

Development of transfer pricing administration and investigation in China

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In brief

Since the issuance of the *Implementation Measures of Special Tax Adjustment (Trial)* (Guoshuifa [2009] No.2, hereinafter referred to as the “Circular 2”) by the State Administration of Taxation (SAT) in 2009, there have been profound developments of tax administration in many countries across the world, including China. Amidst of the gloomy economy around the globe, governments have been seeking a broader cooperation in tax administration. As a result, OECD and G20 governments agreed on 15 action plans to address base erosion and profit shifting (BEPS). The BEPS final reports published in 2015 have set down the foundation and objective for anti-tax avoidance practice.

Under such circumstances, the SAT took initiatives in 2016 to introduce major revisions to existing transfer pricing (TP) regulations, via promulgating the *Public Notice on Matters Regarding Refining the Reporting of Related Party Transactions and Administration of TP Documentation* (SAT Public Notice [2016] No. 42, hereinafter referred to as the “Public Notice 42”)¹ on 29 June 2016, and the *Public Notice on Matters Regarding Enhancing the Administration of Advance Pricing Arrangements* (SAT Public Notice [2016] No. 64, hereinafter referred to as the “Public Notice 64”)² on 11 October 2016.

Based on historical experience in assistance in TP administration and investigation cases, PwC predicts the following potential changes to China’s TP administration and investigation procedures in the context of recent Chinese implementation of the final reports on BEPS Action Plans.

In detail

I Specialised tax officers for TP

During the second half of 2016, the SAT has gone through a series of internal restructuring in relation to anti-tax avoidance resources. As a result, a specialised expert team was built in Beijing, in charge of cases of significance or importance, or cases related to key industries on a national basis. This specialised expert team is led by the SAT officer, Mr. Xia Guang Yu,

and is dedicated to national anti-avoidance (i.e. special tax adjustment) investigation, with an aim to address international tax risks with consistent standards.³

It was reported that Chinese tax authorities have rolled out new plans on their TP administration and investigation procedures. For example, in November 2011, Liaoning Provincial State Tax Bureau initiated a joint meeting with anti-tax avoidance tax officers from Jilin Province and Heilongjiang Province. The

tax officers from the three provinces jointly reviewed the regional anti-tax avoidance cases. This pioneering meeting, spanning the three provinces in north-eastern China, set a milestone for the regional cooperation for TP administration and investigation.

PwC observation

Since 2009, provincial level tax authorities, represented by Beijing, Jiangsu and Shanghai tax authorities, have been tightening up their anti-tax avoidance practice, including TP

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administration and investigation. Specialised expert teams were built and dedicated to TP administration and investigation. Their responsibilities include coordinating the TP administration of local tax authorities and conducting TP investigations with consistent standards. This centralised administration method has been used by the aforesaid leading tax authorities over the past few years.

In addition to the resource integration, it is increasingly common for tax authorities at all levels, including the SAT, to go through “expert panel review” and “specific case review”, to pool resources for joint review and evaluation of TP investigation cases. Based on the current trends and various public information, it is expected that the joint review mechanisms, such as “expert panel review” and “specific case review”, will be more frequently adopted for complicated TP investigations. It also indicated that the review process might be gradually separated from TP investigation.

The specialised expert team in Beijing might leverage their advantage in expert resource, and actively participate into major special tax adjustment investigations (e.g. national joint audits and pan-industry audits), as well as assessments and reviews of bilateral advance pricing arrangements (APAs).

To prepare for the more complicated TP investigation by more specialised teams in tax authorities, multinational corporations (MNCs) should revisit their strategies to monitor TP risks in daily operation. It is crucial for MNCs to establish reasonable TP structures and effective response mechanisms, so as to form systematic defending strategies for potential enquiries or further investigation from tax authorities.

If provincial / municipal level tax authorities could consolidate sufficient resources locally and form specialised teams for TP administration and investigation, with consistent internal working procedures, we anticipate it might be possible that the SAT would grant more autonomy or delegate certain approval rights relating to TP investigation to provincial / municipal level authorities in relation to TP investigation, examination, APAs and other TP related issues. Potential changes may take place in the following aspects:

- More detailed function and responsibility segregation between provincial / municipal level tax authorities and the SAT regarding TP investigation and APAs;
- Refined internal review procedures of the SAT and local tax authorities;
- Clearer scope for case transfer between state tax bureaus and local tax bureaus, or standards for joint investigation, etc.

II New highlights of TP investigation

Echoing the final reports of BEPS Action Plans and G20 governments’ agreement on deepening the reform of international tax administration, the SAT took initiatives in improving anti-tax avoidance practice, and explicitly put forward new requirements on TP arrangements of MNCs based on Chinese characteristics. The new requirements include asking MNCs to note the following “unacceptable tax practices”:⁴

- holding structures or transactional arrangements without economic substance;
- deduction of inappropriate costs;
- loss incurred by Chinese subsidiaries with single / simple functions;
- unreasonable over-pricing of intangibles;
- remuneration inconsistent with contribution to value creation;
- high-tech company with low returns (from the related parties);
- China's location specific advantages not observed; and
- loss transferred from foreign entities to Chinese subsidiaries.

In this context, the SAT promulgated circular Shuizongbanfa [2014] No. 146 in 2014, and SAT Public Notice [2015] No. 16 in 2015⁵, pursuant to which, the payment of service fees and royalties by Chinese companies to overseas related parties became the key focus of local tax authorities’ TP supervision and investigation.⁶

At the video conference on international tax practice held in February 2016, the SAT reiterated its intention to “formulate plans for cases of significance and importance; perform industry-oriented audits and group audits with a focus on luxury, pharmaceutical and imported consumer goods businesses; and leverage anti-monopoly investigation experience on cases of significance and importance.” The SAT also stressed at

the conference that “concepts advocated by Chinese tax authorities such as cost saving, market premium and intangible asset exploitation should be refined and adopted in anti-tax avoidance investigation and bilateral negotiation; Chinese tax sovereignty should be safeguarded by adhering to the core principle that profits should be taxed by jurisdictions where economic activities are performed and values are created.” It was reported that from 2013 to 2016, the SAT’s anti-tax avoidance system, which consists of three integrative elements of administration, services and investigation, has made a considerable achievements in tax collection. During this period, 1,203 cases of anti-tax avoidance investigation were initiated, among which 1,048 cases were settled. The relevant tax adjustment resulted in an increase of tax revenue of RMB 218.7 billion. The annual tax revenue from anti-tax avoidance adjustment increased from RMB 23.9 billion in 2011 to RMB 61 billion in 2015, representing an overall growth of 155% and an average annual growth of 26.4%.⁷

PwC observation

Statistics showed that in 2014, the average tax adjustment amount for formal anti-tax avoidance investigations reached RMB 30.68 million per case⁸. By November 2015, that amount has increased substantially to RMB 60.37 million per case⁹, which reflected the local tax authorities’ strengthened efforts in formal TP investigations and higher expectation on tax adjustment amounts.

It is worth noting that the recently released Public Notice 42 clarifies for the first time that the local file of TP contemporaneous documentation filed by companies for 2016 shall include Value Chain Analysis (VCA) and Local Specific Advantages (LSA) analysis. VCA and LSA analysis per se have long been emphasised by Chinese tax authorities and were extensively used in signed bilateral APAs and settled TP investigations. It is expected that pursuant to Public Notice 42 and Public Notice 64, tax authorities would normalise the requirements for VCA and LSA analysis. It is also possible that tax authorities would incorporate VCA and LSA analysis into their risk assessment system, as important criteria for evaluating the reasonableness of MNCs’ related party transactions. As a result, well

preparedness for VCA and LSA analysis would become indispensable to taxpayers' TP management in the future.

Regarding national joint audits, in addition to the SAT's target industries and major MNCs as mentioned at the video conference, local tax authorities are eager to obtain standardised guidance from the SAT on cross-province TP investigation. We believe it will be possible for the SAT to delegate more authority for initial TP risk assessment to local tax authorities, with limitations to key industries or major MNCs. It is also possible that the SAT would encourage a broader involvement of local tax authorities from different regions to jointly investigate cross-province or industry-specific TP issues, to achieve a higher efficiency of TP administration. In view of this, we are expected to see more and more TP investigations arising from national joint audits and provincial joint audits in the future.

More disputes between taxpayers and tax authorities might arise from TP investigations in the future. Thus, taxpayers would have a stronger willingness for legal remedies subsequent to TP investigations, and the Mutual Agreement Procedure (MAP) would remain the major approach avoiding double taxation. However, given the uncertainties of the MAP settlements and the limited coverage of the current bilateral tax treaty system, it is still possible that taxpayers might go for administrative reconsideration and administrative litigation to solve disputes. PwC recommends companies under investigation should have a thorough preparation of technical analyses and other supporting evidence, especially for the companies under national joint audits. Such analyses could not only defend the TP investigation, but also serve as valid evidence for potential legal remedies afterwards, which is of critical importance for future dispute process.

III Relevant information of overseas related parties

PwC observed that local tax authorities have been requesting for more overseas information in TP investigations since 2014. At the video conference on international tax practice held in February 2016, the SAT explicitly pointed out that "in response to the requirements of international tax reform, international

tax information exchange shall be promoted. By the end of 2016, all information exchange would be conducted through international tax administration platform. Computer systems would be used for automatic information exchange."¹⁰

PwC observation

Under Article 56 and Article 70 of the *Tax Collection and Administration Law*, taxpayers and withholding agents are obligated to cooperate with tax authorities in investigations and to make relevant statements based on facts. Moreover, taxpayers' obligation to provide factual and relevant information is further regulated in the *Implementation Regulations of the Corporate Income Tax Law*, etc.

However, existing laws and regulations have no defined limitation of overseas "relevant information." Where business information of overseas related parties is required, Chinese companies would inevitably find it difficult to provide the requested information. Especially when overseas related parties failed to disclose relevant business information (e.g. financial statements) due to restriction of local legislations, Chinese companies would be under the pressure to address the conflicts between Chinese laws and foreign / international laws. It would be in taxpayers' interest if Chinese authorities could clarify the obligations, responsibilities and legal consequence of the Chinese companies under such circumstances, with due consideration of both equality and efficiency.

Last but not the least, the current implementation of BEPS Action Plans in various countries reflected a worldwide trend for governments to fight against international tax avoidance through closer cooperation. The international tax information exchange for TP investigation will be adopted in a more extensive and efficient manner. PwC predicts that Chinese tax authorities will be able to command more relevant information of overseas related parties in future TP investigations, and perform analyses to assess the reasonableness of TP arrangement from both Chinese and foreign perspectives.

The takeaway

With Chinese tax authorities enhancing TP administration investigation, MNCs will be confronted with a more

comprehensive TP administration system and stricter TP investigation environment. The takeaways are as follows:

- Tax authorities are enhancing the strength and breadth of TP investigation by means of resource integration, joint review, request of VCA and LSA analyses, etc. It is expected that the amount of special tax adjustment will keep increasing.
- It is increasingly common for tax authorities at all levels, especially the SAT and related provincial / municipal level tax authorities, to adopt "expert panel review" or "specific case review" for TP investigations. This separation of case reviews from TP investigations would urge taxpayers to provide more accurate factual information and technical analyses to in-charge tax authorities in TP investigation.
- MNCs would have rapidly growing needs for dispute resolution and avoidance of international double taxation resulted from TP investigation.
- For the purpose of an improved guidance on TP administration and investigation for tax authorities, the SAT might revise and promulgate specific guidelines on special tax adjustments and MAP, based on existing regulations.

Endnote

1. For more details of Public Notice 42, please refer to our News Flash [2016] Issue 21
http://www.pwccn.com/home/chi/c hinatax_news_jul2016_21_chi.html
2. For more details of Public Notice 64, please refer to our News Flash [2016] Issue 29
http://www.pwccn.com/home/chi/c hinatax_news_oct2016_29_chi.html
3. Source: a news clipping from the official website of the 2nd Branch of Beijing State Tax Bureau (BJSTB No. 2 Branch), titled as "Li Yamin, Administrator of Beijing STB, and Liao Tizhong, Director General of SAT International Taxation Department, Visited BJSTB No. 2 Branch and Announced the Reshuffle of the Branch".
http://www.bjsat.gov.cn/bjsat/qxfj/z sefj/sy/zfxxgk/zfxxgkml/gzdt/201608/t20160803_265534.html

4. For more details, please refer to our News Flash [2014] Issue 23
http://www.pwccn.com/home/chi/c/hinatax_news_oct2014_23_chi.html
5. For details of relevant regulations and analysis, please refer to our News Flash [2014] Issue 34 and [2015] Issue 11:
http://www.pwccn.com/home/chi/c/hinatax_news_dec2014_34_chi.html
http://www.pwccn.com/home/chi/c/hinatax_news_mar2015_11_chi.html
6. For details, please refer to our News Flash [2015] Issue 32 and 33:
http://www.pwccn.com/home/chi/c/hinatax_news_jul2015_32_chi.html
7. Source: a news clipping from China Tax News dated 19 February 2016, titled “Major Issues to Be Tackled by China’s International Tax Administration in 2016”
http://www.ctaxnews.com.cn/xinwen/dujia/201602/t20160219_66304.htm
8. Source: a news clipping from the SAT, titled “Anti-tax avoidance Contributed RMB 52.3 Billion to Tax Collection in 2014”
<http://www.chinatax.gov.cn/n810219/n810724/c1507274/content.html>
9. Source: a news clipping from China Tax News dated 4 January 2016, titled “China Deeply Participates in Global Tax Cooperation with a Louder Voice”
http://www.ctaxnews.net.cn/html/2016-01/04/nw.D340100zgswb_20160104_1-01.htm?div=-1
10. Same as Endnote 7.

Let's talk

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