
Bulletin 6 contains long-awaited guidance on the application of the arm’s length principle, including guidance with respect intangible property transactions, intercompany services transactions, location specific advantages, transfer pricing methods, and various procedural matters. Detailed guidance on mutual agreement procedures (MAP) under double taxation treaties is provided.

Bulletin 6 reflects the importance that the SAT places on double taxation treaties and on the international consensus that has developed over the course of the base erosion and profit shifting (BEPS) project led by the Organization of Economic Cooperation and Development (OECD). As discussed below, Bulletin 6 moves Chinese transfer pricing rules and proposed rules into closer alignment with the new international standards developed during the BEPS project in a number of respects.

Bulletin 6 is one of a series of SAT releases that put into place final rules that were proposed in a consultation draft issued by the SAT on 17 September 2015 (the “Consultation Draft”). The consultation draft would have replaced SAT Circular Guoshuifa [2009] No. 2 (“Circular 2”) in its entirety. (Please refer to our previous Transfer Pricing Alert on the Consultation Draft1.)

Intangible property transactions

Bulletin 6 contains a number of provisions specifically addressing intangible property transactions. The provisions are not as detailed as those in the Consultation Draft. For example, Bulletin 6 does not contain a definition of “intangible property”, but other provisions are aligned with BEPS standards to a greater or lesser extent.

Most notably, Bulletin 6 retains the framework introduced by the Consultation Draft with respect to the functions that are relevant in determining the allocation of profits from use of intangible property. After BEPS reforms, the OECD Guidelines identify five relevant functions: development, enhancement, maintenance, protection and exploitation (so-called DEMPE functions). Bulletin 6 adds a sixth function: promotion (i.e., DEMPEP functions). While promotion functions can likely be subsumed under the other DEMPE functions in an OECD framework, the identification of promotion as a separate function demonstrates the importance China places on value created through marketing activities undertaken by Chinese companies.

However, Bulletin 6 provides no guidance on how performance of particular DEMPEP functions should be weighted when determining the appropriate allocation of income related to intangible property. The OECD’s BEPS guidance provides that certain design and control functions are “more important” than other DEMPE functions. Lacking such guidance, Chinese tax authorities may put more emphasis on more routine functions associated with exploiting intangible assets, such as undertaking manufacturing using licensed technology or selling branded products.

Bulletin 6 also retains the Consultation Draft’s approach to how Chinese tax authorities should review intercompany royalties. Tax inspectors are advised to pay particular attention to whether the value of the licensed intangibles has declined since the royalty was initially established, whether price adjustment clauses are commonly found in third party contracts in the industry, whether functions as well as assets and risks have changed, and whether the licensee has performed DEMPEP functions for which it has not been reasonably compensated.

In addition, Bulletin 6 retains two provisions from the Consultation Draft that echoed BEPS guidance: 1) an entity that merely funds intangible development activities but does not perform any DEMPEP functions should only be entitled to earn a reasonable financing return; and 2) an entity that owns bare legal ownership but does not control financing functions or risks – much less DEMPEP functions – should not be entitled to any intangible-related profits at all.
Intercompany services transactions

Bulletin 6 also contains a number of provisions specifically addressing intercompany services transactions. Bulletin 6 follows the internationally accepted and OECD sanctioned “benefit test”. That is, an intra-group service is recognized if the activities of the service provider provide the service recipient with economic and commercial value that will enhance its commercial position and if an independent enterprise in comparable circumstances would be willing to pay a third party to perform the activity or to do it itself.

Bulletin 6 incorporates a provision from 2015’s Bulletin 16 that empowers tax authorities to disallow a deduction for service fees paid to a related party that does not have significant substance. After Bulletin 16 was released, concerns were raised that it might result in the disallowance of a payment that was actually consistent with the arm’s length principle. For example, a related party with limited substance might act as an aggregator of truly beneficial services provided by affiliates in various countries. That is, the affiliates providing the services might charge a fee to the limited substance affiliate while that affiliate would pass the charges on to the Chinese taxpayer with no more than a small additional markup. Arguably, it would be unreasonable to disallow the deduction in its entirety for services that provided actual benefits to the Chinese taxpayer. While Bulletin 6’s wording is somewhat ambiguous, it appears to limit the ability of the tax authority to disallow a service fee deduction to those cases where the fee is not consistent with the arm’s length principle.

Finally, it is worth noting that Bulletin 6’s provisions on intercompany services explicitly apply both to the provision of intercompany services by a Chinese enterprise as well as to the receipt of services. This is a reflection of the growing significance of Chinese outbound investment. The SAT wants to make sure Chinese headquarters are appropriately compensated for services they provide to their foreign subsidiaries.

Location specific advantages

Over the past decade, Chinese tax authorities have put significant emphasis on ensuring Chinese taxpayers are compensated for so-called location-specific advantages (LSAs), such as location savings and market premium, that allow the multinational group to earn higher profits. This emphasis is reflected in the local file documentation requirements under Bulletin 42, where LSAs need to be addressed both with respect to factors affecting transfer prices and profits in the value chain.

Bulletin 6 also emphasizes LSAs. However, compared to the Consultation Draft, Bulletin 6 takes an approach that is in closer alignment with the OECD Guidelines after BEPS reforms. The OECD Guidelines take the view that adjustments for LSAs will generally not be necessary if the comparable companies used in the analysis are from the same country as the taxpayer. Similarly, Bulletin 6 provides that LSA adjustments are only required if the comparables operate in different “economic conditions”. In addition, Bulletin 6 follows the OECD Guidelines in recognizing that the existence of LSAs is a comparability factor for transfer pricing analysis and that LSAs are not themselves intangible property.
Transfer pricing methods

Bulletin 6 continues to be consistent with the OECD Guidelines with respect to specified transfer pricing methods. Bulletin 6 provides for the comparable uncontrolled price (CUP) method, the resale price method, the cost plus method, the transactional net margin method (TNMM) and the profit split method (PSM). Guidance on each of these methods is generally consistent with the OECD Guidelines. In addition, like the OECD Guidelines, Bulletin 6 allows for use of “other methods” where appropriate.

Bulletin 6 identifies three methods that are frequently used for asset valuation as allowable “other methods”: namely, the cost method, the market method and the income method. This is consistent with the OECD Guidelines after BEPS reforms (although the OECD Guidelines provide a great deal more specific guidance on application of the income method).

Bulletin 6 provides that TNMM is not appropriate in transactions where significant intangible assets are involved, but does not clearly define what intangibles would be considered significant. Where the Chinese taxpayer undertakes significant DEMPEP functions, including promotion activities, tax authorities may argue that TNMM is not applicable and PSM should be applied instead. Interestingly, however, Bulletin 6 does specifically allow the use of TNMM for intangible property transactions where the intangibles are not “significant”.

Importantly, in contrast to the Consultation Draft, Bulletin 6 no longer identifies the value contribution allocation method (VCAM) as a type of other method. This is a major change, which appears to be responsive to criticisms made by commentators on the Consultation Draft. It is also noted that the PSM (in both the Consultation Draft and Bulletin 6) was considered appropriate in cases where all it parties made unique and valuable contributions or the transactions were highly integrated. In light of a recent consultation draft of the OECD which emphasizes that the mere fact that it is difficult to find comparable companies was not sufficient to justify applying PSM, the SAT seems to have responded to this criticism and dropped all references to difficulties of identifying comparables in the Bulletin 6.

Procedural aspects

Bulletin 6 has made a number of changes to procedural aspects of Chinese transfer pricing regime. Most notably, there is now a form that taxpayers need to fill out when they make a self-adjustment. Also, Bulletin 6 specifically provides that taxpayers will temporarily not be subject to audit on transactions that are covered by an advance pricing agreement (APA) submission or renewal application. Specifically, the temporary stay on audit applies if the taxpayer and tax authority reached consensus during an APA pre-filing meeting on the treatment of the transactions in prior years and if an APA intentional letter has been filed. Further, Bulletin 6 makes it clear that tax authorities’ examination power extends to non-residents as well as residents; tax authorities can deal with non-residents either directly or through a resident related party. Bulletin 6 also has more detail than Circular 2 on how to deal with documents and data during a transfer pricing examination.
Other observations

There are a number of areas where Bulletin 6 has made only minor modifications (if any) to the rules under Circular 2. These include:

► Adjustments to the median: By its terms, Bulletin 6 provides wide latitude to tax authorities to use arithmetic means, weighted averages or interquartile ranges in examinations. However, it also provides that, when using the interquartile range, tax authorities should generally adjust to the median if the taxpayer’s results are below the median. Circular 2 had a similar rule but it was somewhat more ambiguous. This rule is inconsistent with OECD guidance which specifies that no adjustment should be made if the taxpayer’s results are at any point within the interquartile range.

► Secret comparables: As under Circular 2, tax authorities are allowed to use non-public information (i.e., so-called “secret comparables”). However, Bulletin 6 makes clear that publicly available data is to be preferred.

► Single function entities: Loss-making single function entities still need to prepare transfer pricing documentation even if their transaction levels are below general documentation thresholds. However, they do not have to spontaneously file the documentation with tax authorities.

► Domestic transactions: Like Circular 2, Bulletin 6 provides that transfer pricing adjustments generally will not be made with respect to wholly domestic transactions unless there is a loss of tax revenue overall.

Bulletin 6 is generally consistent with current practice, as well as the Consultation Draft, with respect to toll manufacturing. If comparable companies cannot be found that have the same business model, the value of materials and equipment provided by the principal must be added back to the cost base when applying a cost plus method. While working capital adjustments are not allowed in any other case, they are allowed in toll manufacturing cases if the adjustment is no more than 10%.

A provision in the Consultation Draft regarding the need to make accounting adjustments after a transfer pricing adjustment and reconcile accounts has not been included in Bulletin 6. Local practices differ on these issues, including whether to impute a secondary adjustment such as a deemed dividend or loan.

As compared with the Consultation Draft, Bulletin 6 provides significant detail on comparability factors related to transfers of financial assets (including equity share). Especially for the equity share transfer, Bulletin 6 specifically listed out quite a few comparability factors that need to be taken into consideration when conducting a benchmarking analysis. The factors are specific and concrete; for instance, analysis is required covering the business and assets structure, industry life cycle, the operating stage, geographical factors, shareholder relationships, goodwill, liquidity consideration, historical operation and so on. We believe this change indicates that Chinese tax authorities will be focusing on equity transfers to a greater extent in the future.
Conclusion

With Bulletin 6, China continues to develop its transfer pricing rules. While there are still areas of inconsistency, Bulletin 6 increases the alignment between Chinese rules and international norms reflected in the OECD Guidelines. With its participation in the ongoing work of the BEPS project, China continues to play a significant role in further developing such norms.
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SAT’s newly released Bulletin 6 strengthens MAP procedures in advance of peer reviews and enhances alignment of China’s transfer pricing rules with OECD standards.
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