

## **D.3. China Country Practice<sup>1</sup>**

---

---

### **D.3.1. Introduction**

D.3.1.1. On 5 October 2015, the Organization of Economic Cooperation and Development (OECD) published 15 final reports and an explanatory statement on the Base Erosion and Profit Shifting (BEPS) project. After an intensive two-year process, the international tax reform mandated by the G20 leaders and coordinated by the OECD has finally come to fruition. The post-BEPS era focusing on the implementation of the BEPS outcomes was ushered in. One thing that made this reform different from the previous ones is the involvement of many developing countries in both the early stage when the various measures were developed and the later implementation phase. The voice of the developing countries has started to be heard by the global community when formulating international tax policy. This unprecedented event has provided the developing countries with an opportunity to begin at the same starting line as their developed counterparts. However, the opportunity comes with challenges. Having the right to speak does not necessarily mean being ready to speak. Getting involved is still a long way from being equipped to lead. It is therefore imperative that the developing countries continue to build capacity in tax administration to become more prepared to contribute and lead.

D.3.1.2. As a G20 member, a major economy and the largest developing country, China has been actively involved with the BEPS project since 2013. The State Administration of Taxation (“SAT”) has endeavored to attend every relevant BEPS meeting, trace the progress of the project and research on many topics such as intangibles for transfer pricing purposes and comparability analysis. In the process, the SAT has provided China’s position on various issues like location specific advantages (“LSAs”), exploitation of intangibles, and application of profit split

---

<sup>1</sup> By WANG Xiaoyue, Deputy Director General of the International Taxation Department of the State Administration of Taxation (People’s Republic of

method. During the post-BEPS phase China has valued the outcomes of the BEPS project and has adopted some of them into domestic legislation. China welcomes the OECD's effort to build an inclusive framework by inviting more jurisdictions, especially the developing countries, to commit to the follow-up work including further research on specific areas as well as implementation accompanied by review and monitoring. This will lead to enhanced coordination and cooperation across the globe. On the other hand, China calls for more respect for jurisdictions' sovereignty during the review and monitoring process. Given the nature of developing countries, more flexibility is also essential for them to play on



avoidance prevention and control system with a consistent and standardized approach for administration, service and investigation. To start with, transfer pricing investigations should run parallel to tax avoidance prevention. Ways of preventing taxpayers from evading their tax obligations include strengthened tax administration and improved taxpayer service. Investigations are used as deterrence to foster taxpayer voluntary compliance. Moreover, different measures were taken to build a three-pronged tax avoidance prevention and control system. The first aspect of the three-pronged system is administration. A tracking system was put in place to monitor the profits of MNEs in China. The Chinese tax administration has put extra emphasis on routine reviews of related party filings and contemporaneous transfer pricing documentation. Follow-up monitoring subsequent to transfer pricing audits was implemented to encourage taxpayers to bring their profitability more in line with the arm's length principle. As to the second prong, service, seminars and training were made available to inform taxpayers of the latest tax regulations and policies. Double taxation was prevented or eliminated through unilateral/bilateral advance pricing agreements (APAs) and resolution of issues through the mutual agreement procedure (MAP). With regard to the last aspect, investigation, both isolated and coordinated anti-avoidance audits were carried out to act as deterrence to regulate the profitability of the audited companies and industries. Above all, the tax authorities across the country have coordinated their actions to ensure that both domestic laws and international policies were followed in a consistent and standardized manner. In other words,







the sale and purchase of tangible goods to transactions like transfers of equity or intangibles and corporate financing. The tax revenue contributed by the anti-avoidance work was RMB 679 million in 2006 and RMB 61 billion in 2010. The number of audits was also greatly increased with an annual increase rate of 64.84%. In addition, the average tax assessment from a single case has risen from RMB 3,836,200 in 2006 to RMB 58,450,000 in 2015. The amount is more than 14 times higher. The number of substantial cases has grown exponentially too. In 2006, there were ten cases with a levy over RMB 10,000,000 of which only one case collected over RMB 100,000,000 in tax revenue. In 2015, the number of cases with assessment over RMB 10,000,000 was increased to 77 with 20 cases that collected over RMB 100,000,000.

**D.3.2.6** over -h5b Tw [6720]wk( nu28 Tw )UI)-6 in'ç , nk wB.1[(wi)-4 (on 2015. To265 Td [(6 >F







designing international rules. Both developed and developing countries can find the general rules to be fair and easier to accept if the rules reflect special features of each group. So far004 Twc (f4 ((nd t)-n f)3 (e)4 (a)-1 ( )-10 ( )-10(nd t)(r)3 (n(e)4 ( ))TJ4 (oubl

s r c (f4 ((nd t)-n f)3 on )TJ ofulnd t. ts [(s)- -0.00-w4( [(s)-5 un(nd t)qus)-1 ns as [(s)-5 i s f



RMB 100 million; (3) The annual related party transfer of ownership of intangibles exceeds RMB 100 million; (4) the annual total amount of other related party transactions exceeds RMB 40 million. In addition to what is required in the BEPS Action 13 report, taxpayers will need to provide (1) a value chain analysis including measurement and attribution of value creation contributed by location specific factors; (2) information on outbound investment; (3) information on related party equity transfers; and (4) information on related party services. Also, PN 42 has more stringent and detailed filing requirements in relation to the description of the business, related parties, and related party transactions of local entities. Furthermore, taxpayers will need to describe contributions to the group's overall profit or residual profit by the local entities regardless of the transfer pricing method selected. Aside from the master file and local file, Chinese taxpayers will need to prepare special issue files as part of their contemporaneous transfer pricing documentation if certain criteria are met. Special issue files include a special issue file on cost sharing agreements and a special issue file on thin capitalization. An enterprise that enters into or implements a cost sharing agreement (CSA) should prepare a special issue file for the CSA. An enterprise with a related party debt-to-equity ratio exceeding the threshold should prepare a special issue file on thin capitalization.

#### **D.3.3.5. Transfer Pricing Audits**

D.3.3.5.1. Chinese taxpayers with related party transactions not in line with the arm's length principle are subject to transfer pricing audits conducted by the tax administration. The transfer pricing audit procedures are made very clear in Circular 2. As suggested by the OECD Transfer Pricing Guidelines a comparability analysis is also provided for in Circular 2. However, an investigation is only as important as other means including risk management and taxpayer services listed in Part One of this summary to foster taxpayer compliance.

D.3.3.5.2. Through reviewing taxpayers' related party filings and contemporaneous transfer pricing documentation as well as tracking the profitability of MNEs in China, the Chinese tax administration has been able to identify taxpayers with transfer pricing risks and alert the taxpayers to the risks. The taxpayers are allowed to make self-adjustments after they realize the existence of the risks either as a result of the tax administration's alerts or through an effective internal control system. To the extent

that the adjusted results do not conform to the arm's length principle, the tax administration may initiate transfer pricing audits of the taxpayers.

D.3.3.5.3. During the screening process for transfer pricing audit targets, taxpayers falling into the following categories are likely to be selected: (1) enterprises with a significant amount of or different categories of related party transactions; (2) enterprises with consecutive losses, low profitability, or fluctuating profitability over a long period of time; (3) enterprises with profit lev[ (c)4 (u)-10 (t)-2 (i)-2 (ve)4 ( l)-2 (os)-1 (s)-1 (/e)1 (

covers related party transactions for three to five consecutive years in the future. As per the taxpayer's application, the APA can be retrospectively applied to prior years for up to ten years. The general threshold which a taxpayer needs to meet in order to apply for an APA is that the amount of annual related party transactions should be no less than RMB 40 million for the past three years prior to the application year.

D.3.3.7.2. The Chinese tax administration can prioritize the acceptance of the application from a taxpayer if it falls into one of the following categories. (1) The taxpayer's annual reporting forms for related party dealings and contemporaneous transfer pricing documentation are well completed with adequate disclosures. (2) The

8) - taxpayer -11 (ep)6(a)6alnd l el a i i 3 ( a

disputes. One area which the MAP can be applied to is taxation resulting from transfer pricing adjustments that might require corresponding adjustments from the other contracting state. The MAP can also be used to negotiate bilateral/multilateral APAs.

D.3.3.8.2. Taxpayers who wish to request MAP assistance should complete the Application Form for Mutual Agreement Procedures and submit it with the necessary documentation to the SAT headquarters within the timeframe specified in the relevant tax treaties. The SAT can initiate the MAP process after receiving the aforementioned documents if the submitted documentation is in accordance with provisions in the relevant tax treaties. The SAT can require the taxpayers to provide additional information if the submitted documentation is found insufficient. In a case where the competent authority of the other contracting state requests initiation of the MAP process, the SAT will start the MAP process upon the receipt of the formal notification if the request is in accordance with provisions in the relevant tax treaties. The SAT needs to give written notification to the relevant local tax administration and inform the competent authority of the other contracting state if it decides to initiate a MAP process.

D.3.3.8.3. If an agreement is reached between the SAT and the competent authority under the MAP, it will then be forwarded to the relevant local tax administrations. The local tax administrations need to deliver the agreement to the taxpayer within 15 days from the day they receive the notification from the SAT.



comparables; quantification and allocation of 1



is lacking or inadequate. This limits the amount of publically available information on domestic companies that can be used for transfer pricing analysis. Take China as an example. As of September 2016, there are 2952 listed companies in China whereas the private



iii. Quantify and measure the additional profits arising from the LSA.

iv. Determine the transfer pricing method to allocate the profits arising from the LSA.

D.3.4.2.3.5. In determining LSAs and their impact on transfer pricing, both industry analysis and quantitative analysis are critical.

D.3.4.2.3.6. The automotive industry is a good example where there are many LSAs that have led to extraordinarily high profits that are rightly earned by Chinese taxpayers. The LSAs include:

controlled by the foreign JV partner. The foreign JV partner also controls the supply chain of the parts. To the extent there could still be potential transfer pricing issues, the primary issue involves the JV being overcharged for the parts and services that are provided by related parties. In the absence of such overcharges, the JV's results mainly reflect an arm's length outcome, which in turn reflects the contribution of LSAs to the JVs.

D.3.4.2.3.8. A further example can be that of a Chinese taxpayer performing contract research and development ("R&D") services for an offshore affiliate, with the full cost mark up ("FCMU") as the profit level indicator for a comparable set comprising foreign companies located in developed countries (and hence, incurring higher costs). The following example outlines the steps to calculate the adjusted FCMU taking into consideration the location savings.

D.3.4.2.3.9. It is assumed that the Chinese taxpayer's cost base was 100, the average cost base for the company's R&D centres in developed countries was 150, and the median FCMU of the comparables was 8%. The comparison of the cost base between the Chinese taxpayer and that of the foreign companies is measured on an equal platform, such as the total costs (labour, raw materials, land and rent, etc) per unit of output.

Steps and Calculations

	Steps	Calculations
--	-------	--------------

i.







D.3.4.2.4.3.



transactions to determine how independent parties would have acted in broadly comparable situations. This principle becomes challenging to apply where a company relies on its related parties for both input purchase and output sales. If such a company is to be evaluated on a cost plus basis, a low intercompany purchase price results in an undervalued cost base that will ultimately under-compensate the contract manufacturer. However, the reasonableness of the purchase price is often difficult to assess. A further issue therefore arises regarding how the reasonableness of a taxpayer's intercompany arrangements in this situation should be evaluated.

D.3.4.3.5. The Chinese approach to evaluating such companies is to start with the general presumption that the related party purchase price of materials is at arm's length, and evaluate the reasonableness of the mark up earned by the contract manufacturer on its cost base. The rationale for accepting the related party purchase price is that Customs can act as a check on the reasonableness of the import price of materials and safeguard against unreasonably low intercompany purchase prices. The next step is to proceed with the transfer pricing analysis by adopting a cost plus methodology and using the FCMU as the profit level indicator. The challenge that follows lies in the search for suitable comparable companies, as discussed earlier in this paper.

D.3.4.3.6. Toll manufacturing is a common form used by MNEs in developing countries, but its proper return is difficult to determine since there are only a few independent listed companies that perform such activities. Some taxpayers simply use the FCMU for contract manufacturers as the mark-up for toll manufacturers.-6 (an)-4 (e2 (ng.3.))TJ



**D.3.4.4. Alternative Methods to the Traditional Transactional Net Margin Method**

D.3.4.4.1. While the TNMM may still be used when there is a lack of adequate local

Another potential alternative may be to evaluate the Chinese manufacturer on the return on its assets or capital employed, using the group's results as a comparable for the Chinese manufacturer.

#### **D.3.4.5. Other Experience and Recommendations**

D.3.4.5.1. One of the key issues faced by developing countries is the lack of experience and knowledge on how MNEs operate and on a particular industry. Transfer pricing is commonly acknowledged as one of the most difficult international tax issues, and MNEs as well as tax administrations in developed countries have developed and dedicated substantial resources including talents to this area. The Chinese experience has been that a dedicated team, with accounting, economics, and industry background

pricing documentation requirements coupled with penalty rules have been very effective in encouraging taxpayer compliance. An industry wide or MNE group wide audit has also been a very effective and efficient way for the tax administration to

for the company in the developing country.

D.3.5.3. China has overcome this challenge by using some practical solutions that are sensitive to unique economic and geographical factors for companies operating in China. These solutions include concepts such as location savings, market premium and alternative methods of analysis besides the traditional transactional and profit based methods.

D.3.5.4. The Chinese tax administration has shared its insights on applying the arm's length principle for developing countries, and welcomes other perspectives on these