On 8 October 2017, China’s State Administration of Taxation (“SAT”) issued the China Advance Pricing Arrangement (APA) Annual Report (2016) (hereinafter referred to as “2016 Report”) in both Chinese and English. This is the eighth APA annual report released by the SAT as well as the first APA annual report released after the issuance of Bulletin Gonggao [2016] No. 64 (Bulletin on Issues Related to Improving the Administration of Advance Pricing Arrangements) (hereinafter referred to as “Bulletin 64”) on 11 October 2016 and Bulletin Gonggao [2017] No. 6 (Administrative Measures for Special Tax Investigation Adjustments and Mutual Agreement Procedures) released on 17 March 2017 (hereinafter referred to as “Bulletin 6”), against the background of the implementation of 15 action plans recommended by Organization of Economic Co-operation and Development to combat base erosion and profit shifting (hereinafter referred to as the “BEPS Action Plans”).

Executive summary
The data in the 2016 Report covers the period from 1 January 2015 to 31 December 2016, which is technically prior to the issuance of Bulletin 64.

Nevertheless, the message contained in the report suggests that Chinese tax authorities are encouraging use of APAs to provide tax certainty for multinational enterprises (hereinafter referred to as “MNEs”) to mitigate the risk of international double taxation.

Following the promulgation of Bulletin 64, the 2016 Report emphasizes that tax authorities will consider quality of the application submitted as the most important factor to determine whether an APA application should be prioritized. An application which presents innovative application of transfer pricing methods or high quality quantitative analysis for intangibles, location savings or market premium would be prioritized. In order to accelerate the process, we suggest the tax payers should focus on the completeness of submission documents and the quality of quantitative analyses to meet the criteria of prioritization.

As an effective method to solve the transfer pricing issues and potential international tax dispute, APAs have been increasingly preferred by MNEs operating across the globe.
With further clarity and streamlined procedures introduced by the new APA regulations, and the deployment of more manpower and other resources with Chinese tax authorities, it is anticipated that APA programme will be further accelerated and the number of APA cases of application, negotiation and signing would grow in the coming years.

**Detailed discussions**

The 2016 Report covers statistical data and analyses from 2005 to 2016 and illustrated the latest mechanisms and implementation procedures of APAs in China. Although the 2016 Report specifies that this report does not have legal validity, its detailed content does provide important guidance for the taxpayers to understand China's current APA status, mechanism and future trend.

Below summarizes the key points and our observations on China's APA mechanism and future trend indicated by the 2016 Report:

<table>
<thead>
<tr>
<th>Different application prerequisites</th>
<th>2016 Report</th>
<th>2015 Report</th>
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<tbody>
<tr>
<td>Access to APA is available to enterprises with annual related party transaction amount exceeding RMB 40 million, of which related transaction mainly includes:</td>
<td></td>
<td>Access to APA is available to enterprises meeting the following three conditions:</td>
</tr>
<tr>
<td>(1) Purchases, sales, transfer and using of tangible assets</td>
<td></td>
<td>1. Annual related party transaction amount exceeding RMB 40 million, of which related transaction mainly includes:</td>
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<tr>
<td>(2) Transfer of ownership or the right to use of intangible assets</td>
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<td>2. Prepare, preserve and provide contemporaneous transfer pricing documentation</td>
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<td>(3) Circulate necessary funds</td>
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<td>(4) Labor service provision</td>
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Following Bulletin 64, the 2016 Report simplifies the prerequisites of APA application. The applicant is qualified to apply as long as its annual related party transaction amount for the previous three years is stably above a certain amount. Other factors like compliance level, APA negotiation intention of the competent authority of the other contracting state of treaties are merely considered as priority factors. In this aspect, SAT has lowered the bar for APA application on the one hand, while on the other hand, still expected cases with good quality to be negotiated and signed. For example, both the 2016 and 2015 Reports emphasize that a submission which presents innovative application of transfer pricing methods or high quality quantitative analysis for intangibles, cost savings or market premiums will merit the SAT’s prioritized processing.

It is in particular to point out that Bulletin 64 emphasizes that it would also merit the SAT’s prioritized attention, if tax authorities performed special tax adjustments to enterprises and the case was closed.

It can be observed that the Chinese tax authorities are actively participating in solving international tax dispute to mitigate the risk of international double taxation.
Different procedures of implementation

<table>
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<tbody>
<tr>
<td>Six stages: pre-filing meeting, letter of intent, analysis and evaluation, formal application, negotiation and signing, and implementation and monitoring</td>
<td>Six stages: pre-filing meeting, formal application, review and evaluation, negotiation, signing and monitoring</td>
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EY Insight

In the new process, “letter of intent” stage has been added, while “review and evaluation” have been changed to “analysis and evaluation”, which indicates that Chinese tax authorities are expecting more APAs in good quality, and would like to carry out more detailed review and analysis in the earlier phase to reach an agreement with applicants before the subsequent process is triggered. In the meantime, in the stage of “analysis and evaluation”, if APA is not in line with the arm’s length principle, the enterprise should be able to enter the next stage after relevant adjustments are made. Judging whether the content is in line with the arm’s length principle at this stage could lead to misjudgment of some complicated cases, which would be precluded from an APA. This is due to the fact that for certain complicated cases, more facts and detailed data may only be revealed at the subsequent official negotiation and signing stage.

Different renewal conditions

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<tr>
<td>For an APA with a target price/profit within an interquartile range, if the enterprise’s actual operating price / profit falls outside the interquartile range for any year during the APA covered period, tax authorities shall adjust the actual operating result to the median for the year. Upon expiration of the APA, if the calculated weighted average operating price/profit of the enterprise for the APA covered period falls below the median of the agreed range and has not been adjusted to the median, tax authorities will not accept the enterprise’s APA renewal application.</td>
<td>During the term of the APA, if the enterprise’s overall profit level remains below the median most of the time, where an interquartile range is applied, tax authorities may not accept a renewal application of the APA.</td>
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The 2016 Report emphasizes that if the weighted average value falls below the median of the interquartile range and is not adjusted to the median, tax authorities will not accept the enterprise’s APA renewal application. To a certain extent, it seems that tax authorities are adopting a more reasonable approach and willing to consider the impacts caused by product life cycle, market conditions, and one-off event, etc., as compared with the single year approach in the prior practice. Under the 2015 Report, if the enterprise’s profit level falls below the median for most of the years during the APA period, tax authorities may decline the renewal application already.

B. Comparison with the 2015 Report as well as reports from previous years, the main data characteristics of the 2016 Report

APAs signed by Year

The number of unilateral advance pricing arrangement (“UAPA”) and bilateral advance pricing arrangement (“BAPA”) signed by year in China covering the 2005 to 2016 period is depicted as follows ¹:

It can be observed that the number of UAPAs and BAPAs signed each year has fluctuated in the past few years. Compared with 2015, the number of UAPAs and BAPAs signed in 2016 increased slightly. BAPA can effectively avoid or eliminate international double taxation, compared to UAPA that can only provide certainty to the enterprise’s pricing methodologies and calculation process with respect to its related party transactions within one jurisdiction. However, in the actual application process, BAPA may be subject to external factors such as the severe resource constraints at the SAT level and the degree of cooperation of the counterparty tax authorities. With the enhancement of resources at the SAT level, it is believed that BAPAs would receive more and more attention and get more popular with MNEs.

APAs by Phase

Compared with the previous APA annual reports, the 2016 Report simplifies the APA status statistics by dividing an APA program into three phases, which are intent, application and signing. The following table describes the statistics of APAs by phase as of 31 December 2016.

¹ The graph is developed based on the data in the 2016 Report.
As of 31 December 2016, China’s SAT has signed 84 UAPAs and 55 BAPAs. In signing phase, there are more UAPAs than BAPAs. However, it should be noted that the sum of APAs in the intent, application and signing phases reflects, to a certain extent, future workloads of SAT. In this regard, the sum of UAPAs in these three phases is far less than that of BAPAs, indicating that BAPAs has gained more popularity in the past years and would likely continue such trend in the future.

► Other APA statistics

The 2016 Report contains other types of statistics with regard to APA:

APAs by transaction type: Transfer of the right to use or ownership of tangible assets accounts for nearly two-thirds of the APAs concluded from 2005 to 2016.

APAs by region: All of the 6 BAPAs signed in 2015 were negotiated with Asian countries (4 with Korea and 2 with Japan). While among the 6 BAPAs signed in 2016, 3 were with Asian countries (regions) and 3 were with European countries. This suggests that Chinese tax authorities are keen on expanding their cooperation with tax authorities outside Asia such as Europe and the Americas.

On the other hand, more and more multinational companies headquartered in non-Asian regions are also actively considering signing APAs in China to obtain tax certainty in cross-border transactions.

APAs by completion period: The statistics for BAPAs in 2016 are impressive (three BAPAs concluded within 1 year, one BAPA concluded in 1-2 years, one BAPA concluded in 2-3 years and one BAPA concluded lasting for more than three years). There is a slight increase in the timeline of BAPA negotiation process compared with previous data. It is believed that with the increase of the relevant manpower at the SAT level, the APA negotiation could be accelerated. Considering the increasing concerns from MNEs on the risk of double taxation resulting from higher transparency, it is expected that the application of BAPAs in China may increase rapidly in the foreseeable future.

APAs by transfer pricing method: The transactional net margin method (TNMM) has been by far the most common method adopted in China’s APAs during 2005-2016 (applied for 120 times, which account for 77.4% of the total). While the profit split method was only applied in 4 cases and other methods in 6 cases, the SAT states that the tax authorities have been exploring their application in ongoing APA negotiations, especially where both parties make significant contributions to value creation or where location specific advantages exist.

Industries covered: The most common industry covered by concluded APAs since 2005 to 2016 is manufacturing (116 cases which account for 83.5% of the total).

EY’s observations

Issuance and implementation of Bulletin 64 as well as Bulletin 6 further improve and standardize China’s APA mechanism and relevant procedures. The 2016 Report also reflects the SAT’s positive attitude towards APA.

In addition, the 2016 Report reiterates the principles of prioritizing case acceptance in APA application. In general, applications from taxpayers with good tax credit rating and high-quality analysis (especially high-quality value chain or supply chain analysis, and location specific advantages analysis) are more likely to be prioritized by Chinese tax authorities.

With further clarity and streamlined procedures provided by the newly issued APA related laws and regulations, and the deployment of more resources within Chinese tax authorities, it can be expected that the APA as a win-win mechanism for both tax authorities and enterprises will become more popular in China. The number of APA cases is expected to grow. Companies with significant cross-border transactions are recommended to evaluate the feasibility of entering into an APA with China in order to mitigate the potential risks of double taxation arising from transfer pricing area.
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