



cutting through complexity

Global Transfer Pricing Review

China

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TAX



China



KPMG observation

With nearly 30 years of history in enforcing transfer pricing compliance, China has been actively broadening and deepening its transfer pricing regime. Following the issuance of a set of revamped transfer pricing regulations (Circular 2) in 2009, the State Administration of Taxation (SAT) issued many transfer pricing related regulations and rules addressing issues such as contemporaneous documentation administration, intra-group services transactions, license royalty treatment and single function entities, amongst others. The SAT is expected to release an updated and expanded replacement of Circular 2 in the near future.

The Chinese authorities run an aggressive transfer pricing audit program, a maturing Advance Pricing Agreement (APA) program and have recently put more emphasis on the day-to-day administration, or ex-ante management of taxpayers' transfer pricing issues. The ex-ante focus has led to pre-audit informal assessments by tax authorities, for which the taxpayer can elect to make adjustments to its taxable income, which would be ineligible for any double tax relief.

While Chinese tax authorities leverage experiences of other countries, they are also focused on developing and putting forward their own positions on a number of key transfer pricing technical issues. Having actively participated in the United Nation's (UN) initiative on developing practical guidance for transfer pricing implementation, China formally pronounced its view on location specific advantages (LSAs), translating into lower costs and higher demand, arguing for additional taxable profit in China.

As a member of the G20 and an observer at the Organisation for Economic Co-operation and Development (OECD), China is actively involved in the Base Erosion and Profit Shifting (BEPS) Action Plan. For the year of 2014, a notable development in the macro economy, which could have a profound impact on China's taxation policy, is that the country's outbound direct investment (ODI) as confirmed by the Ministry of Commerce has, for the first time in history overtaken the foreign direct investment (FDI) into China, making China a net capital exporter. Accordingly, BEPS-related tax law changes (including changes to transfer pricing regulations) affecting both inbound and outbound investment are envisaged in the SAT's work program in the coming years.

As an example of this, in the area of transfer pricing, the BEPS country-by-country reporting requirement, in particular, is expected to result in further requirements on taxpayers beyond the currently required disclosures and the highly anticipated revised Circular 2 is expected to reflect such further requirements. Furthermore, the revisions to the OECD Guidelines with respect to a more broadly encompassing definition of intangibles, the recognition of LSAs and other market specific features as comparability factors, as well as the emphasis on actual key functions performed and actual bearing/control of risks in relation to the development and maintenance of intangibles, as opposed to the historical focus on mere legal ownership, are all welcome by the SAT and are likely to be reflected in the revised Circular 2 as well.

The Chinese tax authorities have long been known for their inclination to question the value add/benefit obtained by Chinese entities from intra-group services or licenses provided by overseas related parties. Such challenges in the past have often led to denying of corporate income tax deductions for outbound services/royalties payments made by Chinese entities in MNE groups. Leveraging off the BEPS Action Plan's emphasis on aligning taxation and

value creation, the SAT issued Directive 146 in July 2014, instructing local tax authorities to survey substantial payments of service fees and royalties made to overseas by Chinese entities between 2004 and 2013, with a view to launching extensive audits, placing particular focus on payments to low tax jurisdictions and on cases where foreign related parties conduct only limited, simple functions. This was followed by the issuance of Circular 16 in March 2015, which introduced additional requirements that need to be met before the Chinese tax authorities will allow income tax deductions for payments to overseas affiliates. In particular, Circular 16 puts great emphasis on the commercial substance of the overseas affiliate receiving the service fees and the beneficial nature of the services being rendered for the intra-group services transactions. For intra-group license transactions, this circular looks beyond legal ownership while focusing on all relevant parties' contribution to the economic value in connection with the subject intangibles.

With Chinese tax authorities becoming increasingly sophisticated in transfer pricing and their stepping up of enforcement efforts supported by a more comprehensive and refined regulations framework, taxpayers need to properly manage the balance between the needs for global consistency in transfer pricing policies and attention to the specific circumstances in China.

Transfer pricing study snapshot

The purpose of a transfer pricing study

	Applicable	Required to be contemporaneous	Submission to tax authority required	Thresholds apply/exist
Legal requirements	●	●	●	●
Protection from penalties	●			
Reduce risk of adjustment	●			
Shifts burden of proof	●			

Basic information

Tax authority name

The State Administration of Taxation (SAT) at the central level and various state tax and local tax bureaus under its administration.

Citation for transfer pricing rules

Corporate Income Tax Law (CIT Law) (2007), Implementation Rules for the CIT Law (2007), Circular Guoshuifa [2009] No. 2, Implementation Measures of Special Tax Adjustments (Provisional) (Circular 2) (2009).

Effective date of transfer pricing rules

On 1 January 2008, the comprehensive transfer pricing regulation, Circular 2, came into force. Prior to that there had been various transfer pricing rules since 1991 but none took a systematic approach.

What is the relationship threshold for transfer pricing rules to apply between parties?

Twenty-five percent, be it direct or indirect ownership, or control. This applies whether one party owns another or two parties are owned by a common party. The formula for calculating indirect shareholding percentage is worthy of note: if there is 25 percent or greater ownership in a higher tier subsidiary, it is counted as 100 percent when multiplying the shareholding percentage of each lower level of indirect shareholdings. Other criteria including loans, control of management, or other types of control can also be taken into account.

What is the statute of limitations on assessment of transfer pricing adjustments?

Ten years from the year in which the related party transaction occurs.

Transfer pricing disclosure overview

Are disclosures related to transfer pricing required to be submitted to the revenue authority on an annual basis (e.g. with the tax return)?

Yes. Disclosure of related party transactions must be submitted to the tax authority along with the annual corporate income tax return. The deadline to file the annual income tax return is 31 May.

What types of transfer pricing information must be disclosed?

The following information must be disclosed on nine prescribed forms:

- Description and amounts of related party and non-related party transactions broken down by type (purchases, sales, services, intangible assets, tangible assets) as well as by counterparty location (domestic

or overseas). For tangible assets and intangible assets, the information must be further broken down into several sub-categories.

- Information on financing received from related parties including time period, interest rate and expenses, and guarantor information such as guarantee fee and fee rate.
- A full list of all related parties as well as the address, taxpayer number, legal representative and type of related party relationship.
- Extensive information on outbound investment (outbound from China) including information on the invested enterprise, such as its profit level, income tax payable, effective tax rate and shareholders.
- Information on outbound payments to related and unrelated parties broken into 17 subcategories, along with information on taxation of these payments.

What are the consequences of failure to submit disclosures?

Penalties up to 10,000 Renminbi (RMB) and negative impact on reputation.

Transfer pricing study overview

Can documentation be filed in a language other than the local language? If yes, which ones?

No. The document can only be filed in Chinese.

When a transfer pricing study is prepared, should its content follow Chapter V of the Organisation for Economic Co-operation and Development (OECD) Guidelines?

Yes, for all transactions. In addition, China requires transfer pricing studies to contain certain additional information and completed forms. In particular, one form requires the segmentation of the taxpayer's income statement into four categories of transactions (i.e. related-party transactions vs. non-related party transactions, within China vs. transnational).

Does the tax authority require an advisor/tax practitioner to have specific designation in order to prepare or submit a transfer pricing study?

No.

Transfer pricing methods

Does your country follow the transfer pricing methods outlined in Chapter II of the OECD Guidelines? If exceptions apply, please describe.

Yes.

Transfer pricing audit and penalties

When the tax authority requests a taxpayer's transfer pricing documentation, are there timing requirements for a taxpayer to submit its documentation? And if so, how many days?

Yes, 20 days.

When the tax authority requests a taxpayer's transfer pricing documentation, are there timing requirements for a taxpayer to submit its documentation? Please explain.

The transfer pricing documentation study must be prepared within five months after the end of the calendar year and must be submitted within 20 days upon request by the tax authority in charge.

If an adjustment is proposed by the tax authority, what dispute resolution options are available?

Apart from direct discussion/negotiation with the tax authorities, the taxpayers are, in principle, allowed the options of administrative appeal and litigation. However, such proceedings have strong procedural focus and are thus not likely viable in practice.

If an adjustment is sustained, can penalties be assessed? If so, what rates are applied and under what conditions?

Although there are no penalties as such on transfer pricing adjustments, an interest surcharge may be imposed on tax underpayments if the taxpayer does not comply with documentation preparation and production requirements. Interest may be imposed on tax adjustments which relate to transaction taking place on or after 1 January 2008. This interest rate shall be equal to the People's Bank lending rate plus five percentage points. This interest is non-deductible for corporate income tax purposes. However, if the company complies with documentation

requirements, the five percent extra charge may be dropped.

To what extent are transfer pricing penalties enforced?

As noted, there are no penalties as such on transfer pricing adjustments. However, the punitive interest surcharge in the absence of a transfer pricing documentation is generally enforced.

What defenses are available with respect to penalties?

Not applicable.

What trends are being observed currently?

With a traditional focus on inbound multinational taxpayers, the Chinese tax authorities are expanding their work to include domestic enterprises and outbound investment. There is also a stronger focus on examining intra-group intangible assets transactions, equity transfer, thin capitalization and other 'new' transfer pricing issues. Automotive, pharmaceutical, electronics, real estate and distribution sector companies have received particular scrutiny. The tax authorities have also been conducting joint investigations on certain industries and across-region investigations on certain intra-group companies.

Special considerations

Are secret comparables used by tax authorities?

Yes. Use of secret comparables is specifically sanctioned by Circular 2, however, in most cases, Chinese authorities rely on public company data derived from commercial databases and other sources.

Is there a preference, or requirement, by the tax authorities for local comparables in a benchmarking set?

Preference for local comparables is observed but a broader geographic set is also acceptable, depending on the circumstances.

Do tax authorities have requirements or preferences regarding databases for comparables?

The Chinese transfer pricing regulations do not dictate the choice of database for benchmarking purposes. However,

KPMG in China's experience shows that the Chinese tax authorities have subscribed to a few databases such as Bureau van Dijk's Osiris database, and Standard and Poor's Research Insight database. Both databases are used by the Chinese tax authorities.

Does the tax authority generally focus on the interquartile range in a TNMM analysis?

Yes, sometimes.

Does the tax authority have other preferences in benchmarking? If so, please describe.

Preference for local comparables is observed but a broader geographic set is also acceptable, depending on the circumstances.

What level of interaction do tax authorities have with customs authorities?

Low.

Are there limitations on deductibility of management fees beyond the arm's length principle?

Not applicable. The Chinese corporate income tax law does not permit the deduction of management fees. While not clearly defined in the law, the Chinese concept of management fees can generally be interpreted as remuneration for shareholder activities. In addition, Chinese tax authorities are likely to deny the deductibility of any charges that are literally labeled as management fees, even if the charges are not related to shareholder activities. There are special rules related to the deduction of fees by bank branches.

Are management fees subject to withholding?

No.

Are there limitations on the deductibility of royalties beyond the arm's length principle?

Yes. On intra-group license transactions, the most recently issued Circular 16 specifies that royalties paid by a Chinese entity to an overseas related party which may only have the legal ownership but has not contributed to the value created in connection with further developing, enhancing, and commercially exploiting the subject intangibles, cannot be deducted for corporate income tax purposes.

Are royalties subject to withholding?

Yes.

Are taxpayers allowed to file tax return numbers that differ from book numbers?

Yes. Taxpayers are allowed to adjust taxable income in China upward through a special declaration in the annual tax return, which may lead to the difference of numbers in the tax return and the book. However, the taxpayer would still not be permitted to remit the money into China.

Other unique attributes?

- Circular Caishui [2008] No. 121 focuses on the issue of thin capitalization. An enterprise can deduct its interest expense actually paid to its related parties up to the debt-to-equity ratio of 5:1 for financial institutions, and 2:1 for non-financial enterprises, unless the enterprise can provide relevant supporting documents to the tax authority to prove that the transactions are conducted at arm's length, or that the effective tax rate of the enterprise paying interest expenses to a domestic related party is not higher than that of the domestic related party.
- Circular Guoshuihan [2009] No. 363 provides that enterprises based in China with limited functions and risks should not bear market or "business" risks related to the financial crisis. As noted above, if such companies do generate losses, they must submit transfer pricing documentation to the tax authorities in charge.
- Voluntary transfer pricing adjustments are encouraged:
 - In August 2014, the SAT issued Notice 54, which formalizes the self transfer pricing adjustment program by providing detailed instructions in relation to the self adjustment practice with the SAT's monitoring and administration mechanism.
 - In particular, the SAT encourages taxpayers to make self adjustments, i.e., voluntarily make an upward adjustment to the amount of income tax paid if related party transactions were not carried out on arm's length

standard. Additionally, going forward, the additional five percent interest as stipulated in Circular 2 will not be charged on self adjustments, provided that the transfer pricing documentation is provided as prescribed by law; however, interest should still be paid as stipulated in Circular 2 for tax adjustments.

- To the taxpayers, performing a self-adjustment may lead to double taxation, which is not eligible for treaty relief. Yet such self adjustment does not provide the taxpayer with full protection from audit, since the China tax authorities still retain the right to conduct any transfer pricing audits, even with self adjustment.
- Other recent developments:
 - China played an important consultative role in determining the outcomes of the first set of BEPS deliverables, which are expected to reinforce the trend of recent years towards firmer enforcement of transfer pricing rules. Such intention is manifested in the issuance of Directive 146 and Circular 16, putting into effect the promised greater scrutiny of cross-border services/license transactions within an MNE group. Efforts have also been stepped up in the collection of taxpayer information, with a view to greater policing of outbound investments as well as engagement in international information exchange.
 - Taxpayers continue to await regulations on valuation of equities in the related party context, including a contemporaneous documentation requirement for indirect transfers. This potential regulatory development is consistent with the burgeoning number of tax disputes focusing on intra-group equity transfer.
 - Another continuing development is a focus on the transfer pricing arrangements of the so-called "High-New-Tech Enterprises" (HNTE). Taxpayer with HNTE status enjoys a reduced corporate income tax rate of 15 percent. There is an expectation on the part of the Chinese tax authorities that HNTEs should not pay significant

amount of royalties on licensed technologies and should earn a higher profit margin than the industry average.

Tax treaty/double tax resolution

What is the extent of the double tax treaty network?

Extensive.

If extensive, is the competent authority effective in obtaining double tax relief?

Limited experience.

When may a taxpayer submit an adjustment to competent authority?

After receiving a written tax assessment from the tax authority in charge that may cause or have caused double taxation of the same income in different treaty jurisdictions.

May a taxpayer go to competent authority before paying tax?

No formal rules exist in this area.

Advance pricing agreements

What APA options are available, if any?

Unilateral, bilateral, multilateral.

Is there a filing fee for APAs?

No.

Does the tax authority publish APA data either in the form of an annual report or through the disclosure of data in public forums?

Yes.

Are there any difficulties or limitations on the availability or effectiveness of APAs?

Yes. The SAT published its fifth APA annual report (2013) in December 2014 and will issue periodic disclosure on developments of the APA program. Based on the statistics in the APA annual report, more and more taxpayers in China are seeking tax certainty and thus pursuing an APA, specifically, a bilateral APA. In the future, the Chinese

tax authorities will recruit and train a larger pool of tax officers with transfer pricing expertise to support the APA program, thereby alleviating the current bottleneck between application and conclusion.

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Designed by Evalueserve.

Publication name: Global Transfer Pricing Review

Publication number: 132762-G

Publication date: October 2015