

# **SAT's new rules on advance pricing arrangements reflect its new thinking on tax administration**

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## ***In brief***

On 11 October 2016, the State Administration of Taxation (SAT) issued the Public Notice on Matters Regarding Refining the Administration of Advance Pricing Arrangements (SAT Public Notice [2016] No. 64, hereinafter referred to as "Public Notice 64" or the "New Provisions"). Public Notice 64 provides the process and requirements for an enterprise to apply for an advance pricing arrangement (APA) as well as the criteria for an APA application to be prioritised or declined.

Public Notice 64 becomes effective from 1 December 2016 and replaces Chapter 6 Administration of Advance Pricing Arrangements (hereinafter referred to as the "Original Provisions") of the *Implementation Measures of Special Tax Adjustment (Trial Version)* (Guo Shui Fa [2009] No. 2, hereinafter referred to as "Circular 2"), which shall be annulled on the same date.

According to Public Notice 64, the negotiation, signing and implementation process of an APA involve six stages: 1) the pre-filing meeting, 2) letter of intent, 3) analysis and evaluation, 4) formal application, 5) negotiation and signing, and 6) execution and monitoring. Compared with the Original Provisions, the New Provisions strengthen the tax authorities' control over the APA process, and set higher standards on the enterprise's compliance, cooperation, and information disclosure during the APA application process. An enterprise must obtain approval from the tax authorities before it can submit a letter of intent, and clear the analysis and evaluation process and obtain approval before it can submit the formal application.

The New Provisions have set higher standard for APA applications. Enterprises are required to prepare application packages in accordance with the new requirements, especially to include analyses which China tax authorities pay special attention to, such as the analysis of value chain and location specific advantages. An enterprise must actively cooperate with the tax authorities to perform required analyses, timely provide requested information, actively negotiate with tax authorities on the proposed transfer pricing method and adjust its proposal as necessary, in order for its application to receive expedited processing by the tax authorities.

The New Provisions have moved the analysis and evaluation stage before the formal application stage. This change may have limited impact on unilateral APA applications. For bilateral or multilateral APA applications, however, the impact may be more significant, as changes to an enterprise's applications in China will affect its related parties' application in other countries. The New Provisions require enterprises to agree to negotiate with the tax authorities and adjust their proposed transfer pricing methods as necessary during the analysis and evaluation stage, or their applications may not be accepted. Such a requirement presents challenges to the taxpayers and/or their related parties in managing their APA applications.

Public Notice 64 sets higher standards on the tax authorities' monitoring of APA implementation and on enterprises' actual operating results over the APA period. Enterprises that have APAs need to closely monitor the execution of their APAs. If the interquartile range is used in an APA, the enterprise will need to ensure not only its yearly result within the range, but also the weighted average result over the entire APA period to achieve at least the median level in order to avoid any impediment to the future renewal.

Public Notice 64 provides that enterprises having not received approval to submit formal applications before Public Notice 64 becomes effective will be subject to the New Provisions. This means that they would need to follow the new application procedure and document requirements as set out in Public Notice 64.

### In detail

#### Background

Chapter 6 of Circular 2 issued by the SAT in 2009 provides detailed rules on administration of APAs. Since then, the numbers of APA applications as well as concluded APAs have been growing in China. According to *China's 2014 Annual Report on Advance Pricing Arrangements* published by the SAT, China tax authorities as of 31 December 2014, have received a total of 162 written letters of intent or formal applications for bilateral APAs involving 16 countries, and 42 bilateral APAs had been concluded.

With the implementation of the Base Erosion and Profit Shifting (BEPS) Package that changes the international tax rules in China and around the world, multinational enterprises face increasing uncertainties on their transfer pricing. This creates increasing demand for APAs. On the other hand, the stretched China tax authorities and the SAT in particular are only able to handle a limited number of APA applications each year, especially bilateral APAs, and such situation is not expected to improve significantly in the next few years. More importantly, China tax authorities are eager to reflect their practical experience over the past 8 years since the issuance of Circular 2 and their new thinking and positions on transfer pricing in the administration of APAs. Against that background, the SAT issued Public Notice 64.

Public Notice 64 becomes effective from 1 December 2016 and replaces Chapter 6 Administration of Advance Pricing Arrangements of Circular 2.

#### Conditions for APA applications and the period covered by APA

Public Notice 64 provides that for an enterprise to be eligible to apply for an APA, it should have related party transactions amounting to at least RMB 40 million in each of the past 3

consecutive years starting from the year during which the enterprise's letter of intent is accepted by the tax authorities. An APA may cover 3 to 5 years starting from the tax year in which tax authorities formally accept the letter of intent, as opposed to the year subsequent to the year during which the formal application is accepted under the Original Provisions. In addition, Public Notice 64 also specifies that an APA may be rolled back for up to 10 years.

Public Notice 64 specifies that the tax authorities may decline an enterprise's application for an APA if the enterprise is under open special tax investigation or other tax related investigations, or fails to file the *Enterprise Annual Reporting Forms for Related-Party Transactions* as required by relevant provisions, or fails to prepare, maintain and provide contemporaneous transfer pricing documentation as required by relevant provisions.

#### Amended APA application procedure

Public Notice 64 provides that the negotiation, signing and implementation of an APA involve six stages: 1) pre-filing meeting, 2) letter of intent, 3) analysis and evaluation, 4) formal application, 5) negotiation and signing, and 6) execution and monitoring.

Compared with the Original Provisions which also involved six stages including pre-filing meeting, formal application, examination and evaluation, negotiation, signing, and execution and monitoring, the New Provisions have added a new stage, i.e. the letter of intent, moved the analysis and evaluation stage before the formal application stage, and combined the negotiation and signing stages into one. The new procedure formalises the tax authorities' current practice to conduct analysis and evaluation, and negotiate with the taxpayer on the proposed transfer pricing method

before the taxpayer's submission of formal application. The New Provisions significantly strengthen the tax authorities' control over the application process and raise the bar on enterprises' formal applications by front loading substantial work before the formal application is accepted. They also set a higher standard for the enterprise to cooperate with the tax authorities at the analysis and evaluation stage.

Public Notice 64 provides that an enterprise intending to apply for an APA shall request in writing for a pre-filing meeting. If the tax authorities and the enterprise can reach an agreement at the pre-filing meeting stage, the in-charge tax authorities shall notify the enterprise its approval to submit the letter of intent. Upon receipt of the approval notice, the enterprise shall submit a draft application package to the tax authorities.

Upon receipt of the enterprise's letter of intent, the tax authorities shall analyse and evaluate the information and draft application submitted by the enterprise. The New Provisions provide that at the analysis and evaluation stage, the tax authorities may have discussions with the enterprises regarding the draft application, conduct on-site interviews to understand the enterprise's functions and risks, and request the enterprise to adjust the draft application if it is deemed as not conforming to the arm's length principle. Once the tax authorities are satisfied with the draft application, they may approve the enterprise to submit the formal application. Upon receipt of such approval, the enterprise may submit the formal APA application package to the tax authorities.

The new APA application procedure is summarised in the Appendix.

#### New requirements for APA applications

Public Notice 64 has updated the requirements on analyses to be included in an APA application package, notably to add analyses on location-specific advantages such as location savings, market premiums, and the value chain analysis or supply chain analysis. Public Notice 64 specifies that tax authorities during their review of the enterprise's application shall evaluate whether the value chain or supply chain analysis conducted by the enterprise is complete and clear, and whether location-specific advantages such as location savings, market premiums, and the local contribution to the value creation have been fully considered. Public Notice 64 also specifies that if the enterprise refuses to provide relevant information, or fails to timely supplement or revise information to meet the tax authorities' requirements, the tax authorities may decline the enterprise's APA application.

### **Criteria for APA applications to receive prioritised processing**

Public Notice 64 provides 8 criteria under which the tax authorities may prioritise the acceptance of the application. These criteria take into account factors such as the enterprise's compliance, level of cooperation and information disclosure. Four of the more important criteria are:

1. Enterprises that have closed transfer pricing audits; or
2. Renewal applications for which the original APAs have expired, and there is no substantial change to the facts in the original APAs and the operational environment of the enterprises; or
3. Information and documents submitted by the enterprise are complete and adequate; value chain and supply chain analysis are clear and thorough; location-specific factors such as location savings and market premiums have been given adequate considerations; and the proposed transfer pricing method and the calculation method are reasonable; or
4. Bilateral or multilateral APA applications which the relevant competent authority or authorities show strong interest in and give a high degree of attention to.

### **More stringent monitoring on implementation**

In addition to the requirement to file annual compliance requirement, the

New Provisions include a new requirement on the enterprises' profit level during the APA period. According to Article 12, if an APA adopts the interquartile range to determine the transfer price or profit level, and the weighted average operating results of the enterprise during APA period fall below and are not adjusted to the median, the tax authorities shall reject the renewal application.

### **Our observation**

Public Notice 64 introduces the letter of intent as a separate stage and requires the enterprise to have the pre-filing meeting(s) and prepare relevant documents/ analyses before it is allowed to submit the letter of intent. Except for enterprises that are under open audits for transfer pricing and therefore not eligible to apply, whether the tax authorities and the enterprise could reach an agreement at the pre-filing meeting stage would determine whether an enterprise is approved to submit the letter of intent.

The enterprise is only required to provide brief descriptions of relevant issues during the pre-filing meeting stage, including whether there are location-specific advantages such as location savings and market premiums. However, no detailed value chain or supply chain analysis or analysis of the proposed transfer pricing methods is required at the pre-filing meeting stage. Therefore, it is unclear on what issues the enterprise and tax authorities shall reach an agreement during the pre-filing meeting stage. It is expected that the attractiveness of the potential APA application to the tax authorities, such as the existence of location specific advantages including location savings and market premiums, and the difficulty and possibility to successfully conclude the application, will be the important considerations for the tax authorities.

Public Notice 64 moves the analysis and evaluation stage before the formal application stage and this has different impact on unilateral vs. bilateral or multilateral APA applications. For enterprises applying for unilateral APAs, the impact is limited and mainly on the application process, as once the enterprise is approved to submit formal application, the negotiation and signing process is expected to be completed quickly.

For bilateral or multilateral APA applications, the impact is expected to

be more significant on the enterprises and/or their related parties. As the enterprise must negotiate with the tax authorities and potentially adjust the proposed transfer pricing method, or the tax authorities would not accept the enterprise's application. This may bring challenges to the enterprise and/or their related parties on their applications, as adjusting the proposed transfer pricing method may lead to inconsistency between the enterprise's formal application positions in China and those of its related parties in other countries. Therefore, the enterprises and their related parties must carefully manage this.

Public Notice 64 requires value chain and location specific factor analyses in APA applications, and such requirements have also been included in the updated transfer pricing documentation regulations<sup>1</sup>. The repeated emphasis on such analyses shows the importance that the China tax authorities attach to them. In the APA application process, enterprises should be prepared to face more challenges/ requirements on preparing and providing information related to their global value chains, value chain profits and their allocation. Before deciding on applying for an APA, the enterprise should evaluate the feasibility and applicability of the aforementioned analyses, and prepare accordingly. For enterprises that have already initiated the APA application process but have not been approved to submit formal applications, they should either prepare such analyses or explain why such analyses are considered unnecessary or infeasible and assess the potential impact on the proposed transfer pricing methods.

Setting criteria on prioritising the acceptance of APA applications is intended to encourage the enterprise's cooperation with the tax authorities during the APA application process, its provision of complete information and analyses on value chain, supply chain and location specific factors, and its compliance with the APA terms once APAs are signed. However, Public Notice 64 does not establish a time frame for each stage, so the pressure is all on the enterprise, which must prepare relevant analyses, cooperate with the tax authorities and seek support from the competent authorities of the relevant countries in order for its APA application processing to be prioritised.

According to Public Notice 64, APAs applications that are not formally accepted by tax authorities before the New Provisions become effective are subject to the New Provisions. This implies that such APA applications will have to follow the new procedure as well as the documents requirements as set out in Public Notice 64. Enterprises affected by this should assess the formal application package submitted and prepare additional analyses as necessary, including analyses of value chain and location specific factors in order to facilitate the application under the New Provisions.

Public Notice 64 specifies that, for APAs adopting the interquartile range in the transfer pricing methods, the weighted average operating results over the APA period must reach at least the median, or the renewal application will not be accepted. It is recommended therefore that before applying for an APA, enterprises should evaluate the feasibility of the APA implementation, especially whether it is feasible for the enterprise to achieve weighted average results at the median level over the APA period. It is also necessary for enterprises that have APAs to closely monitor their profitability and make adjustment if necessary, so as to maintain eligibility for renewal.

The processing of APA applications in China is constrained by the SAT's limited resources and slow although efforts are being made by the Chinese tax authorities to improve the situation. The SAT recently established a new division, Anti-avoidance Division 3, and its main responsibilities include the analysis, evaluation and the formation of negotiation positions for bilateral APA applications. The establishment of Division 3 will enhance the SAT's capacity to handle APA applications and therefore help accelerate the process time from the application to the signing of APAs. For taxpayers applying for APAs, to what extent their applications meet the tax authorities' criteria for prioritised processing will be a key factor in determining how fast their applications will be processed.

### ***The takeaway***

Public Notice 64 specifies the conditions, requirements and process on APA applications and monitoring. An enterprise intending to apply for an APA must clear the pre-filing and the analysis and evaluation stages, and receive approvals before it can submit the letter of intent and formal application respectively. Enterprises therefore are recommended to evaluate the feasibility of their potential APA applications in accordance to the new requirements

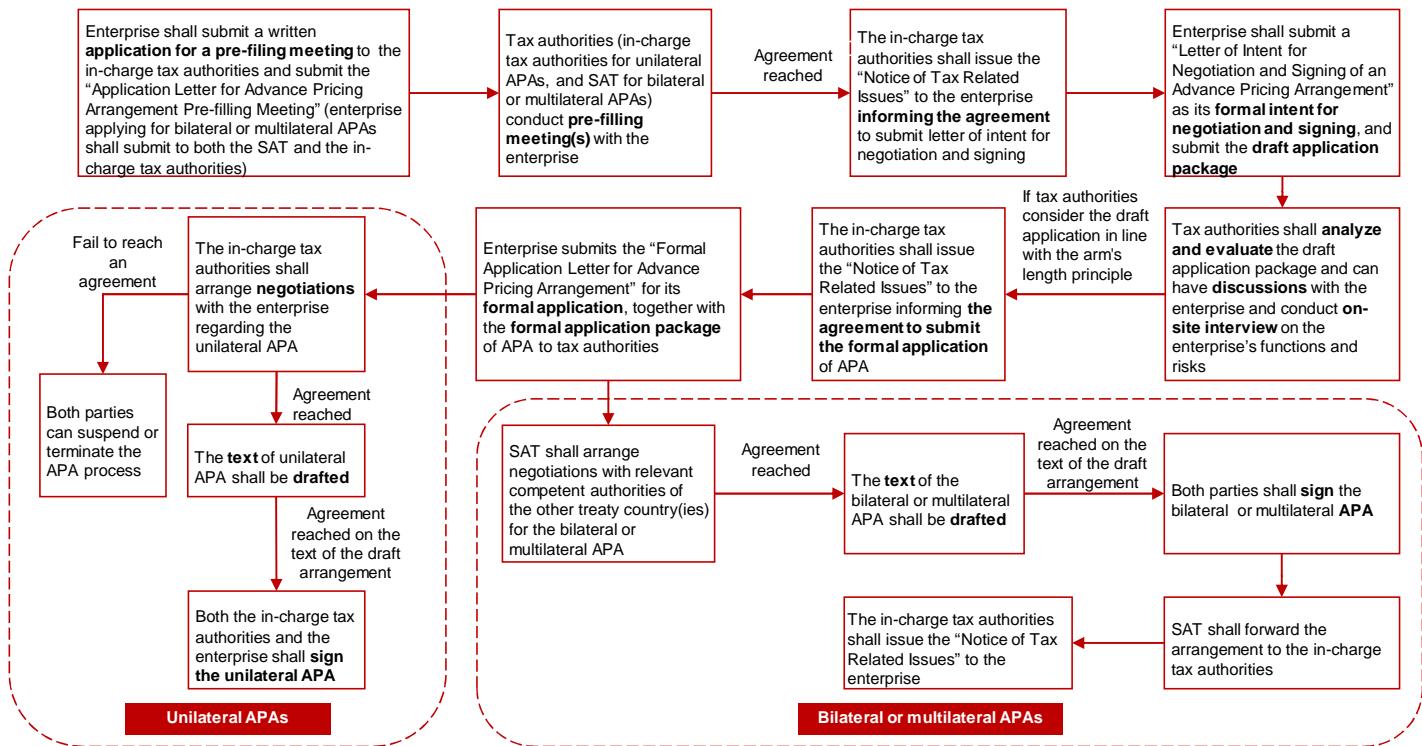
before initiating the application process. When preparing the APA application package, the enterprises are recommended to pay special attention to the aspects that China tax authorities focus on such as the analyses of value chain and location specific factors, in order to win approvals from the tax authorities. The enterprises should also be prepared to fully cooperate with the tax authorities and timely respond to the tax authorities' requests in order for their applications to receive prioritized processing.

Public Notice 64 raises more stringent requirements on monitoring of APA implementation and on enterprises' actual operating results during the APA period. For APAs adopting the interquartile range in the transfer pricing methods, special attention should be paid to the weighted average results over the APA period such that they would not fall below the medians, and necessary adjustment should be made as early as possible in order to avoid impediment to future renewals.

### ***Endnote***

1. Please refer to *PwC China Tax and Business Advisory News Flash [2016] Issue 21*.

## Appendix: New APA application procedure



## **Let's talk**

For a deeper discussion of how this issue might affect your business, please contact a member of **PwC's China Transfer Pricing Service:**

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