricing guidelines in place and are beginning to enforce them, in some cases very actively and vigilantly.

There are many reasons why transfer pricing has become such a high profile issue over the last couple of decades in Asia. These include, but are not limited to:

- the on-going relocation of the production of components and finished products to particular countries;
- the rise of many new economies with skilled yet cheap labor forces;
- round-the-clock trading in financial instruments and commodities; and
- the rise of e-commerce and Internet-based business models.

In addition, the United Nations in 2013 released its transfer pricing guidelines for developing countries.[2] A recurring theme in the UN Transfer Pricing Manual is the view that transfer pricing manipulation is possible with respect to multinational corporations, as these corporations engage in practices that seek to reduce their overall tax bills. This is a stark change from the position that the OECD put forth, which is primarily focused on avoidance of double taxation and ensuring that the "right" level of profits are left in the jurisdiction.

2. United Nations Practical Manual on Transfer Pricing for Developing Countries, issued in February 2013

Understanding Taxation in China

- China's tax system
- Tax collection and enforcement
- Need for Transfer Pricing in China
- Transfer pricing regulatory timeline

2.1 China's tax system

Since the beginning of China's reforms and opening up policies in 1978, China's taxation system has gone through several major reforms and been consistently improving.

At present, China has 19 tax categories. These are:

- Value added tax
- Consumption tax sycophants
- Business tax
- Enterprise income tax
- Individual income tax
- Resource tax
- Urban and township land use tax
- House property tax
- City maintenance and construction tax
- Tax on the use of arable land
- Land appreciation tax
- Vehicle purchase tax
- Vehicle and vessel tax
- Stamp tax
- Deed tax
- Tobacco leaf tax
- Customs duty
- Tonnage dues

Most of these tax categories are to be collected by tax authorities, with the exception of customs duty and tonnage dues, which are collected by the customs department.

China's major tax laws are passed by the People's Congress, and regulations are formulated by the State Council. The Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT") are delegated to provide interpretation and implementation of the tax laws and regulations. In addition, the SAT is also responsible for supervising the enforcement of tax collection at the local level.

"Taxation affects almost all aspects of doing business in China. With an idiosyncratic legal system widely different to that of Western countries, having a strong understanding of China's tax liabilities enables foreign investors to simultaneously maximize the tax efficiency of their overseas investments while ensuring full compliance with the country's tax laws and regulations."

Sabrina Zhang
Partner
Dezan Shira & Associates
Beijing Office

2.2 Tax collection and enforcement

China's tax authorities are in charge of tax collection and administration. In 1994, in order to further straighten out the financial distribution relations between the central and local governments, give a better play to the functional role of national finance, strengthen the macro-control capability of the central government, and promote the establishment of a socialist market economy system, China began to implement a financial control system called the tax distribution system.

The State Administration of Taxation ("SAT") was established at the central government level as an organization directly under the State Council in charge of taxation work. The state tax bureau system and the local tax bureau system were respectively established for the tax authorities at the provincial level and below.

The state tax bureau has four levels of departments; namely the SAT, the offices of SAT at provincial level (autonomous regions, municipality directly under the Central Government), at the prefecture level (city divided into districts, autonomous prefecture, league), and at the county level (city, banner). The state tax bureau system implements the leadership system of vertical management by SAT, and carries out the vertical management in terms of the approval on organization, staffing, funds and leader posts under the principle of one-level-down management. There are three levels of the departments of the local tax bureau system on the basis of administrative division, namely the provincial, the prefecture and county levels. The management system, organization setup, and staffing of the local tax bureaus are subject to the organic law of the local peoples' governments.

The state (local) tax bureaus are established in accordance with the law, and uniformly called the offices of SAT or local tax bureaus, tax branches, tax stations, and inspection offices of the offices of SAT or local tax bureaus; the names and responsibilities of the tax authorities are determined in accordance with the administrative tier, administrative (economic) division or affiliation. The SAT will provide guidance and coordination for taxation purposes to ensure uniform implementation of the taxation system and policy.

The tax bureaus at all levels are full function bureaus. However, tax branches and tax stations are agencies of the tax authorities at higher level, and may be established in accordance with administrative division or economic division.

The state tax bureaus are established in accordance with the law and are uniformly called the offices of SAT or local tax bureaus, tax branches, tax stations, and inspection offices of the offices of SAT or local tax bureaus; the names and responsibilities of the tax authorities are determined in accordance with the administrative tier, administrative (economic) division or affiliation.

The 2008 Enterprise Income Tax (EIT) Law applies to both domestic and foreign-invested enterprises, generally at the same rate, with special rates applying in certain cases.

2.3 Need for Transfer Pricing in China

A number of factors, global and China-specific, have brought the transfer pricing issue to the forefront of the SAT's attention. These include:

- The increasing globalization of the Chinese economy and increasing significance of imports and exports as a proportion of GDP
- The tendency for FIEs in China to rely on intellectual property and services provided by overseas related parties
- The introduction of tough transfer pricing regimes in China's key trading partners
- Accession to the World Trade Organization in 2001 has resulted in a reduction in tariff rates, which creates greater revenue pressures
- Tax policy changes generally, including introduction of dividend withholding tax and uniformity of the corporate tax rate to 25 percent as of January 1, 2008, increased the incentive for MNCs to use transfer pricing to influence effective tax rates.
- The tendency for FIEs in China to declare operating losses - over 50 percent are in this category; the perspective of the Chinese authorities is that large part of these losses can be attributed to transfer pricing
- The tougher economic climate that China and the rest of the world are facing will most likely put even greater emphasis on scrutiny of transfer pricing practices. The SAT needs to compensate for generally lower tax revenue from other sources as the level of business transactions and spending declines.
- Equity or asset transfers between subsidiaries that are subject to 100 percent direct control of the same parent company
    - Under the direction of the parent company, one subsidiary transfers the equity or asset held by it based on the net book value to another subsidiary, and the transferor does not receive payment
    - If the result after subtracting the above items from the gross income is a negative number, then the company is deemed to have incurred a loss. Losses can be carried forward as a deduction for the following year(s), up to five years. An enterprise may not offset the losses of its overseas business agencies against the profits of its domestic business agencies.

Companies need to make sure that such equity transfers have a reasonable business purpose: the company's original business activities may not be changed within 12 consecutive months after the equity transfer, and neither the transferor nor the transferee can recognize such equity or asset transfers as losses or profits for accounting purposes. In the case where the investor makes any change to either the company's primary business activities, the nature of the company, or the equity structure within 12 months after the equity transfer, they are required to report the changes to the local tax bureau within 30 days after the change is made.

2.4 Transfer pricing regulatory timeline

In general, the tax legal framework in China consists of the following three aspects. The first is the enactment of the law. Under the current framework for transfer pricing, this comes from the Corporate Income Tax Law and the Tax collection and Administration law. With the law enacted, the tax authority issues regulations which detail the implementation of the law. These regulations provide more information to the taxpayer on how the tax law should be interpreted.

Despite the fact that the regulations are meant to demonstrate how the views of the tax authority are implemented, actual implementation may raise additional issues and ambiguities that need to be addressed. To serve this purpose, the SAT issues detailed rulings, circulars and announcements to refine and broaden the applicability of the law and regulations.

Against this backdrop, we have summarized the timeline of the development and enforcement of China's transfer pricing regime. There is the introduction of the broad tax law framework as well as detailed announcements / circulars / rulings that have defined the current framework of transfer pricing regulation and enforcement.

- Transfer pricing legislation was first introduced in 1991 by the National People's Congress under the Income Tax Law of the People's Republic of China for Foreign Invested Enterprises and Foreign Enterprises. Under Article 13 of the law, the tax authorities had the right to make reasonable adjustments if transactions were not carried out at arm's length, and thus result in a reduction of taxable income
- On April 23, 1998, the SAT issued comprehensive transfer pricing regulations entitled "Tax Administration Rules and Procedures for Transactions between Related Parties" (SAT Circular No. 59). This circular contains 52 articles and 12 chapters which standardized transfer pricing examination and audit procedures. These regulations were reflected and amended in Guo Shui Fa [2004] No. 143.)
- On September 20, 2004, the SAT issued the "Implementation Rules for Advance Pricing Agreements for Transactions between Related Parties" (Guo Shui Fa [2004] No. 118). The implementation rules set out detailed guidelines on Advance Pricing Agreement ("APA") procedures
- On February 28, 2007, the SAT issued Guo Shui Han [2007] 236 to state their position with respect to the expected profitability of the FIEs and foreign enterprises in China which undertake a sole-function of manufacturing for their overseas parent companies
- On March 16, 2007, the Corporate Income Tax Law of the People's Republic of China (State Council Order No. 63 of People's Republic of China) was passed and came into effect from January 1, 2008. The new CIT Law repealed the 1991 Income Tax Law for FIEs and FEs and includes a range of measures designed to strengthen transfer pricing compliance and enforcement in China, as well as a range of other measures including thin capitalization, controlled foreign companies and anti-avoidance regulations. The regulations relevant to transfer pricing are contained in Chapter 6 of the legislation. This was followed by the release of the "Implementation Rules of the Corporate Income Tax Law in People's Republic of China," promulgated by the State Council on December 6, 2007

- On March 27, 2007, the SAT issued Guo Shui Han [2007] No. 363 stipulating specific documents and information to be submitted by enterprises and the local-level tax bureaus to the SAT during transfer pricing audits
- On April 2, 2008, the SAT released the "Draft Administrative Regulations of Special Tax Adjustment (Trial)" to begin an extensive period of feedback and discussion on the form of the final version of the regulations
- Guo Shui Fa [2008] No. 114, issued on December 17, 2008, detailed the related party disclosure forms that will be required to be completed and submitted by all taxpayers with any related party transactions along with their 2008 tax return on or before May 31, 2009
- Finally, the SAT released the "Implementation Measures of Special Tax Adjustments (Trial Version)" (Guo Shui Fa [2009] No. 2) (China Transfer Pricing Regulations), which repealed Guo Shui Fa [2004] No. 143 and Guo Shui Fa [2004] No. 118. These transfer pricing regulations are the first comprehensive document from the SAT incorporating provisions on contemporaneous documentation requirements as well as other aspects of transfer pricing, including guidance for conducting audits and investigations, thin capitalization, controlled foreign corporations, APAs and cost sharing agreements[3]
- Caishui [2008] no. 121: additional guidance on the application of thin capitalization ratios between related parties
- Guoshuihan [2009] no. 363: requiring loss making single-functioned manufacturer/ distributor/ contract R&D service provider to provide, prepare and submit transfer pricing documentation, regardless of its intercompany transaction amount
- Guoshuifa [2009] No., Notice of the SAT on Enforcing the Collection and Administration of Various Tax and Increasing Tax Revenue
- Guoshuihan (2010) No. 323, (Guoshuihan 323)–Notice on Guidance Given by SAT to Tax Bureaus with respect to Contemporaneous Documentation Reviews
- Guoshuihan (2011) No. 167 (Guoshuihan 167)–The Annual Anti–tax Avoidance Work Report which reports the 2010 anti–tax avoidance enforcement work conducted by SAT and the 2011 work plan
- Guoshuifa (2012) No. 13, (Guoshuifa 13) — Regulation for Internal Procedures of Special Tax Adjustments (Trial Implementation)
- Guoshuifa (2012) No. 16, (Guoshuifa 16) — Notice regarding the "Procedural Guidelines for Joint Review of Significant Special Tax Adjustments Cases (Trial)
- Guo Shui Fa [2012] No. 41 (Circular 41) re-iterates the importance of developing an anti-tax avoidance system which integrates administration, service, and investigation, which is consistent with SAT's prior anti-avoidance circulars
- SAT Announcement [2013] No.56 - Implementation Measures for the Mutual Agreement Procedure of the Tax Treaty which and superseded Guo Shui Fa [2005] No. 115
- Shuizongbanfa [2014] No. 146) - Notice regarding the launch of tax anti-avoidance investigations on remittance of substantial amounts of service fees and royalty payments
- "Announcement of the State Administration of Taxation on Monitoring and Administration of Special Tax Adjustment [2014] No. 54"

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3. In fact, the connotation that its contents are a 'trial version' provides the SAT with flexibility to issue further circulars to interpret and clarify the concepts. In fact, there has speculation that with the increasing global debate on transfer pricing and the OECD's initiative on Base Erosion and Profit Shifting ("BEPS"), there is likely to be a substantial revision in the Chinese Transfer Pricing Regulations in the near future.

Overview of Transfer Pricing Methods

- Comparability factors
- Transfer pricing methods
- Selection and application of transfer pricing method

Chapter 3 of the Chinese Transfer Pricing Regulations covers the various transfer pricing methods that are available to taxpayers. Before a transfer pricing method can be selected, it is necessary to understand the broad comparability factors that are likely to impact the selection of the transfer pricing method.

3.1 Comparability factors

Article 22 of the Chinese Transfer Pricing Regulations notes that "a comparability analysis shall be conducted when selecting the appropriate transfer pricing method". Why is such a comparability analysis required? Although the Chinese Transfer Pricing Regulations do not provide additional context around why the comparability analysis is required, it is possible for us to rely on guidance provided in the OECD Transfer Pricing Guidelines.

Given that the arm's length principle essentially requires taxpayers to demonstrate that the terms and conditions associated with their related party transactions are broadly comparable to the terms and conditions associated with third party transactions, it is clear that the comparability factor will be relied on to evaluate the similarities and differences that exist between the related party transactions and the third party transactions. Specifically, the OECD in Para 1.33 notes that for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.

It should be noted that comparable does not necessarily mean identical. Rather, what is required is that if there are any differences between the related / controlled transactions and the third party (uncontrolled) transaction, such differences will not materially affect the condition being examined in the methodology. Even if there are material differences, then it is possible to make accurate adjustments to eliminate the effect of such a material difference on the price or margin.

In terms of comparability, the Chinese Transfer Pricing Regulations notes that comparability has to be carried out based on the following factors.

"If done properly, transfer pricing can save a foreign investor a substantial amount on their tax bill. However, careful planning is advised: transfer pricing transactions are under special scrutiny. In case of non-compliance, the back taxes and penalties can be severe."

Shirley Chu
Transfer Pricing Manager
Corporate Accounting Services
Dezan Shira & Associates
Dalian Office

3.1.1 Attributes / characteristics of the property

Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions.

Reference should be made to the broad categories of transactions, as the characteristics for specific transactions may differ according to what the transaction is.

With respect to tangible property, such characteristics would include:

- The physical features of the property
- The quality and reliability
- The availability and volume of supply

In terms of services, such characteristics may include:

- Type of service provided
- Nature and scope of services;
- Form of transaction

With respect to intangible property, such characteristics may include:

- The nature of intellectual property rights
- Form of transaction (outright sale of IP / licensing of IP)
- Duration and degree of protection
- Anticipated benefits that may arise from the use of the property

With respect to intercompany financing, although neither the Chinese Transfer Pricing Regulations nor the OECD Transfer pricing guidelines detail the comparability factors of intercompany loans, it can be understood to mean:

- The reason for the borrowing
- The terms of the loan, etc.
- Whether there is a collateral / guarantee associated with the loan, etc.

3.1.2 Functional analysis

In general, the price at which a property / service is transferred will depend on the functions that each enterprise performs in relation to the transaction. Assuming a manufacturer is selling a good to a distributor, and the manufacturer owns significant tangible assets, undertakes a full value chain of functions and bears most of the risks associated with the transaction, it is clear that such a manufacturer will want to obtain a much higher price for the sale of this product as compared to a manufacturer who bears limited functions, bears reduced risks and owns minimal assets. In other words, in transactions between independent entities, compensation will usually reflect the functions that each enterprise performs (taking into account the assets used and risks assumed).

Thus, this factor requires taxpayers to evaluate the terms of the transaction to determine which entity bears the functions, assets and risks, and then compare it with third party transactions to evaluate if the related party and third party transactions are occurring on comparable terms

In accordance with the Chinese Transfer Pricing Regulations, the functions that should be considered should include research and development, design, purchasing, processing, assembly, manufacturing, inventory management, distribution, after-sale services, advertising, transportation, warehousing, treasury, finance, accounting, legal and human resource management.

The extent of similarity in terms of assets employed by enterprises performing the functions shall be considered when comparing functions.

Risks mainly include research and development risks, purchasing risks, manufacturing risks, distribution risks, market promotion risks, management and financial risks.

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3.1.3 Contractual terms

Contractual terms refer mainly to: object of transactions, quantity and price, terms and conditions of payment and collection, terms of delivery, scope and conditions of after-sale services, arrangements for supplementary services, the right to modify or amend the contents of the contract, term of the contract, and the right to terminate or renew the contract.

In arm's length transactions, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. As such, an analysis of contractual terms should be a part of the functional analysis discussed above.

3.1.4 Economic circumstances

Economic circumstances primarily refer to industry overview, geographic location, market size, level of market, market share, extent of market competition, consumer purchasing power, availability of substitute goods or services, price of production factors, cost of transportation, government regulatory control, etc.; and

The arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets taking account of available substitute goods or services.

3.1.5 Business strategies

Business strategies which mainly include innovation and development of strategies, diversification strategies, risk avoidance strategies, and market penetration strategies.

Business strategies must also be examined in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labor laws, duration of arrangements, and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises.

3.2 Transfer pricing methods

Article 21 of the Chinese Transfer Pricing Regulations notes that enterprises engaged in related party transactions and tax authorities reviewing and assessing related party transactions shall follow the arm's length principle, and select the appropriate transfer pricing method. The transfer pricing methods as stated in Article 111 of the Implementation Regulations of the Corporate Income Tax Law include:

a. comparable uncontrolled price ("CUP") method,
b. resale price method ("RPM"),
c. cost plus method ("CPM"),
d. transactional net margin method ("TNMM"),
e. profit split method ("PSM"), and
f. other methods which are consistent with the arm's length principle.

Each of these methods is discussed below. When evaluating the most appropriate transfer pricing method, careful consideration of the various comparability factors is required to determine the most appropriate method for each type of intercompany transaction.

With the further refinement of the OECD Transfer Pricing Guidelines in 2010, the above methods can be classified as one-sided or two-sided methods. A one-sided method is a method that only evaluates the transaction from one side. In other words, these methods argue that if the transaction is "arm's length" from the perspective of one side, it would necessarily imply that the transaction will continue to be arm's length from the perspective of the other party as well. In general, as will be detailed below, the RPM, the CPM and the TNMM are considered to be one-sided methods. On the other hand, the PSM is considered to be a two-sided method, as it considers the facts and circumstances of both parties when it evaluates the transfer pricing outcome.

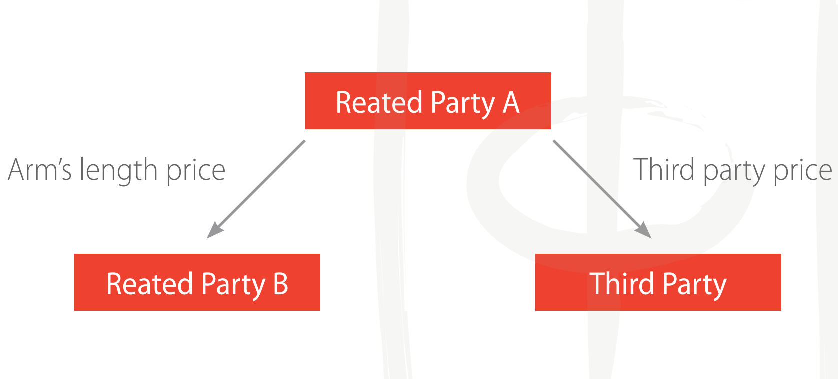
The CUP method is neither a one-sided nor a two-sided method as it does not consider the related party that is entering into the transaction. Rather, it considers the actual transaction.

3.2.1 Comparable Uncontrolled Price ("CUP") Method

The CUP method determines the arm's length price of related party transactions based on the price that is charged between unrelated parties in identical or similar business activities.[4]

The CUP method is potentially applicable to all types of related party transactions. The CUP method requires a high level of comparability and if available would generally provide the most accurate benchmark of an arm's length price for a related party transaction, as it analyzes the actual price at which the transaction is occurring.

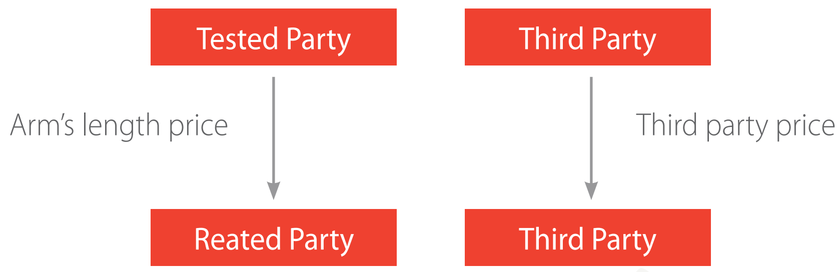
The CUP method can either be applied on an internal or external basis. The internal CUP method is illustrated below.



This method is referred to as the "internal" CUP as the data required to evaluate the arm's length nature of the related party transaction – the transaction between A and B, in the diagram below is internal to related party A. Given that the company (i.e., Related Party A) sells products to both related and third parties, it is possible for us to consider the price that the tested party sells to the third party as a reference to the price that it charges to the related party. The internal CUP method, if it exists, is more accurate than an external CUP method, as there is a higher likelihood of comparability on the characteristics of the property being transferred between the related and third party.

4. Article 23 of the Chinese Transfer Pricing Regulations

The CUP method can also be applied on an external basis, as described in the diagram below.



In the event that the CUP cannot be applied on an internal basis (e.g., because the tested party does not transfer property/services to related parties as well as third parties), it may be possible to apply the CUP on an external basis. In this case, the arm's length price, which is the transaction price that exists between the related parties, is compared to the third party price, which is the price that is established between two independent third parties.

In general, with the exception of commodity prices or financial service products where publicly listed prices exist, it is extremely difficult to determine the actual transaction price between two unrelated parties. No requirements exist for companies to disclose the price at which they transact with each individual third party customer. Thus, it is often very difficult to apply the external CUP on a reliable basis.[5]

3.2.2 The Resale Price Method

The resale price method determines the arm's length price of merchandise purchased by the enterprise from related parties. It is based on the resale price of the merchandise to unrelated parties, minus a gross profit of comparable unrelated transactions.[6] The computation formula is as follows:

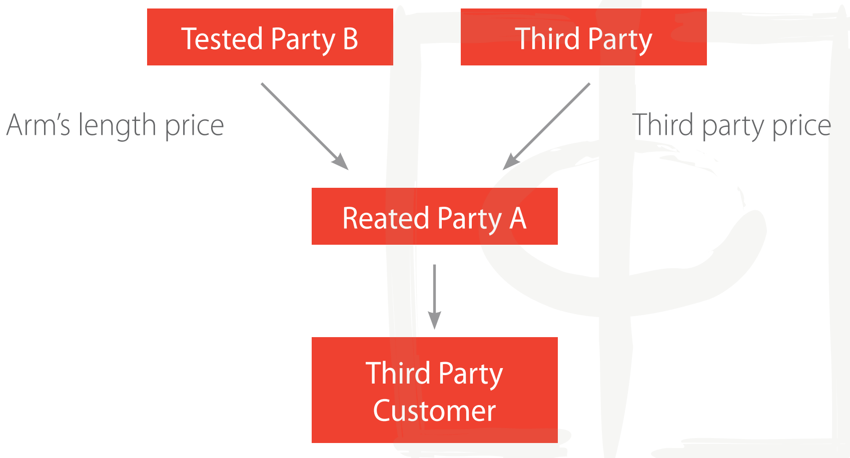
- Arm's length price = resale price to unrelated parties × (1 - gross margin[7] of comparable unrelated transactions)

5. The OECD has recently released a discussion draft on the transfer pricing aspects of cross-border commodity transactions. A key proposal that has been discussed is whether the CUP method can be an appropriate method for commodity transactions between associated enterprises and whether quoted or publicly available prices be used under the CUP method as a reference to determine the arm's length price for the controlled commodity transaction.
6. Article 24 of the China Transfer Pricing Regulations
7. The Chinese transfer pricing guidelines have also provided a definition of gross margin to be Gross margin of comparable unrelated transactions = gross profit of comparable unrelated transactions ÷ net sales of comparable unrelated transactions × 100%.

Given that this method evaluates the arm's length price of merchandise, it is typically used for goods / distribution transactions rather than services.

The resale price method is usually applied to simple processing or pure buy-sell transactions where the reseller does not undertake substantial value-added processing activities, such as changing the product appearance, performance and structure, or replacing trademarks, etc.

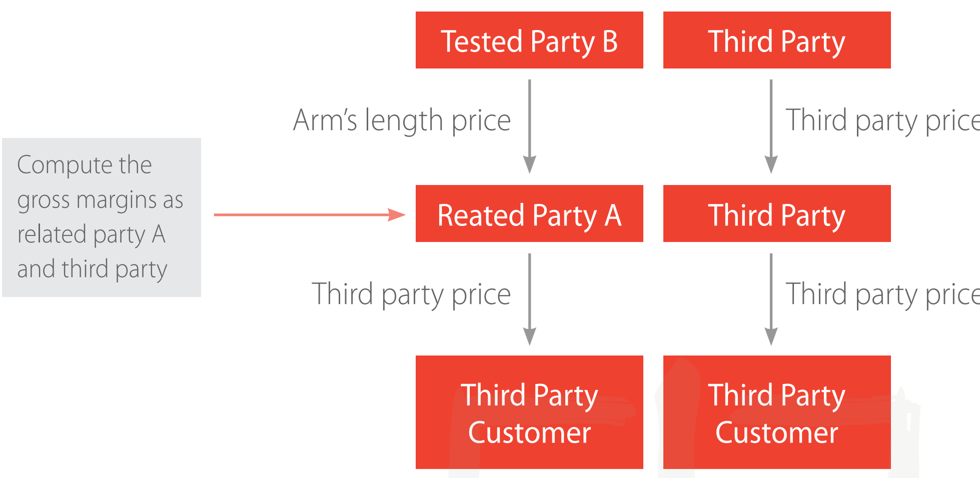
Similar to the CUP method, it is possible to analyze the internal RPM as well as the external RPM arising from the purchase of goods by a related entity for sale to third parties.



The related party gross margin calculates the gross margin earned by Related Party A, which is earned by purchasing products from Related Party B for resale to third party customers. The third party gross margin is the gross margin earned by Related Party A arising from the purchase of products from the third party for resale to another independent company. The internal RPM essentially compares the related party gross margin with the third party gross margin.

The internal RPM is typically used in situations where the related party operates as a routine distributor that purchases various products from both related and third parties for sale to end-customers.

In the event that an internal RPM is not available, it may be possible to apply the external RPM. The diagram below depicts how the external RPM will be applied.



In this case, the gross margin earned by independent distributors is used to evaluate if the gross margin earned by Related Party A is arm's length. In the event that the Related Party A gross margin is arm's length, that would imply that the price at which Related Party A purchases products from Related Party B is arm's length.

Although the comparability factors discussed in Section 4.1 are important, in general, fewer adjustments are normally needed to account for product differences under this method than under the CUP method, because minor product differences are less likely to have as material an effect on profit margins as they do on price. Specifically, in a market economy, the compensation for performing similar functions would tend to be equalized across different activities. In contrast, prices for different products would tend to equalize only to the extent that those products were substitutes for one another. Because gross profit margins represent gross compensation, after the cost of sales for specific functions performed (taking into account assets used and risks assumed), product differences are less significant and therefore one may expect that it would be easier to use a RPM to evaluate the arm's length nature of purchases from related parties.

The main difficulty with the application of the RPM is the availability and reliability of data in respect of the gross margins being achieved by third parties in comparable circumstances. This is particularly the case with external RPMs where differences in accounting policies that may be adopted by companies in accounting for expenses as either cost of goods sold or as operating expenses can also distort the results considerably.

The RPM is considered a one-sided method as it essentially evaluates the transaction from the perspective of the distributor. In the case of the RPM, if the gross margin earned by the distributor is consistent with the arm's length standard (i.e., what other third party distributors earn), then the purchase of the product by the related party distributor is arm's length. This means that the related party sale, from the perspective of the other related party, is arm's length.

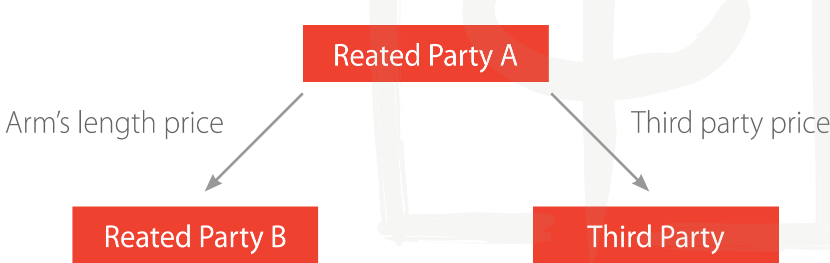
3.2.3 Cost Plus method

The cost plus method ("CPM") determines the arm's length price of related party transactions by adding a gross profit of comparable unrelated transactions to the reasonable cost of related party transactions. The computation formula is as follows:[8]

Arm's length price = reasonable cost of related party transactions ×
(1 + cost mark up of comparable unrelated transactions)

Under the cost plus method, the arm's length price reflects the full cost of the underlying goods or services plus a gross profit mark-up. It should be noted that the cost plus method evaluates the mark-up on only gross costs, i.e., the gross profit mark-ups. The cost plus method is usually applied to the related party manufacturing transactions (particularly on a toll or contract basis) as well as the provision of services.

Similar to the CUP and RPM, the CPM may be applied on an internal and external basis.



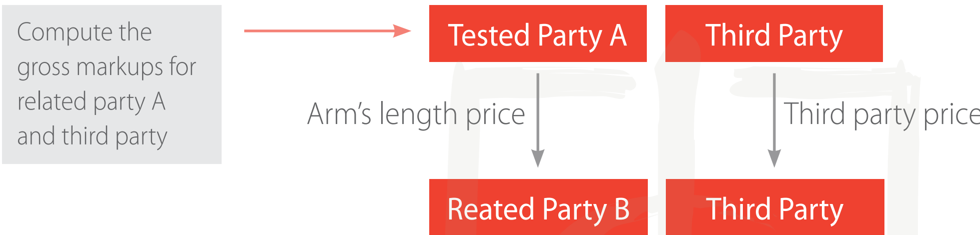
The figure above evaluates the internal cost plus mark-ups realized by Related Party A as a result of transferring products / services to Related Party B and comparing these mark-ups to the mark-ups realized by Related Party A as a result of transacting with an independent third party.

The comparability analysis, in this case, shall especially evaluate the differences in functions, risks, and contractual terms between related party transactions and unrelated transactions, as well as other factors influencing cost mark ups. This includes manufacturing, processing, assembly and testing functions, market and foreign exchange risks, value and useful life of equipment and machinery, employment and value of intangible assets, business experience, accounting treatment and efficiency of management, etc.

8. *Article 25 of the Chinese Transfer Pricing Regulations*

Given that the CPM provides more weightage on the actual functions that are being undertaken, rather than the product or service characteristics, the internal CPM can be considered quite reliable in evaluating the mark-ups that are earned by a related party when it transacts with both related and third parties in providing highly similar services.

In the event that the internal CPM cannot be reliably applied, it may be possible to apply the external CPM. The external CPM is depicted in the diagram below.



In this case, the mark-ups earned by Related Party A on the costs incurred in providing services for Related Party B is compared with the mark-ups earned by an independent third party on its costs when it provides similar services to other third parties.

As one would expect, in the application of the external CPM, it is critical to ensure that the cost bases that are being compared are comparable. However, in most cases, when relying on external data, it may be difficult to ensure that the cost bases are comparable as there are insufficient disclosures on how each entity treats each segment of costs. For example, machines used in manufacturing may either be owned by the manufacturer or leased. If such differences exist between the related party manufacturer and the third party manufacturer, the cost plus mark-up calculations are likely to be tainted. In addition, similar to the RPM, the CPM is also affected by how expenses are categorized into cost of goods sold vs. operating expenses.

The CPM is considered a one-sided method as it essentially evaluates the transaction from the perspective of the manufacturer or service provider. In the case of the CPM, if the gross cost plus mark-up earned by the manufacturer / service provider is consistent with the arm's length standard (i.e., what other third party service providers earn), then the sale of the product / the service provider by the related party manufacturer/ service provider is arm's length, which essentially means that the related party purchase, from the perspective of the other related party, is arm's length.

3.2.4 Transactional net margin method

The transactional net margin method ("TNMM") determines net margin of related party transactions based on the indicator of profit margins of comparable unrelated transactions.[9] The TNMM is usually applied to the related party transactions of sales, transfer and usage of tangible goods, provision of labor services, and transfer of intangible assets.

The TNMM is generally an extension of the RPM or the CPM, where these methods evaluated the compensation earned by the distributor or manufacturer, respectively, at the gross profit level, the TNMM evaluates the compensation earned by the distributor or manufacturer at the net profit level. With respect to the distributor, the TNMM will evaluate the net profit margin, while the RPM evaluates the gross profit margin. With respect to a manufacturer / service provider, the TNMM will evaluate the net cost plus mark-up rather than the gross cost plus mark-up.

The types of profit level indicators[10] that are typically referred to include:[11]

- Return on sales, which are defined as the ratio of operating profit to sales / revenues. This essentially is an extension of the RPM to the operating profit, rather than the gross profit, level.
- Mark-up on total costs, which are defined as the ratio of operating profit to total costs. As explained above, this essentially is an extension of the CPM to the operating profit, where the operating profit to total costs is evaluated, as opposed to evaluating the gross profit to cost of goods sold.
- Return on assets/capital employed, which is defined as the ratio of profits to assets or capital employed. Assets or capital employed is a balance sheet attempt, and there are multiple definitions depending on whether the assets include liabilities. It should be noted that the Chinese Transfer Pricing Regulations do not explicitly define "assets". The OECD Transfer Pricing Guidelines notes that only operating assets should be used in the definition of assets. Operating assets include tangible operating fixed assets, including land and buildings, plant and equipment, operating intangible assets used in the business, such as patents and know-how, and working capital assets such as inventory and trade receivables (less trade payables). Investments and cash balances are generally not operating assets outside the financial industry sector.
- Berry ratio, which is defined as the ratio of gross margin to operating expenses.[12] The Berry ratio is typically used for distributors that do not perform any value-added activities. While the distributor has its advantages, it is highly sensitive to the categorization of expenses between cost of goods sold and operating expenses, and therefore any restrictions that applied on the CPM or RPM will apply on the TNMM using the Berry Ratio.

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9. Article 26 of the Chinese Transfer Pricing Regulations
10. It should be noted that the OECD Transfer Pricing Guidelines, that was revised in 2010 refers to profit level indicators as net profit indicators. Thus, profit level indicators and net profit indicators are used interchangeably
11. It should be noted that Chinese Transfer Pricing Regulations do not explicitly define any of these profit level indicators. As such, we have relied on the definition of these profit level indicators based on either conventional wisdom or based on traditional practice.
12. This NPI has been named after Charles Berry who devised this profit indicator while serving as an expert witness for the Inland Revenue Service. The argument that was made was that distributors should earn a return commensurate with the distribution services performed.

The selection of an appropriate profit ratio will be based on the primary driver of the profitability of the entity. For a manufacturer, return on assets or mark-up on total costs may be more relevant, while for a distributor, the return on sales may be more logical.

In practice, the TNMM is very widely used by both taxpayers and tax authorities. It overcomes the need for exact product comparability, avoids the concern regarding availability of gross margin data and cost classifications. Furthermore, net profit indicators are also less affected by transactional differences than is the case with price. From a tax authority perspective, it is the indicator that directly determines the amount of tax to be paid.

Similar to the other methods, it is possible to evaluate an internal TNMM as well as an external TNMM. An internal TNMM essentially compares the net profit indicator arising from the profit earned by the related party when it transacts with another related party and compares it with same net profit indicator arising from the profit earned by the related party when it transacts with a third party.

Where the internal TNMM cannot be reliably applied, the external TNMM relying on data from third parties may be used to determine if the net profit indicator arising from the profit earned by the related party is arm's length. This is done by making reference to the net profit indicator arising from the profit earned by third parties when they deal in similar products and undertake similar activities.

The TNMM, through the selection of the net profit indicator, is a one-sided method. Given that multiple net profit indicators can be applied, the selection of the net profit indicator will indirectly select the entity that from which the transaction will be evaluated. For example, if either the return on sales or the Berry ratio is used, it is likely that the transaction is being evaluated from the perspective of the distributor, while if one was to use the cost plus method or the return on assets, it is likely that the transaction is being evaluated from the perspective of the manufacturer.

3.2.5 Profit split method

The profit split method determines the profits to be allocated to the enterprise and its related parties based on their respective contribution to the combined profits of the related party transactions. The profit split method is usually applied in situations where each party engaging in related party transactions are highly integrated and where it is difficult to separately assess the results of the transactions to each party.

The OECD Transfer Pricing Guidelines note that the PSM can offer a solution for highly integrated operations for which methods like the CPM / RPM or TNMM may not be appropriate. Furthermore, the presence of unique and valuable contributions on part of both related parties may make it difficult to find reliable comparable information to provide an indication of the arm's length price.[13]

The profit split method can be categorized into the general profit split method and the residual profit split method.[14]

The general profit split method allocates profits to the various parties engaging in related party transactions based on their functions performed, risks borne and assets employed. The allocation key is typically obtained by comparing the intercompany transaction to third party transactions. In general, the general profit split method is difficult to apply as it is extremely difficult to obtain allocation factors based on third parties for a transaction that is highly unique.

The residual profit split method subtracts routine profits attributable to each party engaging in the related party transactions from the combined profits, and then allocates the residual amount to the various parties based on their respective contribution to the residual profits. The contributions are typically tied to the profit generation factors.

In general, the application of the profit split method requires a careful analysis of the functions performed, risks borne and assets used by each associated enterprise as well as the allocation of cost, expense, earnings, and capital between associated enterprises involved in the transaction.

The PSM is considered a two-sided method as it evaluates the specifics of the various parties to the intercompany transaction, unlike the one-sided method, which only evaluates the transactions from one perspective.

By the end of 2014, the number of pilot taxpayers had increased from 2.73 million to 4.1 million, including 760,000 general taxpayers and 3.34 million small-scale taxpayers. Among these, more than 95 percent of taxpayers have benefited from the VAT reform. During the first half of 2015, tax payable was reduced by more than RMB 110 billion due to the VAT reform, according to the State Administration of Taxation.

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13. A recent discussion draft issued by the OECD discusses how the use of the profit split in the context of the global value chain. The finalization of this draft will provide us with additional information on how the profit split method can be reliably applied.
14. Article 27 of the China Transfer Pricing Regulations

3.2.6 Other methods

It should be noted that the Chinese Transfer Pricing Regulations do not provide for other methods to be used where the methods stipulated above cannot be reliably applied. However, the OECD Transfer Pricing Guidelines note that a combination of methods or other methods consistent with the arm's length principle may be used.

In the context of China, given that there is no explicit mention allowing taxpayers to choose and apply other methods, it is recommended that taxpayers choose alternative methods, that are not in line with conventional methods, only as a very last resort and with very good reason. At the very least, it is recommended that any "unfamiliar" or "non-traditional" methods are also supported with a more recognized method.

3.3 Selection and application of the transfer pricing method

With respect to the selection and application of the transfer pricing method, the Chinese Transfer Pricing Regulations notes that taxpayers have to disclose reasons for why a particular method has been selected. If a profits based method is selected, the taxpayer would be required to demonstrate how the profit of the value chain has been calculated.

Once the appropriate transfer pricing method has been selected, keeping in mind the specific factors of the related party transactions, such a transfer pricing method can be applied in the following manner:

a. Determination of internal / external comparable transactions / companies;
b. Description of how the comparable company / transaction supports the selected transfer pricing method;
c. Assumptions and decision made in the process of determining the comparable transaction price or comparable companies' profit; and
d. Evaluation of the transfer price as compared to the arm's length price determined.

Additional details on how the transfer pricing methods are applied can be found in Section 4.2. In general, with the description of the methods and an analysis of the intercompany transactions entered into by taxpayers as well as lack of data, certain assumptions can be made in respect to the transaction type and the most suitable method, which is described in the table below.

Type of Transaction	Methods that may be suitable	Commonly used method
Provision of manufacturing services/Provision of R&D services/Provision of strategic management and administrative services	CUP/CPM/TNMM/PSM	TNMM
Distribution of product	CUP/RPM/TNMM/PSM	TNMM
License of royalty/ patent/known-how	CUP/PSM	CUP
Integrated business operation involving intangibles on both parties	PSM	PSM
Intercompany Financing	CUP	CUP

It should be noted that the above categorization is based on conventional wisdom. However, based on the specific facts and circumstances surrounding the transaction, an alternative method may be chosen as the most appropriate method.

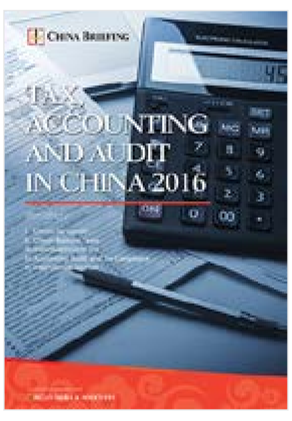
Transfer Pricing Compliance

- Tax return compliance
- Transfer pricing documentation compliance
- Penalties and fines arising from transfer pricing non-compliance

Transfer pricing compliance consists of two aspects:

a. Tax return compliance – this refers to specific information and disclosures that need to be provided by all taxpayers who are engaged in domestic / overseas related party transactions.
b. Transfer pricing documentation compliance – in addition to tax return disclosures, taxpayers that meet certain related party transaction thresholds may be required to prepare and maintain transfer pricing documentation to support the arm's length nature of their related party transactions.

This chapter details both these aspects of transfer pricing compliance obligations that taxpayers operating in China have to meet.



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4.1 Tax return compliance

4.1.1 What is a related party?

The Chinese Transfer Pricing Regulations detail what constitutes a related party. A "related party relationship" as stated in Article 109 of the Implementation Regulations of the Corporate Income Tax Law and in Article 51 of the Tax Collection Regulations refers mainly to any of the following relationships which the enterprise has with another enterprise, an organization or an individual.[15]

1. One party directly or indirectly owns more than 25% of shares of the other party; or a common third party directly or indirectly owns more than 25% of shares of both parties. If one party indirectly holds the other party's shares through an intermediate party, as long as one party owns more than 25% of the shares of the intermediate party, the percentage of the other party's shares held by the intermediate party shall be applied to calculate the percentage of the other party's share held by that party.
2. Debt between one party and the other party (except for independent financial institutions) accounts for more than 50% of its total paid-in capital, or more than 10% of one party's debt is guaranteed by the other party (except for independent financial institutions).
3. More than half of the high level management (including members of the board of directors and managers) of one party or at least one senior board member who is able to control the board of directors of one party are assigned by the other party; or more than half of the high level management (including members of board of directors and managers) of both parties or at least one senior board member who is able to control the board of directors of both parties are assigned by a common third party.
4. More than half of the high level management (including members of board of directors and managers) of one party simultaneously hold the position as high level management (including members of board of directors and managers) in the other party; or at least one senior board member who is able to control the board of directors of one party simultaneously holds the position as senior board member of the other party.
5. The business operations of one party depend on the proprietary technologies (such as industrial property right, technology know-how etc.) provided by the other party.
6. The purchases and sales activities of one party are controlled by the other party.
7. The services received or provided by one party are controlled by the other party.
8. One party has effective control over the other party's business operations and transactions; or there are other connections of interest between the two parties including circumstances where major shareholders of the two parties enjoy basically the same economic benefits, or they are family members and relatives, etc., even though the shareholding percentage is below the percentage prescribed in Item 1 of this article.

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15. Article 9 of the Chinese Transfer Pricing Regulations

It should be noted that what constitutes a "related party" according to Chinese financial reporting / auditing standards may differ from what constitutes a "related party" from a Chinese transfer pricing / tax return disclosure perspective. Thus, it is possible that where certain transactions may not be considered as "related" from an audit point of view, they may still be considered as "related" from a tax perspective.

It is therefore important to closely review each transaction, irrespective of whether it is conducted with a related party or third party, to determine if any of the above definitions may be applicable. It is clear that, in China, determination of whether it is a related party or not is not simply a case of applying the traditional share ownership thresholds. It is imperative for taxpayers operating in China to clearly evaluate their relationships between suppliers / customers to determine if the above mentioned provisions may apply to them.

4.1.2 What is a transaction?

Article 10 of the Chinese Transfer Pricing Regulations includes all forms of transactions between related parties. The following types of transactions have been specifically mentioned:

1. Purchase, sale, transfer and use of tangible assets, including purchase, sale, transfer and lease of tangible assets such as buildings, transportation vehicles, machinery and equipment, tools, merchandise and products, etc.;
2. Transfer or use of intangible assets, including provision of land use rights, license of copyrights, patents, trademarks, customers lists, marketing channels, brand names, trade secrets, and proprietary technologies, etc.; and transfer of ownership of or license of the right to use industrial property rights, such as industrial designs and utility models;
3. Financing, including all types of long-term and short-term loans and guarantees, and all types of interest-bearing pre-payments and deferred payments, etc.; or
4. Provision of services, including provision of market research, marketing, management, administration, technical services, repairs, design, consulting, agency, research and development, legal and accounting services, etc.

Taxpayers should not assume that a transaction not explicitly mentioned may be excluded from analysis. Rather, given the relatively comprehensive nature of the list of transactions, taxpayer should take a conservative position such that all transactions entered into by a multinational company will be covered by the transfer pricing provisions, even though such a transaction may not explicitly be mentioned.

4.1.3 Tax return disclosures

From the 2008 tax year (tax return lodgment due May 31, 2009), when filling annual tax returns, Chinese taxpayers involved in related party transactions should prepare and submit the following documents:

1. Annual Reporting of Related Party Transactions - Associated parties
2. Annual Reporting of Related Party Transactions - Transaction Summary
3. Annual Reporting of Related Party Transactions - Purchases and Sales
4. Annual Reporting of Related Party Transactions - Services
5. Annual Reporting of Related Party Transactions - Intangible Assets
6. Annual Reporting of Related Party Transactions - Fixed Asset Transfers
7. Annual Reporting of Related Party Transactions - Financing
8. Annual Reporting of Related Party Transactions - Outbound Investments
9. Annual Reporting of Related Party Transactions - Outbound Payments

These disclosure forms require all taxpayers with related party transactions to disclose a large amount of detail concerning their related party transactions, including details of amounts and types of related party transactions, the level of documentation available and methodology used to test the arm's length nature of the transactions, and the level of profitability on these transactions.

The significance of these forms as a risk assessment tool for the tax authorities should not be overlooked. Article 31 of the China Transfer Pricing Regulations states:

> Desk-top reviews shall mainly be based on using the information collected from annual tax filings such as the Annual Corporate Income Tax Returns and the Annual Reporting Forms for Related Party Dealings

It is therefore critical that the forms be completed accurately and with a sufficient level of detail. In addition, taxpayers have to ensure that the information on the related party transactions are provided in a consistent manner year on year. Significant changes in the way these forms are filled will be considered red-flags and may be a trigger for a tax / transfer pricing audit.

Information from these forms are input into a database for ease of analysis. Thus, fluctuations in gross / profit margins as well as introduction on additional related party transactions and introduction of additional transacting related parties can easily be identified and further queried.

The experience in other jurisdictions is that such forms act as the primary screening tool for tax authorities to conduct their initial identification of targets for transfer pricing investigation and will provide a very efficient means for the tax authorities to manage their limited resources available in the area of transfer pricing.

4.2 Transfer pricing documentation compliance

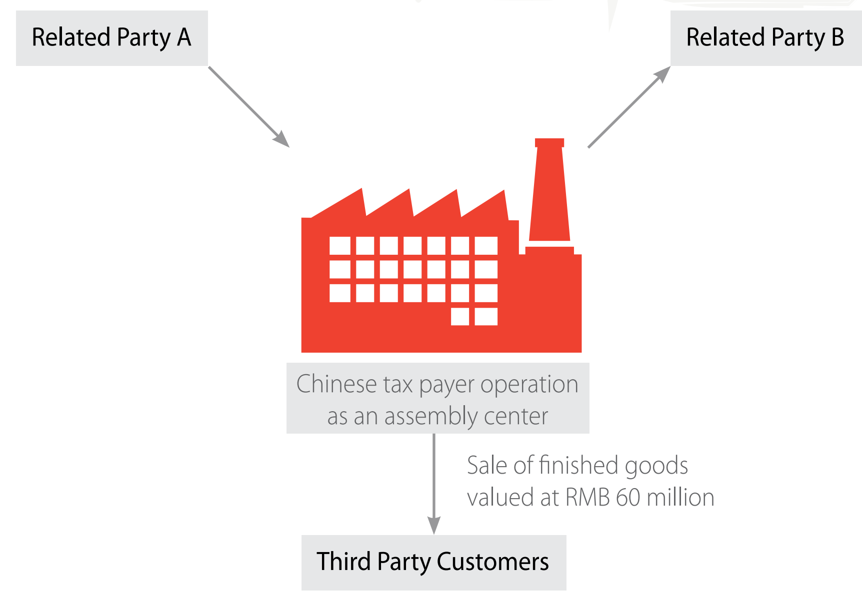
In addition to tax return compliance, there exists a mandatory requirement for taxpayers to prepare and retain detailed transfer pricing documentation to support the arm's length nature of their related party transactions. This section explains the documentation compliance requirement as required by the SAT.

4.2.1 Who must comply?

The Chinese Transfer Pricing Regulations provide the following specific exemptions from the preparation of contemporaneous transfer pricing documentation:[16]

1. Annual amount of related party tangible goods transactions is below RMB 200 million and the amount of related party transactions arising from all other transaction types[17] is below RMB 40 million. It should be noted that the SAT considers the absolute value of the related party transactions as opposed to whether it is a sale or purchase.
2. The transactions are covered by an APA;
3. The foreign shareholding is below 50 percent and the enterprise only transacts with domestic related parties

The following diagram details possible scenarios to help illustrate (1) above.



16. Article 15 of the Chinese Transfer Pricing Regulations.
17. This will include the service income received and paid, royalty income received and paid, interest income received and paid.

In the example above, the Chinese taxpayer operates as a simple assembly center. Semi-finished goods are purchased from various related parties, and the final touches are put on it by the Chinese taxpayer. These finished goods may be sold either to related parties or to third parties. In the above example, although the value of the value-added activity from a commercial / business perspective by the Chinese taxpayer may be small, the Chinese taxpayer will still be required to prepare transfer pricing documentation in respect to its assembly activities, as the total value of tangible goods transactions (i.e., the purchase of semi-finished goods of RMB 105m and the sale of finished goods to related parties of RMB 100m) is RMB 205m, which is in excess of the stipulated threshold of RMB 200m.

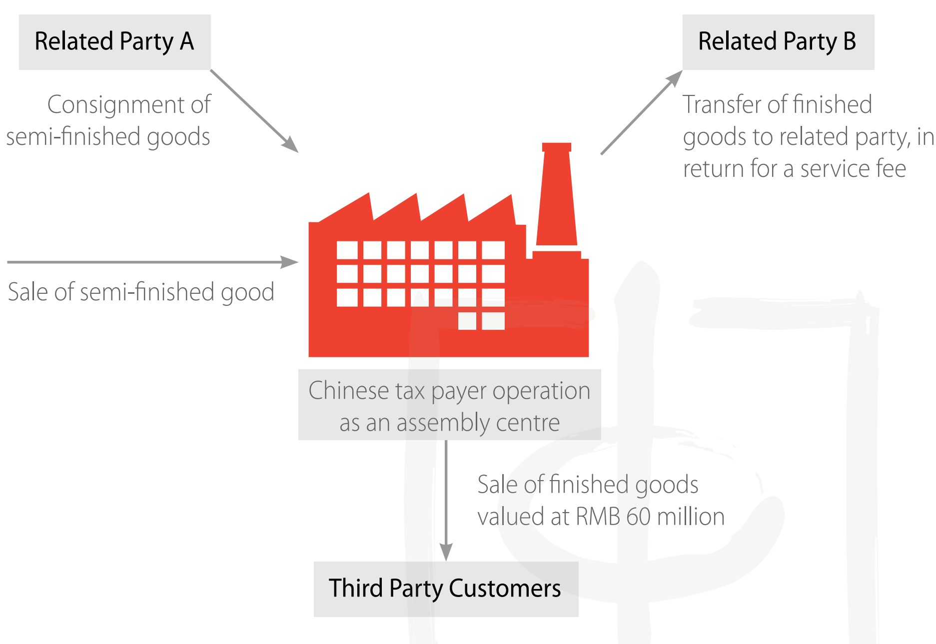
From a transfer pricing methodology perspective, the SAT will first consider if the CUP method can be reliably applied by comparing the prices that the Chinese taxpayer charges to his overseas related party, as well as to his local third party customer. To the extent that there are substantial differences in the terms and conditions of these transactions, the SAT will consider if the internal CP method can be applied by evaluating the gross mark-ups earned by the Chinese taxpayer on their related party sale as compared to the gross mark-ups earned by the Chinese taxpayer on this third party sale.

This might be an appropriate methodology, particularly if the internal CP method can be robust. It is clear that the functions undertaken by the Chinese taxpayers when dealing with related vs. third parties may be different and the CP method may approximate closer to the arm's length standard.

Should this method also be rejected as an appropriate method, one would have to rely on the TNMM as the appropriate method.

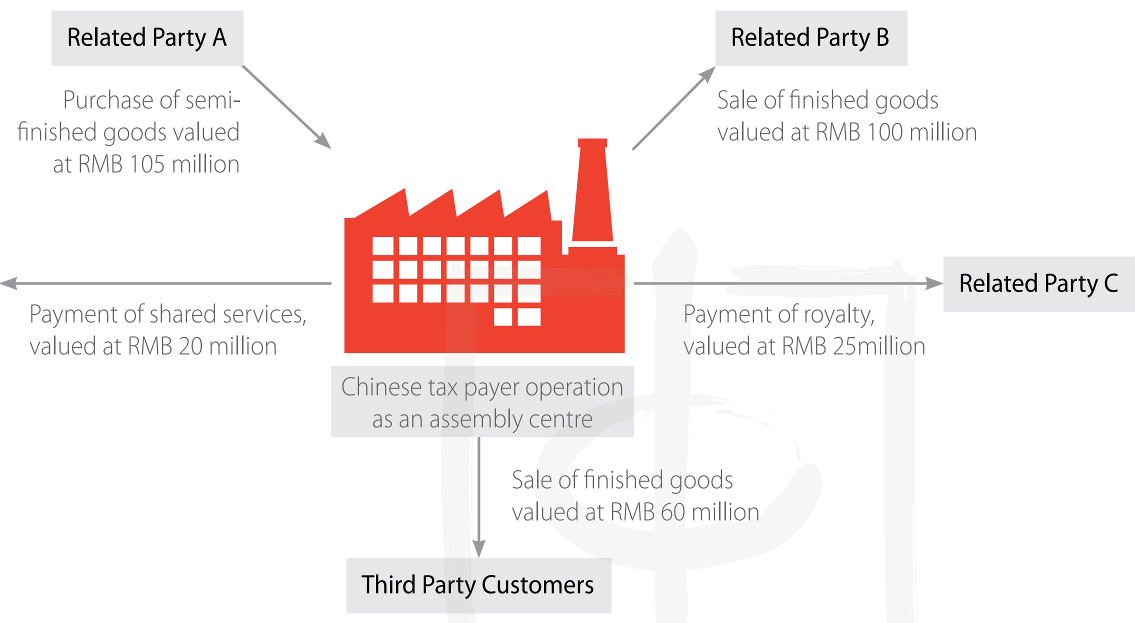
Let us consider another example whereby the semi-finished goods for resale to related parties are consigned to the Chinese taxpayer. In other words, on the related party sale, the semi-finished goods are consigned to the Chinese taxpayer and the Chinese taxpayer is compensated through a service fee for their assembly activities.

The diagram below depicts this situation.



In this case, on the related party purchase and sale, the Chinese enterprise operates as a toll manufacturing service provider. As it does not own the raw material, work-in progress, or the finished goods, the SAT may attempt to use the customs declaration price on import and export as the relevant indication to compute the threshold. In other words, a toll manufacturing service provider will have to adhere to the trade values rather than the service threshold values.

The example below shows the interaction between the trade and services related party transaction thresholds.



In this example, the total value of the tangible goods transaction is less than 200m. However the value of other related party transactions (service fee paid and royalty paid) is valued at RMB 45 million which is in excess of RMB 40 million. Given that the related party transaction service thresholds are breached, the Chinese taxpayer will have to prepare transfer pricing documentation to demonstrate that the following transactions are consistent with the arm's length standard:

a. The purchase of semi-finished goods from related party A
b. Sale of finished goods to related party B
c. Royalty expense paid to related party C
d. Service fee expense paid to related party D

In other words, once the thresholds are reached, all related party transactions entered into by the Chinese entity will need to be documented.

4.2.2 Need for contemporaneous documentation

All taxpayers who are required to prepare transfer pricing documentation are required to do so in a "contemporaneous" manner. Tax authorities globally have differing definitions of what constitutes contemporaneous documentation. Some tax authorities have defined contemporaneous documentation as one that exists when the taxpayer enters into the transactions. The Chinese Transfer Pricing Regulations define contemporaneous transfer pricing documentation as documentation that has been prepared before the tax return is filed on 31 May of the year following the year during which their related party transactions occur.[18]

4.2.3 Compliance matters

The transfer pricing documentation:

- Needs to be completed by May 31 of the year following the tax year;
- Needs to be in Chinese;
- Must be provided within 20 days of request;
- Must be retained for 10 years from June 1 following the relevant tax year;[19]
- Must be stamped with the official chop of the enterprise, and signed or sealed by the legal representative or the representative authorized by the legal representative.

It is not possible to provide detailed documentation within 20 days of a request if it has not already been prepared in advance, particularly given the request can go back 10 years. In any event, documentation prepared at the time or shortly after the transactions take place is considerably more persuasive to a tax authority than documentation prepared at a later point, when the relevant information and personnel may not be available. Such documentation is the only accepted method of giving the tax authorities a clear understanding of the transfer pricing model and commercial realities of the business of a taxpayer. Most significantly, it is the best means of presenting the company's case to the local tax bureau's staff in a favorable light, with a view to avoiding a lengthy and costly transfer pricing audit.

It is important to emphasize that, even if taxpayers are not required to prepare transfer pricing documentation, it is still highly recommended to do so in the following circumstances:

- The taxpayer has characteristics that render it at high risk of transfer pricing audit and investigation, such as being a loss-making manufacturer or a distributor achieving net margins lower than the industry norm;
- The taxpayer operates in a high-risk industry or is part of a large multinational group that is at high-risk of a transfer pricing audit;
- The taxpayer discloses unusual or suspicious related party transactions or transfer pricing methods when completing the obligatory related party disclosure forms;

18. Article 16 of the Chinese Transfer Pricing Regulations

19. The SAT has expanded the statute of limitations that is applicable to transfer pricing adjustments to assist in transfer pricing administration. A longer statute of limitations has been established from transfer pricing because of the difficulties in making transfer pricing assessments and to undertake appropriate transfer pricing analysis.

The taxpayer is exempt for the current year due to the thresholds on related party transactions, but future years are expected to see an increase in the amount .

There can be significant intra-state variation in the application of the transfer pricing compliance. As with the annual filing, some local-level tax authorities may impose due dates or submission timelines other than those listed above, and taxpayers should be prepared to submit documentation earlier if required by the in-charge tax authorities.

4.2.4 Companies with limited functions / risks

In addition to the above-mentioned thresholds, the Chinese Transfer Pricing Regulations note that companies that are engaged in simple manufacturing activities based on orders from related parties must earn a stable rate of return and should not be expected to bear the risks or suffer the losses associated with excess capacity, product obsolescence and other such factors.

In July 2009, the SAT issued Guo Shui Han [2009] No. 363 (Circular 363). Circular 363 which re-emphasized the SAT's position towards losses incurred by companies with limited functions and risks, and even goes one step further than Circular 2 by requiring all loss companies with limited functions and risks to prepare and submit contemporaneous documentation to their in-charge tax authorities by 20 June following the loss-making year – regardless of whether the amount of related party transactions exceeds the materiality thresholds. It is worth noting that, through Circular 363, the SAT has expanded the focus of scrutiny to trading companies and contract R&D service providers in addition to simple manufacturers.

Thus, any limited risk entity, be it a service provider / manufacturer / trader, that makes a loss is expected to prepare and maintain contemporaneous transfer pricing documentation.

"Before profits can be remitted to the parent company as dividends, the subsidiary needs to have paid corporate income tax (CIT) over those profits. However, if the parent charges the subsidiary for a goodor service, this is a cost for the subsidiary."

Hannah Feng
Senior Associate
Corporate Accounting Services
Dezan Shira & Associates
Beijing Office

twitter
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4.3 Penalties and fines arising from transfer pricing non-compliance

Various tax and transfer pricing penalties may be applicable by the SAT / local tax authorities. Although no explicit references are made to penalties arising from the non-provision of transfer pricing documentation in the Chinese Transfer Pricing Regulations, one can make reference to the CIT law for guidance on penalties and fines that will be applicable.

Tax underpayments that result from special tax adjustments (including transfer pricing adjustments) are subject to an interest levy that includes a 5% penalty component. That penalty component can be avoided if the taxpayer prepares and submits contemporaneous documentation in a timely manner upon request, or if the taxpayer is otherwise exempted from the documentation requirement. The interest levy is discussed in more detail later.

Under the CIT law, special tax adjustments (including transfer pricing adjustments) are subject to a special interest levy. The special interest levy mechanism is different from surcharges and fines, which constitute the current penalty measures of tax collection and administration. The rate for the special interest levy will be based on the CNY loan base rate applicable to the relevant period of tax delinquency as published by the People's Bank of China in the tax year to which the tax payment relates, plus five percentage points.[20] This interest levy is not deductible for CIT purposes.

Although companies with annual related party transactions below the materiality thresholds for contemporaneous documentation are not subject to the 5 percent penalty component of the interest levy, such protection does not apply in situations where the amount of related party transactions originally falls below the thresholds, but the restated amount of related party transactions as a result of a transfer pricing adjustment exceeds the relevant threshold. It should be noted that this penalty component can be avoided if the taxpayer prepares and submits contemporaneous documentation in a timely manner upon request, or if the taxpayer is otherwise exempted from the documentation requirement.

20. Article 122 of the Detailed Implementation Regulations

4.3.1 Fines

Taxpayers that fail to file the Annual Related Party Transactions Disclosure Forms to tax authorities, or fail to maintain contemporaneous documentation and other relevant information in accordance with Circular 2, shall be subject to different levels of fines, ranging from less than CNY 2,000 up to CNY 50,000, in accordance with Articles 60 and 62 of the Tax Collection and Administration Law.
Taxpayers that do not provide contemporaneous documentation or relevant information on related party transactions or provide false or incomplete information that does not truly reflect the situation of their related party transactions shall be subject to different levels of fines, ranging from less than CNY 10,000 up to CNY 50,000, in accordance with Article 70 of the Tax Collection and Administration Law and Article 96 of the Tax Collection Regulations. In addition, tax authorities have the authority to deem such taxpayers' taxable income by reference to the profit level of comparable companies, or the taxpayer's cost plus reasonable expenses and profit, or apportioning a reasonable share of the group's total profits; or the deemed profit determined based on other reasonable methods according to Article 44 of the CIT law and Article 115 of the detailed implementation regulations.

4.3.2 Surcharge

In the context of transfer pricing adjustments, taxpayers that have exceptional difficulty and cannot remit the tax payment on time shall apply for an extension in accordance with Article 31 of the Tax Collection Law and Articles 41 and 42 of the Tax Collection Regulations. A daily surcharge of 0.05% will be levied in accordance with Article 32 of the Tax Collection Law if they do not apply for an extension and fail to remit the underpaid taxes and interest levies before the deadline set by the tax authorities on the adjustment notice.

Thus, in conclusion, by not preparing the transfer pricing documentation / the related party transactions disclosure as part of the tax return on a timely basis, transfer pricing adjustments can be made in the event of a transfer pricing audit, and additional tax penalties levied, by the tax authorities, to include years when documentation may not have been strictly required. The limitation period is up to 10 years, and the interest and penalties will not be capable of correlative relief under any double tax treaties.

Preparing Transfer Pricing Documentation

- Introduction
- Group and company overview
- Industry analysis
- Functional analysis
- Transfer pricing design and policy
- Economic analysis
- Chinese transfer pricing documentation requirements
- Tips for preparing documentation

5.1 Introduction

Chapter 3 of the China Transfer Pricing Regulations sets out what is required to be included in contemporaneous transfer pricing documentation. The requirements to a large extent follow those in other jurisdictions, as well as those of the OECD. However, they also stipulate a greater level of detail in respect of the whole value chain of organization.

Any transfer pricing documentation will contain the following sections:

- Company overview;
- Industry analysis;
- Functional analysis;
- Transfer pricing design and policy; and
- Economic analysis.

Every industry is different and even within the same industry, each company has a very different strategy, internal organization, brand, and objective as well as function, asset and risk profile. The objective of the transfer pricing documentation is to outline and detail these differences to the extent that it has bearing on the outcome of the related party transaction.

5.2 Group and company overview

Identifying this business context as early as possible assists in closing the gap between the business reality and the perspective of the various tax authorities. This process combines internal and external sources of information to draw a concise picture of the MNC's business, the industry in which it operates and the key functions of each of the group companies.

The Group and Company Overview should provide information on the overall Group that the Chinese taxpayer is part of, as well as information about the Chinese taxpayer from a business and organization perspective.

It should be noted that the SAT requires additional information on the legal and tax structure of the various entities in the group. For example, the OECD Transfer Pricing Guidelines do not explicitly require the description of the types of relevant income tax, applicable tax rates and the preferential tax treatments of the various transacting related parties.[21]

However, by explicitly requiring the Chinese taxpayer to tabulate the preferential tax rates that the transacting related parties enjoy, and thereby highlighting the tax differential that may exist between the Chinese taxpayer and its related parties, it is clear that the SAT will use such information as a trigger for audit. This can raise suspicion that Chinese taxpayers are transacting with entities that have a beneficial tax regime.

Even if the related party is not experiencing a tax advantage, the existence of a lower headline corporate tax rate may be sufficient to warrant additional scrutiny. Based on discussions with the Chinese tax bureaus, we understand that this headline tax rate is around 12.5 percent. Thus, if China is transacting with an entity that has a tax rate that is lower than 12.5 percent, its related party transactions have a higher chance of being scrutinized.

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20. With the introduction of the country-by-country ("CbC") reporting, taxpayers are required to detail the tax position of all transacting related parties. The headline tax rate of the jurisdiction in which the transacting related parties are located, as well as the income tax paid on a cash basis must be declared.

5.3 Industry analysis

The OECD Transfer Pricing Guidelines, as well as the transfer pricing regulations of all countries, including China, recognize that external economic factors can impact the transfer pricing between related entities. For this reason, the guidelines suggest that it is useful to include in transfer pricing documentation an analysis of the taxpayer's industry.

For example, the global economic crisis in 2008 and 2009 and performance of the macro economy would go a long way towards explaining the low profitability of an entity during this period; that is, to demonstrate that reasons other than non-arm's length transfer pricing are responsible for the profitability of the company.

It should be noted that the Group / taxpayer has a better feel and understanding of how various factors (e.g., fluctuations in the U.S. dollar, oil prices, negative sentiments about the economy, political uncertainty, etc.) affect the operations of the Group and the operations of the Chinese taxpayer. Thus, the onus is on the taxpayer to be able to present industry trends and market outlook correctly in the manner that it affects the Chinese taxpayer and Group either positively or negatively. For more specialized industries, it would be useful to provide an overview of the industry and the various business models that may typically be adopted by companies operating in the industry. Taxpayers need to remember that all taxpayers may not necessarily be well-versed in the specifics of each industry, particularly the more specialized ones.

Specifically, an industry analysis should include:

- Macroeconomic factors impacting the industry
- Description of the key characteristics of the industry, such as:
- growth rates (historical and forecast)
- barriers to entry
- success factors
- regulatory framework
- level of competition
- key players and market shares.
- Market forecasts and anticipated impact on companies in the industry

From a tax authority perspective, industry trends help identify suitable cases for a transfer pricing risk review. Also, once the tax authority has carried out a transfer pricing review or audit in respect of one taxpayer in a particular industry, it has often been the case that the tax authority will use the industry knowledge acquired from that review in order to carry out reviews and audits of other players in the same industry.

The types of information contained within an industry analysis are available in external resources such as:

- analyst reports
- industry research reports
- annual reports of major players in the industry
- general media and other information typically available on the internet.

It should be noted that the Chinese tax authorities do subscribe to industry publications and also are able to obtain a pulse for what happens in their local markets. Taxpayers therefore need to make sure that analyses presented in this section are broadly consistent with the local macroeconomic factors.

5.4 Functional analysis

With the business context provided, the next step in preparing the transfer pricing documentation is the functional analysis. The functional analysis provides an overview of the key activities performed by the entities involved in the related party transactions, the assets used in the related party transactions and risks borne by the parties involved in the related party transactions. It provides a perspective on the role of the entity in the total value chain of the group.

The functional analysis will include an analysis of the functions, assets and risks that are being undertaken by the parties involved in the transaction.

5.4.1 Functions performed

Functions performed are the activities that are carried out by each of the parties to the transaction. In conducting a functional analysis, economically significant functions are to be considered, as such functions add more value to the transaction and are therefore expected to fetch higher anticipated returns for the entity performing such functions. Thus, the focus should not be on identifying the maximum number of functions but rather on the identification of critical functions performed by the associated enterprises.

Some of the important functions that are generally observed and examined in a transaction are:

- Research and development;
- Product design and engineering;
- Manufacturing, production, process engineering and design work;
- Purchasing, materials management and other procurement activities;
- Manufacturing, production or assembly work;
- Transportation, warehousing and inventory;
- Marketing, advertising, publicity and distribution;
- Market intelligence on technological developments; and
- Intra-group services, for example managerial, legal, accounting and finance, credit and collection, training and personnel management services

5.4.2 Assets

The ownership of tangible and/or intangible assets can have a significant impact on the functional classification of the tested party, the selection of the most appropriate transfer pricing methodology for testing the arm's length nature of the related party transactions, and the overall profit expectations of the tested party. This section identifies the tangible and intangible assets in the overall value chain, provides an assessment of their importance and discusses which party in the value chain should be entitled to the economic benefit deriving from those assets.

Assets that are used by, or transferred between, the associated enterprises in the course of an international controlled transaction need to identify the significant assets (tangible as well as intangible) used by, or transferred between, the associated enterprises in the course of an international controlled transaction. The analysis should involve the identification of the type of assets employed, both tangible and intangible, and their significance to the controlled transaction.

Tangible assets

Tangible assets refer to the property, plant and equipment, furniture, office equipment and other such assets. Although the existence of such assets are important, tax authorities are increasingly taking the position that such tangible assets are routine in nature in the sense that they are not required to provide the enterprise with any significant competitive advantage, and therefore the ownership of tangible assets may not be considered to have an impact, either positive or negative, on the ability of the enterprise to realize additional profits from their operations.

The existence of the value and nature of tangible assets will also validate the classification of the company. For example, one would expect that a service provider would own certain tangible assets, although it is not likely to be as extensive as a capital intensive manufacturer.

Intangible assets

The OECD Transfer Pricing Guidelines broadly categorize intangibles as marketing related intangibles and commercial intangibles.

Marketing intangibles are those intangible assets that are used in the marketing or promotion of products or services (such as trademarks, trade names, reputation, market loyalty, design, logo, etc.). Commercial intangibles include patents, know-how, designs, and models that are used for the production of a good or the provision of a service, as well as intangible rights that are themselves business assets transferred to customers or used in the operation of business (e.g. computer software, technology, know-how, etc.).

In general, the existence and ownership of intangible assets will provide additional clarity on the compensation that is received by the enterprise. Care should also be taken to differentiate between the legal and economic ownership of these assets. Where the enterprise owns additional intangible assets, the taxpayer would expect to observe an extra profit potential to demonstrate the ownership of intangible assets, which should result in super-normal profits.

5.4.3 Risks

Risk assessment is important in the functional analysis and it should be considered together with the functions and assets. There are two important aspects to risk: how risk is created and which entity bears the risk. Risk in an MNE is created by the ownership, exploitation or use of assets, or by the performance of functions over time. The next question is which entity bears the risk.

Risk analysis involves the identification of the economically significant risks that are assumed by each of the parties to the transaction. It is commonly understood that the bearing of economically significant risk is related to the anticipation of a reward.

The risks that should be considered include:

- Financial risks (e.g., method of funding, fluctuation in interest rates, funding of losses, foreign exchange risk)
- Product risks (e.g., design and development of product, risks associated with R&D, product liability risk, intellectual property risks, inventory risks)
- Market risks (e.g., fluctuation in demand and prices, business cycle risks, volume risks)
- Collection risks (e.g., credit risk, bad debt risk)
- Entrepreneurial risks (e.g., risk of loss associated with capital investment, single customer risk)
- General business risks (e.g., risk associated with the exploitation of a business, inflation risk)
- Country / regional risks (e.g., political risk, regulatory risk, risk related to government policies)
- The impact of risk on the related party outcome is a key part of allocating profits between the various related parties. In general, if a taxpayer bears risk, it would be expected that the profitability arising from the related party transaction will vary. On the other hand, an entity that bears minimal risk would be expected to earn a consistent level of profits arising from its operations, year on year.[22]

22. Such a rational provides additional insights on the introduction of circular 363, which states that a low-risk entity bearing losses must prepare transfer pricing documentation to support its losses.

5.4.4 *Preparing the functional analysis*

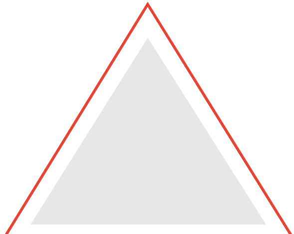
The functional analysis is typically carried out by reviewing key financial / legal and business documents obtained from the Group as well as the Chinese taxpayer. In addition, additional clarity is obtained by speaking to key operational personnel to understand their key roles and responsibilities. How each division interacts with one another within the company also allows the MNC to gain a better insight into its business, the industry and key responsibilities of different companies in the group.[23]

In most cases, the head of each business division can provide:

- an overview of the value chain;
- an explanation of their roles and responsibilities and interaction with other functions and group entities;
- decision making processes within the group and risks borne; and
- relevant industry information and trends as they impact the company.

The functional analysis should also keep in mind the overall business context of the group as well as the industry business models to ensure that there are no inconsistencies between what is being captured during the interview process and the overall business strategy of the Group in respect of the Chinese taxpayer.

Review of contracts suggests that the Chinese taxpayer operates as a sales and marketing service provider and is compensated by way of a service fee



Review of financial statements shows that the Chinese taxpayer has made a provision for stock obsolescence.

Upon speaking to business personnel, one discovers that the Chinese taxpayer pays rent to a third party logistics company for warehousing services

23. *Such a process in known as the functional analysis process.*

When preparing the functional analysis, it is critical for the analysts (whether the internal resource or the external consultant) to tick and tie the business reality with the accounting and legal realities. This essentially means that it is necessary to evaluate if the legal contracts, financial statements, invoices and other such documents are depicting a story that is consistent with what the key operational people are detailing.

A perfect example of an inconsistent relationship between the economic / accounting and legal realities is depicted in the diagram below. Let us assume that the Chinese taxpayer used to function as a distributor and business restructuring has converted the Chinese taxpayer from a distributor to a service provider.

Based on the above example, it is clear that in reality, the Chinese taxpayer actually undertakes additional distribution related activities which are not explicitly covered or noted in the legal agreements. Although the taxpayer may have classified this entity as a service provider, a tax authority upon reviewing the information about this company may turn around and reclassify the Chinese taxpayer as a distributor, given that it still has a warehouse and recognizes inventory risk on its books.

Although the Chinese Transfer Pricing Regulations do not explicitly provide a basis for the tax authority to disregard a transaction, the recently revised OECD Transfer Pricing Guidelines allow tax authorities to disregard the structure adopted by a taxpayer in entering into a related party transaction, particularly where the economic substance of a transaction differs from its form.

5.4.5 Outcome of the functional analysis process

The outcome of the functional analysis process would be to categorize the enterprise with the most appropriate label, based on the functions that are performed, the assets that are employed, and the risks that are borne.

For example, based on the level of risk, assets and functions that are being undertaken, a manufacturer may be labeled as a contract manufacturer, a licensed manufacturer or a full-risk manufacturer.

Similarly, an entity that is undertaking activities to sell the group's products may be considered a sales and marketing service provider (i.e., one that does not undertake distribution and warehousing activities) or a distributor (one that contracts directly with the end-customer for the sale of the goods). In such a case, it would be expected that the distributor should earn a higher margin as compared to the sales and marketing service provider as it und ertakes more functions and bears more risks.

The classification of the related parties entering into the transaction will also provide additional insights on the selection and application of the appropriate transfer pricing method.

5.5 Transfer pricing design and policy

The next section of the transfer pricing documentation details the selection of the transfer pricing method. Care should be taken to outline the price setting policy, which is the policy that the taxpayer adopts to determine how related party transactions should be priced on a day-to-day basis. This is the methodology that is used when the intercompany transaction is entered into the statutory / tax books as journal entries of intercompany transactions.

However, due to certain constraints relating to the availability of data, a separate method may be applied with respect to identification of "arm's length" market references in order to check the arm's length nature of the price and/or profit being achieved on one or an accumulation of similar inter-company transactions.

The price setting policy and the price checking policy may be similar or identical for certain intercompany transactions. However, they may also vary for others, as the price setting policy is the policy that is adopted on a transaction-by-transaction basis, while the price checking policy is the policy that will be used to check the outcomes of the related party transaction on a collective basis, at the end of the financial year.

An intercompany transaction where the price setting and price checking policy may be different would be in a commission arrangement. Principals often pay commissions to sales and marketing agents in return for promoting their products. An entity that receives a commission will record commission income as its "revenue". It should be noted that such an entity is not obliged to disclose the commission rate that it receives from its Principal. Thus, although the price-setting policy is one based on the commission rates, given the lack of publicly available data, it would not be possible for the tax authority to determine if the commission rate charged is arm's length. Therefore, the price-checking policy would resort to a transfer pricing method, possibly the transaction net margin method, to determine the profitability of other commission agents in a similar geographic location. If the profitability of the enterprise operating as a commission agent is broadly similar to the profitability of other entities operating as a commission agent, one can assume that the commission rate that the enterprise received is consistent with the arm's length standard.

With respect to certain transactions, e.g., payment of royalty / service transactions, it is likely that the price setting and the price checking policies are the same. When a related party charges a royalty for the right to use a know-how / trademark or other such intangibles, the licensor will charge a royalty that would typically be a percentage of sales. The use of the CUP method as the price checking method will also arrive at a result which will compute the royalty rate.

As noted earlier, it is necessary to evaluate the pros and cons of each method to determine the appropriate transfer pricing method.[24]

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24. For a review of the transfer pricing methods, please refer to Section 4.2.

5.6 Economic analysis

The final step of the transfer pricing documentation presents the economic analyses where the application of the appropriate transfer pricing method, by analyzing various third party references, is presented to demonstrate that the transactions entered into by the related parties are consistent with the arm's length standard.

5.6.1 Use of database

In order to apply any of the transfer pricing methods on an external basis, it is necessary to use a commercial database. For practical purposes, it is generally not feasible to perform the economic analysis in-house as the license fees required to access such databases are often quite costly.

Various transfer pricing databases are available depending on the nature of the transaction, as well as the application of the transfer pricing method. For example, with respect to the application of the cost plus, resale price and TNMM, it may be possible to use Bureau van Dijk's Osiris database. With respect to comparable uncontrolled price methods, whereby a royalty rate is being analysed, it may be possible to use Bureau van Dijk's KtMine database. With respect to intercompany loan transactions, one typically uses Thomson Reuters' Loan Connector or CUFTAnalytics.

Tax authorities, including the SAT, generally also have access to such databases and may also develop their own database based on tax return submissions of other non-public data. Tax Circular Guoshuihan [2005] No. 239 ("Circular 239") stipulates that all tax bureaus should fully utilize the information databases of China's National Bureau of Statistics and the Bureau van Dijk ("BvD") Osiris[25] database subscribed by the SAT when conducting TP investigations and tax adjustments. In addition, Circular 239 also encourages local tax authorities to collect relevant information from customs, banks and other authorities.

25. Osiris is a BvD database that has information on listed, and major unlisted/delisted, companies around the world.

5.6.2 Comparability analysis

One issue that has arisen recently in the context of economic analysis is the type of comparable company to be selected for inclusion. The typical starting point is to search for publicly listed companies in China that operate in the same industry as the taxpayer. This arises from the SAT's preference to use Osiris as the appropriate database.

In the majority of cases where this produces a very small sample size the taxpayer can expand the search to include:

- Listed companies from other Asia Pacific countries;
- Private companies in China[26]

The first approach has traditionally been used as there is greater confidence on the reliability of the financial information. However, the downside of this approach is that the companies tend to be less comparable, as these companies are large MNCs that perform a range of activities and operate in very different economies to a Chinese taxpayer.

The other approach is to rely on private company data from China and the region. The SAT has outlined the pros and cons associated with both approaches and taxpayers are required to evaluate the soundness of both aspects before undertaking the comparability analysis.

5.6.3 Use of secret comparables

In China, Article 20 of Guo Shui Fa (1998) No. 59 required tax authorities to establish a transfer pricing database that contains income tax return data, market prices of main commodities, trade and industrial profitability ratios, borrowing and lending interest rates as well as structural and managerial information of multinational enterprises. The ruling stipulates that the database should be shared within the tax administration system and should not be available to the public.

Such data is referred to as "secret comparables" and, when used to adjust a taxpayer's profitability, is widely considered to be unreasonable as the taxpayer does not have sufficient information to defend themselves.

Although Circular 239 notes that the tax authorities should use the Osiris database for comparability analysis, Article 37 of the Chinese Transfer Pricing Regulations notes "that both publicly available information and non-public information can be used during analyses and evaluations".

26. Additional comments on the SAT's approach on comparability analysis can be found in Section 12.1.

5.6.4 Capital Intensity Adjustments

This refers to the practice of adjusting the profitability of the comparable companies to equate them to the same proportionate level of receivables, payables and inventory as the tested party. Such adjustments are widely used by tax authorities and taxpayers around the world, particularly in the U.S. However, in July 2005 the SAT released Guo Shui Han (2005) No. 745 stating that local tax authorities should not use capital intensity adjustments in carrying out comparability studies, unless there is strong support for doing so. It is likely that the SAT has taken this position due to the prevalence of state-owned Chinese companies that may be used as comparables, with abnormally high levels of working capital (especially inventory holdings), with the result that capital intensity adjustments could result in benchmarking results with unacceptably low profit ranges, or even losses.

In addition, Article 38 of the Chinese Transfer Pricing Regulations notes that tax authorities shall not in principle make adjustments to the difference in operating profit resulting from the different levels of working capital employed by the enterprise under investigation and comparable enterprises. If such adjustments are necessary, approval of the State Administration of Taxation is required through a reporting process.

5.6.5 Use of the interquartile range

Once the set of comparable companies or transactions have been selected, it is necessary to construct the arm's length range.

It should be noted that transfer pricing is not an exact science. Thus, there will be occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable. While every effort has been made to exclude points that have a lesser degree of comparability, what is arrived at is a range of figures for which it is considered, given the process used for selecting comparables and limitations in information available on comparables, that some comparability defects remain that cannot be identified and/or quantified, and are therefore not adjusted.

Thus, both the OECD Transfer Pricing Guidelines and the Chinese Transfer Pricing Regulations[27] suggest the use of the interquartile range in analyzing and assessing the outcomes of the related party transactions entered into by the enterprises under investigation.

It should be noted that if the outcome is below the median value of a range of outcomes of comparable enterprises, tax authorities may, in principle, make adjustments based on the profit level not lower than the median value.

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27. Article 41 of the Chinese Transfer Pricing Regulations

5.7 Chinese transfer pricing documentation requirements

The general process of preparing transfer pricing documentation has been detailed in this chapter. The table below outlines the specific requirements of the Chinese transfer pricing documentation[28].

	Requirements as per the Chinese documentation rules	Section of the report
Organisation structure	Relevant organizational structure and ownership structure of the group of companies to which the enterprise belongs	Group / Company Overview
	Description of the changes in the relationship between the enterprise and its related parties in the tax year	Group / Company Overview
	Description of the related parties with whom the enterprise has transactions, including the name, legal representative, composition of high level management such as directors and managers, registered address and address of business operation of related parties; and the name, nationality, country of residence, and composition of family members of related individuals; and identify related parties with direct influence over the pricing of related party transactions of the enterprise	Group / Company Overview
	Description of the types of relevant income tax, applicable tax rates and the applicable preferential tax treatments of each related party	Group / Company Overview

28. Article 13 of the Chinese Transfer Pricing regulations

	Requirements as per the Chinese documentation rules	Section of the report
Description of business operations	Business overview of the enterprise, including a summary of the enterprise's development and changes, a summary of the industry in which the enterprise operates and its development, major economic and legal issues affecting the enterprise and the industry such as business strategy, industrial policy, and restrictions facing the industry, etc., supply chain of the group, and the enterprise's position within the supply chain	Industry analysis
	Composition of the principal business operations of the enterprise, revenue from principal business operations and its proportion to total revenues, profit from principal business operations and its proportion to total profits;	Group / Company Overview
	Analysis of the enterprise's market position and relevant competitive environment of the market;	Industry analysis
	The internal organizational structure of the enterprise, relevant information of the functions performed, risks borne and assets employed by the enterprise and its related parties involved in the related party transactions, which the enterprise shall use as a reference in filling out the "Form of Enterprise's Function and Risk Analysis"	Functional analysis
	Consolidated financial statements of the group.[29]	Group / Company Overview
Description of related party transactions	Description of the type of related party transactions, relevant parties engaged in these transactions, timing, amount, currency of settlement, and terms and conditions of the transactions, etc.	Transfer pricing policy and design
	Description of the trading mode of related party transactions, changes in the tax year, and reasons for the change;	Functional Analysis
	Description of the transaction flow, including information flow, physical flow and cash flow, at each level, and discussion of similarities to and differences from transactions with unrelated parties	Functional Analysis
	Description of intangible assets involved in the related party transactions and their effect on pricing	Functional Analysis
	Copies of contracts or agreements relating to the related party transactions, and descriptions of the implementation of these contracts or agreements	Functional Analysis
	Analysis of the major economic and legal factors influencing the pricing of related party transactions	Functional Analysis
	Segmentation of sales, costs, expenses, and profits on transactions with related parties and transactions with unrelated parties. If these items cannot be segmented directly, they need to be segmented based on certain reasonable allocation key(s) together with an explanation of the allocation key(s) selected. The enterprise shall use the above as a reference in filling out the "Form of Enterprise's Annual Related Party Transaction Financial Analysis".	Functional Analysis

29. The enterprise may extend the preparation of this information depending on the fiscal year end of the group. However, such information has to be prepared no later than 31 December of the year following the year in which the related party transactions occur.

	Requirements as per the Chinese documentation rules	Section of the report
Comparability analysis	Considerations of the comparability analysis, including the characteristics of the assets or services involved in the transactions, functions and risks of the parties engaged in the transactions, contractual terms, economic environment, and business strategies, etc.;	Economic Analysis
	Relevant information regarding functions performed, risks borne, and assets employed by comparable companies	Economic Analysis
	Description of comparable transactions, such as the physical attributes, quality and efficacy of tangible assets; normal interest rate, amount, currency, term, guarantee, credit standing of the lender, term of repayment, and interest calculation method, etc. under the financing arrangement; nature and level of services; type of intangible assets and the form of intangible asset transactions, right to use the intangible assets obtained from the transactions, and income from using the intangible assets	Economic Analysis
	Source of comparable's information, selection criteria and the reason for setting these criteria	Economic Analysis
	Adjustments made to comparable's data and the reason for these adjustments	Economic Analysis
Selection and application of transfer pricing method	Selection of transfer pricing method and the reason. If profit method is selected, contribution to the overall group profits or the level of residual profits should be explained	Transfer pricing policy and design
	Description of how the comparable's information supports the selected transfer pricing method	Transfer pricing policy and design
	Assumptions and decisions made in the process of determining comparable uncontrolled price or profit;	Economic Analysis

5.8 Tips for preparing documentation

The contemporaneous documentation requirement has placed and continues to place a significant burden on many taxpayers in China. It is important to plan and manage this information collection and documentation process as efficiently as possible to avoid excessive costs and time commitments, as well as to ensure that maximum benefit is derived from the documentation..

The following are some tips to assist and to gain maximum benefit from this process:

1. Identify internal resources to be involved in the documentation process. Understand what can realistically be in-sourced and what parts will need the help of an external advisor. Specifically, information on the company / group and the industry is something that should readily be available from the taxpayer and therefore is something that can be prepared in-house. Even if it is decided that the entire documentation will be prepared by an external advisor, it is key to identify a project manager who will be able to manage the information request.
2. Develop appropriate templates and tools to simplify and standardize aspects of the process (which will take some time in the first year but will save considerable time and effort going forward).
3. Most MNCs have entities that are located in multiple jurisdictions. It is likely that each of these jurisdictions may also require local taxpayers to prepare transfer pricing documentation. Thus, it will make sense for the Group to review the overall transfer pricing compliance burden in Asia to determine how synergies can be created and / or how it may be possible to leverage from the efforts of other entities.
4. Use the economic analysis in the documentation on a prospective basis to set intercompany prices going forward.
5. Combine the documentation process with a risk assessment of the China entities to highlight areas that may need further attention and close monitoring.
6. Utilize the documentation and risk assessment process to identify opportunities to lower the effective tax rate of the group in an arm's length and defensible manner.

Transfer Pricing Analysis of Intercompany Services

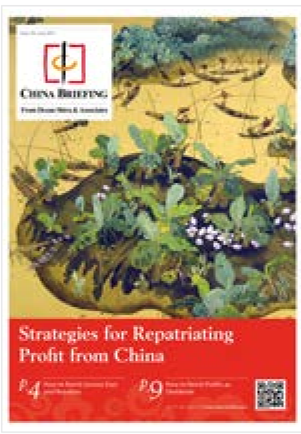
- Introduction
- Transfer pricing analysis of intra-group services
- China's position on intercompany services
- SAT Announcement No. 16
- Concluding remarks

6.1 Introduction

Many MNEs charge intra-group service fees to affiliates for supporting services (for example finance, HR, IT) rendered by global and/or regional headquarters, or by shared service centers. In respect of services being received by Chinese enterprises, the Chinese tax authority remains committed to protecting its tax base from inappropriate charge-out costs.

The Chinese Transfer Pricing Regulations do make reference to services transactions. For example, Article 10 (4) notes that the provision of services, including provision of market research, marketing, management, administration, technical services, repairs, design, consulting, agency, research and development, legal and accounting services, etc., will be covered under the Transfer Pricing Regulations. Section 7 of the Chinese Transfer Pricing Regulations covers the administration of cost sharing arrangements, including the provision of services. However, such guidance is limited to specific structures and the Chinese Transfer Pricing Regulations do not provide a wider scope analysis of the transfer pricing considerations arising from the provision of and receipt of intercompany services by the Chinese enterprise.

Furthermore, it has been a long-established practice of the Chinese tax authorities that management fees being charged by the parent company of a Chinese affiliate are not deductible for corporate income tax purposes under the EIT. This position was confirmed in a circular issued after the new EIT law took effect in 2008. However, in more recent years, the SAT has issued circulars and made announcements on how intercompany services will be treated from a tax and transfer pricing perspective.



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6.2 Transfer pricing analysis of intra-group services

Although the Chinese Transfer Pricing Regulations remain relatively silent on how intra-group services should be analyzed from a transfer pricing perspective, guidance can be obtained from the OECD Transfer Pricing Guidelines. The OECD Transfer Pricing Guidelines note that there are two broad issues that should be analyzed with respect for intragroup services. The first is whether intra-group services have in fact been provided. The other is to determine if the intra-group services have been charged in accordance with the arm's length principle.

Under the arm's length principle, the question of whether an intragroup service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise, or would have performed the activity in-house for itself.

An extension of the concept of economic or commercial value leads to the conclusion that service recipients should not have to pay for services that are shareholder in nature (i.e., services that are essentially undertaken for the shareholder) and services that are duplicative in nature (i.e., where the service recipient undertakes such services on their own, one would not expect them to have to pay for the same service provided by a related party).

Additional guidance is also provided in respect of incidental benefits that arise from the services, and if the services are considered as "on-call" in nature.

To determine if the service charge is consistent with the arm's length standard, the OECD Transfer Pricing Guidelines note that the CUP or the cost plus method would be most appropriate. In respect of the cost plus method, it may be possible to allocate costs either based on the direct charge or the indirect charge used to allocate costs incurred in the provision of services to the various service recipients. Once an appropriate base has been determined, a percentage mark-up will typically be added on to determine the total value of the service charge.

6.3 China's position on intercompany services

6.3.1 Historical position

For many companies, it is popular practice to use the cost plus method to arrive at an intercompany service charge when it comes to services provided between companies in China and their affiliates overseas. Due to the lack of guidance in Chinese transfer pricing regulations on services, both taxpayers and Chinese tax authorities have in the past relied on Guoshuifa [2002] No. 128. Guoshuifa No. 128 provides that in the case of a China holding company, a profit margin of 5 percent of cost can be used to determine the service fee charges against the holding company's Chinese subsidiary. Therefore, in the past, this 5% markup convention has been used by many companies, and not just China holding companies, when it comes to charging service fees.

However, in 2008, the SAT issued circular Guoshuifa No. 863 that provides that the service charges between a China parent company and its China subsidiary should be based on the arm's length standard and noticeably omits any reference to the 5 percent markup convention detailed in Guoshuifa [2002] No. 128. This has led to speculation that perhaps the 5 percent markup of Guoshuifa No. 128 can no longer be relied upon as a safe harbor convention.

6.3.2 SAT's views on management services

In a recent document entitled "Views on Service Fees and Management Fees," the SAT responded to a United Nations Tax Committee request for comments on how China will evaluate and tax service fee charges.[30]

The SAT's position is summarized here.

6.3.2.1 Benefit test – who principally benefited?

The OECD Transfer Pricing Guidelines require that the benefit test be carried out from the perspective of the service recipient – i.e., does the service recipient recognize economic or commercial benefit as a result of the services being provided. The SAT, on the other hand, requires the "benefit test" to be applied to both the service provider and the service recipient to determine whether intercompany services warranting a charge have been rendered. For example, if management consulting services provided by a parent company to its subsidiary will benefit the parent company more than the subsidiary (even if the subsidiary also benefits from the services), the service fees paid to the parent company may be non-deductible.

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30. In January, the UN tax committee requested a subgroup to work on additional chapters to be included in the U.N. Transfer Pricing Manual on intra-group services, management fees and intangibles.

6.3.2.2 Necessity Test – Were the Services Necessary?

Taking into account the nature of the purported service recipient's activities and incorporating a cost-benefit analysis, if the SAT deems that the high-end services (e.g., sophisticated advisory or legal services) unnecessary for the operation of the Chinese taxpayer, the fees charged for such services may not be considered deductible. The specific example included in the example is one of legal services being provided to a Chinese manufacturing entity.

6.3.2.3 Anti-Duplication Test

If a parent company already has been remunerated through, or benefited from, a separate transfer pricing arrangement (e.g., a profit-sharing arrangement) with regard to any specific service it renders to a Chinese subsidiary, the parent company may not be permitted to charge any further service fee to the subsidiary for that service.

6.3.2.4 Are the Fees for Management Services?

From the SAT's perspective, most subsidiaries of MNEs in China have their own management teams. Therefore, the legitimate management function that the parent company performs for its subsidiaries is considered very limited. Many of the pertinent management services being performed are duplicative and unnecessary, with the result that the Chinese tax authorities are likely to challenge the deductibility of fees imposed for parent-subsidiary services of a management nature.

6.4 SAT Announcement No. 16

The SAT's comments to the U.N, while insightful of the SAT's position, were not considered to be a legal position. To correct this, on March 18 2015, an announcement was made by the SAT - Corporate Income tax on Expenses Paid by an Enterprise to its Overseas Affiliated Party – Announcement No. 16. The said announcement in effect reiterates the need for payments made to related parties to be consistent with the arm's length standard. While there has always been a need to provide relevant support (by way of contracts / agreements / invoices and other documents) to demonstrate the authenticity and compliance with the arm's length standard, the recent announcement provides additional considerations that taxpayers in China will have to take into account when making payments to overseas affiliates. Such considerations are necessary to ensure the continued deduction of these expenses.

Consistent with its position to the U.N., the following services were also explicitly excluded:

a. Services that are "management" in nature for the purpose of protecting the direct / indirect investment interests
b. Services that are duplicative in nature – i.e., where the Chinese taxpayer has purchased or carried out by itself the services rendered by the service provider / overseas affiliated party
c. Services that are somewhat passive / ancillary in nature – i.e., there is no specific service that is carried out by the overseas related party specifically for the Chinese enterprise
d. Services that do not bring about direct or indirect economic interests to the enterprise (in other words, there is no direct or indirect commercial benefit arising from the services that were provided)
e. Services that are irrelevant to the risks / business that the Chinese taxpayers carries out;
f. Services that have already been compensated for in other transactions

In addition, the SAT has specifically noted that deductions for payments made to overseas related parties which do not perform any key functions or do not bear risk will be disallowed. This requirement essentially requires the overseas affiliate that will receive payment to perform substantial business activities. In order for the expense to be deductible in China, it is clear that the Chinese taxpayer making the payment has to demonstrate the substantial business activities of the overseas affiliate receiving payment.

6.5 Concluding remarks

In summary, MNEs doing business in China face increasing difficulties in sustaining the deductibility of intercompany service fees without a strong demonstration of the value and necessity of the services in question. Despite recent guidance, the Chinese tax authorities must address a number of issues:

- Because of the lack of clear rules under the existing EIT Laws, tax authorities have too much discretion in the course of enforcement on intercompany services.
- Given the wide variety of intercompany services, the authenticity of intercompany service charges is difficult to verify.
- Tax authorities often have difficulty determining whether certain allocation methods for intercompany services comply with the arm's length principle when an indirect charge method is applied with various allocation key factors.
- Offshore structures and overseas businesses obscure an MNE's overall intercompany service arrangements, and existing international tax information exchange treaties do not provide a mechanism sufficient for the Chinese tax authorities to obtain the necessary information.

As the Chinese tax authorities become more sophisticated, service fees arrangements that currently pass muster may face increasing challenges. It is critical that Chinese enterprises that enter into service arrangements ensure that such service arrangements are consistent with the expectations of the SAT.

Transfer Pricing for Intangibles

- What is an intangible asset?
- Intercompany royalties
- Contract R&D arrangements
- Cost sharing agreements
- Concluding remarks

Intercompany licensing and royalties for the use of intangible property is a common intercompany transaction that has also been under considerable review from Chinese tax authorities.

References to intangible assets and their use can be found in the Chinese Transfer Pricing Regulations. These regulations also provide guidance on how cost sharing arrangements may be evaluated from a transfer pricing perspective. However, cost sharing arrangements are typically entered into for the joint development and assignment of intangible assets.

An alternative intercompany transaction may exist where an overseas related party licenses the right to use certain intangible assets / intellectual property which would typically be compensated for by a royalty payment. In general, the Chinese tax authorities also routinely challenge the royalty paid on the value of the IP licensed to the Chinese subsidiary and the reasonableness of the remuneration.

7.1 What is an intangible asset?

According to the OECD Transfer Pricing Guidelines, the term "intangible property" includes the rights to use industrial assets such as patents, trademarks, trade names, designs, or models. It also includes literary and artistic property rights and IPs such as know-how and trade secrets. Unlike cash, which is a monetary asset with an obvious value, intangible assets such as a patent do not have such an apparent value and may not even be recognized on a company's balance sheet. However, despite their lack of physical form, intangible assets can often contribute greatly to business success and can have considerable value.

The term "intangible assets" has a much wider definition in CIT Law. Intangible assets are defined in Article 65 of the CIT as "non-monetary long-term assets that bear no physical form and are possessed by an enterprise for the purposes of the manufacture of products, provision of labor services, leasing, or business management". Examples given in Article 65 include patents, trademarks, copyrights, land use rights, know-how, and goodwill.

The Chinese Transfer Pricing Regulations provide more examples of intangible assets, including "licenses, such as land use rights, copyrights, patents, trademarks, client lists, marketing channels, brand names, business secrets, and proprietary technology as well as industrial property rights such as industrial product designs or utility models".

"Despite their lack of physical form, intangible assets can often contribute greatly to business success and can have considerable value."

Sowmya Varadharajan
Director
IC Advisors Pte Ltd

7.2 Intercompany royalties

Royalties are fees paid in relation to the use of intellectual property, such as trademarks, patents, copyrights, and proprietary technology. Royalties are deductible for CIT purposes provided they are directly related to the FIE's business operations and charged at normal market rates.

Royalties in the CIT are defined as "revenues derived by the enterprise from the provision of the right to use patents, non-patented technologies, trademarks, copyrights and other licensed rights". The Chinese tax authorities' main concern for multinational companies using royalties is to shift profits out of China inappropriately. While it is common business practice for a company utilizing a know-how or trademark licensed from overseas to pay a royalty fee, in practice, some payments are considered unreasonable. In general, the SAT and local tax bureaus may impose tax adjustments if royalty payments are:

a. Found to lack reasonable basis, i.e., not consistent with the arm's length basis;
b. Believed to be duplicative;
c. For technology or trademarks that are not used in practice or rights that have passed the confidentiality period (i.e. no longer a secret).

7.2.1 Considerations with royalty payments

7.2.1.1 Approval and registration requirements

Making royalty payments are typically subject to foreign exchange requirements. There can be other approval and registration requirements as well. For example, if an overseas company is charging a Chinese entity royalties related to the use of technology and know-how, the underlying royalty agreement must be registered with the local branch of the Ministry of Commerce. However, if the royalties are for the use of trademarks, then either the trademark owner (in this case, the overseas company) or the Chinese affiliate company using the trademark will have to register the trademark with SAIC (State Administration of Industry or Commerce). Therefore, it is incumbent upon both parties involved to perform the necessary due diligence to determine what approval and registration processes need to be adhered to ensure that the remittance of royalties will be allowed.

7.2.1.2 Announcement No. 16 [2015]

While Announcement No. 16 concerned itself primarily with the payment for services, it also mentions situations where the SAT can disallow royalty expenses. In the case of royalties, the SAT brings out an important distinction between legal ownership and economic ownership of the intellectual property rights. If an entity only has legal ownership and does not invest in the economic ownership of the IP, royalty payments may not be deducted.

In general terms, the registered legal owner of such intangibles has the exclusive legal and commercial right to use the IP and has the right to license the IP to others. On the other hand, the economic owner is regarded as the entity which is entitled to the economic benefits or the IP-related returns. Announcement No. 16 also requires the Chinese enterprise to determine the extent to which the economic interest is invested with the overseas affiliated party by accounting for the degree of contribution made by each overseas affiliated party. This supports the deductibility of the royalty payment.

7.2.1.3 Royalties vs. technical services

In its position paper on services to the United Nations, the SAT attempts to draw a discussion between royalties and technical fees. Such a distinction is key due to a tax advantage of using technical services as opposed to royalties.

Under EIT Laws, payments for the licensing of intangible assets such as proprietary technologies (e.g., royalties) are subject to withholding tax—typically 10 percent in the case of cross-border transfers. In comparison, service fees paid by a subsidiary in China to its overseas parent company will not have any Chinese income tax implications (except for turnover taxes) if there is no permanent establishment created in respect of the provision of the services in question.

The SAT has noted that, because it is difficult to draw a clear line between the provision of services and the transfer of intangible assets or licensing of technologies, multinational corporations tend to provide technical assistance services in tandem with the transfer or licensing of technologies, resulting in lower taxes.

While the SAT has developed principles and testing methodologies for management-related service fees, the Chinese tax authorities are still seeking guidance from international organizations such as the United Nations and the Organization for Economic Co-operation and Development in respect of technical services arrangements.

7.3 Contract R&D arrangements

Many MNC groups have established R&D centers in China owing to the abundance of quality professionals and the relatively low costs associated with employing such people. Typically, the Chinese affiliate is characterized as a contract R&D service provider bearing limited risks and remunerated on a cost plus basis.

While it is generally recognized in the international community that the entity which is ultimately responsible for the R&D activities would be considered the economic owner and would be entitled to the IP-related returns, Chinese tax authorities are increasingly focusing on the true nature of the Chinese entity and the substance of the overseas principal to challenge the Chinese entity's low risk characterization.

Many Chinese entities performing contract R&D services are claiming "high and new technology status" in order to benefit from the reduced tax rate. The Chinese tax authorities are of the general view that companies claiming such status should be performing activities that result in the creation of IP which they can claim economic or legal ownership of, and a cost plus approach to remunerate these companies is generally considered inadequate.[31]

Furthermore, the Chinese tax authorities expect consistency between the functional and risk profiles of a company. In cases where the principal entity that is claimed to be responsible for the R&D activities has neither the technical expertise nor the financial capacity to be responsible, the Chinese tax authorities are likely to challenge the characterization of the Chinese affiliate as a limited risk R&D service provider. In addition, the Chinese authorities may seek to attribute part or the whole of the economic ownership of the IP, and the associated economic benefits, to the Chinese affiliate.

In addition, Chinese tax authorities are particularly sensitive to R&D round tripping: The Chinese R&D center will first perform R&D activities on behalf of the foreign principal that will lead to the creation of IP, which the foreign principal will claim legal and economic ownership of; then, the overseas principal will license the IP to a Chinese manufacturer or distributor in the MNC group, for which the Chinese manufacturer or distributor will pay a license fee. In some cases, the IP developed will be licensed to the entity that performs the R&D activities. Such round tripping, especially the latter case, coupled with a high royalty rate, is often viewed as an artificial arrangement with the view to minimize the level of profits in China.

31. Such comments were also detailed in the Chinese Practice chapter in the U.N. Transfer Pricing Manual.

7.4 Cost sharing agreements

7.4.1 An overview

A cost sharing agreement (or cost contribution arrangement) is defined as a framework agreed among related enterprises to share the costs and risks of developing, producing or obtaining intangible assets and services. The agreement will also determine the nature and extent of the interests of each participant in those assets or services. Specifically, participants to a cost sharing agreement shall be entitled to the benefits derived from the activities of developing and assigning intangible assets or service activities, and shall bear the costs associated with such activities.

The basis of a CSA is that each party to the agreement contributes to the costs of development of the intangible or provision of the services and is able to benefit from it through exploitation of the intangible or use of the service. One or more parties may register the intangible (i.e., the legal ownership), while economic ownership will be split between all contributors. The contribution should be in proportion to the expected benefits received.

CSAs have many potential benefits in that they:

a. Can be an effective means of raising the necessary funding for a particularly initiative where it may not be otherwise available in one group company
b. Avoid the need to pay royalties for accessing the intangible at a later stage
c. Enable the risk of R&D activity with an uncertain outcome to be spread
d. May assist in satisfying requirements for tax incentives for high technology activities in certain jurisdictions.

7.4.2 CSAs in China

In 2004, the SAT recognized CSAs when it released a private tax ruling providing that under certain conditions, not only are outbound research and development cost sharing payments tax deductible for FIEs, but the payments will also not be subject to withholding tax.

Article 41 of the CIT law formally introduces the concept of CSAs as follows - costs associated with the joint development or transfer of intangible assets or with the provision or receipt of labour services shall be allocated based on the arm's length principle when computing taxable income. Chapter 7 of the Chinese Transfer Pricing Regulations provides further details on CSAs.

In terms of CSAs, the focus is clearly on the R&D activities that are undertaken for the development of intangible assets. However, the regulations do allow for service-related CSAs in respect of group procurement or group marketing planning.[32]

Some significant factors from Chapter 7 of the China Transfer Pricing Regulations are as follows:

- The CSA must be submitted to the SAT within 30 days of completion of the agreement
- Compensating adjustments can be made to the extent that there is a mismatch between the cost shared and benefits received
- An APA can be requested to cover a CSA
- During the term of the CSA, contemporaneous documentation relating to the CSA must be provided to the SAT by June 20 of the following year.

7.4.2.1 Contents of a CSA

The main contents of a CSA include the following:

- The name of participants, their country (region) of residence, related party relationships, and the rights and obligations under the agreement.
- Content and scope of intangible assets or services covered by the cost sharing agreements; the specific participants performing R&D activities or service activities under the agreement, and their respective responsibilities and tasks
- Term of the agreement
- Calculation methods and assumptions relating to the anticipated benefits to the participants
- The amount, forms of payment and valuation method of initial and subsequent cost contribution by the participants, and explanation of conforming with the arm's length principle
- Description of accounting methods adopted by participants and any changes
- Requirements on the conditions and treatment of amendments to or termination of the agreement
- Requirements on the use of the results of the agreement by non-participants.

32. Article 67 of the China Transfer Pricing Guidelines

7.4.2.2 Ongoing compliance obligations

During the term of the agreement, the following documents should be prepared and maintained.

- Copy of the cost sharing agreement
- Other agreements among participants for the implementation of the cost sharing agreement
- Use of the results of the agreement by the non-participants, the amount of payment, and the form of payment
- Changes to the participants under the cost sharing agreement in the year, including the names of new participants or the participants who have withdrawn from the agreement, their country (region) of residence, related party relationships and the amount and form of the buy-in and buy-out payment.
- Descriptions of amendments to or termination of the CSA, including the reasons for amendments or termination and the treatment or allocation of existing results from the agreement.
- Total cost incurred under the CSA during the year and the cost structure
- Cost allocation among participants during the year, including the amount of cost paid, form of payment, recipient of the payment, and the amount, form and participant's compensations paid or received
- Comparison of actual benefits in the year against the anticipated benefits under the agreement and the adjustments made accordingly.

7.5 Concluding remarks

Transfer pricing analysis of intangibles is an issue that the SAT is increasingly grappling with. The SAT is increasingly reviewing the functional risk analysis associated with enterprises that are potentially dealing with intangibles, manufacturers that are paying a royalty, or contract R&D service providers. Additional comments on how the SAT approaches intangibles are detailed in Chapter 13.

Keeping this in mind and given the SAT's growing sophistication on issues related to intangibles, we recommend that Chinese enterprises ensure that their transfer pricing arrangements with respect to intangible property is sound.

PROFESSIONAL SERVICES

For more information on how intangible assets function in China, please visit www.dezshira.com or contact one of our professionals at china@dezshira.com

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- Recent developments on thin capitalization and intercompany financing
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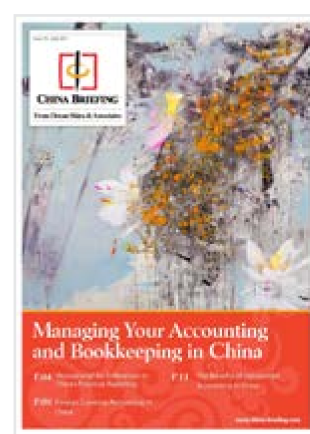

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Although the Chinese Transfer Pricing Regulations do mention intercompany financing (e.g., intercompany loans, guarantees),[33] little guidance has been provided on how such structures should be evaluated and supported from a transfer pricing perspective. Much of the guidance in the Chinese Transfer pricing Regulations has been on thin capitalization and its application to intercompany financing.

8.1 Introduction

The SAT has been aware of the issue of thin capitalization in the PRC for some time and introduced measures to address this in the 2007 CIT Law.

The CIT Law stipulates that when the ratio of debt to equity investment that an enterprise receives from its related parties exceeds a specified ratio, the portion of interest expense connected with that debt paid to related parties would be considered non-deductible for tax purposes (also referred to as the "formula-based" approach). Debt investments as cited in Article 46 of the CIT Law refer to financing that an enterprise has directly or indirectly acquired from related parties, and the enterprise is required to repay the principal and make interest payment or financing that requires other compensation of an interest payment nature.

Debt investments indirectly acquired from related parties by an enterprise include:

- Debt investments made by related parties but through unrelated parties
- Debt investments made by unrelated third parties, with related parties providing guarantees and assuming joint and several liability
- Other debt investments having the nature of liabilities indirectly acquired from related parties
- Equity investments as cited in Article 46 of the CIT Law refer to investments which an enterprise received without being required to repay the principal and make interest payments, while investors have the proprietary rights of the net assets of the enterprise.
- The provision of the CIT Law regarding thin capitalization raises plenty of questions which will need to be considered by multinational corporations. These include:
- Whether to rely on the formula-based approach or the arm's length approach for the purposes of determining the specified ratio to assess the deductibility and non-deductibility of the related party interest expense?
- Can the test be applied on an year-on-year basis on the same loan given that the formula approach is based on the debt and equity amount as reflected in the balance sheet?
- Can the test be applied on a loan-on-loan basis, and what would the treatment be if there are several related party loans – which can be achieved on a combination of formula and arm's length basis with appropriate structuring of the loan arrangements?
- Are intercompany trade payables which attract interest considered debt investments for the purposes of determining the thin capitalization position of a multinational entity?

33. Article 10 (3) of the Chinese Transfer Pricing Regulations

8.1.1 Key definitions

Key definitions as they would apply to thin capitalization are:

1. Debt-to-equity ratio = the sum of monthly average debt financing acquired from related parties in a year / the sum of monthly average equity financing.

Whereas:

- Monthly average debt financing acquired from related parties = (Monthly opening balance of debt financing acquired from related parties + Monthly closing balance) / 2
- Monthly average equity financing acquired from related parties [including domestic funding] = (Monthly opening balance of equity financing + Monthly closing balance) / 2
- Equity financing is the accounting amount of equity recorded in the Balance Sheet. If equity is less than the sum of paid-up capital and capital reserve, then equity financing equals to the sum of paid-up capital and capital reserve. Meanwhile, if the sum of paid-up capital and capital reserve is less than the equity, then equity financing is equal to equity
- Interest expense, as cited in Article 46 of the CIT Law, includes interest, guarantee fee, mortgage fee and other expenses that share the nature of an interest payment which is directly or indirectly incurred for debt financing from related parties.

On September 19, 2008, the Ministry of Finance and SAT jointly published a circular, Caishui [2008] No. 121 setting out the prescribed debt / equity ratio and other relevant rules. The circular specifies the debt : equity ratio of 2:1 for non-financial entities and 5:1 for financial institutions.

8.2 Alternative approach: the arm's length debt test

As an alternative to the formula based approach, taxpayers may elect to use the arm's length debt approach to the extent that its related party interest expense exceeds the specified ratio. To rely on this alternative test, however, will require contemporaneous documentation demonstrating that a set of relevant factors (such as amount of loan, interest rate, terms and financing terms) support the fact that the loan amount falls within the arm's length principle. The regulations do not provide any examples of how a taxpayer can apply these factors to finally arrive at a result that meets the arm's length principle.

For taxpayers wishing to seek the application of this alternative test, guidance can be obtained from other OECD countries which have established guidelines and rulings on this topic. An approach that is commonly used is to make reference to methodology applied by independent credit rating agencies and independent loan transactions in the market place to determine what an arm's length debt to equity funding ratio should be. This method on its own presents a different set of problems – in particular whether the arm's length ratio should be a reflection of what an independent borrower is able to borrow (from a borrower's perspective) or whether an independent investor would likely invest in the business (from a lender's perspective).

8.3 Recent developments on thin capitalization and intercompany financing

8.3.1 Announcement No. 34

SAT Announcement No. 34, issued on 9 June 2011 with effect from 1 July 2011, provides that, in order to obtain deductibility of interest expenses incurred in related party loans, enterprises are required to document that interest payments for loans to non-financial borrowers are 'reasonable', including standard interest rates for similar loans by financial institutions within the same province. Specifically, the taxpayer is required to provide a Statement on the Interest Rate Applicable to Loans of the Same Period and Category Made by Financial Institutions ("Statement on Interest Rate") to the tax authority in charge when it pays the interest on inter-company loan. This is in accordance with the contract and claims deduction of the interest expenses for CIT purposes to provide the reasonableness of its interest expenses incurred.

It should be noted that the interest rate for the same period and category of loan refers to the interest rate applicable to the loans made by the financial institutions under basically the same conditions in respect of terms, amount, guarantee, credit worthiness, etc. In addition, the rules in Announcement 34 are complementary to the thin capitalization rules in the CIT Law in respect of the deductible interest expenses for CIT purposes.

The notice also addresses several other issues, including the implications of an investing enterprise's reduction or withdrawal of its investment.

8.3.2 Entrusted loans

According to the General Provisions on Lending, intercompany loans are prohibited in China, even if the lender and borrower are within the same group. From the group's perspective, this rule blocks sufficient utilization of internal cash and increases the financing cost as the borrower has to pay a high interest rate to the banks while the abundant cash of the sister company may be deposited in banks to earn less interest.

A common workaround that is used in China is to establish an entrusted loan. According to the Notice on Relevant Issues Regarding the Entrusted Loan Business by Commercial Banks, commercial banks are allowed to engage in the entrusted loan services. The entrusted loan is a form of agency service provided by commercial banks under which the capital is provided by the trustor (i.e., lender) and extended to the borrower in a specified amount and at a specified interest rate. This is instructed by the trustor through the trustee bank, which would recover the principal with the interest on behalf of the trustor. The trustee bank charges only a service commission. It should be noted that the Group may still incur costs such as commission charges and legal fees relating to the transaction documents.

In early January 2015, China's banking regulators issued draft rules to tighten supervision of entrusted loans due to excessive margin finance made by certain brokerages.

8.3.3 *Intercompany loans provided by Chinese enterprises*

The PBOC Circular No. 168, issued in July 2013, was a significant step towards liberalizing the RMB market. Its focus was to enable onshore corporates to lend RMB denominated loans to their offshore affiliates without the explicit approval of the People's Bank of China ("PBOC"). Banks in China can process transactions based on careful examination of the documents. The loans must follow three principles:

- Know your customer (KYC)
- Know your business (KYB)
- Proper due diligence

A key requirement of the PBOC scheme is to ensure that the interest rate that is charged is consistent with the arm's length principle. Although the PBOC circular notes that there are no restrictions on the source of funds, different PBOC authorities may apply different guidelines. For example, PBOC Shanghai does not allow onshore local corporates to borrow from onshore banks in order to make loans to related parties.

8.3.4 *State Administration for Foreign Exchange ("SAFE")*

SAFE recently introduced a program for foreign invested enterprises to provide foreign currency denominated loans to related party borrowers (defined as offshore companies that have an equity relationship with the lender)[34] Such loans have to be registered with SAFE and local SAFE approval is required when the quota has been exceeded.

Under the SAFE scheme, loans could only be granted for a maximum of two years. However, this requirement was removed this year.

Similar to the PBOC scheme, as always in China, practices will differ per city (and even per district). Banks may also be required to maintain their own policies on the conditions for approval. With respect to foreign exchange loans as well, intercompany loans are required to meet the arm's length standard. The FIE needs to pay US$25 CIT and business tax on the interest income, though the offshore borrower may offset the CIT paid by the lender if the applicable DTA provides for this.

34. Prior to 2014, the borrower was limited to the FIE's offshore parent.

8.4 Growth of China as a treasury hub

From a finance and treasury management perspective, China is heavily regulated. Control over interest rates by the central bank, the People's Bank of China, and strict restrictions governing intercompany lending are major challenges for companies to practice an optimized liquidity structure in China. However, as noted above, the Chinese government is attempting to relax some of these regulations.

Furthermore, the establishment of the Shanghai Free Trade Zone ("FTZ") provides a useful avenue for multinational corporations located in the FTZ to set up a two-way RMB cash pooling system. Multinational corporations who are interested in establishing a finance and treasury hub in China need to evaluate the tax, transfer pricing and regulatory issues before proceeding. It is likely that the Chinese tax authorities may not be as familiar with complicated intercompany structures involving intercompany financing.

In addition, further guidance is still needed on the application of thin capitalization rules and definitions. However, tax authorities are becoming increasingly concerned about any decisions regarding the funding of related party investment into China.

Transfer Pricing Audits and Enforcement in China

- Overview
- Audit target
- Transfer pricing audit process
- Using the expert panel to resolve transfer pricing audits
- Penalties and interest
- Mutual agreement procedures
- Audit trends
- Tips for managing a transfer price audit

9.1 Overview

Transfer pricing audits have existed in China for some time, although their intensity and scale has markedly increased over the last five years. The first transfer pricing audit took place in 1986.

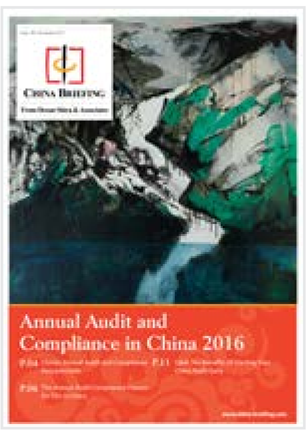
Most of the audits conducted to date have focused on tangible good transactions, in particular those relating to contract manufacturing. However, recently there have been more high profile audits involving intangibles and this trend will continue as the SAT recognizes the significance of intangibles in the value chain of any MNC. This has exposed royalty payments to a very high level of scrutiny and, in line with developments at the OECD, transfer of intangibles and business restructuring are beginning to come under scrutiny.

The figure below details the transfer pricing investigations conducted by tax authorities in recent years.[35]

Year	Approximate total adjustment arising from an audit (RMB millions)
2006	458
2007	680
2008	1,000
2009	1,240
2010	2,089
2011	2,581
2012	2,500
2013	4,600

In cases where MNCs have not prepared transfer pricing documentation, and even in some cases where MNCs have, there is a risk that the tax authorities will select the company for audit. This chapter considers the transfer pricing investigation and audit environment in China and provides practical guidance to help MNCs prepare for and navigate through this process.

35. It should be noted that official statistics on an annual basis, and the table below has been obtained from a presentation made by Zhang Ying of the State Administration of Taxation of People's Republic of China in 2012. The information for 2012 - 2013 has been collated from various representations made by the SAT at public forums.



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9.2 Audit target

The SAT has provided a very transparent list of audit targets to the local tax authorities, which has been evolving over the last few years.[36] Local tax bureaus have been instructed to select the following key targets for transfer pricing investigation and audit.

- Enterprises which have a significant amount of, or various types of, related party transactions
- Enterprises which have been in long-term consecutive losses, low profitability, or fluctuating profit-and-loss situations
- Enterprises whose profit levels are lower than those in the same industry
- Enterprises showing an obvious mismatch between their profit levels and their functional and risk profile
- Enterprises which have business dealings with related parties in tax havens
- Enterprises which have not complied with the reporting of their related party transactions or preparation of contemporaneous documentation
- Enterprises obviously violating the arm's length principle

The final category appears to be a catch-all provision to pick up any other transactions that are not caught within the specific criteria above.

The Chinese Transfer Pricing Regulations explicitly notes that no transfer pricing investigation and adjustment will be conducted on transactions between domestic related parties with the same effective tax burden, as long as such transactions do not directly or indirectly result in the reduction of total tax revenues of the country.[37] Such a safe harbor is consistent with the transfer pricing audit provisions established by other tax authorities that recognize the compliance burden involved in preparing for and defending their related party transactions.

36. Article 29 of the Chinese Transfer Pricing Regulations
37. Article 30 of the Chinese Transfer Pricing Regulations

9.3 Transfer pricing audit process

9.3.1 Commencement of the audit

Once an entity has been selected for transfer pricing audit, the tax authorities are entitled to request any information (in writing) relevant to the pricing of related party transactions. This may include:

- The enterprise's foundation approval documents, including Articles of Association, business and tax registration certificates, investment and operational contracts, feasibility studies, annual financial statements, internal audit reports, account books and vouchers, commercial contracts and other relevant documents
- Financial information, including profits/losses on sale of assets, rates of return on investments, sales revenues, cost of sales and operating expenses, interest rates, and prices paid for the acquisition or use of tangible and intangible property

Once this information has been reviewed, the tax officer will then determine whether there is a need for further scrutiny through a more detailed field audit. Transfer pricing audit fieldwork is carried out by the county or municipal level tax bureau, but all transfer pricing audit settlement determinations must be approved by the SAT.

The China Transfer Pricing Regulations specify the following rules and process for tax authorities in carrying out a field audit:

1. A field investigation team must compromise at least two persons.
2. Field investigators shall produce a "Tax Inspection Permit" and issue a "Tax Inspection Notice" when conducting field investigations.
3. In accordance with relevant legal proceedings, field investigators may raise inquiries, request accounting records, and conduct on-site verifications.
4. Field investigators raising inquiries shall prepare a "Record of Inquiries (Investigation)", and inform the enterprises under investigation of their legal obligations if they fail to truthfully provide the information required. The Record of Inquiries (Investigation) shall be verified and confirmed with the enterprises under investigation.
5. Field investigators requesting accounting records shall, in accordance with Article 86 of the Tax Collection Regulations, prepare a " Notice for Requesting Accounting Records" and a "List of Requested Accounting Records," and follow the relevant legal proceedings. The requested information including book of accounts and vouchers should be kept properly and returned to the enterprises within the legal time frame.
6. Issues identified and information obtained during field investigation shall be described in the "Record of Inquiries (Investigation)" by investigators. The "Record of Inquiries (Investigation)" shall be signed by at least two investigators and verified and confirmed with the enterprise under investigation where necessary, or if the enterprise under investigation where necessary, or if the enterprise under investigation refuses to verity and confirm, the "Investigation Record" can be signed and filed for record by at least two investigators.
7. Notes, tape recordings, videos, photographs and copies of original documents or information can be taken when requesting relevant information associated with the case. However, sources and original record keepers must be quoted. The notes, tape recordings, videos, photographs and copies obtained shall be sealed or stamped, and labeled with "checked against original documents" by the original record keepers or providers.
8. Witnesses, if needed, shall be informed of their legal obligations if they do not truthfully provide the information requested. Testimony and information provided shall be signed or sealed by the witnesses.

In addition, tax authorities are able to request relevant information from the enterprise under investigation, its related parties, and other enterprises relevant to the investigation of related party dealings. In such cases it will issue a "Tax Investigation Notice." This means that, besides the party under investigation, any company considered comparable is required to provide any information requested by tax authorities. It is assumed that in such cases that this information will not be used by tax authorities to also investigate the "comparable" party. In the event that information on overseas entities and transactions is required, the tax authorities may request this through the exchange of information provisions in the respective tax treaties, which need to be notarized by the taxpayer.

During the audit, the tax authorities may request the taxpayer to complete the "Form of Enterprises Comparability Factor Analysis", while the tax authorities will complete the "Related Party Relationships Assessment Form", the "Related Party Transactions Assessment Form" and "Enterprise's Comparability Factor Analysis Assessment Form."

9.3.2 Concluding the audit

- The China Transfer Pricing Regulations outline a very clear process for completion of the audit and proposing the adjustment. Although written from the perspective of the tax authority, these Regulations should provide clear indication of the appropriate protocols to be followed by the tax authority and enable better preparation from the taxpayer.
- Prepare a preliminary special tax investigation adjustment proposal based on simulations, evaluations and comparability analysis.
- Negotiate with the enterprise under investigation based on the preliminary special tax investigation adjustment proposal. Both the tax authorities and the enterprise shall designate a principal negotiator. Investigators shall keep a "Record of Negotiation Content," which shall be signed and confirmed by the principal negotiator from each party. If the enterprise refuses to sign on the record, it can be signed and filed for record by at least two investigators.
- If the enterprise disagrees within the preliminary special tax investigation adjustment proposal, it shall provide further information within the time period specified by tax authorities. Tax authorities shall carefully review the additional information provided and make assessment determination in a timely manner.
- Tax authorities shall issue a "Preliminary Special Tax Investigation Adjustment Notice" to the enterprise based on the assessment determination. The enterprise shall respond in writing within seven days upon receiving the notice if it disagrees with the preliminary adjustment, or it will be deemed to have agreed to the preliminary adjustment notice. Upon receipt of the enterprise's response in disagreement with the notice, tax authorities shall further assess the case and negotiate with the enterprise.
- Tax authorities shall make conclusion on the final adjustment, and issue a "Special Tax Investigation Adjustment Notice" to the enterprise.

9.3.3 The income adjustment

Once the audit is completed, if the tax authority concluded that an adjustment is required it can deem an enterprise's taxable income in accordance with Article 44 of the EIT Law, based on one of the following methods:

- By reference to the profit margin of the same or similar type of enterprises
- Based on the enterprise's cost plus reasonable expenditures and profit
- By reasonable proportion of the consolidates profit of the related party group
- Through other reasonable methods

If considered appropriate, an adjustment to the profitability will be made based on an arm's length range of results from comparable companies. Typically in transfer pricing adjustments, the interquartile range of results (from 25th to 75th percentile) is applied given no comparable is ever going to be perfect. However, taxpayers should be aware that the interquartile range is a new concept in China transfer pricing. The China Transfer Pricing Regulations indicate that if the profitability of the tested party falls below the median, tax authorities shall adjust in principle to the median of the interquartile range of comparable results. If making the adjustments to bring the results of controlled transaction to fall within the arm's length range would reduce the tax liability of China, such downward adjustments are not allowed.

It is unknown how rigorously this standard will be enforced, particularly as there are genuine and valid economic reasons why profitability can and should fall below the median of a sample. If there are valid and defendable reasons for targeting a point such as the lower quartile of the range, these should be thoroughly documented in the transfer pricing report and vigorously defended by the taxpayer.

9.3.4 Appeals procedures

The key overriding point is that it is always recommended to resolve any transfer pricing (or tax) dispute through negotiation whenever possible.

However, if this fails, an appeal can be made to the tax authorities with additional supporting documentation within 60 days for an administrative appeal. A decision on the appeal must be made within 60 days. The tax authorities may re-evaluate their adjustments and consult further with the taxpayer and advisers if deemed necessary.

After reviewing the additional information and submissions by the taxpayer, the tax authorities will issue a notice of their audit decision, at which point in time the outcome is generally regarded as being final.

If the taxpayer is still not satisfied with the decision, it is possible to start legal proceedings in the People's Court within 15 days of receiving the decision. However, before commencing the appeal process, the taxpayer is obliged to pay the assessed tax, penalty and interest. When contemplating taking this final step, the taxpayer should consider carefully the potential damage to the relationship with the tax authority, the realistic chances of success, the broader reputation of the firm as well as the cost of litigation.

9.4 Using the expert panel to resolve transfer pricing audits

Pursuant to internal procedures announced in 2012, the SAT has established an expert panel mechanism to provide professional opinions on transfer pricing audit cases where:

- The registered capital of the entity under review exceeds a certain threshold or the entity has an annual average operating revenue above a certain threshold; or
- There is an industry-wide or nationwide investigation; or
- The Chinese tax authority considers the case to be significant.

Some tax authorities at provincial and municipal levels, such as in Guangdong province, have established expert teams to review and assess the technical merits and adjustment scenarios of transfer pricing audit cases. It should be noted that since this creates one more body to review the methodology, audits going through Expert Panel Review have the potential to proceed more slowly.

The expert panel at the SAT-level aims to standardize the transfer pricing investigation procedures across all levels of the Chinese tax authority. Feedback provided to the audit working team after the expert panel review is intended to improve the quality of analyses and materials supporting the transfer pricing adjustments. It is also worth noting that the Expert Panel Review result (for example profit range and adjustment method) of an industry-wide transfer pricing audit may be viewed as a precedent case for future audits in the same industry.

It should be noted that the Expert Panel Review is not an appeals process. Rather, the Expert Panel Review provides an independent review and a second opinion after an in-depth technical re-examination of the issues under audit.

9.5 Penalties and interest

Section 5.3 of this book provides an overview of the various penalties / interest levies and fines that may be applied on the taxpayer during the transfer pricing audit.

Specifically, it should be noted that if the MNC does not adjust its accounts to reflect a receivable from the other related party for the excess price charged, the amount of the adjustment will also be treated as a deemed dividend which, if the other party is a foreign enterprise, will be subject to dividend withholding tax. Also, if the excess income received by the foreign affiliate is interest or royalty income, then there will be no recovery of the interest or royalty withholding tax already paid.

9.6 Mutual agreement procedures

Chapter 11 of the China Transfer Pricing Regulations is devoted to corresponding adjustments and international consultation through the mutual agreement procedure ("MAP") in the double tax agreements, which is a clear indication that the SAT appreciates the importance of this in any transfer pricing adjustment.

A regulatory framework for MAP was initially set out by the SAT in Guo Shui Fa (2005) No 115, which lists the situations in which a Chinese taxpayer may apply for MAP and provides a list of the information required for the MAP application.

SAT Announcement [2013] No.56, Implementation Measures for the Mutual Agreement Procedure of the Tax Treaty was announced in 2013 and superseded Guo Shui Fa [2005] No. 115. The objective of this announcement was to apply tax treaties precisely, avoid double taxation and resolve international tax disputes, as well as protect the legitimate rights of Chinese tax residents / nationals.

As per the announcement, the MAP refers to the process that the Chinese tax authority communicates with the competent authority of the other contracting state, for the purpose of reaching an agreement on the interpretation and application of the tax treaty, in accordance with relevant articles in the tax treaty.

Although Announcement No. 56 has wider applications, it can particularly be initiated by either the Chinese tax residents / nationals, the competent authority of the contracting state, or the SAT. This is as a result of situations that may lead to double taxation between different tax jurisdictions, which will particularly apply to transfer pricing adjustments.

With respect to transfer pricing, the Chinese taxpayers shall submit written application for a corresponding transfer pricing adjustment within three years starting from the day the enterprise or its related party receives the transfer pricing adjustment notice. Applications submitted after this three-year time limit shall not be accepted by tax authorities.

Key observations from Announcement No. 56 include:

- The initiation of the MAP is irrespective of remedies provided by the domestic law. However, the applicant shall adopt corresponding measures to protect his/her rights to a remedy in the other contracting state.
- Where the MAP has been initiated, the applicant can inquire about the progress of a MAP. Meanwhile, the applicant should provide tax authorities with authentic, complete and accurate documents/information on a timely basis.
- In a MAP process, the applicant can either withdraw his/her MAP application or reject MAP results. However, the applicant is not allowed to lodge a MAP application for the same or similar case again.

9.7 Audit trends

9.7.1 *Single Manufacturing Function*

In 2007, the SAT issued the Guoshuihan [2007] No. 236 ("Circular 236") which called for tax officials to investigate loss making FIEs with "single manufacturing functions". This was a clear indication of low tolerance towards contract manufacturers and toll processors in China, which may be experiencing loss. Given the large proportion of manufacturers reporting losses despite having a limited function and risk profile, the SAT has identified such companies as specific audit targets. Entities with the following characteristics are being and will continue to be targeted:

- Sole function of manufacturing based on the overall business plans and production orders of overseas parent companies
- Overseas parent companies or other affiliates are wholly responsible for operating policy, product R&D and sales
- Do not bear the associated risks and losses arising from ineffective policies, under utilisation of production capacity and slow market demand

The focus on manufacturing functionality is a recurring theme among tax auditors in china.

9.7.2 *Industry focus*

Transfer pricing audits in China typically have an industry focus. SAT officials receive very detailed training from a variety of industry and transfer pricing specialists at intensive week-long training sessions in order to ensure they are equipped to undertake complex and rigorous audits of certain industries.

Emanating from these training sessions, SAT officials have also initiated industry-wide audits on companies operating in specific industries. More recently, attention has been given to companies operating in the automotive, pharmaceutical and retail chain segments.

In recent years, the SAT has adopted a national audit approach, whereby the authorities seek to audit MNCs with a number of subsidiaries with operations across different provinces in China. Such national audits concentrate on both cross border transactions and intra-China related party transactions.

In the future, transfer pricing audits will become more rigorous as the Chinese tax authorities have been strengthening their administrative ability in tax collection. This has been achieved by using a greater degree of computerization in tax administration, the establishment of a rigorous tax inspection system, and formalized tax legislation procedures for dealing with transfer pricing manipulation. As the volume of MNCs doing business in China continues to grow, and the Chinese government continues to draw on the experience of developed economies in enforcing its own transfer pricing rules, it can be anticipated that the tax authorities in China will intensify their investigations of related party transactions over time to prevent the loss of future income.

9.7.3 Focus on services and royalties

In general, scrutiny on service fees and royalties has been on the rise in China.

In July 2014, the SAT released an internal notification (Circular 146) to urge tax authorities at all levels to carry out extensive tax investigations on substantial amounts of service fees and royalties made to overseas related parties during the previous 10 years (2004 – 2013) which fall under the Chinese statute of limitations. Previously, services were generally considered targets for investigative scrutiny when:

- the nominal amount comprised a significant portion of the Chinese taxpayer's business; or
- there were multiple service charges to or from related parties; and/or
- the associated transfer pricing policy (e.g., mark-up) was considered unreasonable.

Circular 146 now invites the examination of intercompany services, which will inevitably broaden the scope of investigation for all levels of tax authorities to capitalize on this opportunity for potential tax revenue.

9.7.4 Provision for self-initiated adjustments

In August 2014, SAT released the Announcement on Issues Relating to Monitoring and Management of Special Taxation Adjustment (Announcement No.54) to further standardize and clarify the risk identification procedures carried out by tax authorities for special taxation adjustment, as well as the legal rights and obligations of taxpayers for this matter, including the option of self-adjustment.

Key observations include:

- Tax authority shall identify tax risk based on the transfer pricing filing and documentation of taxpayer, and inform the taxpayer of the possibility of an enhanced transfer pricing / tax risk;
- Once being informed of such risk, the taxpayer can choose to subject itself to self-adjustment and pay the additional tax liability, or request the tax authority to provide a formal opinion on the matter of special taxation adjustment. In the latter case, this will launch the formal investigation procedure by the tax authority.
- Even if the taxpayer has initiated a self-adjustment, the tax authority reserves the right to launch a formal investigation and assess additional tax, in the event that the adjusted profit levels still fall short of what is being dictated by arm's length principles.
- Although interest and the 5 percent penalty are technically chargeable on top of the tax adjustment, they may be waived if the taxpayer chooses to perform self-adjustment, and duly provide any relevant document requested by

9.8 Tips for managing a transfer price audit

The following are some practical tips in the event that is necessary to prepare for and negotiate an audit:

- Prepare documentation well in advance to maximize the chances of avoiding an audit and to be fully prepared in case one does occur.
- Based on the planning, design and documentation, ensure that a proper transfer pricing system is designed and implemented – one that is supported by the legal agreements, invoices and financial statements
- Maintain a professional and co-operative relationship with the tax auditors from the outset
- Identify the team with responsibility for handling the transfer pricing audit, and be clear over the respective roles and responsibilities
- Keep a detailed record of the information requested by the tax authorities and ensure the tax authorities do the same
- Be aware that the auditors will almost certainly want to interview key staff members, in order to verity to some extent the functional analysis information presented to them by the transfer pricing documentation; select the most appropriate staff members and brief them thoroughly in advance
- Ensure a member of the tax/finance team is present at all interviews and if appropriate an external advisor as well(and keep a detailed record of all discussions)
- Inform and involve the head office where appropriate, they may have gone through the process in other countries and understand the arguments and best way to respond
- Consider working with external transfer pricing specialists to ensure that risk areas are identified as early as possible, so that technical arguments and additional documentation and economic analysis can be prepared in advance
- Understand the situation from the perspective of the tax authority; they will have dealings and possible revenue targets to meet: understanding this enables the negotiating strategy to be optimized
- Identify possible outcomes of the audit to understand the financial impact; this will be a powerful tool in any settlement negotiation
- Investigate the possibility of seeking corresponding adjustments under the MAP procedures
- Bear in mind the possibility if an APA application (discussed in Chapter 11) to encourage the auditors to close off the prior year audit and move forward on a collaborative basis
- Think very seriously before proceeding to appeal or litigate

Advance Pricing Agreements (“APA”s)

- Introduction
- Categorization of APAs
- Administrative guidance on APAs
- Key APA Statistics
- In summary

10.1 Introduction

An APA is an arrangement between tax authorities and taxpayers that can determine the pricing of related party transactions for a number of years in the future. The APA is a proactive instrument that can be used by taxpayers to reduce transfer pricing risks and possible adjustments imposed by tax authorities. Through an APA, taxpayers can obtain certainty from tax authorities that their transfer pricing policies and procedures meet the arm's length standard.

The availability of APAs in China was first announced in 1998 by Circular 59 "Tax Administration Rules and Procedures for Transactions between Related Parties."[38] It was short on detail and had limited application. The SAT corrected these deficiencies by introducing its policy on APAs in 2004 in Guo Shui Fa [2004] No. 118 "Implementation Rules for Advance Pricing Arrangements for Transactions between Related Parties". This document gave detailed regulations on the application, evaluation, consultation, signing and even follow-up on the advance pricing of transactions involving associated enterprises.

In 2002, the APA program was formally introduced in Article 53 of "The Implementation Rules of the Tax Collection and Administration Law of the People's Republic of China" (Guo Wu Yuan Ling No. 362), and APAs were elevated from an adjustment method to a program.

In 2004, the SAT promulgated "Implementation Rules on Advance Pricing Arrangements for Transactions between Related Parties (Trial Version)" (Guo Shui Fa(2004) No. 118), which provided details of the APA program and specific procedures such as negotiation and conclusion procedures, requirements, follow-up execution and monitoring, as well as guidance on APA administration in China. Such a step further regulated the administration of China's APA program. From 1998 to 2004, a number of local Chinese tax authorities initiated trial programs and concluded unilateral APAs with enterprises.

Subsequently, Chapter 6 of the Chinese Transfer Pricing Regulations provided for greater standardization of the APA procedures and aimed to ensure that tax authority resources are only devoted to APAs when there is an economic benefit to China to justify the effort and resources required to negotiate an APA.

"APAs offer a number of advantages. They provide certainty in terms of the tax payable by companies; lower the risk of being investigated; and help avoid double taxation."

Jenny Liao
Manager
Corporate Accounting Services
Dezan Shira & Associates
Shanghai Office

38. It should be noted that the first APA was reached between the tax authority and taxpayer in 1998.

10.2 Categorization of APAs

The Chinese Transfer Pricing Regulations allow for taxpayers to negotiate unilateral, bilateral or multilateral APAs.

An APA may be categorized as unilateral, bilateral or multilateral based on the number of competent authorities involved in the APA.

In an unilateral APA, the enterprise enters into the APA with one country's tax authority. A unilateral APA can only provide certainty to the enterprise's pricing policy and method with respect to its related party transactions within one country, but cannot ensure that the overseas related party(ies) will effectively avoid transfer pricing audits or adjustments with respect to its transfer pricing with the enterprise by the tax authority of the related party. Thus, an unilateral APA cannot prevent international double taxation.

In a bilateral or multilateral APA, the enterprise negotiates and enters into the APA with two or more countries' competent authorities. These authorities will need to reach an agreement with regard to the pricing policies or methods used in the cross-border related party transactions of the enterprise in question. Bilateral and multilateral APAs can be used to effectively avoid international double taxation and provide certainty regarding the transfer pricing policies of the enterprise. Bilateral or multilateral APAs are concluded with competent authorities of foreign jurisdictions in accordance with the mutual agreement procedures in the relevant tax treaties. Therefore, the existence of tax treaties is a pre-requisite for the negotiation and conclusion of the bilateral APA[39].

39. China has entered into nearly 100 Double Tax Agreements (DTA) with other nations.

10.3 Administrative guidance on APAs

This section provides readers with an overview of the administrative guidance that has been provided in the Chinese transfer pricing guidelines.

10.3.1 Eligibility of the APA

The China transfer pricing regulations indicate that the following criteria should be satisfied in order for a taxpayer to be eligible for an APA:

1. Annual related party transactions over RMB 40 million;
2. Compliance with the related party disclosure requirements – refer to Section 5.1.3 for these requirements; and
3. Prepare, maintain and provide contemporaneous documentation in accordance with the requirements – refer to Section 5.2 for these requirements

In order to use its limited resources more effectively and enhance efficiency, the Chinese tax authority in practice will give priority to APA applications made by the following types of enterprises:

d. Enterprises which have provided sufficient and complete information, actively cooperate with the tax authority's examination and evaluation, and proactively submit a reasonable APA proposal;
e. Enterprises which have been investigated by the tax authorities for their transfer pricing policies.

An APA will typically cover related party transactions for three to five consecutive years starting from the year subsequent to the year that the enterprise submits its formal written application.
Article 49 of the Chinese Transfer Pricing Regulations provides for scope of negotiation on the rollback of the APA to the "open" years assuming the business model is broadly similar. This is particularly good news for taxpayers wishing to avoid a protracted audit and confrontational discussions with the tax authorities.

10.3.2 Steps involved in negotiating and concluding an APA

The negotiation, signing and implementation of an advance pricing arrangement usually involves the following six stages: pre-filing meeting, formal application, examination and evaluation, negotiation, signing, and execution and monitoring.

10.3.2.1 Pre-filing meeting[40]

The first step is for the taxpayer to submit a letter of intent ("LOI") which may lead to a pre-filing meeting. When applying for a bilateral (or multilateral) APA, the Chinese taxpayer must submit the LOI to both the SAT and the in-charge local tax authority. The local tax authority / SAT while conducting the pre-filing will complete an APA Meeting Record.

During the pre-filing meeting, the following information will typically be discussed:

- Years to be covered
- Related parties and transaction amounts involved
- Overview of the enterprise's business operations in prior years
- Functional ad risk profit of related parties involved in the arrangement
- Intention to use the approach to address prior years
- Any other relevant factors

In addition, where a bilateral / multilateral APA is being negotiated, information on the arrangement of a pre-filing meeting with the relevant competent tax authority or authorities involved in the APA must also be included.

The APA presents an opportunity for the taxpayer to discuss its operations with the tax authority and form an opinion on whether an APA is the best option to manage transfer pricing risks. This can be conducted on an anonymous basis – such "no names" meetings are common in other jurisdictions with APAs and are an effective means of managing any perception that the tax authority will use the information disclosed inappropriately, such as to audit previous year results. As such, particularly in anonymous pre-filing meetings, taxpayers will request their advisors to represent them in such discussions.

The tax authority is expected to provide a decision to the Chinese taxpayer within 15 days, pursuant to the pre-filing meeting.

If the meeting is successful and the two parties reach agreement, the tax authority will inform the Chinese taxpayer to proceed with the formal lodgment by issuing a "Notice of Formal Meeting of the Advance Pricing Arrangement". If unsuccessful, a "Notice of Rejection of Advance Pricing Arrangement Application by the Enterprise" along with the rejection reasons will be issued.

40. Article 50 of the Chinese Transfer Pricing Regulations

10.3.2.2 Formal application[41]

With a successful pre-filing meeting, the taxpayer has three months to prepare the formal documentation together with the "Formal Application Letter for Advance Pricing Arrangements" and submit such documentation to the respective tax authorities. Additional timelines may need to be adhered to, reflecting the bilateral / multilateral process.[42] The APA formal application documentation package should include the following items:

- Group and organizational structure, related party relationships and transactions
- Financials for the most recent three years and information on product performance and assets (including tangible and intangible assets)
- Types of related party transactions and tax years to be covered
- Allocation of functions and risks among related parties, including business arrangements and financial results such as profit levels
- Proposed transfer pricing methodology, calculation method and supporting information
- Market conditions, including industry development trends and competitive environments
- Annual information on business scale, business result forecasts and business plans for the period covered under the advance pricing arrangement
- Disclosure of potential double taxation issues and other relevant issues in relation to domestic and international laws and tax treaties

It should be noted that where the Chinese taxpayer is requesting for a bilateral / multilateral APA, the reports that it submits to the respective competent authorities should be consistent. If the application report to one tax authority is submitted in a foreign language, it should be fully translated to Chinese when it is submitted to the Chinese tax authorities.

10.3.2.3 Examination and evaluation[43]

Within five months of receiving the above, the tax authority will examine and review the application and request any additional supporting information needed to form their conclusions. The scope of examination and evaluation conducted by tax authorities shall mainly cover the following:

- Overview of historical operations
- Functional and risk profile
- Comparable information
- Assumptions
- Transfer pricing methodology and calculation method
- Expected arm's length price or profit range

The Chinese the tax authority (which is the local tax will bureau) may also conduct an on-site audit to evaluate the actual operation of the enterprise.

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41. Article 51 of the China Transfer Pricing Guidelines
42. In certain specific circumstances, it may be possible for enterprises to apply for an extension to tax authorities relating to the submission of the formal documentation package.
43. Article 52 of the Chinese Transfer Pricing Regulations

10.3.2.4 Negotiation[44]

For unilateral APAs, the tax authority will arrange negotiations and discussions with the enterprise after the tax authority reaches a position following its examination and evaluation process. If both parties can reach an agreement, the draft APA along with an examination and evaluation report will be submitted to the SAT for review and approval.

For bilateral or multilateral APAs, the SAT will arrange negotiations and discussions with the relevant competent authorities after each competent authority has completed its own review and evaluation process.

If all parties agree, a draft APA should be prepared according to the memorandum of negotiation.

10.3.2.5 Signing[45]

For a unilateral APA, the legal representative(s) authorized by the legal representatives of both the tax authority and the enterprise will officially sign the unilateral APA

For a bilateral or multilateral APA, the representative authorized by the SAT and relevant competent tax authorities of the other tax treaty (or arrangement) party(ies) officially sign the bilateral or multilateral APA, and then according to the signed bilateral or multilateral APA, the in-charge tax authority signs a separate agreement with the relevant legal representative of the Chinese taxpayer.

10.3.2.6 Implementation and monitoring[46]

Once the APA is implemented, a comprehensive monitoring and supervision mechanism is in place to ensure compliance with its terms and conditions. The following are the key considerations:[47]

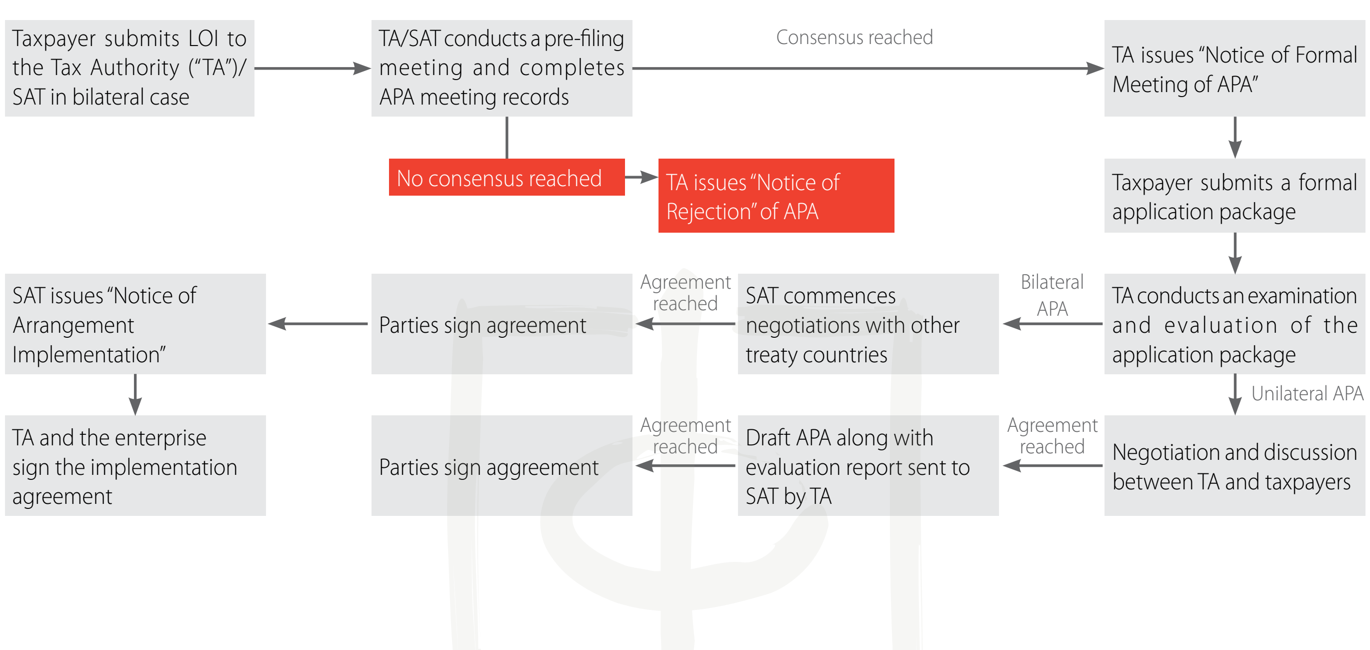
- During the term of the APA, the enterprise shall maintain a complete record of relevant documents and information (including accounting records and other relevant records) which shall not be lost, damaged or transferred;
- The enterprise shall also file an annual compliance report in relation to implementation of the APA to tax authorities within five months after the end of each tax year;
- Tax authorities regularly (normally semi-annually) investigate the enterprise's compliance status. Major areas for investigation include the following:

  - » Whether the enterprise complies with the provisions and requirements in the APA:
  - » Whether the information provided for negotiations of the APA and the annual compliance
  - » Report reflect the actual operations of the enterprise
  - » Whether the basis for transfer pricing methodology and calculation method is correct
  - » Whether the assumptions in the arrangement are still valid;
  - » Whether the application of the transfer pricing methodology by the enterprise is consistent with the assumptions made.

44. Article 53 of the Chinese Transfer Pricing Regulations
45. Article 54 of the Chinese Transfer Pricing Regulations
46. Article 54 of the Chinese Transfer Pricing Regulations
47. Article 56 of the Chinese Transfer Pricing Regulations

- If tax authorities discover a general violation of the APA, they shall, depending on the circumstances, handle the violation and terminate the APA where appropriate. In case of any concealment or rejection to implement the APA by the enterprise, the APA shall be considered invalid by tax authorities from the beginning;
- During the term of the APA, if actual operating results of the enterprise fall outside of the expected range of prices or profits under the arrangement, tax authorities, shall, upon obtaining approval from tax authorities at the next higher level, adjust the actual operating results to be within the range of prices or profits under the arrangement;
- During the term of the APA, if there are substantial changes that have affected the implementation of the APA, the enterprise shall report these changes to tax authorities in writing within 30 days, with detailed explanations to the impact of these changes on implementation of the APA and all relevant information. If the enterprise cannot report such changes within the specified time frame due to the non-subjective reasons, an extension of up to 30 days is allowed;
- Within 60 days upon receiving the written report from the enterprise, tax authorities shall examine and handle the case, including assessing the change of situation, discussing with the enterprise regarding revisions to the provisions and relevant conditions of the arrangement, or taking reasonable measures to amend or even terminate the arrangement depending on the impact of the changes on the implementation of the APA. Upon the termination of the original APA, tax authorities and the enterprise may re-negotiate and sign a new APA in accordance with the provisions of this chapter;
- For APAs signed by both the state and local tax bureaus with the enterprise, the enterprise shall, during the term of the APA, file the annual compliance report and the report specifying substantial changes to both the state and local tax bureaus. The state and local tax bureaus shall conduct joint inspection and examination on the enterprise's compliance status.

The following chart illustrates the overall process of obtaining a unilateral / bilateral APA from the Chinese tax authorities:



10.3.3 Renewal

The taxpayer has the option of applying for a renewal of an APA by submitting an application for renewal 90 days prior to expiry together with an "Advance Pricing Arrangement Renewal Application". This is in addition to providing reliable supporting evidence to confirm that there are no substantial changes to the facts and conditions in the existing APA and that the enterprise has been in full compliance with the provision and requirements in the APA.

Tax authorities shall reply in writing regarding whether the case is accepted within 15 days of receiving the application for renewal, and issue a "Reply Letter on the Application of the Renewal of the Advance Pricing Arrangement" to the enterprise. After receiving the application, tax authorities shall review and evaluate the application documents, and negotiate with the enterprise to draft the new APA. The tax authorities shall complete the renewal process in accordance with the mutually agreed time, place and other relevant matters in relation to the renewal.

For APA involving two or more provinces, autonomous regions, or directly-administered municipalities and cities specifically designated in the state plan, or involving both the state and local tax bureaus, the SAT shall organize and coordinate the process. The enterprise can directly submit a LOI to the SAT.[48]

10.3.4 Confidentiality

Both tax authorities and the enterprise have the duty to keep confidential all information obtained during the whole process of the APA, including pre-filing meetings, formal negotiation for signing examination and analysis. Tax authorities shall record in writing all the meeting discussions with the enterprise and prepare a list of documents exchanged during each meeting indicating the number of copies and the content of information provided, to be signed or stamped by the principal negotiator from both parties.[49]

48. Article 58 of the Chinese Transfer Pricing Regulations
49. Article 60 of the Chinese Transfer Pricing Regulations

10.4 Key APA Statistics

With effect from 31 December 2010, the SAT has released APA reports to provide guidelines to enterprises interested in entering into APAs with the Chinese tax authority, and to serve as a reference for competent authorities of other countries and the general public to better understand China's APA program. The APA reports also serve to enhance transparency of the APA program.

The APA Statistics discussed below have been obtained from the 2013 APA report, which was issued by the SAT in December 2015.

10.4.1 The APA team

The APA program had a total of six staff members in 2014 at the SAT Headquarters level (who are also charged with TP-related MAP cases). Staff are organized into different teams according to their own professional qualifications and expertise and how these qualities fit in with the requirements of bilateral negotiations.

Currently the SAT has three teams responsible for Japan and South Korea, the rest of the Asia Pacific (the US, Australia and other Asia-Pacific countries and regions), and the European countries respectively.

SAT has a strong commitment for the training of local anti-avoidance personnel and mobilizes local human capacity and expertise in cases of examination and analysis. Local personnel are engaged in the APA team for each bilateral APA case so as to ensure that each case merits sufficient input of human resources.

With an effort to enhance the quality of personnel, SAT also devotes a large amount of resources to training activities on a regular basis. Training activities may include sessions featuring experienced APA negotiators from the SAT HQ and local offices and experts from the intermediaries to provide lecturing to APA and TP personnel nationwide on selected topics, i.e., IP, transfer of equity, and application of the income method. In addition, the SAT provides opportunities for local tax personnel to listen to the ideas of experts from the OECD and other international organizations wherein they present global experiences and address current issues.

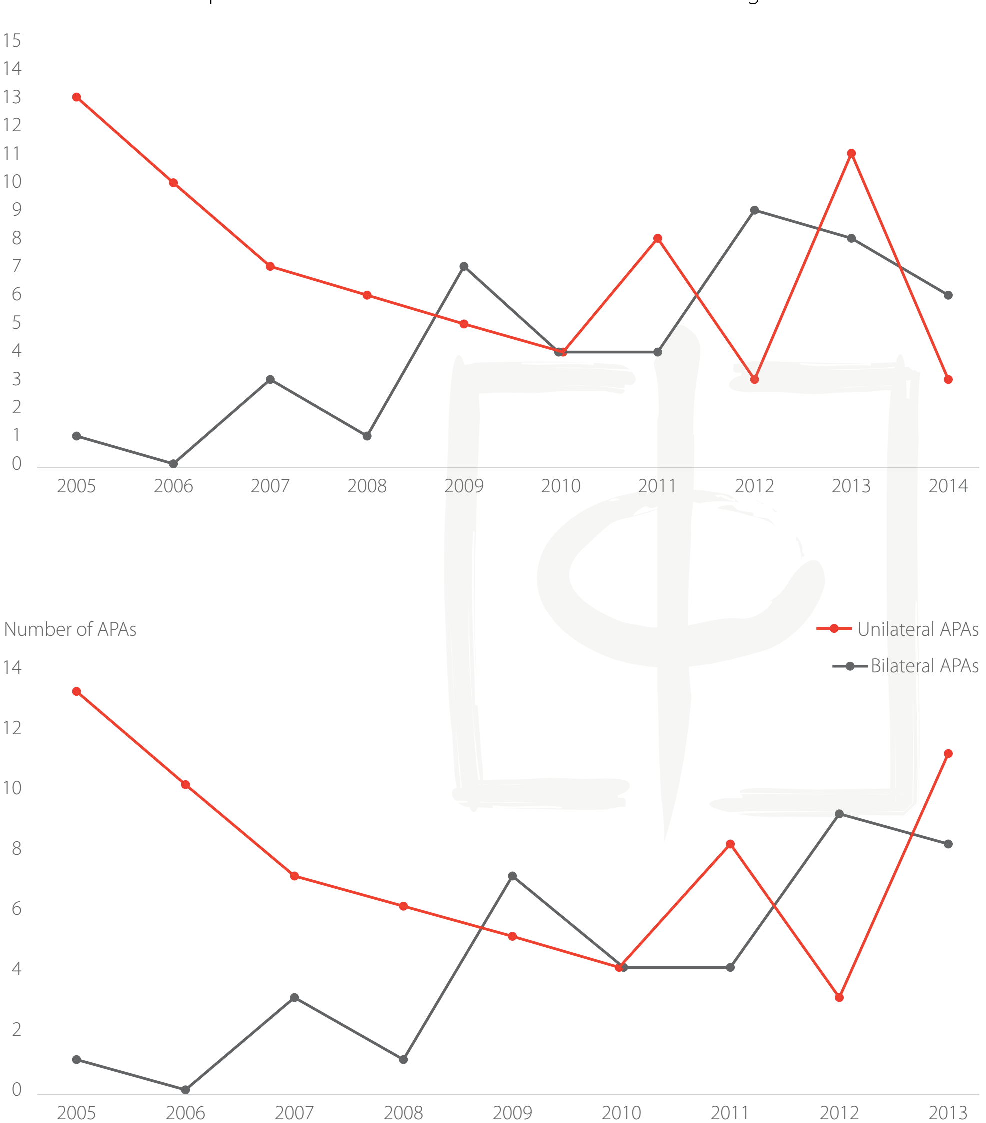
10.4.2 APAs signed by year

The figure below summarizes the number of unilateral and bilateral APAs that the Chinese tax authorities signed during each of the 2005 to 2013 years.

Year	Unilateral APAs	Bilateral APAs	Total
2005	13	1	14
2006	10	0	10
2007	7	3	10
2008	6	1	7
2009	5	7	12
2010	4	4	8
2011	8	4	12
2011 - Renewals	4	0	4
2012	3	9	12
2012 - Renewals	1	6	7
2013	11	8	19
2013 - Renewals	0	4	4
2014	3	6	9
2014 - Renewals	1	0	1
Total	70	43	113

It should be noted that the renewals are not included in the totals, as the original APAs that involve the same taxpayers have already been accounted for. So far, China has not signed any multilateral APAs.

The chart below compares the number of unilateral APAs and bilateral APAs signed from 2005 to 2014.



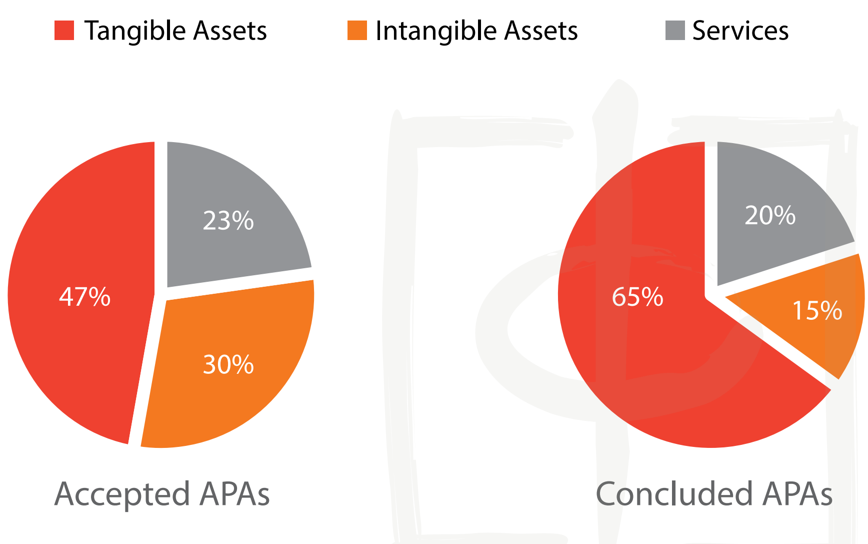
The number of bilateral APAs signed increased to 8 in 2013 from just 1 in 2005.

The number of APAs signed in 2013 reached 19, representing an all year high. This indicates that taxpayers are attaching more importance to APAs and looking for ways to gain certainty and avoid double taxation through the APA process. It also reflects the SAT's intensified effort in promoting the APA program and its taxpayer service. There was a slight decline in 2014. This decline cannot and should not be taken to indicate that taxpayers are not considering APAs as an effective tax management strategy. Rather a reason for the somewhat lower number could be that with the emergence of BEPS related Action Plans, multinational companies are being forced to channel their time and effort to a multitude of tax related issues.

10.4.3 APAs by transaction type

The figures below show the transaction types that Chinese taxpayers are requesting APAs on as of 31 December 2014.

The first details the transaction types for the APAs that were accepted during 2013. Of the 75 APAs that were accepted during 2014, 40 percent related to tangible goods transactions.



The second details the transaction types for all APAs that were concluded as of 31 December 2014. Of the 150 APAs that were concluded as of 31 December 2014, 65 percent were in relation to tangible goods transaction.

The smaller percentage of accepted APAs that deal with tangible goods seems to suggest that taxpayers are more concerned about services and intangible property and are increasingly approaching the Chinese tax authority on such matters rather than a simple tangible goods transaction.

It is expected that the number of APAs involving other types of transactions will increase in the future. As China's tertiary industry develops, an increasing number of service companies may decide to apply for APAs. Thus, more APAs may involve transactions related to transfer or use of intangible assets and services.

To date, no APAs have been concluded in respect of intercompany financing transactions. It is likely that with the growth of China as a regional finance and treasury hub, enterprises in the near future may be interested in obtaining APAs on their treasury and cash management structures as well.

10.4.4 Bilateral APAs by region

From 2005 to 2013, China signed 28 bilateral APAs with Asian countries, 9 with European countries and 6 with North American countries. In other words, nearly 65 percent of China's bilateral APAs are with its Asian treaty partners.

A closer look at China's trading partners will help provide insights into this pattern. The table below summarizes the top 10 trading partners of China, based on the volume of trade in 2013.

Rank	Country	Total trade (in US$ billion)
1	United States	521
2	Hong Kong	401
3	Japan	312.55
4	South Korea	274.24
5	Taiwan	197.28
6	Germany	161.56
7	Australia	136.37
8	Malaysia	106.07
9	Brazil	90.27
Total		2200.34

8 of the 10 top trading partners are based in the Asia Pacific region. Of a total trade value of US$2,200 billion, US$1,427 (i.e., 64.8 percent) was attributed to Asian trading partners.

10.4.5 Time taken to complete APAs

Of the three unilateral APAs that were concluded in 2014, two were concluded in less than a year, and one was concluded within two years. In other words, more than half of the unilateral APAs concluded in 2014 were concluded within one year.

The Chinese tax authorities generally aim to complete the review and negotiation process within 12 months for unilateral APAs and within 24 months for bilateral APAs. Bilateral APAs involve negotiations with relevant competent authorities through the MAP process and therefore require more time to reach a consensus than unilateral APAs do. Only one in the six bilateral APAs were concluded within one year. In addition, the two bilateral APAs took more than three years to complete.

10.4.6 Industry

The table below details the industry of the Chinese taxpayer requesting the APA (be it unilateral or bilateral).

Industry involved	Numbers
Manufacturing	92
Commercial services	5
Wholesale trade and retail	9
Transportation, warehousing and postal services	2
Scientific and technical services	2
Electricity, thermo, gas and water generation and supply	1
Information transmission, software and IT services	2
Total	113

Given the focus of manufacturing in China, it is not surprising that 81 percent of all APAs concluded from 2005 to 2014 were in the manufacturing sector. As China has transformed up the value chain, we would expect further diversification to take place in the types of industries covered in APAs.

10.4.7 Transfer pricing method used

Despite the varied industries from which taxpayers have requested APAs on, most of the APAs were based on the TNMM. The most commonly used PLIs were the cost plus method, in 48 of the cases, and the return on sales in 45 cases. Given that manufacturing was the key focus of most taxpayers entering into APAs, it is not surprising that the transactional net margin method with the cost plus mark-up was most used in the APA applications.

Recently, the Chinese tax authorities have frequently used public data, which explains why the TNMM is the most commonly used method in the signed APAs. Moreover, the TNMM is also used to determine the routine profit when applying a residual profit split method.

APAs have been concluded based on all five methods. In addition, it is interesting that four of the APAs have also been negotiated based on methods, other than the suggested five methods. In other words, if the traditional methods cannot be reliably applied for a particular transaction, it is clear that the SAT is open to utilizing an alternative method. This is an interesting fact, given the Chinese Transfer Pricing Regulations do not explicitly provide for "other methods" to be used.[50]

50. Please refer to Section 4.2.6 for a discussion of other methods.

10.5 In summary

It is clear that taxpayers in China are using the APA regime as an appropriate dispute prevention tool. As compared to other countries in the Asia Pacific region, the SAT has a long history of negotiating APAs with taxpayers both on a unilateral and bilateral basis. Furthermore, arising from various negotiations, the SAT has developed a principle, robust approach for the administration of APAs. In addition, the release of APA reports provides taxpayers contemplating APAs additional data on the possible success of their APA negotiations.

PROFESSIONAL SERVICES

For further guidance on how to use APAs in China, please visit www.dezshira.com or contact one of our experts at tax@dezshira.com

EXPLORE DETAILS

Current Transfer Pricing Issues in China

- Comparability analysis
- Location specific advantages
- Intangibles
- Transfer pricing analysis of contract and toll manufacturers
- Sales, marketing and distribution activities
- Use of the profit split method

Despite a well-defined transfer pricing legislation, the SAT faces several challenges in the practical application of transfer pricing principles and guidelines. The SAT discussed some of these practical challenges and the position that it will adopt from a practical perspective, in the United Nations Transfer Pricing Manual.

11.1 Comparability analysis

As noted in Section 6.6.1, the SAT prefers public comparables rather than private comparables. However, for developing countries like China, there are usually only a small number of public companies, while information on domestic private companies is lacking. This limits the amount of publicly available information on domestic companies that can be used for transfer pricing analysis. Given the SAT's preference for public companies, comparables used in economic analyses are typically dominated by companies from developed countries, simply because there are usually a much larger number of public companies in developed countries. If public companies from developed countries are used, additional comparability adjustments may need to be undertaken to ensure that the comparables are appropriate.

Transfer Pricing in China
Thought Leadership Report
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11.2 Location specific advantages

Location specific advantages ("LSA") is a concept that has been introduced by several tax authorities in developing countries.

LSAs are advantages for production arising from assets, resource endowments, government industry policies and incentives, etc., which exist in specific localities. Examples include large pool of well-educated low-cost labor and well-developed network of suppliers. LSAs arise either from cost savings or market premiums.

The Chinese tax administration has adopted a four step approach on the issue of LSAs:

1. Identify if an LSA exists;
2. Determine whether the LSA generates additional profit;
3. Quantify and measure the additional profits arising from the LSA; and
4. Determine the transfer pricing method to allocate the profits arising from the LSA.

The discussion of the LSAs outlines the SAT's point of view - that multinational corporations establish subsidiaries in China to exploit China's infrastructure, wage cost structure as well as marketability (which includes the ability to sell to more than a billion people). In return for such an offering, China, as a country where the subsidiary is located, should be compensated through additional profit margins.

11.3 Intangibles

Intangibles are as major an issue for developing countries as they are for developed countries. For developing countries, marketing intangibles and LSAs are often closely integrated, and due consideration is necessary to properly compensate the contribution of the subsidiaries in developing countries.

The SAT has provided its view on intangibles across various categories of intangibles, including the manufacturing, R&D and marketing intangibles.

The SAT's views on intangibles are as follows:

- When the Chinese entity was established, certain intangibles may have been provided (either explicitly or implicitly) to the Chinese entity. Once the Chinese entity's operations have been established, it may be undertaking additional value added activities and may in itself enhance the IP and may have contributed to the continued maintenance of such IP. In addition, as a manufacturing center, the Group may also be able to rely on the Chinese entity's experience in other markets. In such an event, should the Chinese entity continue to be considered as a simple manufacturing entity? Or should the local Chinese affiliate be entitled to additional profits? If so, what is the appropriate method to calculate the additional profit?
- On-going payment of royalty
- The SAT explicitly enquires if Chinese manufacturing entities need to continuously pay royalties for manufacturing know-how based on an agreement that has been in place across several years. For example, a Chinese affiliate was charged a royalty for the use of a manufacturing process when the Chinese operations were established ten years ago in 2002. Is it still reasonable for the Chinese affiliate to pay the same royalty in 2012, without revising whether the intangible asset has continued to provide the same value over time? This is the case if the Chinese affiliate has improved upon the manufacturing process provided by its parent company, through a process of trial and error and conducting manufacturing operations over a ten year period.

11.4 Transfer pricing analysis of contract and toll manufacturers

The SAT chapter contains a detailed analysis of contract vs. toll manufacturing arrangements and how these arrangements will be evaluated from a transfer pricing perspective. For example, where the manufacturers purchase products from related parties to manufacture, assemble and sell finished products back to related parties, the SAT notes that the cost plus mark-up will demonstrate that the sale price is arm's length, while they may utilize the customs import valuation to support the purchase price of the raw materials.

With respect to toll manufacturing, the SAT notes the difference in the cost base between contract and toll manufacturing set-ups and details an approach to evaluate the appropriate cost base.

11.5 Sales, marketing and distribution activities

The SAT notes that care should also be applied to marketing and distribution activities as well. Chinese experience shows that many MNEs treat their Chinese distribution entities as a limited risk distributor, and use a set of simple distributors performing limited functions. The comparables used to analyze these companies may either be publicly listed companies in China or comparables from mature markets.

There are a couple of obvious deficiencies in such an approach. Firstly, there is often a mismatch in terms of functional profile, as the Chinese entity may perform significantly more functions than these so-called comparables, which is evident as the Chinese businesses incur significantly more operating expenses relative to sales. Second, it does not account for differences in market differences, with China being a fast-growing economy and having strong demand which requires relatively less selling effort and therefore can achieve higher efficiency and profitability. Other location specific advantages such as country premium and any marketing intangibles that are created by the Chinese entity are also commonly ignored.

11.6 Use of the profit split method

Given the limitations of the TNMM arising from the selection of the appropriate comparables, as well as the need for comparability adjustments, the SAT has advocated the use of the profit split method. Particularly, where significant functions, risks and assets (even if they are tangible assets such as work force and factory plants) are undertaken in China, the SAT may challenge the use of a one-sided method which limits the profits earned by the Chinese enterprise and proposes the use of a profit split method to ensure that the particular facts and circumstances supporting the transaction are taken into account. Furthermore, the SAT may also argue that the one-side approach must be applied from the perspective of the related party, and not the Chinese enterprise, which essentially results in the residual profit being booked in China.

Base Erosion Profit Shifting ("BEPS") Project and its Impact on China

- Introduction
- Impact of BEPS on China
- Revisions to China's transfer pricing rules in a post-BEPS environment

12.1 Introduction

The BEPS project, commissioned by the G-20 and spearheaded by the OECD, has inaugurated a global collaborative effort to modernize, streamline and overhaul the international tax system. The BEPS project aims to create a coherent set of international tax rules to end the erosion of national tax bases and the artificial shifting of profits to jurisdictions solely to avoid paying tax.

The changes that are being proposed by the BEPS Project are leading to the need for businesses to take action to comply with the possible new requirements, from a data and an organizational perspective. More importantly, certain multinational corporations also have to consider the ways in which they do business in various jurisdictions.

As a key partner of the OECD,[51] China has been monitoring the progress of the BEPS Project closely and will roll out new regulations corresponding to certain BEPS action items over the coming months. In November 2014, the OECD also released its new strategy for deepening developing countries' engagement in the BEPS Project. This has been a key initiative, as this will strengthen their involvement in the decision-making process and bring them into the heart of the technical work. Throughout 2014, the SAT organized internal meetings to discuss details of the BEPS project and how to better shape China's approach to new tax rules when considering BEPS. Some of the recent changes introduced by the SAT resonate with the guiding principles of the BEPS Project, particularly on the realignment of taxation and substance. The SAT has also been active in engaging with tax authorities in the Asia Pacific region on these topics.[52]

The SAT published the Chinese translation of all 15 action points of the Base Erosion and Profit Shifting (BEPS) reports only five days after they were released by the OECD in October 2015. In addition, in November 2015, the Commissioner of SAT attended the G20 and the BRIC Leaders Summits, held in Turkey and Moscow respectively. At those summits, consensus was achieved on the strengthening of global tax governance against international economic risks. In addition, BEPS, the automatic exchange of tax-related financial account information standards, and ways to help developing countries raise their ability to collect revenues were all discussed.

"For multinational companies, the preciseness of international tax planning has become more enforced in China; thus, under some circumstances, companies might be forced to change their current business structure, related-party transaction arrangement and transfer pricing policies."

Susan Ma
Manager
Corporate Accounting Services
Dezan Shira & Associates
Shanghai Office

51. It should be noted that China is not a member of the OECD. However, it is a member of the G-20.
52. Interactions at the Study Group on Asian Tax Administration and Research

12.2 Impact of BEPS on China

At the time of writing, several deliverables from the BEPS Project Action Plans have yet to be finalized. The finalization of the BEPS Project deliverables will result in the introduction of a new international tax regime.

Key aspects of the BEPS Project that are likely to have a lasting impact on Chinese tax rules are:

a. Review of actual control vs. management control of each entity under complex group structures;
b. Increasing permanent establishment challenges, especially regarding digital economy and e-commerce;
c. Business substance evidence on the validation of related party charges;[53]
d. Information disclosure requirements from a transfer pricing documentation perspective. Is China likely to revise its transfer pricing documentation regime to reflect the three tiered approach that the OECD has proposed?

In April 2014, the State Tax Bureau ("STB") of the Jiangsu Province issued a paper that summarized Jiangsu STB's current stance towards the BEPS Project[54] and highlighted the most important tax risks in an international context for Chinese enterprises. Most of these comments were related to BEPS. In addition, the paper also introduced an action plan for the Jiangsu tax authorities to further tackle BEPS and address specific tax avoidance schemes witnessed in the Jiangsu province.

Most principles and cases described in the Paper have been consistent with China's recent positions on international taxation. This Paper can therefore be considered as a way for the SAT to gauge the interest and responses of taxpayers and the international tax community before formulating the national position of China.

53. Such a change has already occurred in respect of intercompany services and royalty charges.
54. The paper is titled "Administrative Plan on International Tax Compliance for 2014 – 2015". Only a Chinese version of this paper is available at this time.

12.3 Revisions to China's transfer pricing rules in a post-BEPS environment

On 17 September 2015, the SAT issued a consultation draft circular "Implementation Measures for Special Tax Adjustment", hereafter referred to as the 2015 Draft Circular 2, which would replace the existing Circular 2. The public were requested to provide comments on the draft within a month.

The 2015 Draft Circular 2 proposes new transfer pricing documentation requirements under a three-tier framework, which is consistent with the revised transfer pricing documentation rules under Action Plan 13. Such a framework requires taxpayers to prepare a local file, a master file and the country-by-country report ("CbCR"). Thus, the 2015 Draft Circular 2, if it is finalized in its current form, will require taxpayers to make additional disclosures of their business operations. Specially, under these revised guidelines require Chinese parented multinational group that have global revenues greater than RMB 5 billion to submit a CbCR with their annual tax return which is due on 31 May 2016. All Chinese taxpayers are required to maintain a local file in line with the existing transfer pricing documentation rules. In addition, it would be recommended that Chinese taxpayers require their foreign parent companies to maintain the Masterfile as well, to be provided to the SAT in the event that they require it.

The 2015 Draft Circular 2 also introduces a new requirement for the preparation of a Special File where a taxpayer engages in intra-group services. Under these draft guidelines, the Special File must contain copies of the relevant intercompany agreements, documentation of the cost incurred in providing the service, allocation keys, as well as an explanation of the benefits received by the Chinese taxpayer. A read of the 2015 Draft Circular 2's guidance on intercompany services reflects the prevailing SAT's position detailed in Section 7.3.2. Thus, should the 2015 Draft Circular 2 be implemented, Chinese taxpayers are likely to find it hard to reconcile China's approach to related party services transactions with what other countries' are expecting and the risk of double taxation is very real.

The 2015 Draft Circular 2 also contains a new chapter detailing the transfer pricing approach to be adopted in respect of intangible property transactions. This chapter is broadly consistent with the guidance issued by the OECD under BEPS. However, local peculiarities continue to permeate through the guidance. For example, the 2015 Draft Circular 2 maintains that local activities such as managing customer relationships and localisation of products are critical for the China market. This consultation draft is also consistent with other recent guidance from the SAT with respect to review and examine royalty / IP related transactions.

The 2015 Draft Circular 2 also introduced two new transfer pricing methods – the value contribution allocation method and the asset valuation method. The value contribution allocation method is a method that is familiar to Chinese transfer pricing practitioners as it is commonly used by Chinese tax inspectors. It is similar to the profit split method in that combined profits are allocated between the parties in proportion to appropriate allocation keys, such as revenues, costs, assets or headcount. The value contribution allocation method is typically used where comparables are difficult to find but an allocation formula can be reliably determined. Such an approach may typically allocate more profit to the Chinese taxpayer resulting in additional taxes being paid in China. Asset valuation methods are considered to be akin to valuation based methods, i.e., the income based, cost based and asset based methods.

The 2015 Draft Circular 2 also includes a new chapter providing guidance on how taxpayers should monitor their profitability to establish a risk hierarchy system for use in selecting targets of special tax investigations or other compliance approaches.

As of the time of publishing this book, the 2015 Draft Circular 2 has not been finalized. Yet, they provide a flavor of what is meant to come. The position of the SAT as detailed in the 2015 Draft Circular 2 is comparatively more stringent than what the OECD has proposed in its revised guidance on transfer pricing documentation, services and intangibles. The Draft Circular also confirms the SAT's various positions on transfer pricing as stated in public guidance notes, seminar and notices during the past two years since the BEPS Action Plan was initiated.

As the global tax community has observed across geographies, the 2015 Draft Circular 2 will force taxpayers to accept a shift from a simplified transfer pricing documentation approach to one that is based on a holistic analysis of value creating and analysis of the Group's operations.

While the 2015 Draft Circular 2 broadly details the SAT's position from a transfer pricing perspective, many of the disclosure requirements within the draft circular as unclear as to when they are likely to take effect. We therefore recommend that Chinese based taxpayers carefully consider how the new documentation requirements will affect their business, tax management and compliance burden.

Conclusion

13.1 Conclusion

Transfer pricing is commonly acknowledged as one of the most difficult international tax issues. Multinational corporations, as well as tax administrations in both developed and developing countries, have built up and dedicated substantial resources to this area.

China started looking into transfer pricing issues in the late 1990s. While the early focus of transfer pricing investigations was mostly on tangible goods transactions, it has since been expanded into a range of other transactions, and in particular, those involving intangibles and services.

In addition, the SAT has invested on building up a team of transfer pricing experts with backgrounds in accounting and economics in order to effectively administer transfer pricing rules. The SAT has ensured that tax auditors have a good understanding of the industry in which Chinese enterprises are involved in order to ensure that peculiarities that exist in each industry are appropriately understood in the transfer pricing assessment.

China currently has more than 200 officials dedicated to transfer pricing issues and aims to increase this number to 500 specialists by 2015. This will include a specialist panel to review substantial cases such as national transfer pricing audits. This panel review system, together with the centralized approval system on transfer pricing audit cases and national information systems, will ensure that Chinese transfer pricing investigations are carried out consistently and with a high level of quality.

The SAT acknowledges that China continues to face a number of difficult challenges associated with the administration, implementation and enforcement of transfer pricing. Many of these challenges remain unanswered by the OECD Transfer Pricing Guidelines as well as the U.N. Transfer Pricing Manual.

However, the SAT, through the issuance of circulars and announcements, is attempting to provide additional clarity on many of these challenges.

In recent years, SAT has stepped up its engagement with international organizations, including the UN and OECD. The SAT remains actively involved in the research into the BEPS actions. With the finalization of the BEPS Action Plan in 2016, it is likely that further changes will be made to China's transfer pricing regime.

"With the finalization of the BEPS Action Plan due later in 2016, it is likely that further changes will be made to China's transfer pricing regime."

Sowmya Varadharajan
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