

Tax Analysis

China issues 2019 Advance Pricing Arrangement Annual Report

On 29 October 2020, China's State Taxation Administration (STA) issued the Advance Pricing Arrangement Annual Report (2019) in both Chinese and English.¹ The report provides practical guidance for businesses interested in entering into advance pricing arrangements (APAs) with the Chinese tax authorities. The report describes the latest regulatory framework, procedural requirements, and the implementation status of the APA mechanism in China, as well as providing statistics and analysis of the APAs concluded by the Chinese tax authorities from 2005 to 2019.

Increase in APAs in 2019

Despite uncertainties arising from the reshaping of the international tax framework, Chinese tax authorities continue to direct more resources to the negotiation and conclusion of APAs as demonstrated by the increasing number of APAs signed in 2019 (i.e., 12 unilateral APAs and nine bilateral APAs), which is greater than in any year between 2005 and 2018. This signals the Chinese tax authorities' positive attitude towards the APA mechanism and willingness to resolve transfer pricing cases through international cooperation.

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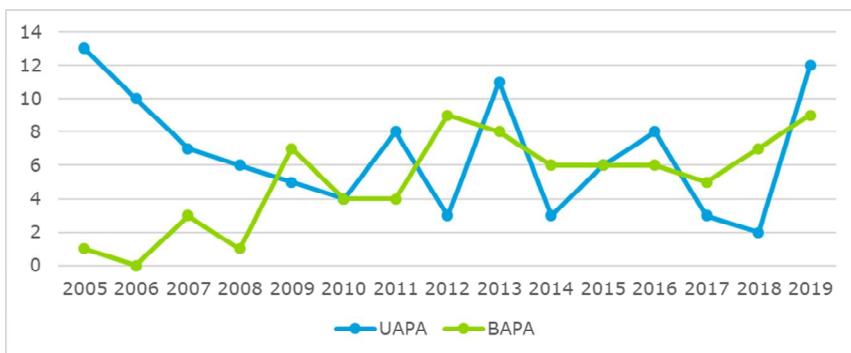
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¹ <http://www.chinatax.gov.cn/chinatax/n810214/n810606/c5157990/5157990/files/2c57f30f874b404186444d529ad62f61.pdf>

In addition to the steadily growing number of bilateral APAs (BAPAs), there is a significant increase in the number of unilateral APAs (UAPAs) signed in 2019 (i.e., 12 UAPAs in 2019 versus 2 UAPAs in 2018). A number of provincial tax bureaus and businesses seem to prefer using UAPAs not only to increase the predictability of transfer pricing matters in future periods, but also to resolve historical transfer pricing disputes by rolling back the APA to previous periods. This is likely because several provincial tax bureaus have launched a simplified procedure to facilitate the application of UAPA mechanism.

Chart 1: Number of UAPAs and BAPAs signed from 2005 to 2019

Number of APAs



Types of transactions

Among the APAs at the end of 2019, more than 60% were in relation to tangible asset transactions. However, the percentage has slightly increased for intangible asset and service transactions.

Chart 2: APAs by transaction type

	By 2015	By 2016	By 2017	By 2018	By 2019
Tangible asset transactions	65.9%	65.6%	65.1%	65.1%	60.7%
Intangible asset transactions	15.6%	14.7%	15.9%	14.8%	17.6%
Service transactions	18.5%	19.7%	19.0%	20.1%	21.7%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Chinese tax authorities have put more emphasis on transfer pricing issues in relation to intangible asset and service transactions in the post-BEPS era, with the focus on Chinese affiliates' contributions towards functions such as R&D and marketing. Since foreign investors' access to the service sectors (notably the financial service sector) has been further relaxed, more APAs likely will be negotiated in respect of intangible asset and service transactions.

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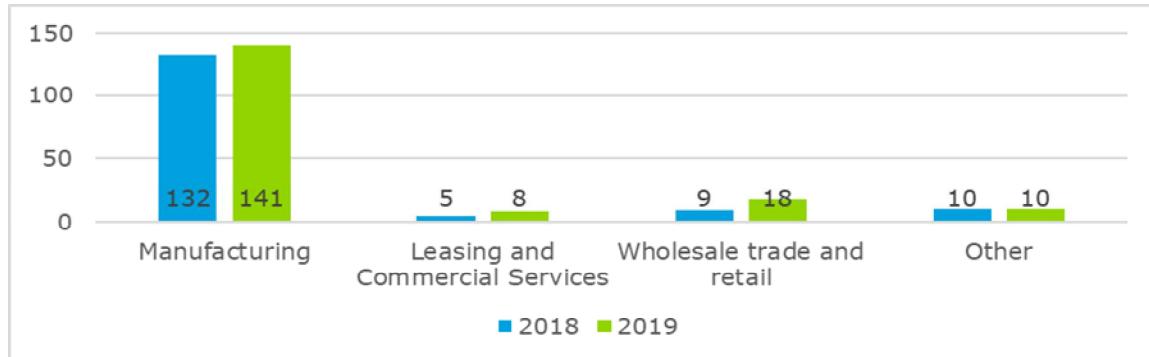
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Industries

Manufacturing remains the primary industry for APAs. However, the number of APAs related to service and trading businesses was still growing in 2019.

Chart 3: Industries covered by APAs (as of the end of 2018 and 2019)

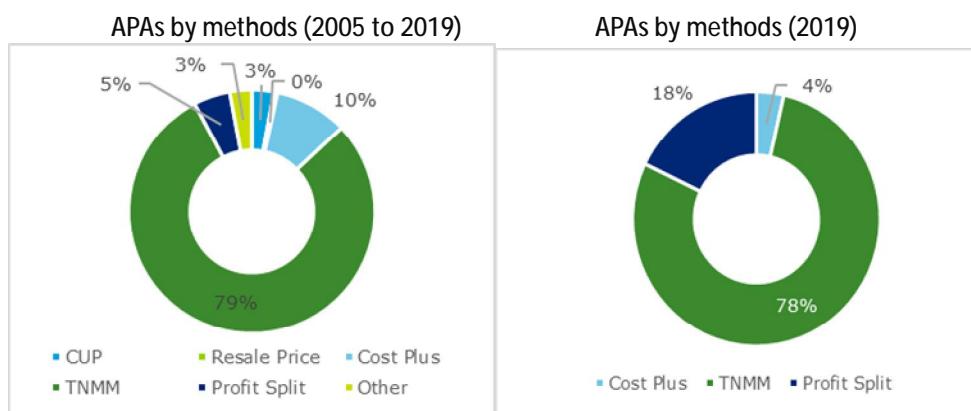
Number of APAs



Transfer pricing methods

The transactional net margin method (TNMM) is still the most frequently used transfer pricing method in APAs, although the use of other methods has been increasing in recent years. Notably, the profit split method has been applied in five new APAs signed in 2019. The profit split method is usually applied for highly integrated operations, such as the joint development of intangible assets. This method seems more welcome than before by Chinese tax authorities, as they believe Chinese companies have become more integrated into the global value chain and been making unique contributions in respect of certain core value creation activities such as R&D and marketing.

Chart 4: Transfer pricing methods applied in APAs



Time to conclude APAs

The efficiency in negotiating and concluding APAs (especially for BAPAs) improved in 2019, probably as a result of more resources having been directed to APAs by the Chinese tax authorities. However, these statistics only count the time from when a formal APA application was accepted. Under current regulations, an applicant must go through three steps before its formal APA application can be accepted: pre-filing meeting, submission of letter of intent, and analysis and evaluation. If an applicant is unable to ensure the quality of the relevant materials submitted or to respond to the tax authorities' queries to their satisfaction during these steps, the entire process could be delayed and the APA application possibly rejected by the tax authorities.

Chart 5: Time spent from formal application through conclusion for APAs signed in 2018 and 2019

Number of APAs

	1 year (including 1 year)		1-2 years (including 2 years)		2-3 years (including 3 years)		More than 3 years	
	2018	2019	2018	2019	2018	2019	2018	2019
UAPAs	2	2	0	4	0	3	0	3
BAPAs	1	5	0	3	1	0	5	2

Counterparties of BAPAs

Among the nine BAPAs newly signed in 2019, six of them were concluded with competent authorities of jurisdictions in Asia. As of the end of 2019, China has concluded 50 BAPAs with Asian jurisdictions (notably Japan and Korea), representing 66% of all the BAPAs signed by China. China's STA has established regular negotiation mechanisms with tax authorities of Japan, Korea, and the United States, which make the negotiation and conclusion of the BAPAs with these countries proceed more smoothly.

With China's Belt and Road Initiative, more Chinese companies have made outbound investments into foreign jurisdictions and some also have been considering APAs to manage their transfer pricing matters. There have been successful cases where the STA negotiated and concluded BAPAs for such Chinese companies.

Observations

From a technical perspective, an analysis of the value chain and location-specific advantages would be required and scrutinized by the Chinese tax authorities when they review an APA application. If the Chinese affiliates have been conducting significant R&D or marketing activities, a DEMPE (i.e., development, enhancement, maintenance, protection, and exploitation) analysis also would be required to determine which parties are entitled to the returns generated by the relevant intangible assets. With Chinese tax authorities gaining more experience and industry knowledge from APAs, their technical positions could become more standardized so that the negotiation and conclusion of the APA would become more efficient.

Apparently, efforts have been made by Chinese tax authorities to make APAs more accessible to taxpayers to enhance the certainty and predictability of transfer pricing rules. The STA even conducted APA negotiations through online meetings during the social distancing period due to the COVID-19 pandemic. The APA mechanism is an important option that should be considered by both inbound and outbound investors for transfer pricing management purposes.

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