

Key changes anticipated in transfer pricing administration in China

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In brief

Since China's 2009 issuance of *Implementation Measures of Special Tax Adjustment (Trial)* (Guoshuifa [2009] No.2 Circular, hereinafter referred to as the "Circular 2") by the State Administration of Taxation (SAT), there have been profound developments in tax administration in many countries, including China. Amidst the weak global economy, governments have been seeking a broader cooperation in tax administration, and the OECD and G20 governments have agreed on 15 Action Plans to address base erosion and profit shifting (BEPS). The BEPS final reports published in 2015 set forth the foundation and objectives for cross-border tax rules.

In light of the background, the SAT undertook initiatives in 2016 to introduce major revisions to existing transfer pricing regulations, promulgating *Public Notice on Matters Regarding Refining the Reporting of Related Party Transactions and Administration of Transfer Pricing Documentation* (SAT Public Notice [2016] No. 42, hereinafter referred to as the "Public Notice 42")¹ on June 29, 2016, and *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 October 11, 2016.

Based on our experience with companies involved in transfer pricing administration and investigation cases, PwC anticipates potential changes to China's transfer pricing administration and investigation procedures. These potential changes are likely to result in:

- Continued enhancement of the strength and breadth of transfer pricing investigation by means of resource integration, joint review, and requests for Value Chain Analysis (VCA) and Location Specific Advantage (LSA) analysis;
- Continuation of the recent trend to adopt an "expert panel review" or "specific case review" for transfer pricing investigations;
- Growing needs of multinational corporations (MNCs) for dispute resolution and avoidance of international double taxation resulting from transfer pricing investigations; and
- The SAT potentially revising and promulgating specific guidelines on special tax adjustments.

In detail

Specialized transfer pricing tax officers

During the second half of 2016, the SAT underwent a series of

internal restructurings in relation to anti-tax avoidance resources. A specialized team was assembled in Beijing, in charge of cases of significance or importance, or cases related to

key industries on a national basis. This specialized team, which is led by SAT officer Mr. XIA Guang Yu, is dedicated to national anti-avoidance (i.e., special tax adjustment)

investigation, with an aim to address international tax risks with consistent standards.³

Chinese tax authorities reportedly have rolled out new plans on their transfer pricing 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 and Heilongjiang Provinces. 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 regional cooperation for transfer pricing administration and investigation.

Observation: Since 2009, provincial level tax authorities, represented by the Beijing, Jiangsu, and Shanghai tax authorities, have been intensifying their anti-tax avoidance practice, including transfer pricing administration and investigation. Specialized teams have been assembled and dedicated to transfer pricing administration and investigation, with responsibilities that include coordinating the transfer pricing administration of local tax authorities and conducting transfer pricing investigations with consistent standards. This centralized administration method has been used by the aforesaid leading tax authorities over the past few years.

In addition to resource integration, tax authorities at all levels, including the SAT, are using “expert panel review” and “specific case review,” to pool resources for joint review and evaluation of transfer pricing investigation cases. Based on the current trends and public information, it is expected that the joint review mechanisms, such as expert panel review and specific case

review, will be adopted more frequently for complicated transfer pricing investigations. Also, the tax authorities have indicated that the review process might be gradually separated from transfer pricing investigations.

The specialized team in Beijing might leverage its advantage in expert resources and actively participate in 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).

Observation: To prepare for the more complicated transfer pricing investigations by specialized teams in tax authorities, MNCs should revisit their strategies to monitor transfer pricing risks in their daily operations. MNCs should make sure there are reasonable transfer pricing structures and effective response mechanisms, so as to form systematic defense strategies for potential enquiries or further investigation from tax authorities.

If provincial/municipal level tax authorities can consolidate sufficient resources locally and form specialized teams for transfer pricing 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 to provincial/municipal level authorities in relation to transfer pricing investigation, examination, APAs and other transfer pricing-related issues.

Potential changes may take place in the following respects:

- More detailed function and responsibility segregation between provincial/municipal level tax

authorities and the SAT regarding transfer pricing investigation and APAs;

- Refined internal review procedures of the SAT and local tax authorities; and
- Clearer scope for case transfer between state tax authorities and local tax authorities, or standards for joint investigation.

New highlights of transfer pricing investigation

Consistent with the final reports of BEPS Action Plans and G20 governments' agreement on deepening the reform of international tax administration, the SAT took initiatives to improve anti-tax avoidance practices, and explicitly put forward new requirements on transfer pricing arrangements of MNCs based on Chinese characteristics. The new requirements include the following tax practices that are deemed unacceptable:⁴

- Holding structures or transactional arrangements without economic substance;
- Deduction of inappropriate costs;
- Losses 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 2015,⁵ 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' transfer pricing supervision and investigation.⁶

During a video conference on international tax practice 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; leverage anti-monopoly investigation experience on cases of significance and importance." The SAT also stressed in the video 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 in the period from 2013 to 2016, the SAT's anti-tax avoidance system — which consists of three integrative elements of administration, services, and investigation — has made considerable achievements in tax collection. In this period, 1,203 cases of anti-tax avoidance investigation were initiated, of which 1,048 were settled. The relevant tax adjustment resulted in increased 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

In 2014, the average tax adjustment amount for formal anti-tax avoidance investigations reached RMB 30.68 million per case.⁸ By November 2015, the average tax adjustment amount increased substantially to RMB 60.37 million per case,⁹ reflecting the local tax authorities' strengthened efforts in formal transfer pricing investigations and higher expectation on tax adjustment amounts.

Observation: Recently released Public Notice 42 clarifies — for the first time — that the Local File of transfer pricing contemporaneous documentation filed by companies for 2016 shall include VCA and LSA analysis. VCA and LSA analysis *per se* have long been emphasized by Chinese tax authorities and were extensively used in signed bilateral APAs and settled transfer pricing investigations. It is expected that pursuant to Public Notices 42 and 64, tax authorities will normalize the requirements for VCA and LSA analysis. It also is 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, preparing for VCA and LSA analysis will be indispensable to taxpayers' transfer pricing management in the future.

Regarding national joint audits, in addition to the SAT's target industries and major MNCs as mentioned in the video conference, local tax authorities are seeking to obtain standardized guidance from the SAT on cross-province transfer pricing investigation. The SAT may delegate more authority for initial transfer pricing risk assessment to local tax authorities, with limitations to key industries or major MNCs. It also is

possible that the SAT would encourage a broader involvement of local tax authorities from different regions to jointly investigate cross-province or industry-specific transfer pricing issues, in order to achieve a higher efficiency of transfer pricing administration. In view of this, an increase in transfer pricing investigations arising from national joint audits and provincial joint audits can be expected in the future.

Observation: More disputes between taxpayers and tax authorities might arise from transfer pricing investigations in the future. Thus, taxpayers might have more willingness to consider legal remedies subsequent to transfer pricing investigations, and the Mutual Agreement Procedure (MAP) would remain the major approach avoiding double taxation. However, given the uncertainties of MAP settlements, and the limited coverage of the current bilateral tax treaty system, it is still possible that taxpayers might prefer administrative reconsideration and administrative litigation to solve disputes.

Companies under investigation should have prepared technical analyses and other supporting evidence, especially companies under national joint audits. Such analyses may help defend a transfer pricing investigation and serve as valid evidence for potential legal remedies afterwards, which is of critical importance for future dispute processes.

Relevant information of overseas related parties

Local tax authorities have been requesting more overseas information in transfer pricing investigations since 2014. During the February 2016 video conference on international tax practice, 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 an international tax administration platform. Computer systems would be used for automatic information exchange.”¹⁰

Under Articles 56 and 70 of *The Law of Tax Collection and Administration*, 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.*

Existing laws and regulations have no defined limitation of overseas “relevant information.” Under circumstances where business information of overseas related parties is required, Chinese companies may find it difficult to provide the requested information, especially when overseas related parties do not disclose relevant business information (e.g., financial statements) due to restriction by local legislation.

Observation: Chinese companies would be under pressure to address the conflicts between Chinese laws and foreign/international laws. It would be in the taxpayer’s interest if Chinese authorities clarify the obligations, responsibilities, and legal consequences of the Chinese companies under such circumstances, with due consideration of both equality and efficiency.

In addition, the current implementation of BEPS Action Plans in various countries reflects a worldwide trend for governments to address international tax avoidance through closer cooperation. The international tax information exchange for transfer pricing investigations will be adopted in a

more extensive and efficient manner. It is expected that Chinese tax authorities will be able to command more relevant information of overseas related parties in future transfer pricing investigations, and perform analyses to assess the reasonableness of transfer pricing arrangements from both Chinese and foreign perspectives.

The takeaway

With Chinese tax authorities strengthening transfer pricing administration investigations, MNCs will be confronted with a more comprehensive transfer pricing administration system and stricter transfer pricing investigation environment. The key considerations are as follows:

- Tax authorities are enhancing the depth and breadth of transfer pricing investigations by means of resource integration, joint review, and request of VCA and LSA analyses. It is expected that the amount of special tax adjustments will continue to increase.
- 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 transfer pricing investigations.
- MNCs likely will have rapidly growing needs for dispute resolution and avoidance of international double taxation resulting from transfer pricing investigations.
- For the purpose of improved guidance on transfer pricing administration and investigation for tax authorities, the SAT may revise and promulgate specific

guidelines on special tax adjustments and MAP, based on existing regulations.

Endnotes

1. For more details of *Public Notice No. 42*, please refer to our *News Flash [July 2016] Issue 21*
http://www.pwccn.com/home/chi/chinatax_news_jul2016_21_chi.html
2. For more details of *Public Notice No. 64*, please refer to our *News Flash [October 2016] Issue 29*
http://www.pwccn.com/home/chi/chinatax_news_oct2016_29_chi.html
3. Source: official website of The 2nd Branch Affiliated to Beijing Municipal Office, SAT (BJSAT No. 2 Branch), *LI Yamin, Administrator of Beijing Municipal Office, SAT, and LIAO Tizhong, Director General of SAT, Visited BJSAT No. 2 Branch and Announced the Reshuffle for the Branch.*
http://www.bjsat.gov.cn/bjsat/qxfj/zsefj/sy/zfxgk/zfxgkml/gzdt/201608/t20160803_265534.html
4. For more details, please refer to our *News Flash [October 2014] Issue 23*
http://www.pwccn.com/home/chi/chinatax_news_oct2014_23_chi.html
5. For details of relevant regulations and analysis, please refer to our *News Flash [December 2014] Issue 34 and [March 2015] Issue 11:*
http://www.pwccn.com/home/chi/chinatax_news_dec2014_34_chi.html
http://www.pwccn.com/home/chi/chinatax_news_mar2015_11_chi.html
6. For details, please refer to our *News Flash [July 2015] Issue 32 and Issue 33:*
http://www.pwccn.com/home/chi/chinatax_news_jul2015_32_chi.html
http://www.pwccn.com/home/chi/chinatax_news_jul2015_33_chi.html
7. Source: *China Tax News 19 February 2016, Focus-International Tax Administration Will Do these Major Issues in 2016:*
http://www.ctaxnews.com.cn/xinwen/duijia/201602/t20160219_66304.htm

8. Source: SAT, *Anti-tax avoidance Contributed RMB 52.3 Billion to Taxation in 2014:*
<http://www.chinatax.gov.cn/n810219/n810724/c1507274/content.html>
9. Source: *China Tax News 4 January 2016, China is Deeply Involved in Global Tax Cooperation with A Louder Voice*
http://www.ctaxnews.net.cn/html/201601/04/nw.D340100zgswb_20160104_1-01.htm?div=-1
10. See Endnote 7.

Let's talk

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