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SAT issues draft guidance on transfer pricing rules and BEPS initiatives

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China's State Administration of Taxation (SAT) released a discussion draft of "Special Tax Adjustment Implementation Measures" (Draft) on 17 September 2015 that would comprehensively revise Circular 2, the existing guidance in this area. Circular 2, issued in 2009, is China's main transfer pricing guidance that contains detailed rules in areas such as transfer pricing adjustments, cost sharing arrangements (CSAs), controlled foreign companies (CFCs), thin capitalization, the general anti-avoidance rule (GAAR), etc. The Draft also incorporates a number of recommendations of the OECD in the context of the base erosion and profit shifting (BEPS) initiative, but does so taking into account China's unique economic environment and factors relevant to the revamping of Circular 2. The Draft also includes new chapters addressing intangible assets, intragroup services transactions and profit level monitoring.

The SAT is seeking public comments on the Draft by 16 October 2015.

Summary of key points in the Draft

- Transfer pricing contemporaneous documentation would consist of a master file and local report(s). Enterprises that meet certain criteria would be required to complete and submit the country-by-country (CbC) reporting form with their annual Enterprise Income Tax (EIT) returns (Chapters 2 and 3).
- Taxpayers would be required to prepare a "special issue" report as part of the contemporaneous documentation if they engaged in related party services transactions, implemented CSAs or exceeded the prescribed thin capitalization ratio at any time during the year (Chapters 3, 7, 9 and 11).
- During the course of a special tax investigation, if the ultimate global holding company of the investigated enterprise is located outside China and that holding company did not provide a CbC report to its local tax authorities, or the Chinese tax authorities are unable to effectively obtain the CbC report of the ultimate global holding company under an applicable automatic exchange of information agreement, the Chinese tax authorities would have the power to request that the investigated enterprise provide a CbC report. The tax authorities also would consider location-specific advantages (LSA), such as location savings, market

premium, etc. when determining whether any additional profits should be attributed to the investigated enterprise (Chapters 5 and 6).

- The Chinese tax authorities would adopt a broader approach in monitoring the profit levels of taxpayers and taxpayers would be assigned risk rankings. Taxpayers would not only have to comply with the contemporaneous documentation and related party disclosure requirements, but also would need to monitor their day-to-day transfer pricing policy implementation and potentially their profit levels (Chapter 13).

The Draft also provides a number of clarifications that would be welcomed by taxpayers:

- The value contribution method and asset valuation method would be formally introduced as examples of other acceptable transfer pricing methods, but the Draft clearly affirms the importance of considering traditional transfer pricing methods (Chapter 4).
- The requirement that CSAs be pre-approved by the tax authorities would be abolished and changes would be made to post-CSA monitoring, which would provide flexibility for taxpayers that intend to implement CSAs (Chapter 9).
- The tax authorities should impose additional tax and/or refund overpaid tax, as appropriate, based on the outcome of a mutual agreement procedure (MAP) in order to eliminate any double taxation arising from a special tax adjustment. Although the Draft sets out situations where applications for a MAP would be denied, it would provide flexibility for the SAT to ignore these criteria in situations where it considers that the MAP would eliminate double taxation, etc.

Details of the Draft

Chapter 2: Reporting of related party transactions

The Draft contains a number of clarifications relating to the recognition of associated relationships. For example, the Draft would:

- Clarify the calculation for combining the shareholding percentage of two or more individuals who have a familial relationship;
- Provide a method for calculating the ratio of total debt owed by a party to the actual paid-in capital;
- Include licensing of trademarks as one of the determination factors for associated relationship;
- In the case of know-how licensing, distinguish between patented know-how and non-patented know-how;
- Emphasize the meaning of “primary control” and “common interest,” and provide an explanation of primary control, a clear definition of senior management personnel, and stipulate that a family relationship should be considered as one factor in determining whether an associated relationship exists. The Draft also would clarify that a shareholding by the state or an association through the delegation of senior personnel by the state to a party would not give rise to an associated relationship.

These clarifications are designed to help the Chinese tax authorities make better practical determinations of the existence of associated relationships.

The Draft would modify and provide additional clarifications of various types of related party transactions. Transfers of financial assets, cash pooling arrangements and equity transfers would be considered related party transactions and “other types of transactions” would be added as a catch-all category.

The Draft would require that the CbC form be submitted with the PRC Annual Related Party Transactions Reporting Form in the annual EIT tax return. The Draft also sets out the criteria for the CbC reporting where a Chinese enterprise is the ultimate holding company of a multinational group and the annual consolidated revenue of the group of the previous fiscal year exceeds RMB 5 billion (equivalent to the EUR 0.75 billion threshold mentioned by the OECD), or where the ultimate holding company of the enterprise is outside China and the China enterprise has been designated by the multinational group to prepare and submit the CbC report.

Chapter 3: Contemporaneous documentation

On the basis of the existing version of Circular 2, the Draft draws on the BEPS 13 Action Plan and states that there would be three types of transfer pricing contemporaneous documentation: the master file, local report(s) and report(s) on special issues that would cover related party services transactions, CSAs and thin capitalization. This is consistent with the domestic initiative to focus on significant outbound service fee and royalty payments, as set out in guidance issued in 2014 and earlier this year (Circular 146 and Bulletin 16).

The requirement to prepare the contemporaneous documentation report, master file and local report(s) would be subject to the same threshold as is found in the current version of Circular 2, i.e. the report would be required where the “aggregate amount of related party purchases and sales exceeds RMB 200 million” or “the aggregate amount of other related party transactions exceeds RMB 40 million.” However, the Draft also would require enterprises with limited functions and that incur losses to prepare a master file and local report(s). The Draft also would eliminate the requirement that the “foreign shareholding percentage be lower than 50% and that the related party transactions only be between domestic associated parties” in Circular 2, so that an enterprise that only had related party transactions with domestic related parties would not be required to prepare the documentation report.

The Draft clearly indicates that if a taxpayer provides false or incomplete information that does not truly reflect the company's related party transactions, the taxpayer would be considered to have failed to comply with the contemporaneous documentation requirement. This implies that the tax authorities may impose stricter requirements on the quality of documentation, as well as disclosure requirements.

Chapter 4: Transfer pricing methods

In addition to the five traditional transfer pricing methods listed in the existing version of Circular 2, the Draft mentions other transfer pricing methods, including the value contribution allocation method and the asset valuation method. The value contribution allocation method typically would be used for transactions that lack comparable information but that can reasonably determine each party’s value creation and the group’s consolidated profit. While the Draft formally would introduce the use of the value contribution allocation method where appropriate, it clearly states that the SAT acknowledges the importance of the proper consideration of traditional transactional methods in the analysis. The Draft stipulates that the asset valuation method consists of the cost method, the market method and the income method, while indicating that when using the income method to evaluate intangible assets, the economic life of intangible assets should be reasonably determined.

The Draft further explains and specifies classifications of types of related party transactions, and adds new types of related party transactions (such as financial assets and equity transfer) to expand the Chinese tax authorities' monitoring of various types of related party transactions.

Chapter 5: Special tax audits and adjustments

Chapter 5 would expand transfer pricing audits, adjustment procedures and the Chinese tax authorities' investigation rights as prescribed in the existing version of Circular 2 (i.e. using electronic data as evidence, providing a CbC report for an investigated enterprise that should have a CbC report). The Draft also states that transactions between domestic related parties temporarily would not be subject to these rules, and that the tax authorities intend to relax the management of domestic related party transactions (as in the case of contemporaneous documentation).

The Chinese tax authorities would have the power during a transfer pricing audit to deny or refine the terms of related party transactions. The Draft emphasizes that regional special factors (such as location savings and market premium, etc.) should be taken into account, and would apply a reasonable basis to determine the additional profit that should be attributed to the audited enterprise as a result of such special factors during an audit. If the ultimate global holding company of the investigated enterprise is located outside China, and that company did not provide a CbC report to its local tax authority or the Chinese tax authorities are unable to effectively obtain the CbC report of the global ultimate holding company under an automatic exchange of information agreement, the Chinese tax authorities would be able to request the China investigated enterprise to provide the CbC report. This requirement is in line with BEPS Action Plans 9 and 13 regarding the characterization of risk and capital, as well as the CbC report.

Based on SAT guidance issued in 2009 (Circular 363), the Draft emphasizes that enterprises with limited functions and risks (i.e. toll manufacturing and contract manufacturing enterprises, and enterprises that carry out simple distribution or contract R&D activities) would be defined as enterprises that are not responsible for bearing any market and business risks associated with decision making, under-utilization, sluggish sales or R&D failures and would be required to maintain reasonable levels of profit. In reference to the adjustment method to be used by a toll manufacturer for recharging the value of raw materials and equipment, the chapter indicates that a capital adjustment of up to 10% of the comparable companies' financial data would be permissible. This is the first time the Chinese tax authorities would officially formalize their practice regarding transfer pricing audits and adjustments for toll manufacturers.

The Draft also mentions “secondary adjustments,” which became a controversial issue after the SAT issued guidance in 2006 (Circular 901); it references the points made on the subject in the most recent OECD transfer pricing guidelines. However, the Draft does not provide any details of secondary adjustments or their impact (e.g. how accounting adjustments should be made and whether dividends arising from a secondary adjustment would qualify for benefits under an applicable tax treaty or tax credit). How the Chinese tax authorities address secondary adjustments in future will need to be monitored.

The Draft indicates that this chapter is temporarily not applicable to domestic transactions. The existing version of Circular 2 stipulates that, for transactions between domestic related parties with the same actual tax rate, no transfer pricing audit or adjustment is required in principle provided the transaction does not directly or indirectly result in the overall reduction of tax revenue. However, transfer pricing adjustments of domestic related party transactions still exist from a practical perspective (i.e. where the transactions involve both foreign and domestic related parties). Clarification on how the SAT would implement this principle in future transfer pricing audits and how a domestic corresponding adjustment would be made if one party is undergoing a transfer pricing audit will be required.

Chapter 6: Intangible assets (New chapter)

The Draft contains a new separate chapter on intangible assets that would include definitions, as well as the principles and factors to be taken into account in allocating returns to intangible assets, and the valuation methods to be used. In general, this chapter would incorporate the new developments in the OECD BEPS action plan on intangibles, and at the same time, evidence the SAT's recent specific positions and practices.

According to the Draft, intangibles may be categorized as technology-related, market-related and other intangibles. Chapter 2 (Reporting and Filing of Related Party Transactions) of the Draft also specifically mentions that intangible assets would include land-use rights, goodwill and going concern value. However, the Draft does not include the controversial LSAs (such as location savings and market premium) in intangibles; instead, these factors would be considered with the group's other functions/risks/assets in the global business and the group synergy as value creation factors when determining the return on intangibles.

Regarding the allocation of return on intangibles, the Draft emphasizes the principle of alignment with economic activities and value creation, which is consistent with the key themes of the OECD BEPS action plan related to transfer pricing. The Draft also provides a detailed list of functions and risks related to intangible assets, and mentions that a company that merely funds the intangibles but does not assume any functions or risks should be entitled to a reasonable return only on the provision of funding. On this basis, it is expected that the Chinese tax authorities would further examine whether a local entity engages in any important functions related to intangible assets, and if so, they could challenge the traditional IP model where an offshore entity that only contributes funding is entitled to a residual return. On the other hand, the Draft also mentions the legal ownership of intangibles, without any contribution to the creation of the value of the intangibles, should not entitle the legal owner to a return on those intangibles. Whether a mere legal owner of intangibles would be entitled to any return in future is unclear.

The Draft mentions that intangible value may be quantified using the comparable uncontrolled price, profit split and other reasonable methods (including the value contribution allocation method and the asset valuation method, etc.). This would be in line with the fact that in recent years the Chinese tax authorities seem to have been advocating profit split, and value contribution and asset valuation methods in transfer pricing controversies. The Draft confirms the SAT's position on royalty payments, for example, the disallowance of a tax deduction for a royalty if the intangible assets concerned are incapable of providing the domestic taxpayer with any economic benefit, and requiring an adjustment of the royalty payment based on changes in the value of the intangibles, as well as changes in functions and risks.

Chapter 7: Intragroup services transactions (New chapter)

The Draft adds a chapter that specifically addresses issues related to the arm's length principle in the context of intragroup services transactions.

The Draft sets out two conditions that would have to be satisfied where service fees are received from or paid to a related party: (1) the service would have provided economic benefits to the service recipient; and (2) the service fee would have to be charged at an arm's length price. Where a taxpayer pays service fees to a related party but does not receive any economic benefits, the tax authorities would be able to impose a special tax adjustment by disallowing a deduction for the service fees in computing the taxpayer's taxable income. The authorities also would be able to adjust a taxpayer's profits using an appropriate transfer pricing method in cases where the service fees charged or paid to related parties do not satisfy the arm's length principle.

According to the Draft, the following types of services would not be deemed to create an economic benefit: duplicative services; shareholder activities; services that give rise to additional benefits simply because of a taxpayer's association with the group; services for which compensation already has been received; services that are unnecessary or unrelated to the function and risk profile of the taxpayer; and services that cannot result in any direct or indirect economic benefit. These principles generally are consistent with the SAT's positions in Bulletin 16, as well as the general views of the OECD.

The Draft would require that the fees for beneficial services charged between related parties be determined based on the reasonable costs incurred and that reflect arm's length profits. The service costs could be allocated using reasonable allocation factors, such as sales income, operating assets, headcount, staff salaries, facility utilization, data flow volume, working hours, etc. Although this chapter does not include a safe harbor rule for low-value added services such as those contemplated in BEPS Action 10, it does provide clearer guidelines to taxpayers on how intragroup services transactions could comply with the arm's length principle.

The new chapter details the specific requirements for the preparation of the special issue file with respect to intragroup services transactions. Specifically, taxpayers would be required to maintain and submit to the tax authorities their service contracts or other documents to demonstrate that the intercompany services are genuine. Taxpayers also would be required to describe in the special issue file how services costs were computed, how the transfer pricing method was selected and the reasons for selecting a particular method, as well as the specific amount of service fees borne by related parties within the group. However, the Draft does not specify whether there would be any exemption threshold for preparing the special issue file for intragroup services transactions.

Chapter 8: Advance pricing agreements

The Draft would eliminate the APA application prerequisites stipulated in the existing version of Circular 2 and the threshold amount for annual related party transactions (i.e. transaction amounts that exceed RMB 40 million). The elimination of these items would allow more taxpayers to apply for APAs. However, considering the limited resources of the SAT to process and prioritize APA applications, an increase in the number of APA applications is not expected in the short term. The Draft enumerates the "priorities" that would guide the SAT in accepting formal APA applications and contains a list of the circumstances in which the tax authorities would be able to deny a taxpayer's APA application.

Priorities factors would include a comprehensive consideration of the value-chain analysis and LSAs, and the reasonableness of the proposed transfer pricing policies and methodologies.

An APA application could be rejected in the following circumstances:

- Where a formal transfer pricing audit is initiated before the application is submitted;
- Where the weighted average profit level during the implementation period of a previous APA is lower than the median of the interquartile range when the taxpayer applies for a renewal of the APA; and
- Where the applicant fails to prepare contemporaneous transfer pricing documentation or submit annual related party transaction filings in accordance with relevant laws or regulations.

In practice, some tax authorities may initiate transfer pricing investigations for prior years before they process an APA application to evaluate the applicant's transfer pricing risk exposure and compliance status. Therefore, taxpayers should re-assess the feasibility of their APA applications and consider whether such applications would be likely to manage the risks of potential transfer pricing challenges.

The Draft clearly states that taxpayers would be required to prepare an APA prefiling package and submit the package to the competent tax authorities and the SAT, along with a written letter of intent for an APA application. The contents of the pre-filing package would have to be comprehensive and include factual information on the taxpayer and its related parties, a technical analysis of the transfer pricing policies and methodologies selected. The prefiling requirement generally is in line with prevailing practice under the existing version of Circular 2, where the Chinese tax authorities expect comprehensive documentation and analyses to be prepared by the applicant in the initial stage of an APA application. Accordingly, the Draft would formalize prevailing practice to make it part of the requirements in APA applications.

The Draft would clarify and detail how to roll back an APA for the same or similar related party transactions to prior years. According to the Draft, the rollback period for transfer pricing policies and methodologies determined in an APA could not exceed 10 years. The rollback period would be counted from the date the competent tax authorities issue the notice of a formal meeting to 1 June of the tax year following the tax year in which the related party transaction(s) took place. The Draft indicates that the rollback would be effected via special tax adjustments, in a manner similar to current tax authority practice. Taxpayers considering whether to apply for an APA should consider the potential impact of rolling the APA back to cover prior year related party transactions.

Chapter 9: Cost sharing agreements

The Draft reiterates and emphasizes the importance of the CSA participants owning the results of the arrangement and the cost-commensurate-with-benefit principle in sharing relevant costs, which also is consistent with the prevailing OECD transfer pricing guidelines. However, the Draft does not appear to have embraced the proposal in the discussion draft on BEPS action 8 as to cost sharing based on "economic value."

Although the Draft does not contain detailed guidance or examples on how to determine reasonably anticipated benefits (RABs) and buy-in and buy-out payments, it underlines the importance of considering the "characteristics" of the relevant intangibles or services in selecting the parameters in a RAB analysis; these should not change in the absence of special circumstances. Therefore, the Draft would impose greater technical requirements on taxpayers that are contemplating CSAs. Potentially affected taxpayers should consider the entire life cycle of CSAs before selecting and applying reasonable and consistent methodologies in their RAB analyses.

Specifically, the Draft requires that the impact of LSAs on the determination of the cost pool being shared should be considered. Generally speaking, there could be such an impact when Chinese participants develop intangibles or provide services based on a much lower level of costs, compared with CSA counterparties located in developed countries, i.e. location savings. Again, this requirement may make the relevant technical analysis more challenging. Potentially affected taxpayers would need to consider whether LSAs exist, how to reflect their impact on the cost base and the RAB analysis throughout the life cycle of the CSA. In addition, although the Draft requires that the terms of a CSA include a balancing adjustment clause, there is no clarification of whether such an adjustment is to be made based on the "ex-ante" or "ex-post" cost information.

The Draft would include changes from ex-ante approval to ex-post supervision, which is specified in the recently issued Bulletin 45. This change generally would be favorable to taxpayers seeking to enter into CSAs.

The Draft sets out the relevant requirements for post-CSA monitoring, the prime focus of which is the functions and risks undertaken by CSA participants. The SAT's position is that any participant that lacks commercial and/or economic substance or that does not carry out any actual functions but only provides funding, should not be entitled to any benefits from the intangibles resulting from the CSA. Considered in conjunction with the clarification and definitions in Chapter 6 of the Draft with respect to the legal and economic ownership of intangibles, it is expected that the Chinese tax authorities would challenge any CSA participant that does not perform actual functions or that does not make actual and continuous contributions to the economic value of the relevant intangibles. From the perspective of implementation, the SAT is expected to further clarify and coordinate with the local tax authorities how to claim a deduction of relevant CSA costs and apply for relevant treatment in both a direct and an indirect tax context after CSAs are registered by taxpayers.

Chapter 10: Controlled foreign corporations

Chapter 10 of the Draft provides additional guidance on CFCs based on the existing Circular 2. It would define "attributable income" (i.e. the part of the profits earned by the CFC that are attributable to resident shareholders) and would provide reference to the determination of the “attributable income." The Draft also lists some typical instances in which certain income (e.g. proceeds from insurance coverage) of CFCs generally would be deemed to be "attributable income."

The Draft explains some key controversial concepts on the determination of when a CFC would exist (e.g. definition of single resident shareholder, calculation of the effective tax rate, etc.), which would provide general guidance and a legal basis for enforcement by the Chinese tax authorities. The Draft also states explicitly that if a CFC is subject to a special tax adjustment audit, the tax authorities would have the right to request the Chinese resident shareholders to provide information on the CFC under their control.

Chapter 11: Thin capitalization

The Draft provides more detailed rules in the thin capitalization chapter than are found in the existing version of Circular 2. For example, the Draft indicates that related party debt from cash pooling should be included in the related party debt-to-equity calculation. In practice, this requirement appears to have led to challenges, especially for taxpayers acting as the cash pool heads that centralize the borrowing/lending positions of the cash pool members. Even though some borrowings are not for the use of the head of the cash pool, such borrowings still are viewed as borrowings by the cash pool heads that increases the related party debt-to-equity ratios. In addition, although existing Circular 2 indicates the ratio calculation referred to above is to be based on average monthly equity and related party debt, the Draft proposes that the calculation be made by reference to each occasion of investment in equity and related party debt.

The Draft also would expand the scope of interest expense that could be recognized. Some instances of this expanded scope (e.g. recharacterized interest expense due to special tax adjustments and foreign exchange gain/loss related to related party debt) would seem to require further clarification.

The Draft would require taxpayers wishing to claim interest expense deductions on related party debt in excess of the standard related party debt-to-equity ratio to prepare contemporaneous documentation similar to what currently is required in Circular 2. However, the Draft also would require the taxpayer to provide an additional item allowing the tax authorities to determine "whether an independent enterprise would be able and willing to accept the (related party) financing conditions, amount and interest rate." If one looks at the components required in the contemporaneous documentation, it seems that when examining thin capitalization issues, the SAT still would focus more on the credit rating and repayment ability of the taxpayer and the pricing of intercompany financing by reference to the arm's length principle.

Chapter 12: General anti-avoidance rule

Chapter 12 of the Draft contains some minor changes to the GAAR. It would add a new measure to the effect that if an enterprise attempts to disguise a related party transaction by way of an agency, a trust or other arrangement, the Chinese tax authorities would be permitted to recharacterize the arrangement as a related party transaction based on economic substance. Since the Draft does not provide detailed guidelines on how this would be implemented, its potential impact remains to be seen.

Chapter 12 also defines the sequence of the application of special tax adjustment provisions, tax treaty provisions and a GAAR audit.

Chapter 13: Profit level monitoring (New Chapter)

The Draft would add a new chapter on profit level monitoring and establish a risk management-oriented approach to enhance the monitoring of taxpayers' real-time profit levels, and to encourage cooperation and compliance.

The Draft would require the local tax authorities to provide guidance to taxpayers that have a high compliance level and a low tax risk ranking. For taxpayers with low compliance levels and high tax risk rankings, the tax authorities would conduct special tax investigations. The tax authorities also would keep track of taxpayers that already have been subject to special tax adjustments and closely monitor their related party transactions and profit levels. However, the Draft would replace the five-year supervision period requirement with ongoing supervision, which demonstrates how the Chinese tax authorities are moving towards a holistic approach to the monitoring of related party transactions. The Draft would place more emphasis on establishing a broader mechanism for risk management to assess taxpayers' risk ranking, as compared to the current practice of focusing on taxpayers that already have been subject to a special tax adjustment. Taxpayers should not only focus on the preparation of contemporaneous documentation and disclosure of related party transactions, but also on ensuring that their day-to-day transfer pricing implementation is in accordance with the arm's length standard.

The Draft also would encourage taxpayers to make “self-adjustments” and report the adjustments to the tax authorities. However, the tax authorities would retain the right to conduct audits and impose special tax adjustments.

Chapter 14: Corresponding adjustments and MAP

Chapter 14 of the Draft would revamp the existing text in Circular 2, by making reference to guidance issued in 2013 (Bulletin 56) to improve the administration of the MAP in relation to special tax adjustments. A MAP request would be able to be initiated by a Chinese tax resident, the competent tax authorities of other contracting state or under other situations where MAP is considered necessary.

The Draft emphasizes that the tax authorities should impose additional tax and/or refund overpaid tax as appropriate, based on the outcome of a MAP in order to protect taxpayers from double taxation resulting from a special tax adjustment. These measures reflect the efforts of the SAT to enhance the MAP in the context of special tax adjustments.

The Draft sets out the situations in which a MAP request would be denied, such as where the taxpayer failed to initiate the request within the time period specified in the relevant tax treaty or where the issue is not covered by the treaty. However, the Draft would provide flexibility for the SAT to ignore these criteria if it considers that the MAP would prevent double taxation, etc. Therefore, more Chinese companies investing overseas, as well as foreign companies doing business in China, would be able to consider the possibility of initiating a MAP as an alternative approach to resolving tax disputes and protect themselves from double taxation that arises from transfer pricing or other special tax adjustments.