Dear Friends,

Welcome back. Slowing economic growth, a steady stock market and increased trade friction with the United States are concentrating business leaders’ minds on the economy, yet Chinese consumers remain upbeat. According to China’s National Bureau of Statistics, in 2016 Chinese consumers spent more than USD750 billion online – more than the US and UK markets combined – and the market size is expected to grow significantly this year. A closer look at how China’s marketplace and consumer behaviors have been evolving will surely provide a glimpse into the future of the consumer product and retail markets, and offer valuable insights for companies around the globe.

In this edition, we present you with three interesting viewpoints:

No. 1. The revolution from “product-oriented” to the new “scenario-oriented” retailing (Tao Song, Advisory Services Partner, Ernst & Young (China) Advisory Ltd.)

In this article, Tao has identified significant changes in the retail world, as well as the digitalization trend, and the growing focus on improvement of life quality. All these factors have driven retailers to switch from “product-oriented” approaches to “scenario-oriented” creations.

No. 2. Impact on the luxury sector in China of major transfer pricing developments (Ivan Chan, Business Tax Advisory Partner, EY Tax Services Limited; Janice Ng, International Tax Services Partner, Ernst & Young (China) Advisory Ltd.)

Ivan and Janice have identified many recent accelerating key trends in terms of tax challenges facing luxury businesses in China, especially in transfer pricing (TP), where the regulatory scheme has been comprehensively updated and the related impacts on luxury groups with Chinese operations are foreseeable.

No. 3. Challenges in overcoming food safety risks in the era of new retailing (Ivan Tong, Climate Change and Sustainability Services Partner, Ernst & Young Hua Ming LLP)

The “traditional” e-commerce platform is unable to provide consumers with human interactions. With the rise of new retailing, a set of new challenges, including food safety risks, has started to draw attention from retail management. Ivan Tong has laid out the key characteristics of the food safety risks associated with new retailing, and provided a framework for the operator to identify and manage risk.

Please enjoy reading the journal, and we look forward to your comments and questions.
The revolution from “product-oriented” to the new “scenario-oriented” retailing

Tao Song  
Partner, Advisory Services  
Ernst & Young (China) Advisory Ltd.  
tao.song@cn.ey.com
Overview

With demographic changes, the world has significantly changed in three aspects: age and wealth, behavior and habit, and interests and hobbies.

These are specifically, the constant flow of wealth to younger generations, the deepening of digitalization of behavior, and the growing focus of interests and hobbies on improvement of life quality.
## Contents

<table>
<thead>
<tr>
<th></th>
<th>Changes in the demand side</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Changes in age and wealth</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Changes in behaviors and habits</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Changes in interests and hobbies</td>
<td>7</td>
</tr>
<tr>
<td>2</td>
<td>Changes in the supply side</td>
<td>7</td>
</tr>
<tr>
<td>3</td>
<td>Problems existing in supply-side operation</td>
<td>8</td>
</tr>
<tr>
<td>4</td>
<td>Solutions for supply-side operation</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>Method 1: Transformation from “customer service” to “user service”</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>Method 2: Insights into users</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>Method 3: Build an integrated omni-channel customer marketing and service system</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>Method 4: Improve the user system</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Method 5: Build a scenario ecological environment</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Method 6: Build a professional operation team</td>
<td>16</td>
</tr>
</tbody>
</table>
Changes in the demand side

With demographic changes, the world has significantly changed in three aspects: age and wealth, behaviors and habits, and interests and hobbies. These are specifically, the constant flow of wealth to younger generations, the deepening digitalization of behavior, and the growing focus of interests and hobbies on improvement of life quality.

Changes in age and wealth

First of all, with the change of demographic structure and the improvement of residents’ income level, China’s high income class tends to be younger. According to Forbes’ 2016 survey, more than 80% of mass affluent were below the age of 49, of which, over 50% were under the age of 39. By the end of 2016, the per capita disposable income of urban and rural residents was double those in 2009.

Changes in behaviors and habits

Meanwhile, benefiting from the deepening of digitalization, China has seen rapid growth in the scale of internet users, online shopping and online payment. By the end of 2016, the number of China's internet and mobile internet users reached 730 million and 690 million, up over 3 and 13 times respectively over the past decade. The size of online shopping and online payment users has doubled over the past 5 years, both accounting for over 63% of the overall number of internet users.

Size of internet and mobile internet users

Size of online shoppers

Size of online payment users

Figure 1: Changes in age and wealth

Figure 2: Increasing digitalization of living behaviors and habits
Changes in interests and hobbies

Interests and hobbies are no longer subject to material conditions. With the increase in disposable income per capita, expenditure on clothing, food, housing and other similar necessities has decreased year by year, while expenditure on travel, communication, education, culture, entertainment, healthcare and other categories has increased. Expenditure on categories that are not necessities but can significantly improve life quality, such as leisure and entertainment, tourism and personal care, has increased, which indicates that society’s willingness to consume is gradually shifting from satisfying survival needs to improving the quality of life.

In conclusion, changes in these three aspects drive people’s demand for products and services, shifting from "satisfying basic needs" to "realizing self-value", and from "standardized" to "personalized".

Changes in the supply side

The world has also seen changes in the supply side as people’s demand change. In the past, traditional retailers adopted a “product oriented” approach for customer management, and promoted profitability through high-efficiency supply chain management and all-around sales channels. Now, emerging retailers are focusing on providing a high quality experience by creating “scenarios”, so as to realize their self-value. Today, retailers are transforming from "product oriented" to “scenario oriented”.

### Figure 3: Consumption structure shifts to services designed to improve life quality

<table>
<thead>
<tr>
<th>Category</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>35.3%</td>
<td>34.4%</td>
<td>33.9%</td>
<td>30.2%</td>
</tr>
<tr>
<td>Clothing</td>
<td>7.7%</td>
<td>7.7%</td>
<td>7.2%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Housing</td>
<td>22.5%</td>
<td>22.6%</td>
<td>21.8%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Life necessities and services</td>
<td>5.6%</td>
<td>6.0%</td>
<td>6.1%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Transportation and communication</td>
<td>12.2%</td>
<td>12.3%</td>
<td>12.6%</td>
<td>13.7%</td>
</tr>
<tr>
<td>Education, culture, entertainment</td>
<td>10.5%</td>
<td>11.0%</td>
<td>11.1%</td>
<td>11.9%</td>
</tr>
<tr>
<td>Healthcare</td>
<td>4.6%</td>
<td>4.0%</td>
<td>3.8%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Other offerings</td>
<td>4.9%</td>
<td>4.4%</td>
<td>4.2%</td>
<td>3.4%</td>
</tr>
</tbody>
</table>

*Source: NBS*

### Figure 4: Changes in operating model

- **Supply chain oriented**: Carry out internal and external supply chain integration for efficient management of upstream and downstream logistics, data and information flow, capital flow, value flow and business flow.
- **Product operation**: Accurately understand customers’ diverse mindsets and needs. Achieve self-value and personalization via customers’ perception of products and services.
- **Experience oriented**: Provide quality products and services for customers from all classes, respond to their demand for value, ensure products and services are driven by customer demand, and continuously assist customers in achieving their desired values at the spiritual and cultural level.
- **Scenario operation**: Build sales channels to eliminate the distance between products, services and users. Promote channel integration to adapt to diversified consumption culture, dual structure market, regional market and industrial market.

**Percentage of top 3 categories of expenditure after income increases**

<table>
<thead>
<tr>
<th>Category</th>
<th>Products</th>
<th>Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>46%</td>
<td>30%</td>
</tr>
<tr>
<td>Clothing</td>
<td>37%</td>
<td>13%</td>
</tr>
<tr>
<td>Health products</td>
<td>17%</td>
<td>9%</td>
</tr>
<tr>
<td>Leisure and entertainment</td>
<td>25%</td>
<td>5%</td>
</tr>
<tr>
<td>Travel</td>
<td>23%</td>
<td></td>
</tr>
<tr>
<td>Personal care</td>
<td>13%</td>
<td></td>
</tr>
</tbody>
</table>

A scenario operation company adopts a strategy of “preferential purchasing” by employing a large number of buyers from all consumer groups to select goods for all types of subject groups. For example, it may set up exclusive shelves for elderly women preferring conservative consumption patterns, a younger group with strong buying power, business persons with certain social status needs and other consumer groups. High quality goods selected by buyers of similar ages and preferences are preferred and welcomed over those purchased through sales models designed for general customers.

Regarding profitability, a major source of profit is the annual membership fee paid by customers, while establishing physical stores in remote locations with lower costs enables an enterprise to attract customers by taking advantage of “underselling”. It also provides convenience to the customers through online stores, and draws customers' sustained attention by means of special goods, discount advertising, membership card renewal services and the like.

The core of such an operation model lies in “experience” and “content”. “Experience” is about the customers' perception of the products and services, and “content” aims to respond to the customers' demand at the spiritual and cultural level. This kind of model is formed in response to changes in the times and social structure, going beyond concepts like “product”, “supply chain”, “channel” and other traditional selling ideas.

Standing out from all the business forms, scenario operation features the identification of customers’ actual rigid demands, which serve as the core driver, and the construction of various “people-centered” scenarios, connecting “people” and “life”, “consumption”, “entertainment” and other scenarios, so as to establish people-centered scenario operation.

Domestic online retailers and certain physical retailers have built scenarios in areas such as entertainment, shopping, tourism and games with even more comprehensive considerations than customers' expectations, enabling customer access to full services through one contact point.

Problems existing in supply-side operation

Even if the supply side changes in alignment with the users' requirements, many problems still exist in the operation due to various historical reasons.

Firstly, deepened digitalization has made various channels readily available to customers, causing changes in the customers' journey and a shift forward in the decision-making process. Accordingly, the transformation of users has been completed in advance.

Secondly, in traditional retailers' operation, user behaviors are spread among the contact points of various channels, which are usually operated separately, so users in a single channel become increasingly “sparse” and fade out and even “disappear”.

Third, the application of the traditional CRM system is not sufficient and a great deal of manual work from customer management strategy to user channel contact points is still required. Such inefficiency and high reliance on human capability results in difficulties in customer marketing and increasing service workloads.

Fourth, the "membership system" as the representative of the customer loyalty program is not really considerate for "users". This operation strategy may be indispensable for an enterprise, but is not helpful to user management. The "membership system" has gradually became a thing of little value or interest or been taken advantage of by people just for discounts.

Figure 5: People-centered scenario operation model
Fifth, enterprises have failed to capitalize on the system of users’ rights and interests, which has been built with “significant investment”, to activate users, promote transformation and improve their loyalty. The system has become an empty shell and has no role in the scenario operation and ecological construction.

**Solutions for supply-side operation**

Enterprises should solve the five problems above by transforming the concept of “customer service” to “user service”, obtaining insight into the users, establishing integrated omni-channel customer marketing and service systems, improving the user system, constructing a scenario ecological environment and building specialized operation teams.

**Transformation from “customer service” to “user service”**

Firstly, enterprises should transform the concept of “customer service” to “user service”, to cope with the changing customer journey.

Traditional retail customer lifecycle management centers on the products, and customers are included only when they are involved in real-name transactions. A large proportion of these customers are inactive customers that fail to be transformed or retained. To achieve the supply side changes, the traditional concept of “customer” operation can no longer cover the expanding customer lifecycle, so enterprises need to transform “customer service” to “user service”, to adopt the omni-channel “user” operation model which covers all of the customer status indicators, including browsing and following, online and offline, membership and non-membership, etc.
In order to realize business model transformation, traditional retailers should first capture online users' website browsing and visiting information, and use technology such as Wi-Fi, GPS probe, sensor, camera image recognition and the like to obtain visitors' and followers' browsing information and retention time in physical stores, and deploy services and marketing in advance, thus obtaining customers earlier. Furthermore, by prioritizing the customer-obtaining process, that is, the real user-centered strategy, and considering the contact point as a starting point, extension of the user lifecycle can be achieved and the benefits from cost per unit increase.

Insights into users

Secondly, enterprises should link the user identifiers of all contact points, and build user profiles to have a deeper understanding of users.

In most cases, enterprises cannot completely integrate the users' information and data scattered among various channels, for each channel operates independently, and the contact method between enterprises and customers, user login security strategies and the user data obtained are inconsistent. Therefore, even as the contact points with customers are increasing, enterprises’ understanding of customers has not improved correspondingly.

![Figure 7: Being user-centered, considering contact point as a starting point, obtaining customers earlier](image)

![Figure 8: Traditional user system operated independently by each channel](image)
Enterprises need to connect the users’ identifiers and data, so that the user identifiers and information scattered among various channels can be mapped to unique users. Based on this, the integrated data is used to perform analysis and modeling on users so as to build user profiles more effectively.

Figure 9: User identifiers in various channels
User profiles map users' basic information (such as age, life stage, social status and asset level, etc.), hobbies (sports, outdoor activities, wealth management, etc.), behavioral habits (online shopping, vehicle, etc.), consumption preferences (daily necessities, luxuries, clothes, shoes and bags) and other aspects of life, which enable enterprises to “label” predictions of users' future behaviors accordingly. With the support of the user profiles and attached labels, enterprises can perform precision marketing on users based on their interests and preferences.

Figure 10: User profile formed by "labels"
Build an integrated omni-channel customer marketing and service system

Third, enterprises should build an integrated omni-channel customer marketing and service system. Between the traditional CRM system and each channel, the strategy is transmitted and implemented through manual processes, which are not only inefficient but also restricted by the capability of personnel. So enterprises need to build an integrated omni-channel customer marketing and service system through an integrated online and offline platform and an omni-channel intelligent service engine, to provide users with a consistent omni-channel experience.

Enterprises need to use these three sets of tools to perform comprehensive control over five levels as follows:

1. at the "refinement operation" level, build a multi-dimensional index system and monitoring system, and create different core indicators for the three stages of marketing activities;
2. at the "channel coordination" level, integrate the promotion resources inside and outside the industry, connect all the channels and conduct consistent management to achieve comprehensive channel docking and unified management;
3. at the "process control" level, establish standardized processes for marketing activities, achieve the point-line-surface combination, establish efficient process management and monitoring;
4. at the "efficiency improvement" level, use a number of built-in supporting tools and customize the tools for each process of the activities, to increase the operational efficiency of each step; and
5. at the "resource management" level, review all kinds of resources required for the marketing activities, classify and aggregate the resources based on use and establish a unified pool of resources to achieve unified resource integration and management.

---

**Figure 11: Build an integrated omni-channel customer marketing and service system**

---
Improve the user system

Fourth, an enterprise should establish user strategies and improve its user system based on a deeper insight into users, and develop an all-around and integrated user management model with sub-systems such as growth, incentives and rights and interests.

In the past, enterprises only implemented loyalty programs for “members”, and thus missed the business opportunity to acquire customers or users who were not qualified as “members”. An enterprise should manage users by hierarchy based on business characteristics and integrate resources from different departments and user levels in order to finally establish a complete “user” service system which covers the user’s whole life cycle. An enterprise can use incentives, rights and interests to enhance user loyalty, resell products and services, improve the user structure, increase touch points between users and sellers, raise interactive frequency and optimize the user experience.

Build scenario ecological environment

Fifth, an enterprise should establish a business model for scenario marketing and a “multi-win” partner profit distribution mechanism to build a scenario ecological environment, and use effective management tools to support its operation.

At present, under the loose collaborative management between traditional enterprises and third-party service providers, schemes such as integral systems and users' rights and interests have been created, but due to their excessive contents and the complexity of user requirements, such schemes have become “chicken ribs” for users and burdens for enterprises. To solve this problem, a scenario focusing on the key products should be established, extending the service radius up and down, expanding the business cooperators along the service radius and building a “multi-win” partner profit distribution mechanism, so as to fully motivate the users, enhance their participation and activity and improve their conversion rate and loyalty.
The scenario ecological environment needs a business model for scenario marketing and a “multi-win” partner governance mechanism, underpinned by a complete, advanced and effective management tool to provide all-around support for service products, service statistics, demand management, directory management, rule and list management, partner management, partner payment and settlement, bonus point core systems and others.

Figure 14: Scenario ecological management platform supporting scenario marketing and profit distribution mechanism
Build a professional operation team

Finally, an enterprise needs to build a professional operation team. The enterprise should:

(1) define the team’s position and objective and design a reasonable roadmap to direct the team’s development;

(2) unify the team's conception and value to strengthen its sense of cohesion;

(3) introduce talents with expertise and skills to ensure the effective operation of contents, activities, users, traffic, products and others; and

(4) implement a reasonable incentive and assessment mechanism to stimulate team members' initiative and creativity.
Impact on the luxury sector in China of recent major transfer pricing developments

Ivan Chan  
Partner, China Tax & Business Advisory Services  
Ernst & Young Tax Services Limited  
ivan.chan@hk.ey.com

Janice Ng  
Partner, International Tax Services  
Ernst & Young (China) Advisory Ltd.  
janice.ng@cn.ey.com
In the *Luxury & Cosmetics financial factbook, 2015 edition*, Partners of EY member firms in China introduced readers to a range of tax challenges facing luxury businesses in China. Since that time, many of the trends that were noted have accelerated. This is especially true with respect to transfer pricing (TP), where the regulatory scheme has been comprehensively updated. Luxury groups with Chinese operations need to react quickly if they have not already done so, and should be prepared to consider operational or TP policy changes if necessary.
Introduction

TP concerns the prices for transactions between related companies involving goods, services, intangible property (IP) and financing transactions. For example, if a China distribution subsidiary purchases products from its foreign parent, the “transfer price” is the price it pays on import. Similarly, if a China subsidiary licenses IP from the foreign brand owner, TP concerns the amount of the royalty paid.

TP is an integral part of corporate income tax, customs duty, and value-added tax (VAT). For the income tax, the transfer price or royalty paid to a foreign brand owner is a deduction: the higher the price, the lower the taxable income. For customs purposes, it is the transfer price itself that could be subject to duty: the higher the price, the greater the customs duty. In the case of CT/VAT, tax will be collected on the transfer price upon import and refunded on final sale.

In this article, we will discuss the relevant recent developments from the Organization for Economic Co-operation and Development (OECD)/United Nations (UN) and how China has localized the base erosion and profit shifting (BEPS) initiatives which may have a profound impact on luxury and cosmetics multinational companies operating in China. We will also share our experience and observations in relation to the luxury and cosmetic sector on the ground from a TP perspective.

Developments: OECD/UN

TP has been a central component of the most significant development in the field of international tax in more than 50 years, the project led by the G20 and the OECD regarding BEPS. The BEPS project involves work on 15 “action items” covering the gamut of international tax issues, including four relating to TP.

The central premise of the BEPS project is that profits should be taxed where economic activities are performed and where value is created. Multinationals were seen as having artificially shifted profits into low-tax jurisdictions; BEPS reforms are designed to make this tax-avoidance-related profit shifting impossible in the future. The Chinese tax authorities are concerned about profit shifting and seek to claim their share of profits that have been lightly taxed. Taxpayers who are not involved in profit shifting or aggressive tax planning are often finding themselves under suspicion as well.

Because TP directly affects profits, manipulation of transfer prices is one way that profits can be artificially shifted. Even if there is no manipulation or intentional profit shifting, the Chinese tax authorities—like their counterparts in other tax jurisdictions—are keenly interested in transfer prices since they determine how much profit each jurisdiction can tax.

Under BEPS reforms, the location of decision-making that is core to profit/value creation is especially important for TP purposes. While the performance of more routine activities needs to be compensated with routine and stable profit, the decision-maker is often the related party that earns any extraordinary profits or bears any loss. When it comes to the development of IP, which is often the driver of extraordinary profits, BEPS TP rules focus on “development, enhancement, maintenance, protection and exploitation” (DEMPE) functions.

In order to monitor TP compliance and assess/select audit targets, many tax jurisdictions require local taxpayers to document their transfer prices. For instance, China has had documentation requirements since 2008. The BEPS project has put in place a new three-tiered documentation framework that is being implemented by jurisdictions throughout the world, including China. This framework consists of a country-by-country (CbC) report, a master file and a local file.

Typically, large multinational groups will be required to file a CbC report with the tax authority where the multinational has its headquarters; that tax authority then shares the CbC report with other tax authorities through treaty-based exchanges. The CbC report provides data on such indicators as revenues, profits, taxes, assets, and headcount of all members of the multinational group. Tax jurisdictions will be using CbC reports to identify companies to audit. For example, if a group is paying very little tax in China in relation to assets or headcount but recorded considerable related party transactions, the Chinese tax authorities will surely take a very close look at its TP policies.

The master file is a document that is prepared by the multinational group's headquarters. It provides a high level overview of the group's business, including its IP and financing strategies, as well as an overview of the group's global TP policies. The headquarters will provide the master file to each of its subsidiaries around the world, who then may provide it together with the local file to the tax authorities in the country where they do business according to the local country requirements. It is therefore important that multinationals exert effort to make the content of their master file and their local files consistent with each other.
The local file is similar to documentation that taxpayers prepared prior to BEPS reforms. It documents the TP policies of a particular member of the multinational group and demonstrates that they comply with global standards (the so-called “arm’s length principle”). As we shall see, China’s local file requirements are far more extensive than the OECD’s recommendations.

The U.N. is on a parallel course with the OECD in terms of creating guidance on TP principles and documentation. Their guidance, however, is focused on the specific issues faced by developing countries. This May (2017), the U.N. just released an updated “practical manual” for this purpose. China contributed a chapter to the practical manual outlining China’s specific views on a number of issues, including “market premium” as discussed below.

Developments: China

In 2016 and 2017, China issued two public notices that localize BEPS recommendations for China. In June 2016, Public Notice 42 implemented the BEPS three-fold documentation framework. Then, in April 2017, Public Notice 6 implemented many of the other BEPS TP reforms.

As we predicted in 2015, China has escalated reporting and disclosure requirements to a new level. China’s requirements with respect to CbC reporting and the master file are largely in line with OECD recommendations. However, China has imposed much more extensive disclosure and analysis requirements for the local file. These requirements take effect for local taxpayers’ 2016 tax year; the first local file must be prepared by June 30, 2017.

Public Notice 42 also greatly increases the reporting burden for disclosure of related party transactions on companies’ Chinese tax returns. Other than the CbC reporting forms, the number of related party transaction reporting forms (RPT forms) has nearly doubled from nine to as many as sixteen. This reporting requirement also takes effect for the 2016 tax year; the new forms must be filed with taxpayers’ tax returns due May 31, 2017.

Many luxury business companies are struggling with some of the disclosure requirements of the local file and the RPT forms. Over the last few months during this first year of implementation, a number of difficult requirements are being worked through, including:

► RPT forms require disclosure of the effective tax rates of related parties in other countries as well as an indication of any tax preferential treatments they enjoy. Gathering this sort of extra-territorial information proved to be an administrative challenge and a challenge to corporate disclosure policies.

► The local file requires a “value chain analysis”. The lack of guidance on how to prepare such an analysis poses challenges. Although the master file also requires disclosure of supply chains, companies are considering whether to make the additional effort of isolating the value chain relating to Chinese business, which may differ from the global supply chain. Taxpayers are also required to provide financial statements and disclose value-chain profits for each related party within the relevant value chain, presenting extra-territorial disclosure challenges even more daunting than the effective tax rate disclosures. In addition, the guidance in Public Notice 42 is silent on the disclosure treatment for multinational groups operating multiple brands/product groups with different value chains which are fairly common within the luxury sector.

► The local file also requires an analysis of “location specific advantages” (LSAs). The LSA concept is emphasized by the Chinese tax authorities both in regulations and in practice. The notion is that companies operating in the Chinese market should earn higher profits because of LSAs, especially location savings and market premium. Luxury businesses do not tend to enjoy location savings given that few have manufacturing operations with low cost labor. However, luxury businesses are finding it a challenge to analyze potential market premium given that luxury products often sell at higher prices in China than they do in other markets. In this context, Public Notice 6, which allows for non-adjustment on LSA when local comparable are utilized, seems to be offering a breathing space for luxury goods operators in China.


3 Location savings are the net cost savings derived by a multinational company when it sets up its operations in a low cost jurisdiction.

4 Market premium relates to the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting the sales and demand of a service or product.
China's contribution to the UN practical manual reveals the Chinese tax authorities' views on market premium. They take note of the heavy sales and marketing activities of Chinese subsidiaries building brand awareness in China and correlate it with “exponential growth” in sales revenue. They take the view that additional profits resulting from the unique characteristics of the China market (e.g., consumer preference for foreign brands and imported luxury products, and China's large population with growing wealth) should be taxed in China, tying it to the BEPS concept of value creation or claiming the existence of local marketing intangibles. The tax authority may also discount the contributions of foreign intangibles based on these concepts. Finally, they note that many Chinese nationals go abroad to purchase luxury products, having acquired the taste for them in China but deterred by higher prices in China. It is suggested that portions of the sales revenue and profits from foreign sales to Chinese customers may be attributed to the Chinese subsidiary.

Luxury business taxpayers sometimes find themselves at odds with the tax authorities’ views on market premium. There are a number of reasons for higher prices in China that have nothing to do with profit shifting and do not reflect a market premium. A major reason for high prices is the high indirect tax burden (customs and CT/VAT) imposed on luxury products. These taxes account for a significant portion of the retail prices. Under recent CT reforms, tax rates on cosmetics are being reduced5; a number of luxury players are reducing prices in response.

Another reason for luxury products' higher prices in China is that the cost of operating in the China market is higher than elsewhere in the world. In location savings inquiries, the notion of location “dis-savings” is being considered; this could be called as market “dis-premium”. For example, relatively expensive television advertising is much more important in the China market. Also, since store image is particularly important in China, extensive store renovations are needed more frequently than that in mature markets.

Public Notice 6 also implements other BEPS reforms, including DEMPE analysis and disregard transactions with related parties that are located in low tax jurisdictions and have limited substance. Luxury business companies that are members of corporate groups that include such low-tax low-substance entities are considering ways to limit their exposure to these provisions.

Public Notice 6 modifies the OECD's DEMPE framework by adding an additional “P” for promotion (i.e., DEMPEP). While promotion could be seen as covered by other DEMPE functions, such as enhancement or exploitation, this modification to the framework reflects China's intense focus on China market activities. This is a very relevant consideration for luxury business where promotional activities are core to their business in China. Moreover, if the Chinese subsidiary is found to have a level of decision-making authority over China promotional activities, there is an even greater risk that the tax authorities will argue it owns significant marketing intangibles. As a result of the DEMPEP framework and the China marketing intangibles issue, some luxury business companies are reconsidering whether a limited risk distributor arrangement, which is very common among companies in the sector, continues to be viable in China. Consideration is increasingly being given to profit split analysis or other non-traditional TP approaches.

---

5 Cosmetic products now divided into high-end and general categories. For high-end cosmetic products, the CT rate would be reduced from 30% to 15%. For general cosmetic products, the CT rate would be reduce to 0% with effect from 1 October 2016.
Audit environment: China

The luxury sector has long been a focus of Chinese tax authorities for investigation. The statute of limitations for TP audits is ten years, so audits launched in 2017 will review related party transactions in years as far back as 2007. The amounts at issue can be very large; there have been many cases in tier one cities involving more than RMB100 million in additional tax liability arising from TP adjustments.

The Chinese tax authorities keep statistics on three types of tax collection efforts: investigation, services and administration. In 2016, formal investigations reportedly generated RMB9.4 billion in tax revenue. However, RMB4.2 billion in tax revenue was attributed to "administration", which includes informal and follow-up investigations. Seemingly routine TP inquiries from the authorities should not be taken lightly; authorities put great pressure on taxpayers to reassess their transfer prices, make self-assessments and pay additional taxes.

Authorities are aggressively challenging luxury and cosmetics product taxpayers that have lower profits than their industry peers, or have losses. Over the past few years, the authorities have developed databases based on RPT form disclosures, TP documentation and other data. These databases give them unprecedented visibility into the transfer prices and reported profits of luxury sector businesses. The tax authorities are using this information to rebut taxpayer claims that their losses are attributable to industry downturns or other competitive factors.

The luxury market in China has suffered a number of setbacks in the past few years due to foreign exchange issues and the government anti-bribery campaign. However, when tax officers see flagship stores in expensive upscale malls and extensive advertising campaigns, they form an impression that these high profile luxury stores should all be making a lot of profits.

The tax authorities take note of the significant advertising and promotion expenses in China, but they do not stop there. They also start looking at the high rental costs associated with flagship stores and similar costs. The authorities argue that these costs are essentially “advertising” for the benefit of the brand owner and argue that the Chinese subsidiary should be compensated by the brand owner with a service fee for its advertising services.

We not only have seen some multinational companies chose to adopt this sort of TP arrangement, but also are aware of some instances of such arrangements between luxury brand owners and unrelated franchisees. When designing a TP arrangement, serious consideration should be given to this approach.

Even before Public Notice 42, authorities have been looking at “value chain” profit. That is, they are focusing on the worldwide group’s global profits rather than China-specific profits.

In addition, authorities are focusing on decision-making. For loss-making entities, taxpayers may argue that the China subsidiary makes the decisions and bears the risk of losses. Conversely, where there are profits, taxpayers may argue that the brand owner makes the decisions and the China subsidiary only deserves a routine return (i.e., a limited risk distributor arrangement). Addressing these issues requires careful consideration; taxpayers should pay attention to how they are disclosed and analyzed in their local files and master files.

So far, we have not encountered tax authorities arguing that a China subsidiary that has been building the brand in China should be rewarded for Chinese customers purchasing abroad in audit cases. However, as noted above, this argument has been raised in China’s contribution to the U.N. practical manual. It can potentially be addressed through the service fee approach—i.e., rewarding the Chinese subsidiary for all of its brand-building and advertising activities, regardless of the level of sales actually made in China.

For many luxury taxpayers, the only notable related party transaction is purchase of merchandise by the Chinese subsidiary. These companies are often caught between customs authorities (demanding higher transfer prices) and corporate income tax authorities (demanding lower prices). Due to the constraints of compliance with customs authorities’ demands, many companies have found it a struggle to properly implement a limited risk distributor arrangement, which would limit the Chinese subsidiary’s profit level. Consideration can be given to profit split methods or service fee arrangements to bridge the gap between customs and income tax.

In fact, during customs valuation audits and investigation, one of the most common challenges is the arm’s length nature of the import price. In China, it is very common for Customs Offices to request for companies’ TP documentation when they challenge the declared dutiable value. Given the new disclosure requirement under Public Notice 42, there is much more information (e.g., the value chain analysis, additional details related to intra-group services, and location specific advantages) previously unknown to Customs may cause reassessment of the customs valuation. Therefore, while significant attention should be given to BEPS/TP, taxpayers should not under-recognize/address the related customs and trade implications.

6 No. 22, Vol. 25, Tax Management Transfer Pricing Report, Bloomberg BNA
Conclusions

Given the above, multinational companies likely will have growing needs for dispute resolution and avoidance of international double taxation resulting from TP disputes. China has recently updated its guidance on advance pricing agreements (APAs)\(^7\) and mutual agreement procedures (MAP)\(^8\). A bilateral APA is an agreement between the tax authorities and the taxpayers on both sides of a related party transaction regarding TP arrangements in the future (and retrospectively in selective countries). Similarly, MAP involves the tax authorities trying to reach agreement regarding taxpayers’ TP arrangements. The difference is that MAP occurs years after the related party transactions occurred—specifically, after one or the other tax authority has challenged the TP arrangements and sought to collect more taxes.

In light of the many challenges they face, luxury businesses may want to consider pursuing APAs to get in front of the issues and ensure they do not face double taxation due to tax authorities taking different positions. If, on the other hand, a luxury business is already facing a large tax adjustment relating to its TP, the possibility of taking the case to MAP should be seriously considered.

In all events, luxury industry taxpayers should take a hard look at their businesses and their current TP arrangements in China, and revisit their strategies to monitor TP risks in daily operations. We recommend they talk to a trusted advisor to assess whether adjustments are needed to take into account the ever-changing local audit and regulatory environment. China should be an integral part of multinational’s global risk management and TP documentation strategies.

---

\(^7\) SAT Public Notice [2016] No. 64 - Enhancement of Administration of Advance Pricing Arrangements.

\(^8\) Public Notice 6.
Challenges in overcoming food safety risks in the era of new retailing

Ivan Tong
Partner, Climate Change and Sustainability Services
Ernst & Young Hua Ming LLP
ivan.tong@cn.ey.com
What is new retailing?

In recent years, numerous online retailers have surfaced as a result of widespread e-commerce retail platforms that are available on the Internet. However, a new study indicated that e-commerce retail sales only accounted for about 10% of the total volume of social retail sales. This implies that a majority of the consumer traffic and consumption is still being conducted via offline channels. This is mainly due to the critical shortcoming of e-commerce platforms in their inability to provide consumers with human interaction which could otherwise be offered via offline channels. Jack Ma, the executive chairman of Alibaba Group, mentioned in October 2016 during his speech at the 2016 Computing Conference, “...the singular model for e-commerce will come to an end in the next one to two decades. E-commerce on its own will no longer exist and will be replaced by the new retail.” That is to say, the real era of new retail will only come about when there is a complete integration of online/offline channels and associated logistical support.

Challenges of the evolving regulatory landscape for food safety management

Online retail and offline retail, complemented with modern logistics, are inseparable elements that are interlinked for retailers in the era of new retailing. However, this new model also implies that retailers will face new challenges, including challenges related to food safety. For example, China’s National authorities amended the China Food Safety Law in 2015 to heighten regulatory control over food traders. Among other changes, Article 62 of the Food Safety Law stipulates that “...online platforms that trade food (are required) to (i) register the real contact information of its food traders, (ii) check the food operation licenses of its food traders, and (iii) report illegal activities.” To further strengthen efforts in investigation and punishment, the Measures for the Investigation and Punishment of Illegal Acts Concerning Online Food Safety issued by the China Food and Drug Administration (CFDA) was made effective on October 1, 2016 and focus on food safety safeguards that can adapt to the new online retail model.

---

1 Sina: 2016 China e-commercial consuming behavior report  
These regulatory requirements emphasize the responsibilities of online retail platform providers and stipulate the requirement for online platform providers to establish management procedures on food safety. Such procedures typically include: internal verification on food safety levels, compliance with food safety requirements and penalty systems in case of violations, transparent disclosure of food safety management through reporting, ensuring chain of custody in food handling and the management of food-safety related complaints, etc. The online platform providers should also verify and keep record of the Production and Operation Licenses from food, food additives or agricultural product providers. In addition, it is also stipulated that the online platform providers should establish a food safety management committee or hire a food safety professional to undertake relevant responsibilities. Moreover, these regulatory requirements also cite that transportation and storage conditions need to meet relevant food safety requirements. The Local FDAs are authorized to take samples from online platform providers for lab testing without prior announcement.

The regulatory landscape for food health and safety in China has undergone continuous improvement and relevant laws and regulations are becoming more stringent. Online retail companies should actively respond to the state’s appeal and play a role in promoting development within the industry in a sustainable way. The model for new retailing brings about numerous opportunities but will simultaneously introduce a new spectrum of risks concerned with food safety. Under such circumstances, an enterprise should take action to safeguard food safety, not only with the objective of complying with relevant regulations, but also to develop internal control procedures and minimize food safety related risks.

Food safety risks in the three elements of new retail businesses

1. Online retail – There will be limitations in the control and management over suppliers and difficulties in retailers’ ability to verify suppliers’ compliance levels.

People, products and place are the main three elements of a retail business. Traditional retail businesses tend to focus on place, where the display of products in the best position is a crucial means for effective brand building and sales promotion. However, having shifted to the era of new retailing, the focus is now on people. Behavioral data collected through online platforms become invaluable data sets that are accurate and representative for identifying consumers’ demand patterns.

- Limited control over extensive supplier base due to huge quantities of stock keeping units (SKUs)

It was reported that an e-commerce retail platform’s SKUs can reach around 40 million. The significant numbers of SKUs have brought profits to the company and opened up various choices for customers. However, the significance of associated food safety risks should not be overlooked. Recently, The CFDA disclosed that four batches of food products that were sold on four different renowned online retail platforms failed their food sample testing. Among them, one batch of walnut kernels had traces of mold of up to 360CFU/g, which exceeded the national standard limit by 13.4 times. The CFDA requires that disqualified products be taken off the shelves immediately and the companies be punished according to relevant laws. It was also required by the CFDA that corrective action progress be disclosed to the public within three months. As stipulated in Article 124 of the Food Safety Law, any companies producing or distributing food or food additives which exceed food safety standard limits in pathogenic microorganisms, pesticide residues, vet drug residues, biotoxins, contaminants (heavy metals, etc.) and other substances hazardous to human health are subject to a fine of between RMB50,000 to RMB100,000; severe and repeated violators may have their business licenses revoked.
The huge quantities of SKUs on online platforms create added difficulty for retailers to maintain in-depth food safety risk control over each supplier. In contrast, traditional offline retailers are in the position to conduct risk classification on suppliers and conduct annual reviews of high-risk suppliers. As a result, online retailers’ sometimes comparatively relaxed management over suppliers poses limitations on their ability to obtain a full picture of the food safety management levels of their suppliers.

Difficulties in identifying suppliers operating beyond their licensed business scope and compliance issues with food labeling

Suppliers’ tendency to supply items that are beyond their licensed business scope has become an increasingly common challenge within the industry. There are limitations in relying on the online system to automatically identify such traits, as professional judgement and visual identification is often required. However, given the huge volumes of SKUs on online platforms, it would be unrealistic to require online platforms to rely on manual vetting to identify and eliminate such cases.

Retailers will find it difficult to verify if the food labels provided by suppliers are in fact in compliance with related requirements. According to Article 97 of the Food Safety Law, “...imported prepackaged food and food additives shall have Chinese labels, while labels for pre-packaged food should comply with the general standards for the labeling of prepackaged foods issued by the Ministry of Health.” If imported foods sold online do not contain labels or labels which are in accordance with state regulations, the online retail platform providers may be penalized by the monitoring authorities or challenged by customers. In January 2017, Jinan Food and Drug Administration announced that an e-commerce enterprise was warned for selling imported food without Chinese labels. All products concerned were confiscated and the enterprise was subject to a fine of RMB 10,000.

Advantages of logistics in the era of new retail – utilizing big data to avoid overstocking and lower costs

Currently, logistics costs account for 17.8% of the gross domestic product (GDP) of China, which is triple the logistics costs in developed countries. For manufacturers, logistics costs may even account for up to 30-40% of the total costs of the final product. *The function of logistics in the new retail era can be described as the most important belt connecting online channels with offline channels. Enterprises are hence able to project sales and accurately distribute stocks based on data collected online, and ultimately deliver the products to customers. This practice will significantly reduce stocking and logistic costs, and will also enhance customers’ offline experience.*

Food safety risks in the new retail era – poor temperature control in transfer process will directly affect food safety levels

The logistics industry is experiencing rapid growth in the era of new retailing, and there is significant room for improvement in the management of the food transfer processes. The hygiene requirements and food safety hazard controls during food transfer processes should not be overlooked. For example, the requirements for transfer conditions such as temperature control should be relatively stringent. Failure to maintain optimal temperature control will easily ruin customers’ offline experience and even result in food poisoning due to microbial reproduction. It is recommended that modern logistics providers utilize new retail online platforms to establish online temperature monitoring systems to fully control and maintain optimal transfer conditions throughout the entire food transportation and delivery process.

---

5 NetEase: The impact on logistics of the new retailer explosion 
http://dy.163.com/v2/article/detail/CO6JRVS30518CSND.html
2. Offline experience - issues of improper storage of food, selling of expired food and inaccurate labeling of production date/expiration date continue to affect new retail businesses

There are no substantial differences in the offline experience between businesses in the new retail era and traditional retail business. However, with the convenience of back-end data on customers’ demands and preferences, businesses in new retailing are able to provide better and more personalized services.

A superior offline experience for food products begins with food safety. In recent years, monitoring authorities have been proactive in exposing food safety issues experienced by various major retail stores. Commonly exposed issues include: improper food storage conditions, selling of expired food products and inaccurate labeling of production date/expiration date on food products, etc. These risks will also apply to the offline-experience stores which are interlinked with new retail businesses. Food safety risks are diversified and will continue to affect the emerging offline-experience stores. Therefore, appropriate risk assessments should be conducted at early planning stages, and businesses should consider developing preventive measures targeted to areas which are prone to food safety issues.

Food safety management recommendations for new retail businesses

The evolvement of new retail businesses has been aimed at providing better and timelier services to customers with the aid of back-end data analytics. Meanwhile, food safety will remain as the bottom line for quality services. Hence, food safety management is a material issue for the development of the new retail era. The following are recommendations for new retail businesses to consider:

► Accurately identify the demands of customers, decrease the number of suppliers, continuously optimize the supplier management system and enhance supplier supervision
► Attach importance to brand building, fully emphasize and integrate food safety culture into all processes, raise awareness in the importance of food safety among every level of employees
► Establish food safety management systems according to the company’s development progress, continuously improve processes and procedures for all stages and oversee implementation effectiveness
► Establish a food safety tracking system that covers the entire value chain and establish a recall system
► Increase investment in Research & Development to improve efficiency in food safety management
► Pay close attention to regulatory trends and respond actively, engage in establishing and improving industry standards and push for improvement across the industry
EY services on food safety

Food safety is one of the most important issues for the general public. EY strives to assist corporations to effectively enhance food safety management, prevent major loss brought by food safety issues, raise consumer confidence towards clients’ products and continuously increase brand loyalty. We have provided food safety-related services to several large-scale multinational corporations and fast-moving consumer goods corporations, including food safety risk assessment and management enhancement, food safety traceability mechanism construction, food safety audit, food safety due diligence and food safety-related development strategy consultancy.
About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2017 Ernst & Young (China) Advisory Limited
All Rights Reserved.

APAC no. 03005180
ED None.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

Follow us on WeChat
Scan the QR code and stay up to date with the latest EY news.