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China Spotlight

Bulletin 16: A Significant China Tax Guideline on Outbound Payments to Related Parties

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Agenda

Background of the release of Bulletin 16

Highlights of Bulletin 16

Consistency between Bulletin 16 and the BEPS project

Key considerations in making an outbound payment

Takeaways

Questions & Answers

Background of the release of Bulletin 16

SAT's new focus

Outbound intra-group service fees and royalties

April 2014	• **The SAT submitted a "<u>Comment Letter</u>" to the sub-committee of the United Nations Practical Manual on Transfer Pricing (TP) in Developing Countries on intra-group service fees and management fees**
June 2014	• **The SAT introduced <u>six tests</u> that aim to test intra-group service fee payable by a Chinese subsidiary to its foreign parent company during an international conference in Washington, D.C.**
July 2014	• **The SAT issued <u>Directive 146</u> to launch a comprehensive tax examination on significant outbound service fee and royalty fee payment to related parties of a MNC, with an aim to strengthen the tax administration on intragroup charge and prevent profit shifting**
Sept 2014	• **The SAT announced "<u>15 Unacceptable Behaviors</u>" of MNCs in a keynote speech during a conference with taxpayers on 2014 BEPS deliverables, and on its official website. One of unacceptable behaviors is "*Tax deduction for expenses that are not reasonable*"**
March 2015	• **The SAT released <u>Bulletin 16</u> as well as its official Interpretation, to formalize its transfer pricing position on outbound payments of expenses to overseas related parties**

Highlights of Bulletin 16

Bulletin 16 – summary

- More than only intra-group service fees and royalty fee, Bulletin 16 guidelines all types of outbound payments to overseas related parties

Taxpayer's burden of proof

- Intercompany contracts / agreements
- Relevant evidence / documents to verify the authenticity/benefits of the transaction
- The documentation to support that the transaction complies with the arm's length principle

Unqualified overseas related party

- Do not undertake functions, and / or bear risks
- No substantial business operations or activities

Unqualified overseas licensor

- Only has the legal title of the intangible assets but has no contribution to its value creation, i.e., not an economic owner

Unqualified services (in line with "six tests")

- Non-beneficial services
- Shareholder / stewardship activities
- Duplicative activities
- Incidental benefits or passive association
- Services that have been remunerated
- Services that do not create value to the taxpayer

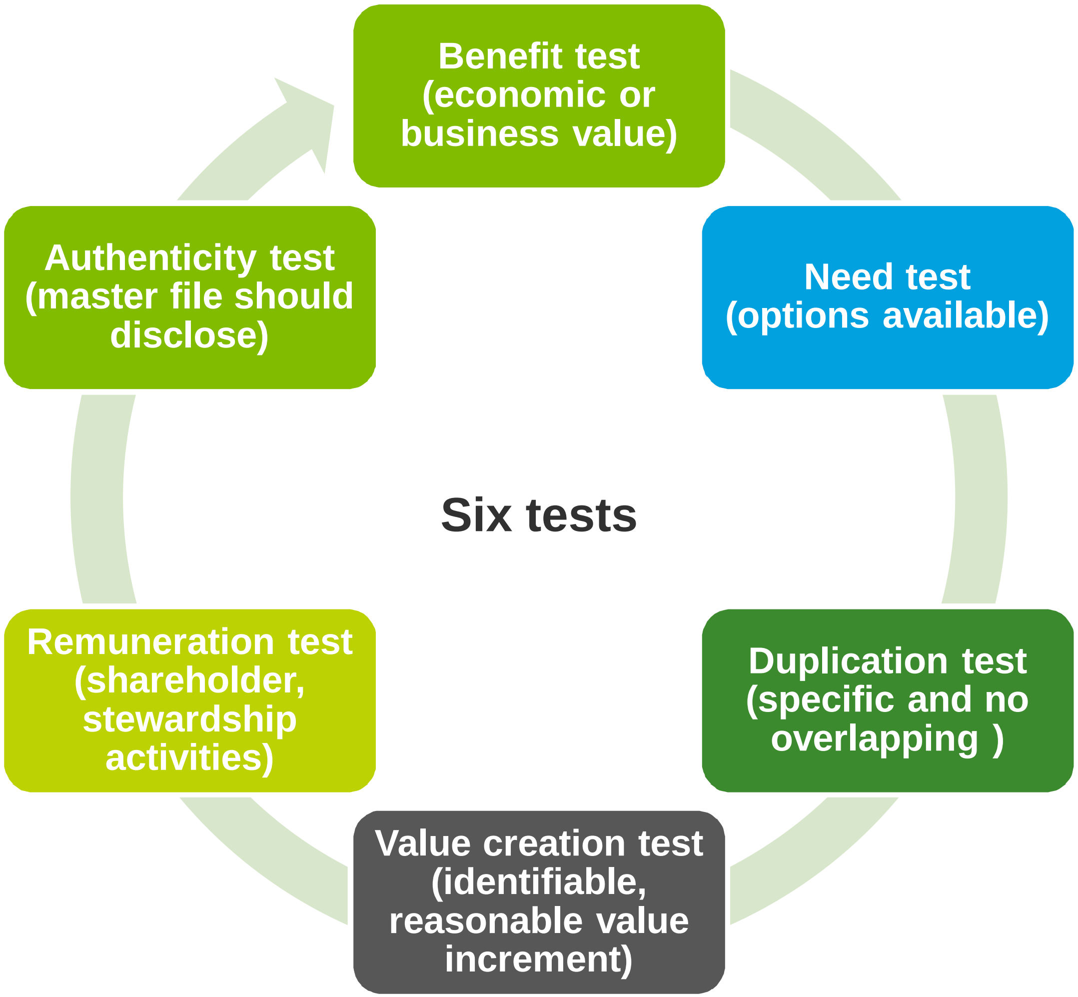
Unqualified intangibles

- The incidental benefits derived from the financing or listing activities undertaken by the offshore holding / financing companies
- The main purposes of the said offshore companies are for financing or listing only

Subject to ten years statute of limitations for TP adjustment!

Bulletin 16 – further discussion

Intra-group service perspective



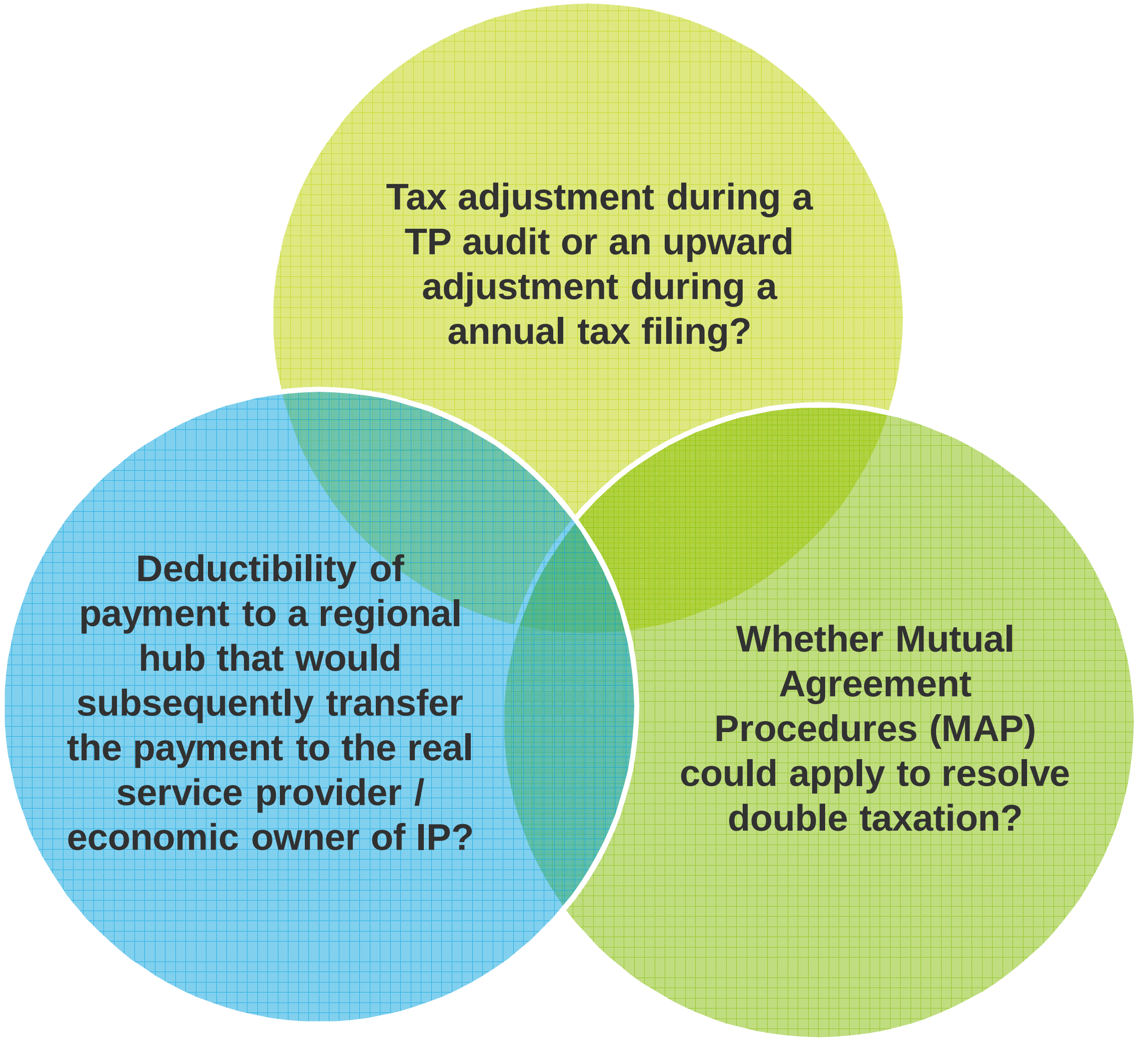
Polling question 1

How does your group find remittance or deduction of outbound payments from China to overseas affiliates?

- Frustrating
- Challenging but manageable
- Smooth
- Not applicable / outbound payments are not significant

Bulletin 16 – practical issues

- More guidance needed…



Consistency between Bulletin 16 and the BEPS project

Bulletin 16 vs. OECD's views in BEPS action plan deliverables

Official Interpretation on Bulletin 16 by SAT

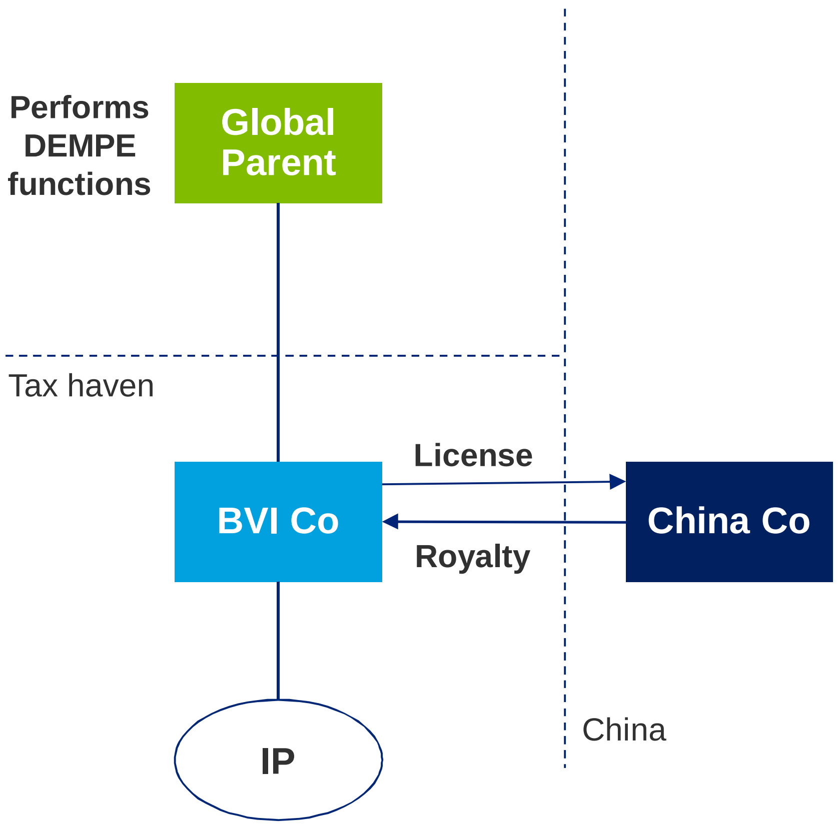
- When determining whether a royalty payment is at arm's length, analysis should be conducted to assess the functions performed, risks assumed and assets owned by the related parties involved during the development, enhancement, maintenance, protection and exploitation of the IP, and based on this to determine the value creation of the IP by each involving party
- Royalty payments to related parties who merely possess the legal ownership but fail to contribute to the value creation of the intangibles are not deductible

OECD's BEPS action plan deliverable

- In order to determine arm's length conditions for the use or transfer of intangibles it is important to consider as part of the comparability and functional analysis … the contributions of MNE group members to their development, enhancement, maintenance, protection and exploitation
- …determination (of legal ownership) is separate and distinct from the question of remuneration under the arm's length principle…

Case study

Comparison of Bulletin 16 and OECD's views in BEPS action plan deliverables



- BVI Co
  - Has no full-time employees and no substance
  - Acquired intellectual property (IP) ownership via contract R&D arrangement
- DEMPE functions in regard to IP (the development, enhancement, maintenance, protection, and exploitation) performed by employees of the global parent company
- BVI Co funded R&D activity using its considerable capital base
- BVI Co licensed IP to Chinese subsidiary within the group
  - Royalty reflects arm's length value of license
- Chinese subsidiary has not performed any DEMPE functions in regard to the IP

Case study

Comparison of Bulletin 16 and OECD's views in BEPS action plan deliverables (cont'd)

Possible treatment under Bulletin 16	Analysis under BEPS Action 8
• BVI Co is a mere legal owner, but has not performed any of relevant functions • In these circumstances, no deduction will be given to Chinese subsidiary for royalty charge	• Actual royalty paid to mere legal owner will be recognized • Contribution of global parent company (which performed all DEMPE functions) would be rewarded, in form of notional service fee payment from BVI Co to parent • Whether that notional service fee payment would be equal to BVI Co's royalty income still under discussion – Specifically, whether BVI Co would be entitled to a net return for its funding of R&D • At least a large proportion of BVI Co's royalty income likely to be notionally redirected to global parent, in the form of notional service fee • <u>No disallowance</u> of Chinese subsidiary's tax deduction for royalty

Case study

Comparison of Bulletin 16 and OECD's views in BEPS action plan deliverables (cont'd)

- Conflict
  - Under Bulletin 16: might lead to no deduction in China
  - Under BEPS: full deduction in China, and a re-allocation of income from BVI Co to global parent
- If both tax adjustments occur, double taxation between China and global parent's country will be triggered

Polling question 2

Is payment to a company in a tax haven becoming a concern to your group?

- Yes
- No, no such issue for us
- Don’t know / not applicable

What can we do for better certainties?

- For historical transactions
- Evidence documenting functions and risks of the entity receiving the charges
- Commercial reasons
- Special purpose documentation report
- For future arrangements
  - Possible amendments to current structures
  - Planning: Chargeable activities, cost pooling, allocation method, pricing policy
  - Cooperation with operation people, data collection
  - Advance pricing agreement (APA) application

Key considerations in making an outbound payment

Key considerations in making an outbound payment

Nature of charges

Historical charges	Future arrangement

↓

Possible forex implications

↓

Possible tax implications

Type of services	Earning Income Tax (EIT): exemption? deductible?	Value-added tax (VAT): 6%

↓

Procedures of foreign remittance

Discuss with tax bureau (contract filling)	Discuss with bank / forex bureau

Takeaways

Tax authorities' new angle in examination

High profit is no longer safe harbour for TP audit

Chinese tax authorities begin to target service payments to overseas related parties that were hidden by the umbrella of high-profits

Payment to Tax Havens/Low-tax Jurisdictions

The tax authority in Beijing launched a special examination on service charges/royalties paid to a list of tax havens and low-tax jurisdictions, including 40 countries / regions

Local contributions to intangibles are stressed

Chinese tax authorities increasingly assert local activities contribute to the value of MNC's global intangible, and further argue for a bigger entitlement to profits

Suggestions

1. Timely and periodically sort out supporting information of intra-group service / royalty transactions

Legitimacy of the relevant licensing arrangement	Transaction flow	Legal documents	Pricing policy

2. Analyze the substance, necessity and reasonableness of the royalty payment based on business needs and economic substance

- **Business needs when the transactions were implemented**
- **Function and risk analysis for involving parties in the context of the service / royalty arrangement**
- **Examine the economic substance of the service / royalty transaction and identify any areas of potential duplication**
- **Review of the group pricing policy and the reasons of changes, if any**

Suggestions (cont'd)

3. Review the ownership of intangibles from both legal and economic perspectives, and prepare relevant supporting documents to substantiate the contribution of value creation to the intangibles from both licensor and licensee

4. Maintain close communication with the group and seek for information / assistance and integrated solutions on the group level. This requires collaboration between the local company and the parent company

Questions & Answers

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