SAT Bulletin 6: Transfer pricing reform and special tax adjustments after BEPS
The Dbriefs Special Edition – China Spotlight series
Eunice Kuo / Victor Li / Jerry Wang
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Agenda

• China’s transfer pricing response to BEPS
• Key elements of Bulletin 6
• Risk mitigation strategy
• Questions and answers
China’s transfer pricing response to BEPS
China’s transfer pricing response to BEPS
Incorporating BEPS concepts with certain extensions

- China’s State Administration of Taxation (SAT) was an active participant throughout the BEPS project
- During the BEPS project, the SAT was ahead of most other countries in preparing and releasing its 2015 Discussion Draft on new Special Tax Adjustment Regulations – which was released shortly before the BEPS Actions
- Given the single regulation in the Discussion Draft, we anticipated a single regulation, however SAT has ended up releasing multiple documents
  - Bulletin 64 – administration of Advance Pricing Arrangements (2016) – addresses some of the issues from BEPS Action 14 (2 years for negotiations)
- Bulletin 6 has largely completed the reform to replace major contents of Circular 2 and also to replace Circular 363 and Bulletin 16
## China’s transfer pricing response to BEPS

**Before and after**

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<th>Circular 2</th>
<th>Revised Regulations</th>
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<td><strong>Chapter 2 – Reporting and Filing of Related Party Transactions</strong></td>
<td>Bulletin 42 (Articles 1 – 27)</td>
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<td><strong>Chapter 3 – Administration of Contemporaneous Documents</strong></td>
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<td><strong>Chapter 4 – Transfer Pricing Methods</strong></td>
<td>Bulletin 6 (Articles 3 – 29, 39 – 46)</td>
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<td><strong>Chapter 5 – Transfer Pricing Audit and Adjustment</strong></td>
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<td><strong>Chapter 6 – Administrative Guidance Concerning Advance Pricing Arrangements</strong></td>
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<td><strong>Chapter 7 – Administrative Guidance Concerning Cost Sharing Agreements</strong></td>
<td>Circular 2 (Article 69 and 74 annulled); Bulletin 42 (Article 16)</td>
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<td><strong>Chapter 8 – Administrative Guidance Concerning Controlled Foreign Corporations</strong></td>
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<td><strong>Chapter 9 – Administrative Guidance Concerning Thin Capitalization</strong></td>
<td>Circular 2 (Article 89 annulled); Bulletin 42 (Article 17)</td>
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<td><strong>Chapter 10 – Administrative Guidance Concerning General Anti-Avoidance</strong></td>
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<td><strong>Chapter 11 – Corresponding Adjustments and International Negotiation</strong></td>
<td>Bulletin 6 (Articles 47 – 61)</td>
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<td><strong>Chapter 12 – Legal Responsibility</strong></td>
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| Circular 363 | |
| **Simple function entities with loss position** | Bulletin 6 (Article 28) |

| Bulletin 16 | |
| **Outbound payments to related parties – services and intangibles** | Bulletin 6 (Articles 30 – 38) |
Polling question 1

After the introduction of BEPS, do you think that the tax authorities have changed their attitude towards transfer pricing audits?

- Significantly more aggressive
- Relatively aggressive
- No change
- Less aggressive
- Don’t know / not applicable
Key elements of Bulletin 6
Key elements of Bulletin 6
Technical transfer pricing regulations

• Comparability analysis remains largely unchanged
• TP methods consistent with OECD
  – Asset valuation methods added – income, cost, and market methods
  – “Other methods” that match the economic activities and value contribution
• Tested party and comparable changes bring rules closer to common practices
  – Party performing simpler functions selected as tested party
• Priority given to public comparables – but “secret comparables” permitted
• Authorities have flexibility with statistical methods for evaluating prices
  – Adjustments to median remain
  – Flexibility to use arithmetic average, weighted average, or quartile method
  – Year by year or multiple-year average basis to calculate comparable ranges
  – Authorities should make year-on-year testing / adjustments
Key elements of Bulletin 6
Adjustments to comparable analysis – taxpayer led adjustments

• Bulletin 6 incorporates the requirements of Circular 363
• **Simple function entities are targeted (no clear definitions)**
  – Simple manufacturing (toll manufacturing or contract manufacturing)
  – Simple distribution (presumably limited risk distributors (LRDs))
  – Contract R&D
• Simple function entities are required to maintain reasonable profit
• Taxpayers will choose these structures to recognize limited scope of activities in China, and to get certainty of profit in China entities
• Taxpayers need to select appropriate comparable companies to establish the arm’s length range for the “simple functions”
Key elements of Bulletin 6
Adjustments to comparable analysis – taxpayer led adjustments (Cont’d)

Special factor adjustments

• Commonly seen reasons used by taxpayers to explain results compared to arm’s length range
  – Capacity adjustments – if plant materially has over capacity during start-up or for other reasons, adjust COGS to reflect that under utilization – increasing pro forma profit
  – Yield adjustments – if yield from manufacturing is lower than expected production yield, adjust COGS accordingly – increasing pro forma profit
  – Extraordinary adjustments – reverse out extraordinary amounts that would not be in comparable accounts

• Tax authorities may not necessarily accept such comparability adjustments and taxpayers will need to argue their position based on company’s specific business case
Key elements of Bulletin 6
Adjustments to comparable analysis – tax authority adjustments

Authorities would like taxpayers to do self review and tax adjustment on their own – not likely to make a difference as it disadvantages taxpayer.

Location specific advantages / local intangibles

• Need to decide how to account for any perceived location saving/market premium, or the impact of extensive local marketing
• China comparables included in set not necessarily a solution as authorities challenge the particularly selected China comparables

Toll manufacturing

• Toll manufacturers must restore value of consigned materials and equipment
  – If 80 of consigned goods, 20 processing cost and 10% mark-up (22 tolling fee), the restoration of consigned materials results in 2% overall mark-up
• Material related working capital adjustment for toll manufacturing comparable allowed only if taxpayers can provide the whole value chain information including total profits of related parties and meanwhile the adjustment is below 10%
  – Practically limited use – NCP of 5% would adjust to either 4.5% or 5.5% – unlikely to be useful for tolling
Key elements of Bulletin 6
Adjustments to comparable analysis – tax authority adjustments (Cont’d)

Toll manufacturing

Restoring the value of consigned materials in the China model for the purpose of the service income, would increase the service fee to $30. Total profit would be 10% of the “total cost” of $100, i.e., $10.
Key elements of Bulletin 6
Intangibles

Intangibles – detailed definition from discussion draft removed

 Likely to result in more controversy in the future

• Determining the value of intangibles requires comprehensive analysis on value creating factors
  – “Mere legal owners” should not be entitled to any return – deductions denied
  – “Cash boxes” that fund development entitled to reasonable return on capital

• Development, enhancement, maintenance, protection, exploitation, and promotion (DEMPE+P) analysis required
  – “P (promotion)” has been formally introduced – tax authorities expected to use this to argue for local marketing intangibles

• Authorities able to make special tax adjustments in specified circumstances

Bulletin only discusses analysis and considerations from a conceptual point of view without enough clear guidance on practical implications
Key elements of Bulletin 6

Services

**Services** – benefit test key, with expanded list of “non-beneficial” services

- May be harder to support deductions of group provided services given some definitions of “non-beneficial” services
- “Six tests” brought in from Bulletin 16 – considers following to have “no economic substance”
  - Duplicative services – already purchased or undertaken
  - Supervisory services to benefit shareholder – effectively shareholder services
  - Incidental benefits without specific service, due to being in the group
  - Services where provider already compensated through other transactions
  - Irrelevant services that are not required for business
  - Other services that do not bring economic benefits
- In essence the “benefit” test is the most important consideration

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**Tax authority’s prior approval is no longer required. However, supporting documents and contracts will be essential when tax authorities challenge arrangements**

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Polling question 2

After China introduced new transfer pricing rules (Bulletins 42, 64, and 6) how much time has your company spent dealing with Transfer Pricing compliance in China?

• Significantly increased
• Slightly increased
• No change
• Less time
• Don’t know / not applicable
Risk mitigation strategy
## Risk mitigation strategy

### Special tax adjustments – tax authorities and environment

<table>
<thead>
<tr>
<th>Circular 2</th>
<th>Bulletin 6</th>
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<tbody>
<tr>
<td>Desktop verification and analysis to select enterprises for audit</td>
<td>Focus on risk management, and build and develop a system for indexing and monitoring profit levels of related party transactions</td>
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<tr>
<td>Tax authorities generally encourage taxpayers to self-review and made self-adjustments</td>
<td>Taxpayers can self identify adjustments and make a “self-adjustment”</td>
</tr>
<tr>
<td>Information gathering processes deals with accounting books and associated records</td>
<td>Information requested can be in hard copy or electronic copy without limited of type of documents. Clear processes for how to collect information</td>
</tr>
<tr>
<td>Information can be requested from enterprise, its associated parties, and other entities related to the related party transaction</td>
<td>Information can be requested from the audited enterprise, its related parties, and any other enterprise involved in the audit</td>
</tr>
<tr>
<td>May use public or non-public information for analysis and evaluation</td>
<td>Tax authorities should focus on comparability and give priority to public sources, although non-public sources can also be used</td>
</tr>
<tr>
<td>Should use quartile method</td>
<td>May use various statistical methods, including arithmetic average, weighted average, quartile method to calculate the mean value or inter-quartile range of profit level, on year by year basis, or multiple year average basis</td>
</tr>
<tr>
<td>Adjust tested party to at least the median</td>
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</table>
Risk mitigation strategy
Special tax adjustments – tax authorities and environment (Cont’d)

- Bulletin requires authorities to put a focus on risk management, and build and develop systems for indexing and monitoring profit levels
  - Expect results will be reviewed by “big data” type analysis
- Self adjustment is a formalized process, with taxpayers being expected to initiate
  - Formalizing process will reinforce tax authorities’ requests for self-adjustment
- Enterprises with certain risk characteristics to be focus of audits
  - Wide range of entities could be captured – new additions for companies exceeding thin cap ratios, Chinese controlled entities in countries with low tax rates, and enterprises that conduct tax planning or have business arrangements without reasonable commercial purposes
- Information collection powers extended and processes confirmed
  - Covers provision of hard and electronic copies – information may be requested from overseas with translation / certifications
  - May request from audited enterprise, related parties and any other enterprises related to the audit
Risk mitigation strategy
Special tax adjustments – considerations for tax directors

• Review compliance with Bulletin 42 requirements
• On receiving a Letter of Tax Risk on Special Tax Adjustment, can consider using self-adjustments
  – Doesn’t remove audit risk and MAP unlikely to be available
  – Even if no self-adjustment to be made need, should consider any risk areas identified, and potential tax cost
• Need to plan approach for responding to information requests and collection of data during field visits
  – Questions still remain over jurisdiction of China authorities over overseas information, but not responding has implications
  – Need to understand whether CbC Reporting or other information sharing may mean not providing information is unnecessary
• Review circumstances and consider possibility of location specific advantages
• Have a plan for dealing with proposed special tax adjustments and how company will negotiate on any adjustments
Risk mitigation strategy
Special tax adjustments – audit process

• Bulletin 6 sets out details for audit processes
  – If no adjustments are made, a “Notice of Special Tax Audit Conclusion” should be issued
  – Where authorities identify special tax adjustment issues, there is a fixed procedure to follow
  – Taxpayers may appeal to higher tax authorities, or to People’s Court
    • In practice appeals are rare – no clear signs this will change

• In principal, for transactions between domestic related parties – if the effective tax rate is the same, a special tax adjustment is not required

• Bulletin does not include the previous 5 year follow up period, although the deletion leaves this as a “grey area” and subject to judgement of tax authorities
  – To mitigate risk discuss with authorities during audit period to understand their intention

• Interest will be charged at penalty rate (i.e., PBOC rate plus 5%)
Risk mitigation strategy
Mutual agreement procedure

- Mutual Agreement Procedure (MAP) rules are expanded from the previous regulations
- APA and MAP are ways to resolve possible disputes on cross-border transactions
  - APA is dealt with in Bulletin 64 and generally used for future transactions – although roll back is available
  - MAP is dealt with in Bulletin 6 and helps resolves prior year issues
- Procedure for initiating MAP is clearly set out, as are the situations where SAT will launch the process, as well as situations where the tax treaty contracting party initiates the procedure
  - SAT needs to notify provincial tax authorities where SAT initiated MAP
  - MAP applications are subject to rejection, as well as suspension or termination of the process
  - May suspend or terminate MAP process at request of taxpayer
- Bulletin 6 MAP regulations apply to MAP cases that are accepted but not concluded before publication of the regulation
Risk mitigation strategy
Tax authority information gathering procedures

- Information gathering powers and detailed processes
  - Powers of tax authorities to gather hard and electronic data is clarified
    - In prior years have seen efforts to gather data from large number of companies to run through risk assessment tools
  - Collection of information from related parties and “other companies” may be difficult if they are outside China
- Expansion of information gathering powers aligns with Bulletin 42 requests for information likely held offshore – Master File, aspects of value chain
- Although related party transactions between domestic parties with same “effective tax rate” should not be reviewed, they may still be questioned
  - If the effective tax rate of the domestic related parties are different, the related party transactions would also cause the attention of the tax authorities
Risk mitigation strategy
Managing audits in the future

• SAT is known to have increased resources for special tax investigations – in particular through secondment of auditors from other tax bureaus in China
  – Anticipate that the growth in headcount will increase to manage growing number of audits in the future
• Tax authority is known to be bringing together tools to analyze taxpayer risk using data analytics tools
  – Should allow better targeting of taxpayers with risks that haven’t been subject to audits in the past
  – Once CbC Reports are available, can expect that this would feed into SAT risk analysis tools
• Understand that MAP is a focus area for authorities, and that priority will be given to meet 2 year timeframe for completion – although no guarantee of no double taxation
Risk mitigation strategy

Final thoughts

• **Consistency**: ensuring consistency with global transfer pricing policy is essential given expected level of transparency

• **Jurisdiction**: under Bulletins 42 and Bulletin 6, there is strong intention to collect overseas data. Ensure appropriate and effective compilation of overseas information

• **Proactive defense**: consider preparing “preemptive” defense files for known risk areas – preparing for arguments on marketing intangibles, value chain, location specific advantages. APAs are possible proactive solutions

• **Relief procedures**: never give up explaining TP position, never give up at self-adjustment stage, never give up at any stage before and during formal audit. Given lack of experience with appeal / litigation, the early phases are very important and will determine amount of adjustment and possibility of MAP negotiation
Questions and answers
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Contact information

**Eunice Kuo**
Tax Partner  
Deloitte Shanghai, China  
eunicekuo@deloitte.com.cn

**Victor Li**
Tax Partner  
Deloitte Shenzhen, China  
vicli@deloitte.com.cn

**Jerry Wang**
Tax Partner  
Deloitte Suzhou, China  
jerrywang@deloitte.com.cn
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