GARRIGUES

COMMENTARY
TAX CHINA

1-2017 • JULY 5, 2017

ANNOUNCEMENT ON SPECIAL TAX INVESTIGATIONS, ADJUSTMENTS AND MUTUAL AGREEMENT PROCEDURES

On 17 March 2017, the State Administration of Taxation ("SAT") issued Announcement on Special Tax Investigation, Adjustment and Mutual Agreement Procedures ("Announcement 6") to step up and enhance administration on transfer pricing, adding to the framework of Announcement 42[1] and Announcement 64[2].

Announcement 6, effective from May 1, 2017, will replace Chapter 4, 5, 11 and 12 of Circular 2[3], Circular 363[4], Announcement 54[5], Circular 188[6] and Announcement 16[7].

A comparative study will be performed in the below sections by comparing and contrasting the similarity and difference of the aforementioned circulars and announcement.

EXECUTIVE SUMMARY

In order to align with Base Erosion and Profit Shifting ("BEPS") principle of "profits should be taxed where economic activities take place and value is created" , Announcement 6 has integrated the topics of intangible assets and intra-group services as well as improving the clauses in Circular 2 regarding special tax investigation, comparative analysis and transfer pricing methods, and Mutual Agreement Procedures ("MAP").

As a result, Chinese tax authorities are likely to attach greater attention to both the inbound and outbound remittance of royalty fees and intra-group service fees. The determination of the contribution level and the corresponding income distribution for the value of intangible assets together with matching principal (i.e. the amount of fees shall match the economic benefits generated from intangible assets and flowed into the enterprise or its related parties) are addressed for royalty fees. On the other hand, the concept of 'beneficial services' is introduced and defined in details with examples.

Announcement 6 also sets forth certain major transfer pricing issues, expands the scope of Special Tax Investigation, clarifies the mindset of judging certain types of related party transactions, and updates the procedures and analytical methodology of special tax investigation and adjustment. Furthermore, more detailed MAP are introduced in Announcement 6.

[1]Announcement 42 refers to SAT Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation, SAT [2016] No. 42, issued on June 29, 2016.

[2]Announcement 64 refers to SAT Announcement on the Enhancement of the Administration of Advance Pricing Agreements, SAT [2016] No. 64, issued on October 18, 2016.

[3]Circular 2 refers to SAT Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation), Guoshuifa [2009] No.2, issued on January 8, 2009.

[4]Circular 363 refers to SAT Circular on Strengthening the Monitoring and Investigation of Cross-Border Related-Party Transactions, Guoshuihan [2009] No. 363, issued on July 6, 2009.

[5]Announcement 54 refers to SAT Announcement on Monitoring and Administration of Special Tax Adjustment, issued on August 29, 2014.

[6]Circular 188 refers to SAT Circular on Strengthening the Transfer Pricing Follow-up Administration, Guoshuihan [2009] No. 188, issued on April 16, 2009.

[7]Announcement 16 refers to SAT Announcement regarding Enterprise Income Tax Matters on Outbound Payments to Overseas Related Parties, SAT [2015] No. 16, issued on March 18, 2015.

1. SPECIAL TAX INVESTIGATION

Provisions for special tax investigation are included in Article 2 to Article 14, Article 23 to Article 29 and Article 37 to Article 46 of Announcement 6. Comparative study for this section is addressed on the following three aspects:

- More targeted enterprises for special tax investigation
- More detailed methodology for analysis and evaluation of related party transactions
- Increased scrutiny and flexibility for the investigation of special tax adjustment
- Enhanced administrative regulations

(a) More targeted enterprises for Special Tax Investigation.

Based on the target enterprises for special tax investigation mentioned in Circular 2, Announcement 6 further expands the target enterprises listed as below:

- Enterprises whose shared benefits are not proportional to the allocated costs;
- Enterprises that have related party transactions with affiliates in countries (jurisdictions) with low taxation;
- The ratio of the debt investments accepted by the enterprise from its related parties in proportion to the equity investments exceeds the prescribed standards; or
- Enterprises in a country (jurisdictions) where the actual tax burden is less than 12.5% established by a resident enterprise or a resident enterprise controlled by a Chinese individual that is, and not distributing profit or distributing less profit due to reasonable business needs.
- Tax planning or tax arrangement of the enterprise lacks reasonable business purposes.

Article 5 specifically mentions that tax authorities are empowered to make special tax adjustments to non-tax resident enterprises.

(b) More detailed methodology for analysis and evaluation of related party transactions.

Announcement 6 infuses major updates to the quantitative and qualitative analysis and evaluation of related party transactions as below:

- **Article 23**: The tax authorities shall *select the party with a relatively simple function as the testing object* when analyzing and evaluating the related party transactions of investigated enterprise;
- **Article 24:** *Public information* shall be used *as a priority* by tax authorities in the comparative analysis;
- **Article 25:** *More statistical methods are introduced* for analyzing and evaluating whether related party transactions are in line with an arm's length principle, including the choices of *arithmetic method, weighted average method* or quartile division method etc. according to the actual situation to calculate the average or inter quartile range of the profit or price of the comparable enterprise *on an annual basis* or on a weighted average basis for multiple years;
- **Article 26:** In the absence of comparable enterprise or transaction, tax authorities may make adjustments on the value of materials and equipment that have not been priced by the related parties of an enterprise. *Tax authorities may make comparative adjustment on the difference of working capital resulted from the value adjustment of materials and equipment*. However, tax authorities shall reselect a comparative enterprise when the adjustment of profit level exceeds 10%.

- **Article 27:** When analyzing and evaluating whether the related party transactions of the investigated enterprises are in line with an arm's length principle, *regional factors such as cost savings and market premium etc. shall be taken into account if the selected comparative enterprise is in a different economic environment of the investigated enterprise*. Tax authorities shall select a reasonable transfer pricing method to determine the contribution level of profitability as a result of the regional factors.

(c) Increased scrutiny and flexibility for the investigation of special tax adjustment.

Similar to Circular 363, Article 28 of Announcement 6 stipulates that enterprises engaged in a *single production such as tolling or contract manufacturing etc.*, or *engaged in distribution, contracted research and development businesses*, shall in principle maintain a reasonable profit level. *The aforementioned enterprises shall prepare local files in the loss-making year for the supervision and administration by tax authorities, regardless whether the thresholds for contemporaneous documentation have been achieved.* Moreover, tax authorities may make special tax adjustments to the said enterprises for their risks and losses resulted from incorrect decision-making, under-capacity, slow-selling products, failure in research and development etc. that shall be borne by the related parties of the enterprises.

In contrast with Article 40 of Circular 2, Article 29 of Announcement 6 not only require tax authorities to make special tax adjustments to restore the offsetting related party transactions as mentioned in Circular 2, but also requested that hidden related party transactions shall be restored and adjusted, if they may lead to a reduction in the overall tax revenue of the state.

Circular 2 merely required the investigated enterprise, its related parties and other relevant enterprises that are comparative enterprises to provide information to tax authorities upon request. Article 6 of Announcement 6 *expands the obligation parties to other enterprises that are relevant to the investigated enterprises*, for example, customers and suppliers.

Announcement 16 required that all outbound payments to overseas related parties that do not perform any function, assume any risk or lack of substantial business activities are not tax deductible when calculating the Enterprise Income Tax payable, whereas Article 37 of Announcement 6 allows outbound payments to overseas related parties that do not perform any function, assume any risk or lack of substantial business activities *but comply with an arm's length principle could be tax deductible*. Otherwise, the tax authorities may make special tax adjustments to the deductible expenses at full amount.

(d) Enhanced administrative regulations.

Announcement 6 also supplements some administrative regulations including:

- The following enterprises can be excluded as the target for special tax adjustment for the time being by reaching consensus with tax authorities after the preliminary discussion, excluding the years and related party transactions that are not covered by the advance pricing arrangement:
    - Enterprises that have already submitted the Letter of Intent for Discussing and Signing an Advance Pricing Arrangement to the tax authorities and have applied for retroactive application of the advance pricing arrangements for the previous years; or
    - Enterprises that have submitted an Application for the Renewal of an Advance Pricing Arrangement to the tax authorities.
- An enterprise can pay taxes at its own discretion before receiving the Notice on Special Tax Investigation and Adjustment. To pay taxes at its own discretion, an enterprise shall fill in the Tax Payment Form for Self-assessment of Special Tax Adjustment.

Please be noted that the enterprises that are audited for special tax adjustment by tax authorities no longer need to prepare contemporaneous documentation for the 5 year follow-up administration period under Announcement 6, unless they have reached the thresholds as required by Announcement 42.

2. COMPARABILITY ANALYSIS AND TRANSFER PRICING METHODS

This section contains a comparative study of Article 15 to Article 22 in Announcement 6 and Chapter 4 of Circular 2.

The scope of comparability analysis has been expanded in terms of the followings:

- Asset or service transactions: The character, details and risk management etc. of financial assets have been included in Announcement 6.
- Contract terms: Announcement 6 addresses that analysis of contract terms shall also focus on the ability and conduct of executing the contract by enterprises as well as the creditability of contract terms signed by related parties.
- Economic environment: The regional factors shall be taken into account in determining the pricing and profitability, for example, cost savings and market premium.
- Business strategy: Synergy effects have been taken into consideration in Announcement 6.

A number of changes have been made in transfer pricing methods:

- Comparable uncontrolled price method
    - Following the confirmation of transfer of financial assets between related parties as related party transactions under Announcement 42, the detailed factors to be taken into account for comparable analysis on the transfer of financial assets (in particular, equity transfer) have been introduced in Announcement 6.
    - User right or ownership transfer of intangible assets: the comparative analysis may also consider the factors of geographic location, useful life, development phase, the rights of maintenance, improvement and update, costs and expenses of the transferee, functions and risks, amortization method as well as other factors that may have an influence on the fluctuation of prices.
- Resale price method
    - Comparable analysis on valuable intangible assets for marketing purposes has been suggested by adopting the resale price method, if applicable.
- Transactional net margin method ("TNMM")
    - Detailed calculation formulas for profit margin before interest and tax, full cost mark-up, return on assets and Berry ratio are illustrated in Announcement 6.
    - The applicability of TNMM has been limited to enterprises that do not possess significant intangible assets regarding the ownership transfer or user rights of both tangible and intangible assets. However, Announcement 6 does not specify whether both parties involved in the transaction are subject to the limitation of 'significant intangible assets'. Neither has the said Announcement defined the extent of 'significant intangible assets'.
- Profit split method
    - The regional factors, such as cost savings and market premium, have been included in the profit split method.
    - In the case that comparable information are difficult to obtain but the consolidated profit (either actual or estimated) can be determined on a reasonable basis, the actual situation and the contribution value related factors of income, costs, expenses, assets and number of employees etc. may be considered for the analysis of contribution in value by each related party and distribute the profit accordingly.
- Other methods that comply with an arm's length principle
    - Other methods may include valuation methods such as cost method, market value method and income method etc. as well as other methods that could reflect the matching principle, i.e. profit shall be taxed in the place that economic activities are performed and the values are created.

3. INTANGIBLE ASSETS

Article 5 and Article 6 of Announcement 16 in relation to the outbound payments of royalty fees in terms of the use of intangible assets of related parties and benefits derived from financing activities of listed companies have been replaced by Article 30, 31 and 33 of Announcement 6. The improvements and developments made in Announcement 6 mainly include the followings:

- Article 30 replaces and supplements Article 5 of Announcement 16, which proposes some approaches in determining the contribution level by each party in the light of the value of the intangible assets and the corresponding income distribution, including:
    - A comprehensive analysis on the global operating procedures of the group company that the Chinese enterprise belongs to;
    - Consideration of the contribution value involved in the development, enhancement of value, maintenance, protection, application and promotion ("DEMPAP"); and
    - Realization method for the value of the intangible assets; and
    - Interactions between intangible assets and the functions, risks and assets of other businesses of the group company.
- Article 30 further stipulates that enterprises that only possess the ownership of intangible assets but do not contribute to the value of the intangible assets shall not participate the income distribution of the intangible assets. In addition, enterprises that merely provide funds but do not actually perform related functions and bear related risks during the forming and exploitation process of the intangible assets could only obtain the reasonable return on the cost of capital.
- Article 31 requires that royalty fees received or paid as a result of the transfer of the user rights of intangible assets between enterprises and their related parties ("Royalty Fees") shall adjust the amount in accordance with the following situations, where special tax adjustment could be made by the tax authority if adjustments are failed to be made by the enterprises themselves:
    - The value of intangible assets has changed fundamentally;
    - In accordance with usual business practices, an adjustment mechanism of royalty fee shall be in place for comparable transactions between unrelated parties.
    - The functions performed, risks assumed and assets used by the enterprise and its related parties have changed during the course of the exploitation of intangible assets.
    - The enterprise and its related parties have not been appropriately compensated in the process of continuing DEMPAP of intangible assets.
- Article 32 addresses the matching principle that Royalty Fees shall be matched with the economic benefits generated from intangible assets and flowed into the enterprise or its related parties. If the amount of royalty fee does not match the economic benefits and leads to a reduction in the tax payable or taxable income of the enterprise or its related parties, the tax authorities are empowered to make special tax adjustments. The tax authorities could adjust the full amount of deducted expenses of royalty fee, if the said expenses fail to meet the 'an arm's length' principle and fail to bring any economic benefit.
- Article 31 and 32 of Announcement 6 shift the focus on outbound remittance of royalty fee to both inbound and outbound remittance.

4.INTRA-GROUP SERVICES

The most significant improvements in Article 34, 25 and 36 of Announcement 6 for intra-group services in comparison with Announcement 16 is the introduction of the concept of 'beneficial services' for determining whether the services between related parties are in line with an arm's length principle.

- Article 34 defines intra-group services that meet an arm's length principle as the beneficial services that are priced in the normal course of business and the fair transaction price with non-related parties in the same or similar circumstances. The term of 'beneficial services' is further defined as services that can bring direct or indirect economic benefits to the service recipients, which the non-related parties are willing to buy or carry out by themselves in the same or similar circumstances.
- Article 34 also addresses the two-way related party transactions for intra-group services.
- Article 35 is generally in consistency with the six listed exclusions of non-deductible service fees in Announcement 16. However, some revisions are made for the clarification of non-beneficial services based on the said exclusions.
    - *Service accepted by the service recipient from its related party* that has already been procured or carried out by itself.
    - *Service accepted by the service recipient from its related party* and carried out to exercise control, management and supervision by the enterprise with a view to protect the investment interests of a direct or indirect investor. *The service activities mainly include:*
        - *Services rendered for shareholders' activities such as shareholder meetings, board meetings and share issuance etc.;*
        - *Activities related to the preparation and analysis of the operating report or financial report of the direct or indirect investor, headquarter and regional headquarter of the service recipient;*
        - *Funding activities related to the operation and capital management of the direct or indirect investor, headquarter and regional headquarter of the service recipient;*
        - *Activities related to finance, taxation, personnel and legal etc. carried out for the needs of decision making, supervision, control and compliance of the group; and*
        - Other similar circumstances.
    - *Service accepted by the service recipient from its related party that is not specifically carried out for the service recipient* but which has obtained an incidental benefit as an affiliate of the group. *The service activities mainly include:*
        - *Restructuring activities of the group such as change in the legal form, debt restructuring, share acquisition, asset acquisition, merger and split-off that may bring the resource integration and scale effects to the service recipient;*
        - *Related activities that may bring benefits to the service recipient, for example, a reduction in financing costs, as a result of the improvement of credit rating of the group; and*
        - Other similar circumstances.
    - *Service accepted by the service recipient from its related party* that has already been compensated for in another related party transaction. *The service activities mainly include:*
        - *Services related to patent or non-patent technology that have been compensated from the payment of royalty fee;*
        - *Loan related services that have been compensated from the payment of interests; and*
        - Other similar circumstances.

- Related party services that are not relevant to the functions or risk profile of the service recipient, *or do not meet the business needs of the service recipient*.
- Other related party services that cannot bring direct or indirect economic benefits to the service recipient *or that non-related parties are not willing to purchase or carry out by themselves*.

- Article 36 sets out the calculation method for determining the service fee, which are:
  - Direct method: If the costs of intra-group service can be allocated in accordance with each service recipient and each service rendered, the transaction price shall be determined based on the reasonable costs of the corresponding service recipient and service rendered.
  - Indirect method: If the costs of intra-group service cannot be allocated in accordance with each service recipient and each service rendered, the transaction price shall be determined based on the allocated costs according to the reasonable standard and ratio allocated to each service recipient and service rendered.

5.MAP

Article 46 to 61 of Announcement 6 ("Articles of Announcement 6") replaces Chapter 11 of Announcement 2 ("Chapter 11"). In comparison with Chapter 11, Articles of Announcement 6 details the followings:

- Content of mutual agreement
- Date of application by post or in person
- Right of SAT for requesting the additional documents
- Internal procedure of Chinese tax authorities when receiving the application of an enterprise
- Obligation of the Chinese tax authority within a specified period for delivering the notice of accepting the application to the enterprise
- Circumstances that the Chinese tax authority could deny the application of the enterprise or the request of the contracting state of double taxation treaty
- Circumstances that the Chinese tax authority could suspend the MAP
- Circumstances that the Chinese tax authority could terminate the MAP
- Obligation of the Chinese tax authority within a specified period for delivering the notice of the suspension or termination of the MAP to the enterprise
- Obligation of the Chinese tax authority within a specified period for delivering the notice of entering into the MAP with the contracting state of double taxation treaty to the enterprise
- Calculation of tax payable or refund in relation to foreign exchange and interest issues
- The obligation of confidentiality of the Chinese tax authority for the MAP
- The right of the tax authority to deal with the fraud or other illegal behavior identified during the MAP in accordance with the tax administration law and its implementation rules.
- Announcement 56[8], which explains the clauses of double taxation treaties and the implementation of MAP, remains in force.
- It is worth noting that Announcement 2 requires that the enterprise or its related parties must make the application of special tax adjustment within 3 years upon receiving the notice of transfer pricing adjustment. Announcement 6 replaces the 3 year period by referring to the time period as agreed in the taxation treaty

[8]Announcement 56 refers to SAT Announcement on Implementation Measures for Mutual Agreement Procedures of Taxation Treaty, SAT (2013) No. 56, issued on September 24, 2013.

Follow us:

www.garrigues.com

3205 West Gate Mall 1038 Nanjing Xi Lu - 200041 Shanghai
T +86 21 5228 1122 - **F** +86 21 6272 6125

China World Trade Center 1 Jian Guo Men Wai Avenue (Tower 1 – Office 1815) - Beijing 100004
T +86 10 85720000 - **F** +86 10 85720020