China's State Taxation Administration released its COVID-19 transfer pricing guidance

January 2022

EY Tax Alert

Overview

The International Taxation Department of China's State Taxation Administration ("STA") released the "Response to Questions Relating to Anti-Tax Avoidance Issues During the COVID-19 Pandemic" ("STA COVID-19 TP Guidance") on 30 September 2021 via the STA official website. This Guidance has considered the impact of the COVID-19 pandemic on taxpayers' business operations and related party transactions, and provided transfer pricing ("TP") guidance on the following five aspects:

- The principles for conducting transfer pricing audit for the COVID-19 pandemic
- The considerations of losses incurred by enterprises who were negatively impacted by the COVID-19 pandemic
- The key considerations of local file documentation preparation during the COVID-19 pandemic
- The impact of government assistance on transfer pricing; and
- The impact on the execution of existing advance pricing arrangements ("APAs") during the COVID-19 pandemic

Background

On 18 December 2020, the Organisations for Economic Co-operation and Development ("OECD") issued the Guidance on the transfer pricing implications of the COVID-19 pandemic (“OECD COVID-19 Guidance”) to address the challenges for transfer pricing practice that may arise due to the special economic environment , and to provide guidance for tax authorities and multinational corporations in various jurisdictions. [1] The OECD Guidance reflected the consensus view of 137 member jurisdictions of the Inclusive Framework on Base Erosion and Profit Shifting ("BEPS"). Though China is one of the members of the Inclusive Framework on BEPS, the STA did not officially adopt the OECD Guidance or issue any transfer pricing guidelines or local interpretations related to the COVID-19 pandemic like the tax authorities in other jurisdictions (such as Singapore, Australia, New Zealand, and China Hong Kong).

In 2020, in response to the global pandemic and the economic and trade uncertainties, the Chinese government issued a series of preferential policies for tax and governmental charges relief as well as measures for the prevention and control of COVID-19 to help enterprises resume business operations, which in turn helped stabilize the economy. With these preferential policies, as well as other measures to improve the business environment, helps China's economy achieved an overall growth of 2.3% in 2020. In 2021, China maintained the momentum of pandemic prevention and economic development. In the first half of the year, China’s Gross Domestic Product (GDP) increased by 12.7% year-on-year, reflecting the strong recovery of the economy. [2]

The tax and fee relief measures provided by relevant governmental authorities helped alleviate tax burden and improve the efficiency and scale of business operations, while at the same time promoted further investment and economic growth, which are expected to expand the tax base over time. Having said that, it is also expected that the Chinese tax authorities may further strengthen tax enforcement and increase tax collection efficiency to enable fiscal incentives offered.

Detailed Q&As and EY’s observation

In the context of the robust economic recovery in China, and the enhanced services by Chinese tax authorities, the International Taxation Department of the STA provided its COVID-19 TP Guidance on 30 September 2021 in the form of the STA COVID-19 TP Guidance via the STA official website. The STA COVID-19 TP Guidance addressed relevant impacts of COVID-19 pandemic on taxpayers’ business operations and related party transaction arrangements from a Chinese transfer pricing perspectives, and provided guidance in the following five aspects.

1 Source: OECD releases guidance on transfer pricing implications of COVID-19 pandemic | EY - Global
2 Source: Overview of China's economic core data in the first half of 2021 (chinaiol.com)

TP issues during the pandemic	Summary of STA responses	EY observations/recommendations

Principles for conducting TP audit during the COVID-19 pandemic	► Impact of pandemic on businesses varies greatly from industry to industry
	► Tax authorities will follow the arm's length principle when analyzing specific impact of the pandemic on related-party transactions in TP audits
		► In addition to industry differences, impact of pandemic on business within the same industry may also be very different, depending on different market/value chain positions.
		► Companies are advised to review the profit level of their overall business and the related-party transactions in a timely manner.
		► Companies are advised to assess specific facts and circumstances when conducting TP analysis:
		  ► Companies severely hit by the pandemic are recommended to analyze specific impact on their operations and related-party transactions in a timely manner, and to quantify relevant impact as applicable for management to evaluate risks, discuss potential risk management measures, and retain supporting evidence.
		  ► Companies earning profits higher than expected during the pandemic are advised to analyze specific reasons contributing to such profits. Management is also advised to assess other beneficiary related parties and the related party transactions involved, to avoid the disconnection or significant time-lag of certain transactions such as non-trade remittances, while at the same time be mindful of certain risk areas, e.g., locally booked expenses/losses that should have been borne by overseas related parties without proper compensation.

TP issues during the pandemic	Summary of STA responses	EY observations/recommendations
Pandemic related loss considerations during TP audits	► Tax authority would take a holistic view on the impact of pandemic on businesses (with due considerations of functions/risk, related party transactions, industry characteristics, comparable situations, etc.) ► Comparability adjustments may be applied on a case-by-case basis, for certain additional expenses due to the prevention and control of pandemic, or other pandemic related expense increase. Tax authorities will fully consider how relevant the expenses are allocated between/among third parties in a comparable situation ► Management is advised to clearly split and quantify relevant costs and expenses, and retain supporting evidence for future reference	► Allocation of risks is a key consideration of tax authorities in TP audits. Management may refer to the OCED COVID-19 Guidance and review the risk-taking rationale among related parties as well as the business reason for any change before and after the COVID-19 outbreak, with due consideration of realistically available options of independent companies under same or similar circumstances. ► OECD COVID-19 Guidance holds open the possibility that "limited-risk" entities may also incur losses in the short-run. ► STA Public Notice (PN) [2017] No. 6 stipulates that, in principle, companies engaging in single production business such as processing trade, or operating as distributors or contract R&D service providers for benefits of overseas related parties should maintain a reasonable level of profit. ► Although such companies incurring losses or assuming additional expenses due to COVID-19 may still be challenged by tax authorities or even subject to TP audits/adjustments, robust technical and factual analyses would help justify that independent parties had assumed the same risks or additional costs under the same or similar pandemic situation, a comparability adjustment may be applied on a case-by-case basis.

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Detailed analysis should be prepared to explain the specific impact of the pandemic on related-party transactions, value chain and etc. in the TP local file
Use of comparable financial in the same year, with the same location, industry, product and functional profile is important in conducting a comparability analysis, to properly reflect the impact of the pandemic on profit level.

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According to STA PN [2016] No. 42, local files should be prepared before 30 June of the year following the documented year, while same-year financials would not be available for most comparable companies. Although STA COVID-19 TP Guidance has not discussed specific issues regarding the same-year comparable financials, management is advised to apply the arm's length principle and refer to the following international practices or guidelines in the comparability analysis based on specific facts and circumstances:

"But-for analysis", which simulates the financial results that a company would have obtained in the absence of the COVID-19 pandemic, as a quantitative special factor analysis to evaluate a company's transfer pricing compliance status.
"Term testing", as a testing mechanism provided by the Inland Revenue Authority of Singapore (IRAS) in September 2020 to taxpayers in response to the COVID-19 pandemic. Use of multiple-year financials to calculate weighted average results during the pandemic, via comparing the tested party's three-year financials (e.g., 2018 to 2020) against comparable results with the most recent three-year financials available (e.g., 2017 to 2019) may help offset single year financial extortion caused by the pandemic, thus improve reliability of the comparability analysis.
OECD recommends that when preparing local file, interim comparable financials such as quarterly or half-year earnings releases, if available for the same documented year may also be considered.
Management may also consider a financial update later when same-year comparable financials are available, as a supplementary document to the local files, for submission to tax authorities at a later stage.
In addition to the issue of same-year comparable financials, management shall also pay attention to geographical comparability in the comparability analysis.

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Impact of COVID-19 related government assistance to TP adjustment	► Chinese authorities introduced a series of assist programs in terms of rent, taxes, financing during the pandemic ► If taxpayers hold the view that government assistance has an impact on their transfer pricing arrangement, they should provide relevant analysis in the transfer pricing documentation to substantiate their position. ► Tax authorities will follow the arm's length principle to evaluate each comparability factor, in order to ensure fairness and consistency of the comparability analysis.	► It is worth noting that without an accurate analysis of specific economic factors concerning the government assistance, it may not be reasonable to make any TP related accounting treatments, such as offsetting relevant subsidy income against operating costs and thus reducing transaction amounts due from related parties. ► From a Chinese TP perspective, government assistance may be viewed as a location-specific factor, which requires special consideration in the comparability analysis. ► Management may consider proper quantitative analysis and adjustment for such a location-specific factor; or alternatively search for Chinese comparable companies if possible in the comparability analysis, to ensure geographic comparability without further comparability adjustment if comparable companies in China have similarly benefited from government assistance.
Implementation considerations of existing APAs if impacted by the pandemic	► If the pandemic caused a "substantial change" in business operations that affected the implementation of an existing APA, the company can report to the in-charge tax authorities in writing to explain the impact of the pandemic in detail with supporting documents. ► The in-charge tax authorities would analyze and assess the impact of substantive changes on the existing APA and determine an appropriate response: ► Unilateral APAs - consult with the taxpayer to revise or terminate the APA; ► Bilateral/multilateral APAs - report level-by-level to the STA for coordination and consultation with competent authority.	► OECD COVID-19 Guidance pointed out that significant economic changes due to the COVID-19 pandemic were unexpected at the time of concluding the APAs. Therefore, it is necessary to determine the impact of changes in economic conditions on the implementation of existing APAs. ► OECD COVID-19 Guidance mentioned that existing APAs and their terms should be respected, maintained and upheld, unless a condition leading to the cancellation or revision of the APA (e.g., breach of critical assumptions) has occurred. ► Although the "substantial change" mentioned in the STA COVID-19 Guidance is not clearly defined, it literally appears to have a broader scope than the "breach of critical assumptions", which can be viewed as a kind gesture of the STA to encourage taxpayers to initiate active discussions and collaboration with tax authorities in a sincere and open manner.

Summary

The International Taxation Department of the STA released its COVID-19 TP Guidance in the column of "Ensuring Priority and Stability in Six Areas [3] and Six Guarantees [4] " in its official website. The Guidance was published in the form of a Q&A rather than a formal release of a tax regulation or an announcement, which indicates tax authorities' efforts to transform tax administration approach by strengthening constructive communication with taxpayers with a service mindset, active sharing of administrative concepts with taxpayers, and providing more guidance for voluntary compliance.

Emphasis on the arm's length principle is throughout the STA COVID-19 Guidance, which is consistent with recommendations in the OECD COVID-19 Guidance. It also reflects that China, as a member of the BEPS Inclusive Framework, has actively responded to the OECD recommendation of best practice on how the arm's length principle should be applied on issues arise in the context of COVID-19. Nevertheless, in view of transfer pricing enforcement responsibilities of the local in-charge tax authorities, there are still uncertainties as to how local tax authorities would interpret STA COVID-19 Guidance and carry out relevant recommendations in practice.

From the standpoint of Chinese taxpayers, they are also faced with many practical difficulties such as lack of precedent references from historical years, lack of reliable comparable third-party information, and lack of specific guidance on required analyses and supporting documents, etc. Considering that the statute of limitation of transfer pricing audits is up to 10 years, management is recommended to follow the arm's length principle when analyzing related party transactions, and actively collect relevant information on how similarly situated third parties deal with their commercial and economic relations based on specific facts and circumstances. Based on the information collected, companies shall perform detailed analyses with robust evidence and supporting documents on the transfer pricing of related-party transactions affected by the COVID-19 pandemic. Management is also advised to seek professional assistance from external tax consulting agencies as necessary. With proper analysis, management shall then consider timely and appropriate measures to effectively manage potential transfer pricing risks. These measures may include but are not limited to transfer pricing adjustments or profit compensation; re-negotiating the allocation of risks and expenses as well as related commercial terms with related parties based on comparable third-party conditions; and enhancing certainty through the application of APAs etc.

3 On 31 July 2018, the Politburo meeting of the Communist Party of China ("CPC") Central Committee put forward the "Priority and Stability in Six Areas" policy for the first time, covering employment, finance, foreign trade, foreign investment, domestic investment, and market expectations, which are the main priorities of China's economic development.

4 At the Politburo meeting held on 17 April 2020, based on the analysis of the current economic situations, the "Six Guarantees" were proposed for the first time – to guarantee Chinese residents 'employment, guarantee basic livelihood, protect market players, guarantee food and energy security, ensure stability of the industrial supply chain, and maintain basic-level operations.

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