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News from Transfer Pricing

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China's Tax Authorities issue groundbreaking consultation draft to update transfer pricing rules in a Post-BEPS environment

Executive summary

On 17 September 2015, China's State Administration of Taxation (SAT) issued a consultation draft circular *Implementation Measures for Special Tax Adjustments*, which would replace the existing Guoshuifa [2009] No. 2 (Circular 2). The public is invited to provide comments on the consultation draft by 16 October 2015. Circular 2 contains the main body of rules governing transfer pricing in China and also covers other areas such as thin capitalization, controlled foreign corporations and the general anti-avoidance rule.

The consultation draft incorporates the internationally accepted arm's length principle and, in many instances, closely mirrors guidance issued in the course of the G20/Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project. Notwithstanding this, there are still many aspects of the consultation draft that have a distinctly Chinese approach, such as the strong views on location savings, market premium and other location specific advantages (LSAs). The divergences from BEPS guidance are as informative as the areas of consistency.

The consultation draft would bring many changes to the transfer pricing (TP) framework established by Circular 2. This Alert outlines many of the more important changes, including: documentation requirements, intra-group services, intangibles transactions, transfer pricing methods, and advance pricing agreements (APAs).

Detailed discussion

Documentation requirements

The consultation draft's TP documentation requirements would put China at the forefront of countries adopting the recommendations of BEPS Action 13. It implements Action 13's threefold approach to documentation, comprising the Master File, the Local File and the Country-by-Country (CBC) Report. The consultation draft would also require companies to prepare so-called Special Files for intra-group services, cost sharing arrangements and thin capitalization.

The much anticipated rules on CBC reporting are largely consistent with BEPS recommendations. Chinese-parented multinational groups that have global revenues greater than 5 billion RMB are required to submit a CBC Report with their annual tax return (due 31 May). At current exchange rates, the filing threshold is marginally lower than the €750 million threshold set by BEPS. While the deadline also is earlier than the BEPS recommendation of 31 December, the consultation draft allows Chinese filers to apply for an extension. China also will accept CBC Reports from Chinese subsidiaries that have been designated by their foreign parent company to make the official filing, consistent with the BEPS secondary filing mechanism. Notably, there is no requirement for other Chinese subsidiaries to file a CBC Report in China. However, in the event China is not able to obtain the foreign-filed CBC report through treaty exchange procedures, Chinese tax inspectors are authorized to require the local subsidiary to provide a copy of the CBC Report in the course of a special tax investigation.

The thresholds for required preparation of the Master File and the Local File remain consistent with prior contemporaneous documentation requirements, namely 200 million RMB for buy/sell transactions and 40 million RMB for all other types of transactions. The contents of the Master File are fully consistent with the BEPS guidelines. As for the Local File, the discussion draft's requirements are significantly more extensive, including a requirement to provide a "value chain analysis." Taxpayers will need to give serious thought as to their strategies for gathering and presenting information relating to the allocation of profits across their value chains.

Intra-group services

The consultation draft introduces an entirely new requirement for the preparation of a Special File wherever a taxpayer engages in intra-group service transactions. The Special File would contain copies of the relevant intercompany agreements, documentation of service cost identification and allocation keys, and—perhaps most importantly—documentation of the benefits received by the Chinese service recipient.

In principle, China continues to adhere to 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. However, like other recent guidance, the consultation draft takes a very strict and somewhat idiosyncratic view of what activities meet the benefit test. For example, the discussion draft takes a very broad view of what activities constitute "shareholder activities" that cannot be charged out, imposing a strong presumption that management, control and oversight activities fall within this category.

Taxpayers will find it hard to reconcile China's approach to intra-group services with other countries' approaches and the risk of double taxation is very real. Companies are well advised to devote significant attention to both planning and documentation around headquarters service charges.

As a final note, a notable divergence from the developing BEPS consensus is that the consultation draft does not contain a safe harbor for low value-adding services, contrary to many observers' expectations.

Intangibles transactions

The consultation draft contains an entirely new chapter concerning intangible property transactions. Although it is a few weeks before the OECD unveiling of the final BEPS guidance on transfer pricing for intangibles, many of the consultation draft's provisions follow very closely the language in the BEPS discussion drafts. This is not surprising given

China's very active participation in the BEPS process. There are, however, some notable differences as well.

The consultation draft adopts the same broad definition of intangible property as the OECD: something other than a tangible asset or a financial asset that is capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated between independent parties in comparable circumstances. The definition specifically includes goodwill and going concern value. Among other things, customer lists and marketing channels are specifically enumerated, which—although not inconsistent with OECD guidance—reflects China's view of the importance of its markets. At the same time, this definition reflects China's accession to the OECD's view that, because they cannot be owned or controlled, location specific advantages are comparability factors rather than intangible assets.

The consultation draft distinguishes between "legal ownership" and "economic ownership" of intangibles. Economic ownership is said to accrue to the party or parties that substantially contribute to the value of the intangibles through the performance of development, enhancement, maintenance, protection, and exploitation (DEMPE)—as well as "promotion"—activities. BEPS guidance does not use the "economic ownership" terminology but propounds the same basic principle: intangible-related returns should accrue to the party or parties that perform important DEMPE functions.

Another subtle difference between the consultation draft and BEPS guidance lies in the consultation draft's addition of "promotion" activities to the other DEMPE activities. It appears clear that the OECD agrees that promotion activities are relevant; they could be subsumed under the "enhancement" category (i.e., promotion activities enhance the value of a brand). However, by explicitly adding this activity, China is again emphasizing the importance of the Chinese market—and of the role of Chinese affiliates in harnessing that market.

Similarly, the consultation draft displays a different emphasis on what DEMPE activities are most important in intangible value creation. BEPS guidance emphasizes design and control functions, such as control over the direction of a research program and control over budgets. The consultation draft agrees that these functions are important, but does not seem to differentiate between them and frontline performance functions, such as performance of research and development and collection of marketing information. The consultation draft also emphasizes local activities such as managing customer relationships and localization of products.

The consultation draft is consistent with other recent guidance from the SAT with respect to review and examination of royalty transactions. 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 DEMPE functions that have improved the intangibles.

Finally, the consultation draft echoes two principles from BEPS guidance: (1) an entity that merely funds intangible development activities but does not perform any DEMPE functions should only be entitled to earn a financing return; and (2) an entity that owns bare legal ownership but does not control financing functions or risks—much less DEMPE functions—should not be entitled to any intangible-related profits at all.

Transfer pricing methods

The consultation draft provides for all of the TP methods that are specified in OECD guidance: the comparable uncontrolled price method, the resale price method, the cost plus method, the transactional net margin method and the profit split method. In addition, the consultation draft describes two types of "other methods" that can be applied: the value contribution allocation method (VCM) and asset valuation methods.

The VCM is very familiar to Chinese transfer pricing practitioners as it has been used in practice by Chinese tax inspectors. It is similar to a 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. However, the consultation draft provides different guidance with respect to when the two methods might be most applicable. Consistent with OECD guidance, the profit split method is particularly applicable where the parties make unique and valuable contributions or where the transactions are highly integrated. The VCM, on the other hand, is said to be applicable where comparables are difficult to find but an allocation formula can be reliably determined. Insofar as Chinese authorities have repeatedly noted the lack of good comparable companies in developing countries like China, there is concern that this criteria can lead to VCM being applied in order to allocate more profit to a Chinese entity that does not own or owns limited intangibles.

Asset valuation methods include cost methods, market methods and income methods. These methods are not new—they are described at some length in the latest OECD guidance. They are particularly useful for valuation of equity shares and of intangible property. The income method for valuation of intangible property will be very familiar to those acquainted with US regulations on cost sharing buy-ins. Interestingly, in a direct challenge to US tax authority practice, the consultation draft explicitly provides that income projections for intangible property should reflect a limited economic life.

Advance pricing agreements

The consultation draft refines APA procedures and specifies the conditions when the Chinese tax authorities can prioritize and reject the APA application.

Specifically, the Chinese tax authorities may prioritize taxpayers who provide complete application materials, include comprehensive and clear analysis on value chain or supply chain, consider location specific advantages such as market premium and location savings, and plan to adopt appropriate TP principles and calculation methods. Proactive cooperation by the taxpayers as well as strong focus and proactive attitude of the corresponding competent authorities would also be prioritizing factors. The draft also clarifies the right of tax authorities to reject taxpayer's letter of intent, renewal application, or formal APA submission under different conditions.

It is also worth noting that the transactional volume requirement of 40 million RMB for APA applications is removed in this discussion draft.

Other important provisions

Other important provisions include:

- *Related party definition*. The definition of related parties to which TP rules apply has been clarified and expanded. For example, companies owned by family members who are related by up to three generations of kinship now meet the definition.
- *Loss company documentation*. Single function entities that have incurred losses are required to prepare a Master File and Local File without regard to transactional thresholds. This is an extension of the pre-existing documentation requirement for loss companies.
- *Tax inspector discretion*. Tax inspectors are given broad discretion in undertaking TP investigations. They may use a single comparable if it is found to be particularly reliable. They may use secret comparables. They can refer to the average, the median or the interquartile range of comparable benchmarks. They can rely on year-on-year results or multiyear average results for both the comparables and the taxpayer.
- *Anti-profit shifting provisions*. Specific provisions are addressed directly at perceived profit-shifting behaviors. Consistent with prior guidance, deductions for service fees and royalties paid to entities with insufficient substance can be disallowed, even if the payments are otherwise consistent with the arm's length principle. In the case of other transactions with low substance affiliates, that affiliate can be treated as the tested party in transfer pricing analysis, thereby allocating all residual profits to the Chinese taxpayer.
- *Corresponding adjustments*. The consultation draft adds a provision requiring taxpayers to reconcile accounts after a TP adjustment has been made. If no corresponding adjustment

is made, the taxpayer will be treated as having made a dividend distribution to its foreign counterparty.

- *Cost sharing arrangements (CSAs)*. Consistent with recent guidance, SAT pre-approval is no longer required for taxpayers to enter into CSAs; however, there will be more emphasis on review and examination of all CSAs. Although the consultation draft continues to require that the parties adjust cost shares for differences between actual results and reasonably expected benefits, contrary to OECD guidance, a welcome clarification has been added that only "significant" differences require adjustment.
- *Thin capitalization*. A Special Report is required demonstrating that the taxpayer's related party debt levels are consistent with the arm's length principle if its debt to equity ratio exceeds specified ratios. While such documentation was previously required, it is likely to be required in more cases because the consultation draft expands the types of related party debt that are considered beyond loans to trade receivables, cash pooling balances and the like.
- *Share transfers*. The consultation draft makes TP provisions specifically applicable to the valuation of equity shares in taxable transactions between related parties, including both direct and indirect share transfers.
- *Tax deregistrations*. The consultation draft requires local tax authorities to investigate a company's historic TP compliance before approving its tax deregistration. Deregistration is necessary whenever a Chinese subsidiary is shut down or relocated as part of a corporate reorganization. The consultation draft directs authorities to pay particular attention to whether intangible property has been transferred for little or no compensation; given that goodwill and going concern value is now considered an intangible, this directive may prove to have significant impact.
- *Profitability monitoring*. The consultation draft includes a new chapter providing for monitoring of taxpayers' profitability to establish a risk hierarchy system for use in selecting targets of special tax investigations or other compliance approaches.

Implications

Most observers would agree that the BEPS process is the most dramatic change in international tax in more than 50 years. The revisions to Circular 2 to be made by the consultation draft are every bit as significant in the Chinese context. Now is the time for multinational companies to assess their Chinese operations in relation to their worldwide tax structure and value chains and determine if any changes are appropriate. Companies also will have to prepare for stringent new documentation requirements in advance of next year's 31 May deadline.

EY is now collecting feedback from taxpayers and will be submitting comments on the consultation draft to the SAT in due course and welcomes feedback from readers.

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