

China Transfer Pricing and Anti-tax avoidance update in 2015

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A presentation by

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1. Chinese Transfer Pricing overview

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- Anti-tax avoidance data analysis since implementation of new corporate income tax (CIT) law during 2008-2014

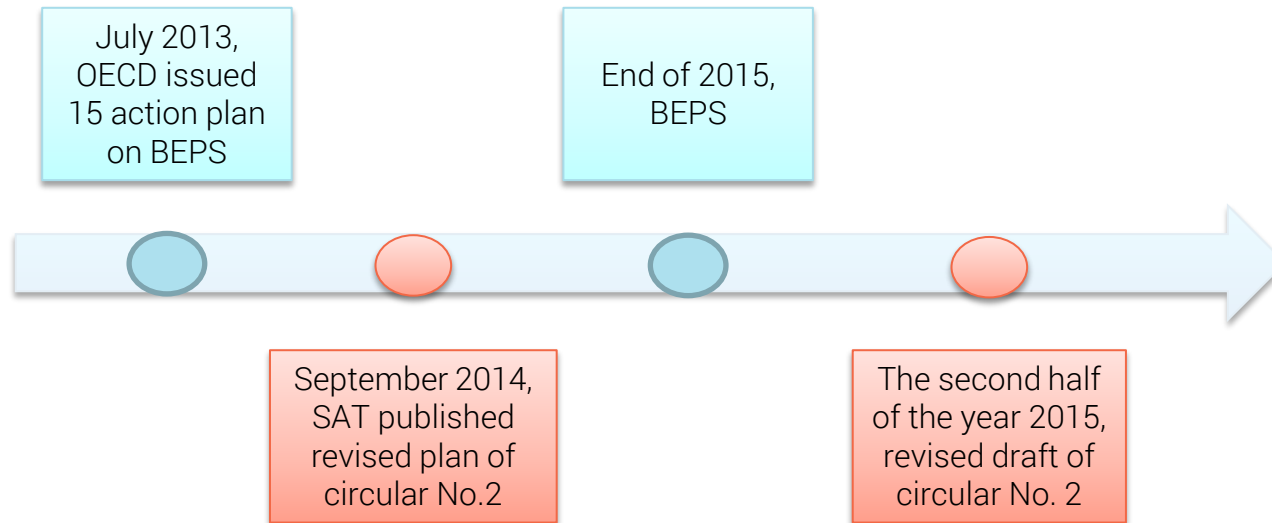
Year	Tax Contribution (billion)	Special tax adjustment (billion)	Number of closing files	Average tax adjustment per case (million)
2014	¥52.3/\$8.54	¥7.89/\$1.29	257	¥30.68/\$5.00
2013	¥46.86/\$7.65	¥4.6/\$0.75	211	¥21.77/\$3.55
2012	¥34.6/\$5.65	¥4.6/\$0.75	175	¥26.20/\$4.28
2011	¥23.9/\$3.90	¥2.4/\$0.39	207	¥15.07/\$2.46
2010	¥10.27/\$1.68	¥2.31/\$0.38	178	¥14.61/\$2.39
2009	¥2.09/\$0.34	¥2.09/\$0.34	167	¥12.52/\$2.04
2008	¥1.24/\$0.20	¥1.24/\$0.20	152	¥8.16/\$1.33

Source: public information by SAT

Exchange rate: USD:RMB = 1:6.08 (dated on 22 July 2015)

1. Chinese Transfer Pricing overview – continued

- Year 2015, circular Guoshuifa [2009] No. 2 will be modified



1. Chinese Transfer Pricing overview

- Modification area of circular Guoshuifa [2009] No. 2
 - Transfer Pricing
 - Arm's length principle
 - Transfer pricing methods
 - Documentation
 - Intangible assets between related parties
 - Intercompany services
 - Advance pricing arrangement (APA)
 - Other anti-tax avoidance items
 - Control foreign corporations
 - Thin capitalization
 - Cost sharing agreement (CSA)
 - General anti-tax avoidance rules

2. Transfer Pricing changes in practice

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- Regarding intercompany transaction disclosures and transfer pricing reports, the tax authorities will:
 - Strengthen the investigation of related party transactions disclosed in CIT returns;
 - Compare the description differences between the related party disclosure forms and the follow-up transfer pricing reports; and
 - Compare the changes of transfer price methods and profit levels in previous years with the recent year.

2. Transfer Pricing changes in practice – continued

- Mainly focus on the following intercompany royalties payments:
 - Royalties paid to entities located in tax havens;
 - Royalties paid to overseas related parties that perform no or limited functions/substance;
 - Significant amounts of royalties paid for intellectual property (IP) to which the payer made significant contributions; and
 - Significant amounts of royalties paid for IP with declined or impaired value

Source: Circular Shuizongbanfa [2014] No. 146

2. Transfer Pricing changes in practice – continued

- For royalties in compensation for usage of intangible assets provided by an overseas related party, the contribution of each party to the value creation of the intangible assets should be considered to determine the economic benefits that each party is entitled to.
- Royalties paid to an overseas related party which only owns the legal rights of the intangible asset but having no contribution to its value creation, not in compliance with the arm's length principle, is not deductible for CIT purpose.

Source: Circular SAT announcement [2015] No. 16

2. Transfer Pricing changes in practice

- Service fee payments to overseas related parties in compensation for the following services are not deductible for CIT purposes:
 - Services that are unrelated to the functions and risks borne by the enterprise or operation of the enterprise;
 - Intra-group services relating to the protection of the investment interests of the direct or indirect investor of the enterprise, including control, management, supervising activities for the enterprise ;
 - Intra-group services that have already been purchased from a third party or have been undertaken by the enterprise itself;
 - Services where the enterprise obtains additional benefits solely for being part of a corporate group, and the enterprise has not received any specific services from related party within the group;
 - Services that have been remunerated through payments for other related party transactions; and
 - Other services that have not provided the enterprise with any direct or indirect economic benefits.

Source: Circular SAT announcement [2015] No. 16, article 4

3. Other anti-tax avoidance items

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- Cost Sharing Arrangement (CSA)
 - Documentation requirements upon conclusion/adjustment of a CSA
 - No approval requirements for execution of a CSA
 - Compensating adjustments during the execution of a CSA
 - Effective date

Source: *Circular SAT announcement [2015] No. 45*

3. Other anti-tax avoidance items

- General anti-tax avoidance
 - December 2014, “Measures for the Administration of General Anti-Tax Avoidance (Trail)” (*Circular SAT order [2014] No. 32*)
 - February 2015, “Several matters relating to corporate income tax on indirect transfer of properties by non-tax resident enterprises” (*Circular SAT announcement [2015] No. 7*)
 - Article 11: rules of investigation and adjustment for indirect transfer taxable income in China

4. Court cases

Case 1: anti-tax avoidance case of cross-border service fees

- A Fortune 500 multinational's two subsidiaries in Xiamen, China
- Sales revenue of Chinese entities gradually increasing, but profit significantly decreasing since 2008
- Between 2008 to 2010, Chinese entities paid substantial cross-border service fees (with total amount of RMB 3.8 billion, approx. USD 620 million) to the affiliate in Singapore
- Xiamen tax authority started a transfer pricing investigation in May 2010

Case 1: Analysis

- Different service fees allocation method

Allocation of cross-border service fees between MNE headquarter in US and Singapore entity: based on the number of employees in related departments

Allocation of service fee charges between Singapore entity and Chinese subsidiaries according to revenue

- Different service fees allocation base

- Service fees allocation base for Chinese subsidiaries should be cost pool assigned to Singapore entity but not the global cost pool

- Economic ownership for the intangibles

Singapore entity obtained economic ownership for the company's information systems development, research, marketing, and other intangibles

Chinese subsidiaries shared higher proportion of cost, but does not have any ownership rights and interests

Case 2: anti-tax avoidance case of cross-border royalties payments

- A foreign invested enterprise, located in Chengdu (Company A), engaged in the sale of luxury goods
- Company A's affiliate (Company B), incorporated in the British Virgin Islands, legal owner of intellectual property (IP)
- Company A paid royalties to Company B with a total amount of RMB100 million (approx. USD 16 million) between 2008 to 2012
- Chengdu tax authority started a transfer pricing audit in 2013

Case 2: Analysis

- Company A did not submit the transfer pricing documentation for the related transaction (i.e. trademark licensing agreement) to the tax authority
- The legal owner of the trademark was located in a tax haven
- Company A's sale profit margin was low based on Chinese comparables from Chengdu, Nanjing, Wuhan and other cities in China
- Company A had made a significant contribution to the trademark value through many years of marketing activities
- Based on the “principle of matching expenditures and benefits”, profits arising from the value of trademark should be retained by Company A

Appendix 1 – List of released anti-tax avoidance circulars since 2014

- Notice regarding the implementation of tax collection (Shuizongfa [2014] No. 78)
- Public notice regarding information disclosure by tax residence enterprises on outbound investment and overseas income (SAT public notice [2014] No. 38)
- Administrative measures for the general anti-tax avoidance rules: trial implementation (SAT order No. 32)
- Notice regarding the launch of tax anti-avoidance investigations on remittance of substantial amounts of service fees and royalty payments (Shuizongbanfa [2014] No. 146)
- Notice regarding several issues related to the monitoring and administration of special tax adjustments (SAT announcement [2014] No. 54)
- Several matters relating to corporate income tax on indirect transfer of properties by non-tax resident enterprises (SAT announcement [2015] No. 7)
- Notice regarding corporate income tax issues related to fees paid to overseas related parties (SAT announcement [2015] No. 16)
- Notice regarding regulating the administration on cost sharing agreements (SAT announcement [2015] No. 45)

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