Milestone bilateral advance pricing arrangement for intangible asset transaction reached between the Chinese mainland and Hong Kong

In April 2024, the State Taxation Administration of China (STA) and the Inland Revenue Department of the Hong Kong Special Administrative Region (HKIRD) reached a consensus and completed the final signing on a bilateral advance pricing arrangement (BAPA). The BAPA covers the transfer pricing arrangement for an intangible asset licensing transaction between a Chinese mainland entity and a Hong Kong entity within a multinational high-end consumer goods group (covered transaction), providing great certainty to the taxpayers' transfer pricing arrangement.

During the analysis and assessment process, the STA and the HKIRD conducted in-depth analyses, discussions and negotiations on various aspects relating to the covered transaction. This includes, but not limited to, the scope of licensing of significant intangible assets, functional and risk profiles of the Chinese mainland and Hong Kong entities, the entities' value contributions to the significant intangible assets, cross-validation of different transfer pricing methodologies, etc. Ultimately, the two tax authorities reached a consensus on the BAPA in principle.

Under the highly complex international tax environment, the successful conclusion of this BAPA provides a valuable precedent for multinational corporations (MNCs) to deal with transfer pricing issues related to significant intangible asset transactions by adopting APAs. It also marks a strong manifestation of the mainland's further optimization of the foreign investment environment and advancement in a high-level open economy.

Overview

The BAPA covers two entities within a multinational high-end consumer goods group (the Group), one located in the Chinese mainland and the other in Hong Kong. As the founder and owner of the intangible assets, the Hong Kong entity is primarily engaged in wholesale and retail operations in regions outside the mainland and responsible for core development, enhancement, maintenance, protection and exploitation (DEMPE) activities of the intangible assets. The mainland entity focuses on local manufacturing, wholesale and retail operations, and carries out certain marketing and promotional activities of the intangible assets in the Chinese market.

Given the rapid growth of the business, there was an increasing need for the Group to regulate the management of intangible assets from both operational and tax perspectives. As the reasonableness of the covered transaction has been closely scrutinized by tax authorities in both regions, the Group applied for the BAPA to effectively manage the related risks and achieve operational and tax certainty. The successful conclusion of the BAPA defined a reasonable standard for royalties charged between related parties for licensing of intangible assets.

Key features of the case

A. Related-party transactions on licensing of "Significant intangible assets"

According to the latest "*China Advance Pricing Arrangement Annual Report (2022)*" published by the STA (the Report), a cumulative total of 260 APAs were signed between 2005 and 2022. Of the concluded APAs, transactions involving the transfer of the right to use or ownership of tangible assets remained the primary type of related party transactions, while transactions involving the transfer of the right to use or ownership of intangible assets accounted for 19.53% only. In terms of sectors, the manufacturing industry was the predominant sector among the concluded APAs, while the wholesale and retail industry accounted for 10.38% only.

The covered transaction in this case involves a **significant intangible asset licensing transaction** between a mainland entity and a Hong Kong entity in the wholesale and retail industry. The successful conclusion of the BAPA marks a milestone, which provides a valuable precedent in terms of analytical framework and transfer pricing methodology for MNCs to deal with transfer pricing issues related to significant intangible asset transactions by adopting APAs and serves as a valuable reference for APA applicants from the wholesale, retail and business service industries.

B. Technical innovation in analysis methods

According to the Report, the transfer pricing methods adopted in vast majority of the 260 concluded APAs continued to be the Transactional Net Margin Method (TNMM), while the Comparable Uncontrolled Price (CUP) method was adopted eight times only, and other methods a total of seven times.

Therefore, the case has made significant technical breakthroughs in the application and innovation of transfer pricing analysis methods: various technical methods, including the CUP, asset valuation method, value contribution analysis, among others, were used to cross-validate the reasonableness of the arm's length pricing range in order to reach the consensus of the BAPA.

Being rational and pragmatic for a win-win cooperation

Both the STA and the HKIRD attached great importance to this BAPA and engaged in the negotiation in a rational and pragmatic manner. Under the general framework of international transfer pricing rules and considering China's specific technical position, the two tax authorities have conducted active and constructive dialogues in aspects of detailed scope of the covered transaction, lifecycle analysis of intangible assets (DEMPE analysis), location specific advantages, etc. Through extensive on-site inspections and desktop analyses, the tax authorities from both sides demonstrated innovative thinking in technical deliberations, striving for rational consensus to encourage compliance by taxpayers.

Throughout the negotiation process of this BAPA, EY[1] made proactive contributions in facilitating consensus among the parties. EY assembled a professional service team composed of transfer pricing professionals from both the Chinese mainland and Hong Kong, who are well-versed in the consumer goods industry and are familiar with the characteristics of the industry. From preliminary discussions to confirming intentions, analysis and assessment, communication and negotiation, and the final signing, the EY service team provided critical end-to-end support throughout the entire process. In addition, EY's service team facilitated smooth communication among the tax authorities and taxpayers in both regions on technical analysis and ultimately contributed to the successful conclusion of the BAPA, providing an important reference for APAs in significant cross-border intangible asset transactions.

Conclusion

In the current fast-developing economy and ever-changing tax environment, the successful conclusion of this case serves as an important reference for MNCs to manage transfer pricing risks related to cross-border operations by adopting APAs. The ongoing and close cooperation between the STA and the HKIRD has played a positive role in the successful conclusion of this BAPA.

In recent years, the STA has been concerned on the overall profit allocation principle and its reasonableness along the value chain of MNCs, while significant intangible asset transactions are also a technical challenge in the transfer pricing field as highlighted by the Organization for Economic Co-operation and Development (OECD). Considering the above, this case introduced the value contribution analysis based on traditional transfer pricing analysis method when analyzing significant intangible asset licensing transactions. It facilitates both parties to reach a consensus, which not only follows the current trend, but is also innovative and exploratory in terms of technical method. The case not only provides valuable takeaways for taxpayers, but also effectively strengthens EY's professional practice and leading position in BAPAs.

EY recommendation

EY suggests that enterprises should proactively manage transfer pricing risks based on specific circumstances and professional advice. This includes proper transfer pricing planning, comprehensive preparation of transfer pricing compliance documentation and active consideration of adopting APAs for effective dispute resolution management under relevant conditions. Through these measurements, taxpayers can manage and control transfer pricing risks more effectively and enhance tax certainty under this rapidly changing business and regulatory environment.

1. *Ernst & Young (China) Advisory Limited, hereinafter referred to as EY.*

Please contact us for more information

Travis Qiu

Greater China Transfer Pricing Leader
Ernst & Young (China) Advisory Limited
+ 86 21 2228 2941
travis.qiu@cn.ey.com

Kenny Wei

Transfer Pricing Partner
Ernst & Young Tax Services Limited
+852 2629 3941
kenny.wei@hk.ey.com

Yolanda XG Sun

Transfer Pricing Director
Ernst & Young (China) Advisory Limited
Guangzhou Branch Office
+86 20 2838 1420
yolanda-xg.sun@cn.ey.com

Yuri Huang

Transfer Pricing Senior Manager
Ernst & Young Tax Services Limited
+852 2849 9379
yuri.huang@hk.ey.com

Krystal Qin

Transfer Pricing Senior Manager
Ernst & Young (China) Advisory Limited
Shenzhen Branch Office
+86 755 2502 8372
krystal.qin@cn.ey.com
