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Managing Transfer Pricing Risks by Multinational Companies in China

In the past year, the Chinese tax authorities have issued three new circulars to outline their position and approach in dealing with transfer pricing issues. This article seeks to identify the specific areas that are likely to draw heightened attention from the Chinese tax authorities from now on and provides recommendations on how to prepare for the new audit environment.

1. Introduction

Since the OECD launched the BEPS initiative, China has rapidly utilized the international tax developments to upgrade its transfer pricing system. In the past 12 months, the Chinese central tax authorities, the State Administration of Taxation (SAT), have issued three important circulars, Bulletin 42, Bulletin 64, and Bulletin 6, to outline its positions and approaches in dealing with transfer pricing issues. The new circulars not only leverage from the BEPS action plans but also incorporate unique stances that the SAT has consistently advocated on various occasions. Under the new transfer pricing regulatory environment, multinational companies (MNCs) are expected to face increasing compliance and audit pressure on both historical and future periods. It is important for taxpayers to have a clear understanding of the exposure areas so that actions can be taken to control the tax risk.

This article seeks to identify the specific transfer pricing areas that are likely to draw heightened attention from the Chinese tax authorities going forward and provides recommendations on how to prepare for the new audit environment. It is expected that Chinese tax auditors will devote more of their attention to the following situations in the intercompany setting: (i) outbound payment of service fees and royalties, (ii) allocation of returns related to intangible assets, (iii) location specific advantages in comparability analysis, and (iv) single function entities. Certain domestic related-party transactions with overall reduction in Chinese tax revenue have been subject to scrutiny in practice as well. Each of these areas is analysed in this article.

2. Service Fees

The Chinese subsidiaries of foreign headquartered MNCs frequently pay service fees to their group affiliates outside of China. The deductibility of those the service fees has been subject to increasing government scrutiny since the end of 2014 and this is expected to remain so with the recent release of more developed regulatory guidance in the area. In a nutshell, payments of service fees by Chinese entities to their foreign related parties need to pass a rigorous benefit test in order to be deducted for corporate income tax (CIT) purposes. Service fees that fail the test will be subject to tax audit adjustments.

The tax audit focus in this area is whether the services from related parties overseas provide genuine benefits to the Chinese payer and whether the amount of the service fees is commensurate with the amount of the benefits derived. The tax authorities are not concerned with the payment of service fees to unrelated parties because the opposing commercial interests between third parties would help to ensure that the Chinese entities will only pay for services that would pass the benefit test. The regulations provide some scenarios where the benefit test is not satisfied in the intercompany scenario. Although the examples are given from different angles with different emphasis, the key message is the same. The intercompany services to China must clearly and primarily benefit the Chinese entity and are essential to the Chinese operations. If the Chinese payer would be unwilling to buy the services from a third party at the same price, the services would fail the benefit test. The Chinese payer will be denied CIT deduction partially or entirely in such situations.

For instance, take a case where a Chinese subsidiary pays for general IT support that the overseas headquarters provides to group affiliates worldwide, but meanwhile the Chinese entity also engages third-party vendors to provide comprehensive external IT support to the Chinese operation. Unless this subsidiary can prove that the intercompany IT support services are substantially different from the externally acquired IT services and are necessary to the Chinese entity, the Chinese tax authorities may view the intercompany services as duplicative in nature and not meeting the benefit test. In another example, if the intercompany services provided to a Chinese subsidiary are related to improving the internal control of the latter to ensure the foreign shareholders' compliance with regulatory requirements in their own jurisdictions, the Chinese tax authorities may view the intercompany services as for the purpose of safeguarding shareholder interests and thereby falling under non-deductible stewardship activities. Furthermore, some affiliates within an MNC may perform global or regional headquarters functions on behalf of the group and, according to their local requirements, may need to allocate overhead expenses such as those related to accounting or human resource support to group members in other jurisdictions. If the services as represented by the overhead allocations are not intended to benefit the Chinese subsidiary specifi-

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cally and the actual benefits gained by the Chinese entity from such services are considered ancillary and remote, the Chinese tax authorities will view the services as not meeting the benefit test.

Although tax audit adjustments on outbound payment of service fees to related parties are in the form of the denial of CIT deduction, the adjustments are made in the context of transfer pricing. The usual statute of limitations for Chinese tax matters is between 3 and 5 years, but transfer pricing matters are subject to an extended statute of limitations of 10 years. Therefore, in principle, the Chinese tax authorities can apply the new rules to make tax adjustments on outbound intercompany service transactions that took place a long time ago.

3. Royalties

Similar to service fees, outbound payment of royalties to an overseas related party is also subject to the benefit test. The Chinese payer needs to prove that it derives a clear benefit from the intercompany licensing transaction and that the amount of royalties it pays is not excessive compared with the benefits it receives. The Chinese tax authorities are empowered to deny CIT deduction on a part or all of the royalties based on the benefit test.

In recent cases, the following situations have been observed where the Chinese tax authorities applied the benefit test on royalties. The Chinese entity may have licensed technical IP which is related to older technologies. The technologies may have been available on the market for a long time and are no longer the latest or cutting-edge. Similar or competing technologies can be accessed from third parties at significantly lower prices. In such cases, the Chinese tax authorities would argue that the value of the original IP has diminished materially and the current value of the IP does not justify the amount of royalties being paid. In addition, if the Chinese entity could have secured a better deal by acquiring similar IP rights from a third party for a lower royalty, the Chinese entity would have a "realistic alternative" at its disposal instead of paying the royalty at the current amount. Furthermore, if some third-party licensing transactions involving similar IP contain a mechanism to adjust the royalty rate down over time to reflect the gradual decay in IP value, the Chinese tax authorities could request a similar declining royalty arrangement for the related-party transaction.

In the case of marketing intangibles, Chinese affiliates of a foreign headquartered MNC group may have licensed trademarks or trade names from overseas when they commence operation in China. Sometimes the trademark and trade name of the MNC group may be household names in foreign countries but are quite unknown at the Chinese market at the initial market entry. In such situations, the risk is that the Chinese tax authorities may challenge the deductibility of the royalties based on the argument that the Chinese subsidiary does not gain benefits from the licensing that warrant the amount of royalty payments.

All of the situations described above would give the Chinese tax authorities a technical basis to deny at least a part of the royalties from CIT deduction. Again, due to the long statute of limitations accorded to transfer pricing matters, there is a wide time frame for the tax officials to request information and examine the royalty arrangement long after the intercompany licensing transaction in question has been completed.

4. IP Ownership

China takes the position that mere legal ownership of IP does not determine entitlement to IP-related returns, and such returns among group affiliates should be allocated based on the respective contributions made in developing, enhancing, maintaining, protecting, applying and promoting the IP in question. In reality, there exist many situations where the legal ownership of certain group IP resides with a group affiliate outside China, but once the IP is deployed in the Chinese market, Chinese affiliates participate materially in the subsequent development, enhancement, maintenance, protection, application and promotion functions (DEMPEP).[1] In such cases, the Chinese tax authorities may contend that some economic ownership of the IP and the associated IP-related returns should be attributed to the Chinese operation.

This attribution of economic ownership has two implications for Chinese transfer pricing analysis. First, when a Chinese taxpayer makes a royalty payment to an overseas affiliate for IP that is partially owned by the Chinese payer, the Chinese tax authorities may challenge the full deduction of the royalty payment on the ground that one should not pay for using something that one already owns. Second, if the Chinese tax authorities consider that the Chinese taxpayer has at least partial economic ownership of the IP because of its contribution in the IP's DEMPEP processes, they may demand an arm's length return on the portion of the IP that the Chinese taxpayer economically owns from a Chinese CIT perspective.

Attributing economic ownership of IP to a Chinese entity may have serious implications on the selection of an appropriate transfer pricing method. In the past, the most commonly used transfer pricing method in China was the transaction net margin method (TNMM) with the Chinese entity in a cross-border related-party transaction being the tested party. The implicit assumption of such a methodology is that the Chinese entity has simpler functions and no valuable IP. Recent Chinese transfer price regulations emphasize that the TNMM is not a suitable method in cases where the Chinese entity owns important IP. Therefore, if a Chinese taxpayer who legally or economically owns highly valuable IP uses the TNMM to determine its arm's-length profits, the Chinese tax authorities may claim that the TNMM understates the right level of profits earned by the Chinese taxpayer as an IP owner, and that the residual profit split method should be used instead to allocate the profits between China and overseas jurisdictions based on the respective contributions made.

1. Compared with the abbreviation "DEMPE" in the OECD BEPS Action Plan, China adds "promotion", which represents local market promotion of foreign IP, as an extra function contributing to IP economic ownership, so the Chinese abbreviation is DEMPEP.

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Chinese subsidiaries with a High and New Technology Enterprise (HNTE) status should pay particular attention to this potential issue, because one of the preconditions to achieve HNTE status in China is the possession of important IP in China.

Even if the Chinese tax authorities concede that the economic ownership of the IP for which the royalty is being paid rests outside China, they may still challenge the deductibility of the royalty payment based on the argument that the foreign IP legal owner receiving the royalty is not the economic owner of the IP in question. For example, the foreign IP legal owner may contract with other affiliates outside China to perform the DEMPEP functions. Technically this should not concern China as there is no erosion of the Chinese tax base as long as the amount of royalty paid satisfies the arm's length standard according to benefits that the Chinese entity obtains from the foreign IP. This is arguably consistent with the recently issued Bulletin 6.[2] However it remains to be seen whether the local Chinese tax officials agree with such an interpretation.

5. Location-Specific Advantages

When performing economic analysis using a profit-based transfer pricing method, MNCs operating in China often find it difficult to identify local comparable companies. The reason for this is that the public companies listed in Chinese stock exchanges usually carry out diversified operations. Only a particular division or business line of a Chinese public company may be suitable for benchmarking purposes, but the relevant segment data associated with the division or business line are often not sufficiently disclosed to make reliable comparability analysis feasible. Financial data for private companies in China are difficult to come by. Therefore taxpayers often use third-party Pan-Asian companies to make up for the lack of comparable companies in China.

When non-Chinese comparables are used for benchmarking, the Chinese tax authorities strongly advocate making comparability adjustments for two types of location-specific advantages (LSAs). The first type of LSA is location savings. The Chinese tax authorities believe that compared with developed economies, Chinese costs for labour, infrastructure, utilities, raw materials and environmental compliance, etc., are significantly lower. When these location savings translate into additional profits for the MNC, the Chinese tax authorities demand that such additional profits should be kept at least partially by the Chinese entities through which the location savings are realized and be taxed in China. The second type of LSA is the market premium. The Chinese tax authorities assert that the Chinese domestic market has unique characteristics that in some situations would allow an MNC to charge higher prices in China than in other markets for the same product. For example, the Chinese consumers have a strong preference for imported products or products of certain foreign brands and are willing to pay a premium price to purchase them. Compared with consumers in some other markets, the Chinese consumers tend to have lower price elasticity in their demand for luxury merchandise and are willing to accept prices that are higher than commonly charged in overseas markets. In such cases, the Chinese tax authorities believe that additional profits generated by the MNC due to the market premium in China should be left to the Chinese entities and be subject to Chinese CIT.

The OECD's position[3] on LSAs is that they affect comparability analysis but they do not represent IP themselves. It appears that China does not openly deviate from this view. Nevertheless, the Chinese tax authorities will be expected to frequently apply the LSA concept when reviewing and challenging the comparability analysis conducted by the taxpayers.

6. Single Function Entities

Many MNCs have affiliates in China that serve as toll manufacturers, contract manufacturers, contract R&D service providers or limited-risk distributors. Chinese companies with such entity characterizations are referred to as "single function" entities by the SAT. These entities do not have diversified operations and are assigned limited risks in contracts with their overseas affiliates. The Chinese tax authorities do not expect these entities to incur losses from their intercompany dealings with their overseas affiliates. If there are overall losses in the supply chain due to fluctuating market conditions, R&D failures, bad management decisions, etc., the Chinese tax authorities expect that such losses are borne by the foreign entrepreneurs while the single function entities in China should maintain a reasonable level of profits. Any time a single-function entity in China incurs losses, it is required to prepare and submit contemporaneous transfer pricing documentation for the local operation to explain the losses and such submission will be closely examined by the local tax officials.

There are special transfer pricing rules for toll manufacturers in China. A toll manufacturer differs from a contract manufacturer in that some or all of the raw materials and equipment in toll manufacturing are consigned to the Chinese toller by an overseas principal. A toll manufacturer is a service provider and the cost base for determining any cost-plus margin should exclude raw material costs and depreciation expenses for equipment that it does not own. In practice, because of the lack of third-party toll manufacturers as profitability benchmark, taxpayers often use third-party contract manufacturers as comparables. This has led to a situation where an MNC taxpayer applies the cost-plus percentages from third-party contract manufacturers to the smaller cost base of a toll manufacturer (as the tested party) and computes a profit level that is below arm's length from China's perspective. The Chinese tax authorities stipulate that in such situations taxpayers need to first adjust the cost base of the tested

2. Bulletin 2017 - 6, art. 37.

3. OECD, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), International Organizations' Documentation IBFD.

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party upwards so that the cost profiles of the tested party and the comparable companies (which are contract manufacturers) are similar. The cost-plus percentages of the comparable companies can then be applied to the adjusted cost base of the toller to derive its arm's length profit level. Capital intensity adjustment in some cases may be allowed subject to the discretion and limitation of the tax authorities in charge.

To control the Chinese transfer pricing risk, MNCs should ensure that their single-function entities in China earn a reasonable level of profits. In addition, if the cost profiles of the tested party and the comparable companies differ significantly, the differences in the cost structure should be adjusted to ensure that comparisons are made on an equal basis. An implication of such adjustments is that the arm's length profit of a toll manufacturer in China may not be significantly lower than that of a contract manufacturer.

7. Certain Domestic Transactions

While the SAT has mainly focused on cross-border intercompany transactions, the local Chinese tax officials have not turned a blind eye on related-party transactions among domestic entities. The Chinese local tax authorities are highly vigilant in safeguarding their local tax revenues and will jump on domestic intercompany transactions if they believe that the related parties manipulate the transaction prices to achieve tax advantages, even though none of the parties are foreign. For example, due to tax incentives, some Chinese affiliates within an MNC group may be entitled to a CIT rate lower than the standard 25% and some Chinese affiliates may have expiring net operating losses (NOLs). Therefore, the MNC group may be tempted to direct more income to the low-tax affiliates or to affiliates with unutilized NOLs in China through transfer pricing. Some of the intercompany pricing arrangements may be driven by non-income tax considerations. For example, under the domestic VAT rules, some Chinese software developers are entitled to a VAT incentive that would put a 3% cap on their net VAT burden so that VAT in excess of 3% will be refunded to the taxpayers. Here, taxpayers may find it advantageous to have the software developers charge high prices to their Chinese affiliates as they can enjoy bigger VAT refunds while their Chinese affiliates can take bigger VAT input credits. In those situations, the tax authorities from the local Chinese tax jurisdictions whose revenues suffer will be incentivized to challenge the legitimacy of the intercompany pricing arrangement. A number of tax audit cases have been reported in this area.

Moreover, as the current transfer pricing system in China heavily focuses on cross-border intercompany transactions, some taxpayers may be tempted to transform related-party transactions into third-party transactions in form. A common example is to insert a third-party Mid-Co in a cross-border related-party transaction, so that one related-party transaction is broken up into two back-to-back third-party transactions. The third-party Mid-Co does not take risks in the transactions and receives a small guaranteed return for its participation. The recently issued Bulletin 6 clearly indicates that such related-party transactions in disguised form will be on the radar of the Chinese tax authorities. Upon discovery, the Chinese tax officials are empowered to recast the back-to-back third-party transactions based on their commercial substance and restore the intercompany transactions according to substance.

8. Recommendations

Transfer pricing is the most important anti-avoidance area in China. The Chinese tax authorities have steadily increased their resources to conduct transfer pricing investigations. The amount of revenues collected through transfer pricing audits has increased more than 500 times in the past eight years. This trend of non-stop concentration on transfer pricing compliance is likely to continue in the future. The recent Chinese transfer pricing bulletins give the Chinese tax authorities broad rights to access overseas data and documentation through either direct information requests to the Chinese taxpayers or through information exchange with foreign competent tax authorities. This unprecedented access to global information provides the Chinese tax authorities ample ammunition to identify weak spots in the transfer pricing arrangements of MNC taxpayers and raise challenges.

For MNC taxpayers, proactive planning of defence strategies taking into account the major potential risks and pitfalls, and maintaining high-quality transfer pricing documentation is critical to manage Chinese transfer pricing risks. In this new regulatory environment, Chinese transfer pricing policies of MNCs must have a sound legal and technical basis. They should be inherently consistent with the transfer pricing positions that the MNCs take in foreign jurisdictions and should be backed by well-prepared intercompany contracts and supporting documents. Furthermore, MNCs should bear in mind that it is increasingly difficult to move profits out of China through contractual risk allocation alone. Having rigorous contracts put in place is an essential first step. The Chinese tax authorities will also examine whether the related parties have the capacity to execute the intercompany contracts as drafted, whether the actual conduct of the parties is consistent with the contractual terms, and how credible it would be for the parties to enter into the same contract if they were unrelated. It is generally expected that the party that assumes contractual risks also performs key functions to control the risks. Passive risk taking by a foreign affiliate does not justify entitlement to residual profits in itself. Therefore, MNCs should ensure that the actual functional activities of the related parties support the contemplated transfer pricing outcome.

In the case of outbound payments of service fees and royalties, for example, taxpayers should be prepared to present evidence indicating the value of the services provided to China or the IP licensed to China. The supporting documents should illustrate why such services and IP are critical to the Chinese operation, and that the Chinese entities would have engaged third parties to provide such

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services and IP at similar prices in the absence of the intercompany transactions. To show proof that a foreign affiliate possesses both legal and economic ownership of the IP, the Chinese taxpayers should present carefully drafted intercompany agreements delineating the activities and responsibilities of the parties with respect to the DEMPEP functions. For example, the foreign IP owner may hire the Chinese entity to provide support in some of the DEMPEP functions as a subcontractor without intending to transfer any economic ownership of the IP to China. In such cases, the intercompany agreements should clearly indicate that the foreign entity makes detailed plans, and gives detailed instructions and supervision to the Chinese entity when the latter performs the supporting functions. The key messages to convey are that (i) the foreign entity not only assumes risks with respect to IP, but also controls the risks associated with the DEMPEP processes of the IP by physically performing the key functions and activities; (ii) the Chinese entity does not assume risks and receives a fair compensation for the supporting functions it performs in the DEMPEP process; and (iii) the extent and scale of the supporting DEMPEP functions performed by the Chinese entity do not exceed what is customary among third-party competitors that are comparable to the intended characterization of the Chinese entity.

When non-Chinese companies are used as comparables in economic analysis, taxpayers should be ready to answer questions from tax auditors on whether LSA adjustments have been made in calculating the targeted profitability range. In situations where the taxpayer alleges that no LSA adjustment is appropriate in the comparability analysis, it should provide convincing explanations on why the Chinese operations do not obtain location savings in China or benefit from the market premium in China. Such LSA analysis should be included in the annual transfer pricing documentation that the Chinese taxpayer maintains.

Well-formulated transfer pricing policies, thorough supporting documents and consistent functional activities serve as the foundation of an effective transfer pricing audit defence in China. Nevertheless, these measures do not always prevent transfer pricing controversies from arising in reality, as a transfer pricing audit can be initiated due to a number of factors outside the control of the taxpayer. A bilateral advance pricing arrangement (APA) is an effective way to achieve certainty and mitigate audit risk for highly material intercompany cross-border transactions in China. However, the current program in China is not particularly accessible and may not be an option available to all taxpayers. If, despite all good transfer pricing planning and documentation preparation, the Chinese operation of the MNC still gets audited, it is important for the taxpayer to communicate with the tax officials proactively and explain the justification of its transfer pricing positions strategically with valid supporting documents early on during the audit process. If no satisfactory settlement outcome can be reached, the taxpayer should be prepared to challenge the Chinese local tax authorities through administrative review by the upper local tax authorities or a judicial process at a Chinese court when needed. In some situations, the taxpayers may find a resolution by escalating the case to the Chinese SAT under the mutual agreement procedure (MAP) article of an income tax treaty. When there is much at stake and the taxpayers have a sound legal basis behind their transfer pricing positions, they should fully utilize the means and channels prescribed in the Chinese transfer pricing regulations and aim to achieve an equitable tax outcome.

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