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China's SAT issues new rules to improve administration of Special Tax Investigation and Adjustment and Mutual Agreement Procedures

On 17 March 2017, China's State Administration of Taxation (SAT) issued new regulations – Bulletin 6 – to improve the administration of Special Tax Investigations and Adjustments and Mutual Agreement Procedures. These regulations largely complete the revision of the transfer pricing-specific clauses of Circular 2, and add to the transfer pricing framework set out in the previously issued Bulletin 42[1] and Bulletin 64[2].

The Bulletin enters into effect on 1 May 2017, and the corresponding sections of previous regulations are repealed.[3]

Following the release of the three new regulations (Bulletins 42 and 64 in 2016 and Bulletin 6 in 2017) on Special Tax Adjustments, the regulatory framework for Transfer Pricing in China is now spread across a number of regulations. The following table shows the effect of these changes, and aligns the old regulations with the SAT's 2015 discussion draft on revising Circular 2, and the newly issued bulletins.

Circular 2	2015 Discussion Draft	Applicable Regulations
Chapter 2 – Reporting and Filing of Related-Party Transactions	Chapter 2 – Reporting and Filing of Related-Party Transactions	Bulletin 42
Chapter 3 – Administration of Contemporaneous Documents	Chapter 3 – Administration of Contemporaneous Documents	
Chapter 4 – Transfer Pricing Methods	Chapter 4 – Transfer Pricing Methods	Bulletin 6
Chapter 5 – Transfer Pricing Audit and Adjustment	Chapter 5 – Special Tax Audit and Adjustment	
	Chapter 6 – Intangible Assets	
	Chapter 7 – Related Party Services	
Chapter 6 – Administrative Guidance Concerning Advance Pricing Arrangements	Chapter 8 – Advance Pricing Arrangements	Bulletin 64
Chapter 7 – Administrative Guidance Concerning Cost Sharing Agreements	Chapter 9 – Cost Sharing Agreements	Circular 2 (Article 69 and 74 annulled); Bulletin 42
Chapter 8 – Administrative Guidance Concerning Controlled Foreign Corporations	Chapter 10 – Controlled Foreign Corporations	Circular 2
Chapter 9 – Administrative Guidance Concerning Thin Capitalization	Chapter 11 – Thin Capitalization	Circular 2 (Article 89 annulled); Bulletin 42
Chapter 10 – Administrative Guidance Concerning General Anti-Avoidance	Chapter 12 – General Anti-Avoidance	Circular 2
	Chapter 13 – Profit Level Monitoring	Bulletin 6
Chapter 11 – Corresponding Adjustments and International Negotiation	Chapter 14 – Corresponding Adjustments and Mutual Agreement	
Chapter 12 – Legal Responsibility	Chapter 15 – Legal Responsibility	

Note: This table is a summary of the regulations related to special tax adjustment issued in 2016 and 2017 with reference to Circular 2 and the discussion draft only, which does not cover all current regulations related to special tax adjustment such as the Administrative Measures for the General Anti-Avoidance Rule (for Trial Implementation) (SAT Order No. 32) and SAT Bulletin on Regulating Cost Sharing Agreements (SAT Bulletin [2015] No. 45). We have also omitted references to introductory, administrative, and supplemental chapters of Circular 2 and the discussion draft.

[1] See Deloitte Tax Analysis on Bulletin 42: https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2016/deloitte-cn-tax-tap2412016-en-160713.pdf
[2] See Deloitte Tax Analysis on Bulletin 64: https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2016/deloitte-cn-tax-tap2482016-en-161018.pdf
[3] In addition to corresponding sections in Circular 2, a few other regulations are repealed: Guoshuihan [2009] No. 188, Guoshuihan [2009] No. 363 (Circular 363), SAT Bulletin [2014] No. 54 and SAT Bulletin [2015] No. 16 (Bulletin 16).

Bulletin 6 has clarified certain key transfer pricing issues, as well as the methodology and procedures for special tax audits and adjustments. In making the changes, the SAT has generally incorporated positions taken in the discussion draft regarding intangible assets, related-party services and the monitoring of profit levels, as well as the guidance on mutual agreement procedures. Bulletin 6 puts more emphasis on a risk-oriented tax administration system that looks to improve cooperation between enterprises and tax authorities, and overall compliance with the regulations. In clarifying the technical positions, the regulation incorporates changes arising from the OECD's Base Erosion and Profit Shifting (BEPS) Actions 8-10 and Action 14.

Another encouraging sign is that the SAT has given due consideration to comments provided by enterprises and the public, and has revised and clarified some points that were of concern to taxpayers, or were not entirely clear, for example:

- Reinforcement of the arm's length principle as the primary requirement for transfer pricing in China;
- Removal of the controversial "secondary adjustment" provision, as well as similar provisions allowing tax authorities to deny or recharacterize related-party transactions; and
- Permitting working capital adjustments when analyzing toll processing businesses, with the requirements of revisiting comparable companies when the adjustment to profit levels exceeds the acceptable range, that is, when working capital adjustments result in a profit level adjustment by more than 10 percent.

Key points of the bulletin are discussed in more detail below.

Monitoring of profit level

In the past, companies may have been subject to tax authority scrutiny on an ongoing basis only after they had been audited, with a five-year follow-up supervision period. However, in the future all companies may have their profit levels and transactions monitored through the improved related-party transaction disclosure requirement. It will be more important for companies to manage their transfer pricing risks proactively than ever before.

With this in mind, the introductory article of Bulletin 6 establishes an expectation that the tax authorities will focus on risk management, strengthening the monitoring of profit levels, and enhancing compliance with tax laws through special tax adjustments, supervision, and investigation. Tax authorities' monitoring of profit levels may lead to a taxpayer receiving a "Notice of Taxation Matters" from the authorities, indicating that a transfer pricing risk has been identified. Taxpayers will be encouraged to make self-adjustments if they agree with the issues raised by the authorities – although the tax authorities can still conduct a special tax audit in the future.

Overall, the changes are expected to lead to a more comprehensive, real-time, and dynamic monitoring environment. The SAT is already looking to leverage "Big Data" analyses of the information that is collected, and we expect that this will allow the SAT to more reliably monitor and focus on transfer pricing risk areas.

Special tax audits and adjustments

Bulletin 6 is written from the perspective of how the tax authorities should make special tax adjustments to a taxpayer's related-party transactions. Articles 4 to 43 step through the audit process, and the technical process that the tax authorities should follow – covering audit processes, comparability analyses, transfer pricing methods, and the treatment of services, royalties, losses, etc. Taxpayers will use this prescribed process as a roadmap for their own transfer pricing analysis.

Types of enterprises be focused on special tax audits: Article 4 of the Bulletin lists nine risk characteristics the tax authorities should focus on when conducting special tax audits. Compared with Circular 2, new characteristics are added, for example, when an enterprise is in excess of the standard related-party debt-to-equity ratio, or has tax planning or business arrangements without a bona fide commercial purpose. The Bulletin also includes a risk criteria for enterprises controlled by a Chinese resident in tax jurisdictions with an effective tax rate below 12.5 percent, and distributing no or minimal profit without reasonable business needs – effectively targeting Chinese controlled foreign companies. This new criteria reflects an understanding that Chinese "One Belt One Road" and "Go Global" enterprises have global operations and that further scrutiny of their subsidiaries may be necessary.

Transfer pricing methods: In addition to the traditional five transfer pricing methods introduced in Circular 2, Bulletin 6 permits other asset valuation methods that comply with the arm's length principle, including the cost, market, and income approaches – generally used for valuing tangible or intangible assets. The value contribution allocation method, which was introduced in Article 35(1) of the discussion draft is not prescribed as a transfer pricing method in Bulletin 6, although the general profit split method specifically includes consideration of value contribution.

Bulletin 6 also allows the tax authorities to apply other methods that could align the profit with economic activity and the creation of value. Therefore, although the "value contribution allocation method" is not specifically included, this clause, current tax authorities' practice, and the contents of Bulletins 42 and 64 suggest that the authorities may be able to allocate profits based on their perception of where the value is created.

Loss-making enterprises with simple functions: Following the release of Bulletin 42, one missing element was the documentation requirement for simple-function entities that had losses. The existing Circular 363 requirement was still applicable, but the required content of the documentation was unknown. Bulletin 6 now confirms the requirement for loss-making simple-function entities (pure manufacturing, distribution, or contract R&D activities) to maintain a reasonable level of profit in principle. If they are in a loss position, the enterprises should prepare the China local file – although there is no requirement to submit the file. The master file would be required only if the thresholds in Bulletin 42 for a master file were met.

Bulletin 6 also states that tax authorities should focus on reviewing the local file of these simple-function entities and strengthen their ongoing monitoring activities. This reveals that the Chinese tax authorities will rely on the monitoring system to identify transfer pricing risks of such loss-making entities. It also puts more pressure on subsidiaries with losses and limited activities within China – management will need to consider the rationale for any losses, and ensure robust documentation is prepared.

Concealed transactions: The Bulletin also makes specific reference to restoring any "concealed related-party transactions" reducing the collection of tax nationally – impacting domestic companies not charging their overseas related parties. If the tax authorities discover through their information-gathering activities that a Chinese company is providing a service, or allowing the use of intangible property, but not charging the related parties, a special tax adjustment may be made to restore the transaction. Along with other changes in the Bulletin, this is reflective of the fact that the Chinese tax authorities are paying more attention to the transfer pricing issues associated with "Go Global" enterprises.

Intangibles: Unlike the discussion draft, Bulletin 6 does not have a separate chapter considering intangibles. Rather, it discusses specific analyses and considerations that the tax authorities should have before making Special Tax Adjustments – as well as incorporating Bulletin 16 requirements. The definition of intangibles from the OECD comments that was included in the discussion draft has been removed, along with specific definitions and references to separate "legal" and "economic" owners of the IP.

However, the regulations have incorporated the requirement that entities that own IP without contributing to the value of the intangible will not be entitled to any returns from the intangible. Likewise, parties that contribute only funding or capital will be entitled only to a reasonable return on their capital. The regulations are consistent with the contents of the BEPS action plan.

When reviewing a royalty or other IP arrangement, the tax authorities are directed to analyze the value creation factors for the IP, and the contributions of all parties to the development, enhancement, maintenance, protection, exploitation, and promotion ("DEMPE+P") of the intangible. If the recipient of a royalty has not contributed to the value creation or DEMPE+P, and not complied with the arm's length principle, then the tax authorities may make an adjustment.

The Bulletin's specific reference to "not in accordance with the arm's length principle" seems to provide an exemption for "mere legal owners" if the royalty arrangement would still be an arm's length transaction (despite the lack of value creating functions and risks), for example, if the IP was acquired from a third party and needs to be licensed to the China subsidiary. Further observation will be needed to determine whether such related-party transactions would be acceptable.

The focus on "Go Global" companies also has been considered, specifically in relation to intangibles. The tax authorities' practice in the past has focused on reviewing royalty payments by enterprises, and the discussion draft had language focusing on the payment side of the transaction. However, the Bulletin has broadened the requirement for tax authorities, asking them to also consider royalty recipients, and whether they have received a sufficient return.

Combined with the references to “concealed related-party transactions,” this underlies the increasing focus on China “Go Global” enterprises.

Intragroup services: The section on intragroup services is no longer a standalone chapter, and similar to the royalties articles, takes existing regulations from Bulletin 16. The Bulletin unifies the “beneficial service” and arm’s length principles, and confirms the requirement for services to bring economic benefits to the recipient, and for the service fee to be calculated in the same way as services taking place in the marketplace, or that third parties would be willing to engage in such services or otherwise perform them themselves in the same or similar circumstances. The Bulletin also sets out the “six tests” from Bulletin 16 in more detail, and clarifies that transactions failing the tests are not beneficial services.

One change from the discussion draft is the removal of the language “plus an arm’s length mark-up” from the regulations on calculating a service fee – the basis for the calculation is now only the “reasonable cost” or the “apportioned cost.” Therefore, any service fee calculation will need to take into consideration the cost of the service, as well as the benefit or value created by the service provider when determining the arm’s length service fee. For example, if an overseas related party had outsourced almost all of the service that is provided to a China subsidiary, and therefore not created a benefit itself, the overseas related party should not be entitled to charge the China subsidiary a mark-up on that external cost.

Reinforcing this point, and also applicable to intangibles, the Bulletin specifically provides that payments made to overseas entities that do not have functions, risks, or substantial operating activities, may be subject to special tax adjustments, if the payments do not otherwise comply with the arm’s length principle.

Procedures for special tax audits and adjustments: The Bulletin provides a clear outline of the formal procedures where the tax authorities conduct an audit, discussing procedures whether there are or are not going to be any special tax adjustments. This also establishes the process for when an enterprise disagrees with the tax authorities’ proposed adjustment, etc.

Under the process, enterprises that disagree with proposed special tax adjustments may choose to pay the disputed tax, interest, and surcharges, and then file an application for “administrative reconsideration,” and subsequent “administrative litigation.”

The Bulletin also ensures that the common practice of “self-adjustments” of tax are now formalized through the “Special Tax Adjustment Self-declaration”, where payments may be made before receiving a Special Tax Adjustment Notice.

Irrespective of whether the enterprise makes a self-adjustment or not interest will continue to be calculated based on the Basic Lending rate published by the People’s Bank of China. The additional 5 percent penalty interest will apply in situations where the taxpayer does not provide contemporaneous documentation and other documents requested by the tax authorities. This means that if an enterprise thinks it is below the threshold and is not required to prepare documentation, but the tax authority considers the transactions are underpriced, or there are “concealed transactions”, the 5 percent penalty interest may be triggered if the restored transactions exceed the threshold and the taxpayer has not prepared the documentation.

One omission from the Bulletin is the absence of the “secondary adjustment” language that was included in the discussion draft. This controversial provision seems to have been dropped in response to comments and advice received from taxpayers and advisors.

Corresponding adjustments and mutual agreement procedure

Recent regulatory changes show that China has positively implemented changes coming out of the BEPS project, through both Bulletin 42 and Bulletin 6. The revisions to China’s dispute resolution mechanisms for Special Tax Adjustments, amending the existing rules in Circular 2, continues this. The changes have given more certainty to taxpayers that plan to apply for the mutual agreement procedure (MAP), with further guidance on requirements for initiating the process and providing information, as well as outlining the situations when the authorities will reject an application, or suspend or terminate the MAP process. The Bulletin also confirms that the new regulation will apply to all MAP applications that have been accepted, but not concluded at the effective date of the Bulletin.

It is noteworthy that Bulletin 6 has also specified circumstances when a "suspension of mutual agreement procedure" is applicable. This gives both taxpayers and tax authorities the right to suspend the process. This could be a response by the authorities to feedback received regarding time limits for dispute resolution mechanisms. This would show that the Chinese tax authorities are actively looking for solutions to some of the practical issues they encounter in practice, and that they will continuously implement these solutions in newly issued regulations. However, some rules are tighter under Bulletin 6. For example, when discussing circumstances where the SAT may reject a MAP application (from either an enterprise or the competent tax authorities of the tax treaty contracting party), the SAT may reject the MAP application when the enterprise fails to pay taxes from a Special Tax Adjustment.

Deloitte observation

Bulletin 6 is an important release for the administration of transfer pricing and special tax adjustments. The Bulletin has implemented changes from the Discussion Draft, and improved the regulations related to special tax audits and adjustment. Overall, the reform to the regulations through this and earlier bulletins, shows how the SAT has responded to BEPS and how it will look to monitor transfer pricing in the future. Overall, there is a strong signal that the SAT will pay more attention to the management of prospective risks in tax administration, a transition from the current "ex-post" focus in audits, to looking problems on an "ex-ante" basis. This should allow the authorities to administer the regulations through the contemporaneous documentation requirements, the annual related party transactions reporting forms, continuous monitoring of profit levels, and by encouraging self-adjustments.

We have now seen from Bulletin 42, Bulletin 64, and Bulletin 6, that the Chinese tax authorities are paying attention to technical positions regarding intangible assets, related party services and value chain analysis. Taxpayers should respond to this, by reviewing their transfer prices for related party transactions, and making changes to any unsupportable transaction pricing proactively. At the same time, taxpayers should consider the profits in the supply chain on an overall basis, and ensure that they can support the allocation as consistent with the arm's length principle through both qualitative and quantitative analysis. This will help establish a base line level of compliance, in preparation for any special tax audits or adjustment.

Finally, the changes clearly show that the Chinese tax authorities are paying more attention to related-party transactions and transfer pricing policies of Chinese-headquartered companies that are expanding around the world. There is a clear focus on identifying transactions where the Chinese company has not been adequately remunerated for its contribution to value creation, intangible development or service provision. Chinese headquartered companies will need to consider how they meet these new challenges, and put more focus on dealing with their global transfer pricing.

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