PRC & INTERNATIONAL

Recent Developments in Transfer Pricing in China

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China has seen the continued evolution of its transfer pricing enforcement towards a data-based administrative approach and away from aggressive audits.

In respect of the international scene, China has committed to the Organisation for Economic Co-operation and Development's ("OECD") Base Erosion and Profits Shifting ("BEPS") Action 14 minimum standards ("BEPS 1.0 Project") and is also one of the countries endorsing the Inclusive Framework of the BEPS 2.0 Project to be rolled out in 2022.

This article will focus on the latest developments in China's transfer pricing enforcement during 2021. China has continued to follow the approach developed since 2018. This approach will be discussed from the following three broad perspectives:

1. Transfer pricing compliance
2. Focus on "non-trade" transactions
3. Resolution of international disputes through prioritising the Mutual Agreement Procedure ("MAP") and facilitating transfer pricing certainty by promoting advance pricing agreements ("APAs")

Transfer Pricing Compliance

From the transfer pricing perspective, the State Administration of Taxation ("STA") has been redirecting its efforts from an investigative approach to a preventative approach, referred to as the "administration/management approach". It is anticipated that tax revenue would be increased not by doing more transfer pricing audits but by taxpayers complying with the administration of transfer pricing policy.

In a seminar organised by the Korean Embassy and the STA in September 2018, it was noted by a panellist that when the administration/management approach was introduced in 2018, it was expected that the amount of additional taxes collected from formal transfer pricing audits would drop by almost 30 per cent compared to 2017. On the other hand, the taxes collected by greater compliance with the transfer pricing administration would increase by 8 per cent when compared to 2017. It has not been confirmed whether this was indeed the case.

Under the administration/management approach, the Chinese tax authorities' focus is on strengthening the administration of related party transaction filings and enforcing the preparation of transfer pricing documentation (i.e. Master Files, Local Files, and Special Issues Files).

This administration/management approach is further enhanced by the big database and analytical tools obtained by the Chinese tax authorities from multiple sources.

In taking the administration/management approach, many provincial tax authorities have adopted a multi-criteria profit monitoring mechanism for large multinational enterprises ("MNEs") as well as taxpayers with complex related party transactions. These selected taxpayers would be required to complete multiple forms, some quite onerous, so that the tax authorities would be able to benchmark this information with their database and provide specific feedback to the taxpayers on improvements and modifications to their tax risk management systems and transfer pricing policies. The provincial tax authorities adopting the criteria profit monitoring mechanism include Guangdong, Sichuan, and Jiangsu.

Non-trade Transactions

The STA has always held the view that inter-company cross-border service fees and royalty payments are transactions enabling profit shifting from the transfer pricing perspective.

Take, for example, a foreign branded appliance manufacturer that sets up a manufacturing and a distributing operation in China focusing on the Chinese market: The China operation also carries its research and development ("R&D") and marketing functions in China. If the foreign parent company charges the Chinese subsidiary company royalties for the use of technology in the manufacturing operation and for the use of trademark and service fees for establishing the distribution network and for marketing the products in China, the Chinese tax authority may question the rationale for and the value of the support and technology received by the Chinese subsidiary and thus the quantum of royalties and service fees being charged to the Chinese subsidiary. This may be the case even if the profit margins remain high after deducting the royalty and service charges made by the foreign parent company.

In the Local File being prepared by a Chinese entity, the entity is required to analyse whether there is a contribution to the profits made by the Chinese entity, the so-called "location specific advantages", which would be an add-on to the profits on an arm's length basis.[1]

With respect to licensing transactions, MNEs should ensure that royalty fee recipients have done the necessary functions to control and perform the development, enhancement, maintenance, protection, and exploitation ("DEMPE") functions in order to justify the royalty. The DEMPE analysis framework was introduced by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations following the BEPS 1.0 Project. China adopted this in Bulletin 6[2] in 2017. In Bulletin 6, China added another element, Promotion, to the DEMPE functions, making it DEMPE + P.[1]

Non-trade transactions is another focus of the Chinese tax authorities in its latest developments in transfer pricing. For example, in 2018, the Shenzhen tax authority initiated preliminary information and data collection on more than 300 enterprises with large outbound non-trade payments. These enterprises were required to perform self-assessment and make adjustments as appropriate.

Prioritising the MAP

On 18 October 2021, the OECD released the Stage 2 peer review report on China relating to the outcome of the peer monitoring of the implementation of the BEPS minimum standard under Action 14 on improving resolution mechanisms (also known as "MAP Review Report").

Overall, the report concluded that China meets most of the elements of Action 14's minimum standards.

This is illustrated in the following:

1. The number of MAP cases had increased from the Stage 1 peer review. During the period 2016 to 2019, the number of newly initiated MAP cases and closed cases was 125 and 92, respectively, and the number of outstanding MAP cases increased from 89 cases at the end of 2015 to 122 cases at the end of 2019.

2. There were more and more non-transfer-pricing-related cases, even though 84 per cent of the closed cases were still transfer pricing related cases.

3. The time taken by Chinese tax authorities to resolve MAP cases is lower than the international average or the time period recommended by the OECD.

Prioritising the MAP is one the three developments initiated by Chinese tax authorities to service business enterprises, a cooperation model advocated by the STA.

Promoting APAs — Simplified Procedures of Unilateral APAs

APAs are arrangements reached between enterprises and tax authorities with respect to the pricing principles and calculation methods for related party transactions. An APA is an important tool for MNEs to obtain transfer pricing and tax certainty for cross-border business operations. It plays an important role in reducing transfer pricing compliance costs and promoting cross-border investments and operations. A unilateral APA is an arrangement between an entity and the tax authority in which the entity is located. A multilateral APA (e.g. a bilateral APA) is an arrangement between the related entities and the relevant tax authorities in which the related entities operate. On 26 July 2021, the STA issued Bulletin 24,[3] which sets forth simplified procedures for unilateral APAs for enterprises that meet certain conditions. Bulletin 24 became effective on 1 September 2021.

In recent years, the Chinese government has been actively working on deepening reform to delegate power, streamline administration, and improve the business environment. The Chinese tax authorities have been launching relevant implementation measures and have held a "Tax Convenience for the People" campaign.

Since the introduction of the APA programme over 20 years ago, the number of unilateral APAs has not been as high as the Chinese tax authorities expected. Bulletin 24 reflects the increasing flexibility the Chinese tax authorities have towards unilateral APAs. It is hoped that there will be a growing number of companies choosing to achieve tax certainty through unilateral APAs.

Bulletin 24 outlines three phases in the APA process:

1. Application evaluation

2. Negotiations and signing

3. Monitoring and execution

Compared with the normal APA process under Bulletin 64,[4] which sets forth six phases, namely, 1) pre-filing meeting, 2) letter of intent, 3) analyses and evaluation, 4) formal filing, 5) negotiations and signing, and 6) monitoring and execution, the procedures under Bulletin 24 are far simpler.

In addition, the simplified procedures set time limits for tax authorities with regard to acceptance of APA applications and negotiations and signing. The relevant tax authority must send a "Notice on Tax Matters" to the applicant within 90 days of receiving the application to inform the enterprise as to whether the application has been accepted. The tax authority must complete negotiations within six months of issuing the Notice of Tax Matters. Of course, any time spent by the enterprise on the preparation and submission of additional information required by the in-charge tax authority is not included in the time period noted above. In the event that there is no time delay in preparing and submitting information, the APA application under Bulletin 24 can be concluded within six to nine months. Consequently, not only are the procedures simplified, but also the time required is shortened.

The three phases can be summarised as follows:

Phase	Activities
(i) Application evaluation	The enterprise submits the application form. The tax authority analyses and evaluates the information and conducts on-site interviews relating to the function and risk undertaken by the enterprise. The tax authority must send a Notice of Tax Matters within 90 days upon receipt of the application to inform the enterprise whether the application has been accepted and/or the reasons for rejection.
(ii) Negotiations and signing	The tax authority must negotiate with the enterprise with respect to whether the related party transactions are in compliance with the arm's length principle. The negotiation must be completed within six months. During the negotiations, the tax authority may request additional information and additional analyses to be provided by the enterprise. The time spent by the enterprise in gathering the additional information and the additional analyses is not considered in counting the 6-month period.
(iii) Monitoring and execution	During the execution of an APA, the APA would be terminated if there were any significant changes that would affect it. If the enterprise wished to have another APA with the changed facts, it would have to reapply in accordance with Bulletin 24.

Applicable Conditions under Bulletin 24

According to Article 3 of Bulletin 24, the simplified procedures are applicable to enterprises which had annual related party transactions exceeding RMB40 million in each of the three years prior to the tax year in which the in-charge tax authority serves the Notice of Tax Matters to formally accept the unilateral APA application.

In addition to the RMB40 million threshold, an enterprise must have met any one of the following three conditions:

1. It must have provided the tax authorities with contemporaneous documentation for the three years prior to the simplified procedures application, and such documentation must comply with the requirements set out in Bulletin 42.[5]

2. It must have executed an APA within the 10 years prior to the simplified procedures application and been in compliance with the requirements of the APA.

3. It must have been audited by tax authorities for special tax adjustments in the 10 years prior to the simplified procedures application, and the case must have been concluded by the tax authorities.

Under any of the following circumstances, the in-charge tax authority may reject an application filed by an enterprise:

1. The tax authority has already initiated a special tax adjustment investigation or other tax investigation on the enterprise, and the relevant tax investigation has not been closed.

2. The enterprise fails to file its annual related party transaction disclosure forms as required by the relevant regulations and does not make corrections on time.

3. The enterprise fails to prepare, maintain, and provide contemporaneous documentation as required by the relevant regulations.

4. The enterprise fails to provide relevant information required by Bulletin 24 or fails to provide additional and/or corrected information if the information originally provided does not meet the requirements of the tax authority.

5. The enterprise fails to cooperate with the tax authority in carrying out on-site functional and risk interviews.

For unilateral APAs, both the general procedures under Bulletin 64 and the simplified procedures under Bulletin 24 may apply. Therefore, if an application under the simplified procedures is rejected or negotiations fail within the 6-month period, the enterprise may apply for an unilateral or bilateral APA in accordance with Bulletin 64. However, for information that had already been submitted, resubmission would not be needed.

Key Points to Make Simplified Procedures Successful

In the work plan issued in February 2021,[6] the STA stated that it is necessary to complete setting out the simplified procedures for unilateral APAs within 2021. The simplified procedures also help the local in-charge tax authority to handle more applications for unilateral APAs. It is also important for enterprises to get certainty in their transfer pricing arrangements and relief during periods of economic uncertainty.

It is therefore important that both tax authorities and enterprises pay close attention to the simplified procedures and resolve any issues during the negotiation and signing stage. Our view is that these issues would include the following:

1. Find out the reasons for the discrepancies between the financial data and the pricing policy of related party transactions and explain these reasons to the in-charge tax authority well during the submission. In particular, the fiscal years with a low profit margin should be analysed and the reasons for the low profit margin, with the impact quantified, should be explained to the in-charge tax authority.

2. To the extent that there should be adjustments for prior years from any benchmarking analysis, the enterprise could bring this to the attention to the in-charge tax authority. This would be the case when there were historical fluctuations of profits.

3. The role of the enterprise in the group value chain, especially the role played by the China companies in R&D and marketing, if any, must be clearly defined. In particular, the role must be explained and demonstrated during the functional on-site interviews. For example, R&D activities relating to the production process must be segregated from R&D activities relating to product development. These expenditures are often grouped into a single item called R&D expenses in financial statements.

4. There should be an analysis done on the significant impact of special factors during the COVID-19 pandemic on the enterprise's operation, with actual business data as evidence. For example, logistics costs could have gone up significantly during the COVID-19 pandemic. An enterprise should be able to illustrate the impact of the rise in logistics costs.

5. As in all APAs, forecasting the future operation of the enterprise is essential. An enterprise should perform a reasonable economic model, including the basis of the forecast and its comparison with historical data.

STA's 2020 APA Annual Report

The STA has been issuing its APA annual report since 2009. On 29 October 2021, it published the 2020 Annual Report. The report contains statistical data and analyses of APA cases from 2005 to 2020. Despite the impact of the COVID-19 pandemic, during 2020, China signed 15 unilateral APAs (including 4 renewals) and 14 bilateral APAs (including 6 renewals), both reaching new highs.

The 2020 Annual Report also introduced the simplified APA procedures discussed above.

The statistics showed the following observations:

1. Among the 29 APAs signed in 2020, 19 were signed in the first round, which is equivalent to the corresponding number for 2019. Despite the adverse COVID-19 impact, the Chinese tax authorities still actively carried out online communications and negotiations and ultimately signed these APAs.

2. In terms of the industries covered by APAs, manufacturing remains the most prevalent industry, accounting for 80 per cent of the total number of APAs signed between 2005 to 2020, followed by wholesale trade and retail, accounting for 10 per cent of the total number of APAs signed between 2005 to 2020.

   The STA hopes that APAs involving the service and other types of industries will increase in the near future. As China's economic structure becomes increasingly diversified, it is expected that this will be achievable.

3. In terms of transaction types, about 58 per cent of the APAs signed between 2005 to 2020 involved the transfer of tangible assets and 42 per cent involved the transfer of intangible ownership and intangible use rights (i.e. royalty and labour transactions, such as service charges). In particular, the latter transactions reveal an upward trend in recent years. This corresponds to the focus of the Chinese tax authorities on non-trade transactions.

4. In terms of the time required to achieve an APA, the overall goal of the Chinese tax authorities has been to complete the review and negotiation of unilateral APAs within 12 months and to complete the review and negotiation of bilateral APAs within 24 months. Among the 15 unilateral APAs signed in 2020, 13 cases were completed within one year.

   The Chinese tax authorities hope that with the introduction of simplified procedures under Bulletin 24, most unilateral APAs can be completed within nine months.

5. In terms of the transfer pricing methods used, among the APAs that were signed between 2005 and 2020, the transactional net margin method ("TNMM") remained the most prevalent transfer pricing method. It was used in 81 per cent of APA cases (199 cases) during this period.

   In the 2020 Annual Report, the STA expressed a hope that taxpayers applying for an APA could provide more sufficient transaction and price information to promote the use of other transfer pricing methods, such as the resale price method and the profit split method.

6. As regards countries/regions that have bilateral APAs with China, from 2005 to 2020, Asia continued to be the region where China signed the most APAs (59 cases), followed by Europe (19 cases) and America (11 cases). In 2020, a bilateral APA was signed with an Oceanian country.

7. The statistics also show that bilateral APAs are still preferred by many MNEs under the growing uncertainty of global trade. This is understandable as MNEs would desire to avoid double taxation, and a unilateral APA does not eliminate the double taxation aspect in transfer pricing. It is hoped that

the simplified procedures under Bulletin 24 may attract more enterprises to seek a unilateral APA.

The Way Forward

To further drive transfer pricing compliance, the Chinese tax authorities introduced a multi-criteria profit monitoring mechanism for large MNEs, levering data obtained through data analysis tools. The STA has been redirecting its efforts from an investigative approach to a preventative approach.

Non-trade payments are key transactions that will constantly be reviewed by the Chinese tax authorities.

In responding to the demand by taxpayers expecting better services, the STA and local tax authorities are entering into more MAPs and APAs, as noted in the APA Annual Report and the MAP Review Report. In addition, to promote more unilateral APAs, the STA introduced simplified procedures for unilateral APAs in July 2021. In respect to this, MNEs should have strong documentation in place to defend their transfer pricing models or to enter into APAs to obtain certainty.

Endnotes

1. *Legal Ownership of Intangible Assets versus Economic Substance: OECD Perspectives – BEPS Action Plans 8-10*, written by Anthony Tam and published in Asian Journal of Taxation Vol.21 No.2-2017

2. Announcement of the State Administration of Taxation on Issuing the Administrative Measures for Special Tax Adjustment and Investigation and Mutual Consultation Procedures (Public Notice [2017] No.6)

3. *Public Notice of the State Taxation Administration on Matters Regarding Application of the Simplified Procedures for Unilateral Advance Pricing Arrangements* (Public Notice [2021] No.24)

4. *Public Notice on Matters Regarding Enhancing the Administration of Advanced Pricing Arrangements* (STA Public Notice [2016] No.64)

5. *Public Notice on Matters Regarding Refining the Filing of Related Party Transactions and Administration of Contemporaneous Transfer Pricing Documentation* (STA Public Notice [2016] No.42)

6. *Opinions of the State Taxation Administration on Carrying out the 2021 "I Do Practical Work for Taxpayers and Convenient Taxation Spring Breeze Actions"* (Shuizongfa [2021] No.14) T