

Tax Analysis

PRC Tax Transfer Pricing Services

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SAT issues APA Report 2010

On 12 April 2012, China's State Administration of Taxation (SAT) released the 2010 Advance Pricing Arrangement (APA) Annual Report; this is the second time the SAT has released a comprehensive commentary and statistics on the APA program. The report is similar to the 2009 report, although additional comments are made regarding the protection of taxpayer rights.

Key content

The 2010 report includes a new preface by Wang Li, the Deputy Commissioner of the SAT, in which he comments on how the release of the 2009 report was well received by taxpayers in China and other revenue authorities. The SAT views the report as a key component of its efforts to increase the transparency of the Chinese APA program.

The opening sections of the report largely follow the layout of the 2009 report, covering the following topics:

- Introduction to China's APA program
- Historical development of the APA program
- Details of the APA procedure, including the six-step process for applying and implementing an APA
- Explanation of the confidentiality requirements and freedom of contract rights that protect taxpayers entering the APA program
- Statistics for the APA program for the years 2005 to 2010

Protection of taxpayer rights

This section goes through the rights of taxpayers entering the APA program, in particular with respect to the confidentiality of information and the freedom to contract. These are important factors for companies considering an APA.

The 2010 report confirms that pre-filing meetings with the tax authorities regarding a potential APA may be conducted on an anonymous basis, thus

enabling a taxpayer to discuss whether the SAT will accept an application without raising the taxpayer's profile. This encourages taxpayers to approach the tax authorities without risking a follow up audit if the APA is not pursued. The confidentiality provision also reiterates the duty of both the taxpayer and the tax authorities to keep the details of the APA process confidential.

The APA report comments on the freedom to contract also are helpful to taxpayers considering an APA. The report outlines the rights of the tax authorities or the taxpayer to suspend or terminate APA negotiations. In such a case, any non-factual information relating to the enterprise (such as suggestions, inferences, ideas and conclusions) that has been gathered may not be used in future tax investigations on transactions that would have been covered by the proposed APA. This may make taxpayers more comfortable about abandoning negotiations if an acceptable resolution seems unlikely.

APA statistics

The 2010 report includes the same categories of statistics as those provided in 2009, providing some insights as to how the APA program has operated:

APAs signed per year

China signed four unilateral APAs and four bilateral APAs in 2010 (one fewer unilateral APA and three fewer bilateral APAs than in 2009). The general trend for APAs continued throughout 2010, with a reduction in the number of unilateral APAs, and more emphasis on bilateral APAs. In addition to the APAs signed, the report shows that a further three unilateral and two bilateral APAs have been agreed on, but not yet signed. Presumably, these will be included in the 2011 statistics.

APAs by phase

The report shows that, up to the end of 2010, China concluded 48 unilateral APAs (34 expired, 11 active and three agreed, but not signed) and 18 bilateral APAs (three expired, 13 active and two agreed, but not signed). The total number of APAs in the negotiation stage climbed from 15 in 2009 to 25 (four unilateral and 21 bilateral) in 2010, and the number of pre-acceptance stage APAs increased from 51 to 65 (31 unilateral and 34 bilateral). The following table (from the SAT's APA report) shows the detailed statistics:

Phases		Unilateral	Bilateral	Total
Pre-acceptance	Proposal / letter of intent	4	24	28
	Pre-filing meeting	27	10	37
	Subtotal	31	34	65
Accepted applications	Examination and evaluation	3	9	12
	Negotiation	1	12	13
	Subtotal	4	21	25
Concluded APAs	Agreed but not signed	3	2	5
	Executed and monitored	11	13	24
	Expired	34	3	37
	Subtotal	48	18	66
Total		83	73	156

The SAT's preference for bilateral APAs is clear from the number of bilateral APAs compared to unilateral APAs that are currently being negotiated: 84% of accepted applications are for bilateral APAs, while only 52% of pre-acceptance APAs are for bilateral APAs.

APAs by transaction type

The 2010 report shows that APAs involving the purchase/sale of tangible assets still represent the majority of APAs. The split of transaction types has not changed materially from the 2009 report, for both accepted applications and concluded APAs. It is worth noting that although 64% of transactions covered by concluded APAs are for purchases/sales of tangible assets, only 46% of accepted applications are for tangible goods transactions. The split between the different types of transactions may change in the future.

Notably, the 12 APAs concluded in 2010 were for an average of more than one type of transaction (the report added 16 concluded transactions to the transaction breakdown statistics in 2010). These were two service transactions, two intangible asset transactions and 12 tangible asset transactions.

Bilateral APAs by region

Of the four bilateral APAs signed in 2010, three were with Asian countries and one with a European country. There was no material change to the overall (2005 to 2010) split of bilateral APAs by region: 75% with Asian countries, 19% with European countries and 6% with a North American country.

APAs by processing time

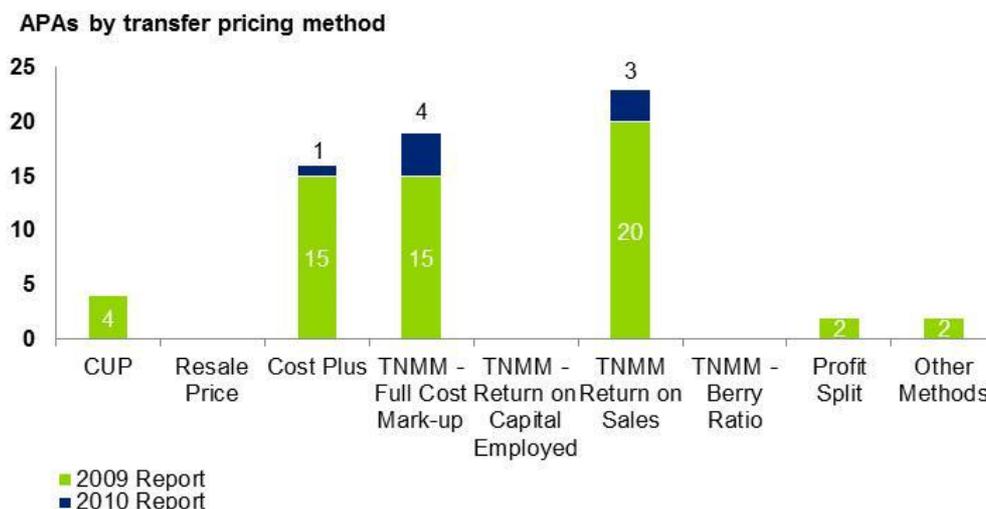
The SAT generally aims to complete the evaluation and negotiation of a unilateral APA within 12 months and within 24 months for a bilateral APA. For 2010, one unilateral APA was completed within a year, and the other three unilateral APAs were completed within two years, meaning that 75% of unilateral APAs were completed outside the target completion date. For bilateral APAs, two of these were completed within one year, while the other two took between two and three years.

The following table shows the time taken to complete the APAs signed in 2010, along with the statistics for APAs from 2005 to 2010 included in brackets.

Type of APA	From application to signing				
	< 1 year	1-2 years	2-3 years	>3 years	Total
Unilateral	1 (24)	3 (21)	0 (0)	0 (0)	4 (45)
Bilateral	2 (9)	0 (3)	2 (3)	0 (1)	4 (16)

APAs by transfer pricing method

The 2009 report showed that the transactional net margin method (TNMM) was the most popular method used in APAs. The cost plus method was the only other frequently used method. The 2010 report shows that the TNMM was used for seven APAs (three using return on sales and four using full cost mark-up), with one APA using the cost plus method. No other methods are clearly recorded as being used in 2010.



The statistics for transfer pricing methods are particularly interesting for the comparison to 2009, given the types of transactions discussed above. An assumption can be made based on the information provided. For example, the split between the use of the return on sales and full cost mark-up indicates that these APAs were for three distributors of products and four manufacturers or potential service providers.

Of further interest is that there was no disclosed increase in the use of the profit split method or comparable uncontrolled price (CUP) method. The 2010 report disclosed that APAs were concluded for two intangible asset transactions (see APAs by transaction type). In practice, the SAT typically prefers to use the CUP and profit split methods for dealing with intangible property, and the report does not indicate any change in the total number of these methods. While this is possibly because the intangible asset was of limited value in the overall APA, the failure to record additional profit split and CUP methods indicates that these methods were not used. This would be a surprising outcome. This is especially the case because the SAT is making considerable efforts to promote the use of these methods for intangible transactions and presumably would include them in the statistics if they were able.

Deloitte observations

The release of the 2010 APA report reaffirms the SAT's commitment to the program and to increasing transparency. While the information in the report is largely the same as in the 2009 report, there are some interesting facts from which conclusions may be drawn.

The section on taxpayer rights is welcome, the rights discussed are in line with international best practices and should encourage taxpayers to consider APAs more often.

As with all tax authorities, the SAT continues to be resource constrained in its ability to negotiate and conclude APAs. However, looking at the number of APA applications in each of the phases (pre-acceptance, accepted, concluded), the SAT is clearly making progress. In addition to the seven APAs concluded and signed in 2010, there were an additional five APAs agreed on, but not signed. Assuming these APAs would be signed in due course, there would have been a total of 12 APAs concluded in 2010 (seven unilateral and five bilateral). This figure exceeds the 10 new applications that were accepted in 2010, and is just below the 14 new applications in the pre-acceptance stage. While there are still 25 APAs in negotiation and 65 at the pre-acceptance stage, being able to conclude as many APAs as new applications accepted is a significant achievement.

A notable statistic is the SAT's tendency to conclude APAs for tangible goods transactions, with APAs (mostly bilateral) for intangible transactions remaining in the examination/negotiation or pre-acceptance stage. The percentage of completed APAs for intangibles is less than the number of intangible transaction APA applications. APAs for intangible transactions are always more complex, particularly because the result may be regarded as precedent for other APAs, so countries in a bilateral APA may be reluctant to give ground on disputed technical matters. The SAT is encouraging more taxpayers to enter the APA program for intangible transactions using profit split methods. The SAT will have to match this encouragement by demonstrating that negotiations with foreign tax authorities can be resolved when dealing with intangibles. Otherwise, the specter of double taxation will deter taxpayers with complex intangibles from considering APAs.

The statistics also make it clear that the SAT favors bilateral APAs over unilateral ones. Based on the figures provided and following on from the statistics provided in 2009, it is clear that very few unilateral APA applications are being accepted and taxpayers considering unilateral APAs should take this into account.

Overall, the 2010 report demonstrates the continued development of the Chinese APA program. This cause for optimism is somewhat tempered by the fact that the SAT's resource constraints are restricting the growth of the program. As a result, a taxpayer applying for an APA may to some extent be a hostage to fortune: a taxpayer with an interesting or novel transaction may well enjoy a successful APA experience, but a taxpayer simply looking for certainty may not be able to obtain it. In the short term, this problem may be exacerbated because of the introduction of the new Hong Kong bilateral APA program - causing an influx of applications in relation to transactions between the mainland China and Hong Kong.

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