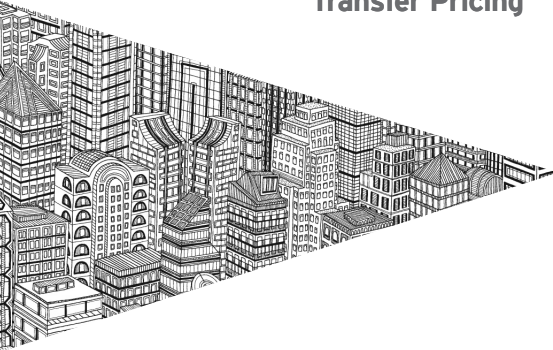


International Tax Alert

News and views from
Transfer Pricing



China's SAT issues first Advance Pricing Arrangement annual report

On 30 December 2010 China's State Administration of Taxation (SAT) published Chinese and English versions of the *China Advance Transfer Pricing Arrangement Annual Report (2009)* (2009 APA Report), marking the first time China has published such a report on the APA program to external readership.

The report, covering the statistical data and analyses for the period 2005 to 2009, mainly describes the rules and regulations, implementation procedures and practical development of China's unilateral, bilateral and multilateral APAs. Conveniently attached to the report are standardized forms for APA application and communication purposes, as well.

Through its planned annual publication of the report going forward, the SAT hopes to achieve systematic administration of APAs, promote the use of APAs, and increase the transparency of the APA process.

In this Alert, we summarize key points and our observations with regard to the 2009 APA Report. The report is available in its entirety by following the internet links below. Unless otherwise noted, we cite all references to the report:

- ▶ English version: <http://www.chinatax.gov.cn/n8136506/n8136608/n9947993/n9948014/n10517889.files/n10518029.pdf>
- ▶ Chinese version: <http://www.chinatax.gov.cn/n8136506/n8136608/n9947993/n9948014/n10517889.files/n10518017.pdf>

Why the SAT chose to publish the 2009 APA report

Ernst & Young considers transfer pricing administration to be one of the most important anti-tax-avoidance tasks throughout China's tax administration system. In 2009, the SAT concluded 167 transfer pricing investigations with tax assessment and we expect that number to grow substantially in 2010. To mitigate transfer pricing related risks in China, multinational corporations and China-based companies alike share a strong interest in increasing tax certainty through cooperative approaches such as the APA.

From China's tax administration perspective, the SAT recognizes that cooperative approaches such as APAs create significant efficiency in tax collection, especially in the area of transfer pricing where taxpayer-provided information is essential in supporting a principled analysis. Furthermore, the SAT recognizes that a bilateral or multi-lateral APA involving the treaty partner(s) tax jurisdiction(s) is an effective tool to achieve increased certainty on overall tax revenue allocation in the spirit of international cooperation.

Thus, the SAT aims to emphasize both preventive and investigative strategies as a means to increase the effectiveness of transfer pricing administration, noting that a comprehensive anti-tax-avoidance system should balance among "administration, service and investigation." The SAT views the APA program and bilateral

negotiations for double-tax relief as a key tool in effecting the "service" aspect of anti-avoidance work.

The 2009 APA Report does not imply any legal authority nor is it an official circular of tax administrative measures.

Background of APAs in China

China first recognized the APA program in 1998 through the SAT's issuance of Article 28 of Guoshuifa (1998) 59. Then, with its publication of Guoshuifa (2004) 118, i.e., The Implementation Rules on Advance Pricing arrangements for Transactions between Related Parties [Trial], the SAT set the standards for China's APA program by outlining with clarity the program's application and negotiation procedures, filing and implementation requirements. Under the measures outlined by Guoshuifa (2004) 118, China signed its first bilateral APA in 2005 and by 2008 had signed five bilateral APAs and 36 unilateral APAs.

In January 2008, China's corporate income tax law (CITL) took effect. The Special Tax Adjustment chapter of the CITL strongly focuses on transfer pricing administration; further, Article 48 stipulates that interest be imputed on assessed tax. Considering such changes in the China tax environment, the number of APA applications and bilateral negotiating countries has since grown tremendously. In January 2009, the SAT published Guoshuifa (2009) No.2 with a dedicated chapter (Chapter 6) outlining the new APA procedures.

China's six-stage APA process

China's APA procedure comprises six stages: Pre-filing, Formal Application, Examination, Negotiation, Signing and Monitoring.

Bookending the Pre-filing phase is the submission of an Intent Letter and the arrangement of a formal Pre-filing meeting.

The Intent Letter marks the beginning of the tax authorities' involvement in the APA application; once the Intent Letter is lodged, the application is counted in the SAT's case plans.

The competent authority for lodging a unilateral APA application (the APA in-charge bureau) is the tax bureau one level up from that in charge of collecting taxes from the taxpayer. The competent authority must get the SAT's approval before concluding any unilateral APA. The competent authorities on the Chinese side for a bilateral APA include the APA in-charge bureau and the SAT.

The arrangement of a formal Pre-filing meeting concludes the Pre-filing phase, a critical milestone as the SAT will determine whether to invite the taxpayer to continue the process by submitting a formal APA application or issue a letter of rejection to discontinue the process. Upon submission of the formal APA application, the SAT organizes the proper team with the APA in-charge bureau to accomplish the remaining Review, Negotiation, and Conclusion phases.

Although official-documentation support for the Pre-filing phase is limited, our experience is that the APA in-charge bureau and the SAT carefully review taxpayer credibility, case merit and case load prioritization during this phase. Therefore, we highly recommend that any taxpayer pursuing an APA in China be adequately prepared before and during the Pre-filing phase to increase the success rate of being formally accepted into the APA program and concluding the case in a timely manner.

Subject to the taxpayer's application, if the related-party transactions in the year of application or any prior year are the same or similar to those covered in the APA, the transfer pricing methodology and calculation method specified in the APA can be applied retrospectively as far back as 10 years, upon approval by the tax authority.

Further, a taxpayer can renew its APA application by filing a follow-up application to the tax authority 90 days prior to the expiration of the original APA.

APA statistics: cases concluded as of 31 December 2009

The 2009 APA Report focuses on cases negotiated under Guoshuifa (2004) 118 and the current Chapter 6 of Guoshuifa (2009) No. 2 during the period 2005-2009, in which China carried out 53 APA agreements – 41 unilateral, 12 bilateral. Since 2009, there has been a continual decline in the number of unilateral cases with a sharp increase in bilateral cases.

As of 31 December 2009, those 53 cases represented less than half of the cases the SAT was handling at the time. Nearly 70 other cases were in progress; 51 of which had not yet passed the Pre-filing phase. This shows the increasing popularity of the APA program (especially the bilateral type) as well as the SAT's careful evaluation of case merits during the Pre-filing phase.

APA statistics: transaction types

Among cases concluded in 2005-2009, the report shows that more than half involved tangible property transactions. However, recent applications are clearly trending towards intangible property and service-related transactions.

So far, there have been no intercompany financing transactions under any APA negotiation.

APA statistics: bilateral APAs negotiated by region

The report shows that among the 12 bilateral APAs concluded, the majority of the APAs, i.e., nine APAs were concluded with Asian countries while two were with European countries; and only one was with the United States.

APA statistics: time required for concluding cases

The SAT's goal is to conclude a unilateral APA within 12 months of the submission of the formal APA application. However, a bilateral case may take an extra year or even longer to negotiate depending on the individual case circumstances.

Of the 41 unilateral APAs concluded during the 2005-2009 period, 23 cases were concluded within 12 months while the rest concluded within 24 months. As for a bilateral APA, the SAT's goal is to conclude it within 24 months. However, of the 12 bilateral APAs mentioned, one took over three years to conclude while seven cases concluded within 12 months.

The speed of progression has much to do with the covered transactions' complexity, the quality of the application submitted along with the cooperative spirit of the taxpayer, the in-charge bureau's review resources, and the negotiating country's (in the case of a bilateral APA) case plan.

APA statistics: transfer pricing methods

During the 2005-2009 period, the Transactional Net Margin Method (TNMM) using Return on Sales ratio as the profit level indicator (PLI) was by far the method most frequently used to conclude APAs, although similar approaches such as TNMM using Full Cost Mark-up ratio as PLI or the Cost Plus Method were also used.

As at December 2009, no APAs were concluded using the Berry Ratio or using TNMM with Return on Operating Assets as PLI. Nor were any APAs concluded using the Resale Price Method, as the SAT observed that a Resale Price Method application would require the taxpayer to provide sufficient details on a transactional level as well as market price information.

The Comparable Uncontrolled Price (CUP) Method was used to conclude four of the 53 cases – this application rate seems to reflect that the CUP Method is much less applied in common transfer pricing analyses due to the high requirement of comparability. And although only four cases were concluded applying the Profit

Split Method and un-prescribed other methods, based on our communications with the SAT the trend is that more intangibles-transactions will be introduced to the APA program; thus, we anticipate the use of the Profit Split method in APAs going forward to likewise increase.

Our recommendation

We recommend that companies in general observe the relevant views and policies of the China's tax bureaus with respect to APA procedures and seek professional transfer pricing advice to help mitigate potential tax risks and increase the acceptability of APA applications by tax authorities.

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