

Tax Analysis

China

Deloitte Tohmatsu Tax Co.

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SAT Issued New Rules to Improve Administration of Advance Pricing Arrangements

On 11 October 2016, China's State Administration of Taxation (SAT) issued new regulations (i.e. SAT Bulletin [2016] No. 64¹, or "Bulletin 64") to improve the administration of Advance Pricing Arrangements ("APAs"). Bulletin 64 is released as the second significant revision, following the previous issuance of SAT Bulletin [2016] No. 42 ("Bulletin 42") in June 2016 on reporting of related party transactions and contemporaneous documentation, to the relevant chapters of the Implementing Measures for Special Tax Adjustments (for Trial Implementation) (SAT Circular Guoshuifa [2009] No. 2 or "Circular 2") and become another important rules of Chinese special tax adjustment. Bulletin 64 will apply from 1 December 2016 and the applicable sections concerning APAs in the old regulations (i.e. Chapter 6 of Circular 2) will be repealed.

Bulletin 64 is a quick-and-significant issuance by the SAT after Bulletin 42. APA is an effective method to resolve tax disputes in advance and improve taxation certainty. Specifically, bilateral or multilateral APAs can resolve in advance tax disputes amongst jurisdictions and effectively avoid double taxation. As one of the minimum standards, OECD's Action 14 of Base Erosion and Profit Shifting ("BEPS") Project, i.e. Making Dispute Resolution Mechanisms More Effective, also has listed "the implementation of bilateral APAs" as one of the best practices to improve the effectiveness and efficiencies of Mutual Agreement Procedure ("MAP"). Bulletin 64 is another localized rule by Chinese tax authorities to the outcome of the BEPS actions, representing the proactive attitude of Chinese tax authorities towards APAs and the emphasis on further normalizing relevant administration mechanism. Bulletin 64 would also mark the significant improvement of Chinese tax authorities on relevant technical capabilities and efficiency of administration in transfer pricing area.

From an overall perspective, under the new taxation environment of China, Bulletin 64 further clarifies relevant requirements on APA matters such as the threshold of application, procedures of concluding APAs, roll-back period and application materials, etc. The bulletin is expected to have significant impacts on APAs in China.

(1) Changes and key points in APA applications

Under Bulletin 64, an APA generally applies to an enterprise with annual related party transaction amount reaching RMB 40 million during the three years prior to the year in which the competent tax authorities issue the "Notice of Taxation Matters" to the enterprise notifying the acceptance of the enterprise's intent for an APA.

Therefore, all enterprises can raise their intents of APA to tax authorities, however generally only enterprises meeting the following criteria may eventually conclude APAs with Chinese tax authorities: 1) the written intents of APAs are accepted by Chinese tax authorities; and 2) the annual related party transaction amount reached RMB 40 million during all the three years prior to the year in which the competent tax authorities accept the intent via "Notice of Taxation Matters".

¹ See full text in Chinese: [SAT Bulletin \[2016\] No. 64, or Bulletin 64](#)

Compared to old rules² in Chapter 6 of Circular 2, although the threshold amount of related party transactions remains the same, by introducing the aforesaid consecutive three-year period criteria, the new rules effectively enhances the requirements to applicable enterprises with focus on the on-going operation and consecutive arrangement of related party transactions. In addition, Bulletin 64 provides that the tax authorities may reject the application if the enterprise fails to fulfill its obligations to report related party transactions or prepare contemporaneous documentations.

Bulletin 64 lists the situations where the tax authorities may "prioritize" or "reject" APA applications :

| "Prioritize" (continued) | "Reject (to accept the written intent)" (continued) |
|---|---|
| <ul style="list-style-type: none"> ■ The enterprise submitted the full disclosures and comprehensive filings of related party transactions and contemporaneous transfer pricing documentation; ■ The tax compliance rating of the enterprise is graded as "A"; ■ The enterprise was audited by tax authorities for special tax adjustment and the case was already concluded; ■ The enterprise applies for renewal of the APA after the execution period, and the facts and operating environment stated in the existing APA do not have any significant changes; ■ The enterprise is able to submit the comprehensive materials as required by the APA application, with a clear and complete analysis on the value chain or supply chain taking into consideration any location specific factors such as market premium and cost savings, and the proposed transfer pricing principle and calculation methods are reasonable; ■ The enterprise proactively cooperates with the tax authorities to conduct the APA procedure; ■ For a bilateral or multilateral APA, the competent tax authorities in other countries are very eager to negotiate and conclude the APA, and consider the APA application to be of high importance; and ■ Other factors facilitating the conclusion of the APA. | <ul style="list-style-type: none"> ■ The tax authorities have already initiated special tax investigation or other tax investigation to the enterprise which has not been concluded; ■ The enterprise fails to submit "Annual Related Party Transactions Disclosure Forms" according to relevant ■ The enterprise fails to prepare, preserve and submit contemporaneous documentation according to relevant regulations; and ■ The tax authorities and the enterprises fail to reach a consensus during the phase of pre-filing meeting |
| | "Reject (to accept the formal application)" |
| | <ul style="list-style-type: none"> ■ The proposed pricing principles and calculation methods in the draft APA application is not reasonable and the enterprise refuses to negotiate and make any adjustment; ■ The enterprise refuses to provide relevant information requested by the tax authorities, or refuses to provide additional and/or corrected information if the information originally provided does not meet the requirements of the tax authorities; ■ The enterprise refuses to cooperate with the tax authorities to conduct on-site functional interviews; and ■ Other circumstances where the APA is inappropriate to reach. |

For enterprises interested in applying for APAs, it will be important to consider how to increase the possibility for the APA applications to be accepted by the tax authorities. In practice, Chinese tax authorities will require for quantitative analysis on location specific advantages ("LSAs") such as location savings and market premium as well as the analysis on value chain and supply chain. Therefore, enterprises should re-evaluate the feasibility of APA applications against the new rules, as well as relevant impacts on profitability arising from Chinese market factors and the contribution of Chinese enterprises in their global value chain within multinational groups.

² According to article 48 of Chapter 6 of Circular 2, an APA generally applies to any enterprise which meets all of the following requirements: 1) annual related party transactions amount reaches RMB 40 million; 2) the enterprise fulfills its obligation of making relevant related party transaction filings in accordance with the regulations; and 3) the enterprise prepares, preserves, and submits contemporaneous documentation in accordance with the relevant regulations.

(2) Tax authorities involved in APA procedures

Bulletin 64 clarifies which level of tax authorities for the applications of each type of APA (i.e. unilateral, bilateral or multilateral) to be submitted to:

| | Whether involving tax authorities in multiple regions or both state tax and local tax bureaus | | |
|----------------------------------|---|--|--|
| | No | Yes | |
| | | Application stage | Signing stage |
| Unilateral | Competent tax authorities only | SAT and its designated tax authorities | The APA may be signed by the SAT (or its designated tax authorities) with the enterprise; alternatively, the APA may also be signed by each involved local tax authorities with the enterprise respectively* |
| Bilateral or multilateral | SAT and competent tax authorities | Coordinated by the SAT | |

* Where a unilateral APA involves tax authorities in multiple locations but within the same province, the relevant work should be coordinate by the provincial tax bureau.

(3) Changes and key points in APA process

In Bulletin 64, an APA process generally includes the following phases: pre-filing meeting, intent for APA, analyses and evaluation, formal filing, negotiations and signing, and monitoring and execution. Compared with the old rules³ in Circular 2, Bulletin 64 rephrases the "examination and evaluation" to "analyses and evaluation" and re-orders the "formal filing" after the "analyses and evaluation".

Practically speaking, the tax authorities generally prioritizes the "analyses and evaluation" phase to improve the efficiency in the "formal signing" phase. Therefore, Bulletin 64 makes the change accordingly. It clearly signals the importance of comprehensive analyses on the business operation and related party transactions of applicants, as well as reasonable evaluation of the transfer pricing policy and calculation methodology adopted in the draft APA application, both of which would be critical for the tax authorities to determine whether to accept a formal filing.

Compared with the old rules in Circular 2, Bulletin 64 specifies the materials required for the pre-filing meeting and draft APA application report for the unilateral and bilateral (multilateral) APAs respectively, considering the differences for each type of APAs.

| Procedures | Key Changes |
|---|---|
| Phase 1: Pre-filing meeting | <ul style="list-style-type: none"> ■ The "Application for APA Pre-filing Meeting" must be submitted to the competent tax authorities and/or SAT; ■ Increased information to be provided, e.g. market conditions, whether LSAs exist such as market premium and location savings etc., whether double taxation exists together with relevant explanations |
| Phase 2: Intent for APA | <ul style="list-style-type: none"> ■ The applicant must submit the Letter of Intent together with the draft APA application report; ■ Increased information to be provided in the draft APA application report, e.g. tax years to be covered, analysis on value chain or supply chain, and consideration of LSAs such as location savings and market premium etc. |
| Phase 3: Analyses and evaluation | <ul style="list-style-type: none"> ■ The arm's length principle is specified as the general analysis principle; ■ Expanded scope of analysis and evaluation by tax authorities, e.g. analysis on related party transaction data, and value chain and contribution analysis etc.; ■ The tax authorities may conduct on-site functional and risk interviews. |

³ An APA process may generally divided into six phases: pre-filing meeting, formal filing, examination and evaluation, negotiation, arrangement signing, monitoring and execution (see article 46 of Circular 2).

| | |
|--|--|
| Phase 4: Formal filing | <ul style="list-style-type: none"> ■ The situations where the tax authorities may accept or reject formal applications are specified. |
| Phase 5: Negotiations and signing | <ul style="list-style-type: none"> ■ Removal of the requirement for unilateral APAs to be reported to the SAT for confirmation; ■ Increased content of the APA file: e.g. renewal of the APA, information exchange for unilateral APAs, etc.; ■ Changes in the manner of notification to the enterprises for bilateral and multilateral APAs: the SAT will forward the signed APA to the competent tax authorities which will send the files to the enterprises; ■ Articles are added in relation to the adjustment of over-/under-paid tax. |
| Phase 6: Monitoring and execution | <ul style="list-style-type: none"> ■ The deadline of annual report of APA under execution is extended from five months to six months after the year end; ■ Softcopy reports are newly requested; ■ Tax authorities will enhance relevant monitoring and the profit level must be kept within inter-quartile range during the execution period of the APA; tax authorities continue to require the submission of relevant files if there are any substantial changes affecting the APA. |

According to BEPS Action 14, participating countries shall commit the efforts to resolve bilateral MAPs within an average timeframe of 24 months⁴ including bilateral or multilateral APAs. Chinese tax authorities have now adjusted APA process and execution procedures to increase efficiency and shorten the whole timeframe of concluding an APA. The Bulletin would be regarded as one more step of localizing BEPS Actions in China.

In addition, the enterprise should pay attention to the following in respect to the APA process and execution procedure mentioned above:

- (i) **Draft APA application report:** Bulletin 64 clarifies the value chain analysis and LSA analysis as part of the application report. If the applicant has made a comprehensive and sound analysis in relation to the value chain and LSA in the draft application report, it may help to facilitate the process of the negotiation and conclusion.
- (ii) **Requirements on submission deadline and extension:** Bulletin 64 does not keep certain stipulations previously provided in Circular 2 regarding the extension of the timeframe on documentation submission in the APA procedures (e.g. there is no extension provided in Bulletin 64 for the submission of the "Formal Application of APA"), except where extension is still allowed for an enterprise to report substantial changes during the APA execution period in certain circumstances. It suggests that tax authorities will keep control of the whole APA procedure and increase the efficiency. The relevant enterprises are advised to plan proactively and well manage daily schedule as well as prepare robust materials. Timely communication with the tax authorities is also recommended in order to avoid missing the deadlines of documentation submission.
- (iii) **Monitoring of profit levels:** During the APA execution period, if the actual operating performance of the enterprise is out of the agreed range of prices or profit margins, Circular 2 was requiring to adjust the profit level to the agreed range of price or profit margins. Bulletin 64 has further stipulated that such adjustment should be made to the median of the agreed range of prices or profits. In addition, if the weighted average of actual operating results of the enterprise for the APA covered years is below the median and is not adjusted to reach the median, the tax authorities will not accept any renewal application of the APA according to Bulletin 64.

In practice, the renewal of APA could be difficult when the profit level of the enterprise for the covered years is below the median of the agreed range of prices or profits. Now this requirement has been formalized in Bulletin 64. Therefore, relevant enterprises should strictly manage relevant transfer pricing of the related party transactions covered by the APA, to ensure the actual profit level of a single year reach the median, and moreover the weighted average of actual operating results of the enterprise for the APA covered years is not lower than the median, otherwise the renewal of APA will not be accepted.

- (iv) **Payment/refund of under-/over-paid tax:** Tax refund was hardly seen in historical APAs while technically tax refund should be possible to exist in a bilateral APA. In the past, even if the bilateral MAP

⁴ See paragraph 18 of the final report of BEPS Action 14: Make Dispute Resolution Mechanisms More Effective

concluded the necessity of tax refund, it could be difficult for the enterprise to actually obtain tax refund given no clear regulations. In view of such circumstances, Bulletin 64 clarifies relevant rules and makes it possible for enterprises to obtain tax refund through APAs.

(4) Covered period and roll-back of APA

Bulletin 64 clarifies and updates the covered period and roll-back period of APA:

| | Chapter 6 of Circular 2 | Bulletin 64 | Key Changes |
|-------------------------|---|--|---|
| Covered period | Related party transactions occurring during the three to five consecutive years after the year in which the formal APA application is filed | Related party transactions occurring during the three to five consecutive years starting from the year in which the competent tax authorities issues "Notice of Taxation Matters" to the enterprise notifying the acceptance of the enterprise' intent for an APA | The starting year of covered period of APA will be the year when the tax authorities accepts the intent for APA instead of the following year of formal application |
| Roll-back period | If the related party transactions in the filing year or prior years are the same or similar to those covered in the APA, upon the enterprise's application and the tax authorities' approval, the pricing principle and calculation method applied in the APA may be applied to evaluate and adjust the related party transactions occurring during the filing year or prior years. | If the related party transactions in the filing year or prior years are the same or similar to those covered in the APA, upon the application of the enterprises, the tax authorities may apply the agreed APA terms in relation to the pricing principle and calculation method to evaluate and adjust such related party transactions of the enterprises in prior years. The roll-back period shall not exceed 10 years. | Bulletin 64 basically follows the previous rules, with clarification to the period limit as 10 years. |

The clarification of the roll-back period in Bulletin 64 is in line with relevant guidance of the BEPS Action 14⁵, which to some extent indicates that Chinese tax authorities will fully accept the roll-back adjustment under an APA as an alternative to the special tax adjustment. From the perspective of on-going practice, the roll-back of APA could be considered as a method for enterprises to improve the certainties of related party transactions and reduce compliance costs.

(5) Information exchange for unilateral APAs

As stated in the final report of BEPS Action 5, the enhancement of transparency would be treated as the primary mission to counter harmful tax practices. The framework to require compulsive and spontaneous information exchange mechanism is the best approach to enhance the transparency with regard to specific taxation rulings against taxpayers. Unilateral APAs involving cross-border transactions is also required as part of the information exchange as one of the six specific taxation rulings.

Bulletin 64 newly adds the content of information exchange for unilateral APAs. Except for the information related to national security, the SAT will have the right to carry out information exchange with other countries' competent authorities regarding unilateral APAs which are signed off after 1 April 2016. Such information exchange is also relevant to the requirements on contemporaneous transfer pricing documentation, especially the master file which would require to disclose effective unilateral APAs within the enterprise group. Consequently, information exchange covering unilateral APAs can enable tax authorities to perform cross-verification of the information from different sources, which follows the trend of creating a more transparent tax environment globally as advocated by BEPS Actions.

⁵ According to paragraph 33 of the final report of BEPS Action 14, an APA should be allowed to be applied to previous years when applicable in complying with the time limit.

(6) Miscellaneous

1) Suspension and termination of APA procedures

Bulletin 64 clarifies the situations where the APA procedure may be suspended or terminated in different phases. Specifically, if an enterprise does not provide necessary information for the APA procedure or provide false or incomplete information, or is considered taking other uncooperative actions, the tax authorities may suspend or terminate the APA procedures. Therefore, to avoid unnecessary losses caused by the suspension or termination of APA procedures, relevant enterprises should be more cautious in preparing relevant application materials.

2) Renewal

Bulletin 64 basically follows the rules in Circular 2, and adds that if the weighted average of actual operating results of the enterprise for the APA covered years is below the median of the agreed range and not adjusted to the median level, the tax authorities will not accept any renewal application of the APA.

3) APA and special tax adjustment

Bulletin 64 stipulates that the signing of an APA will not affect special tax adjustments, investigations, monitoring and administration by the tax authorities on the enterprise in relation to its related party transactions not covered by the APA. Compared with the relevant rules of Circular 2⁶, the provisions in Bulletin 64 appear to be clearer with more certainty.

(7) Deloitte's observation

As a new guidance to Chinese transfer pricing administration, Bulletin 64 summarizes the practical experience in recent years by Chinese tax authorities in the area of APA management. The issuance of Bulletin 64 marks not only the focus of Chinese tax authorities on transfer pricing but also a signal from the authorities to develop APA practice in China and enhance government service quality to taxpayers. The Bulletin will undoubtedly prove to be another milestone regulation of Chinese APA practice, taking comprehensive considerations to the specific economic environment in China and integrate the management standards of tax administration with developed countries, making a positive contribution to managing APAs in China.

From a practical perspective Chinese tax authorities have been more prudent and stricter in reviewing the application of APAs by applying higher standards, due to the sophistication and experience gained by Chinese tax authorities in handling APAs during the recent years. As evidenced by Bulletin 64, the implementation of BEPS actions will be accelerated in China.

⁶ According to article 49 of Circular 2, the signing of an APA will not affect the tax authorities' transfer pricing investigation and adjustments of related party transactions occurring during the year in which the formal APA application is filed or during any prior years.

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Contacts

Sarah Chin, Partner sachin@deloitte.com.hk

Issued by

Deloitte Tohmatsu Tax Co.

Tokyo Office

Shin-Tokyo Building 5F, 3-3-1 Marunouchi, Chiyoda-ku, Tokyo 100-8305, Japan

Tel: +81 3 6213 3800

email: tax.cs@tohmatsumax.co.jp

Corporate Info.: www.deloitte.com/jp/en/tax

Tax Services: www.deloitte.com/jp/tax/s/en

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