

China Tax Alert

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State Administration of Taxation (SAT) Issued Announcement on the Enhancement of Administration of Advance Pricing Arrangement (APA)

Regulations discussed in this issue:

- The State Administration of Taxation (SAT) of the People's Republic of China (PRC) Announcement on the Enhancement of Administration of Advance Pricing Arrangement (APA) ("Announcement 64"), published in public domain on 18 October 2016
- SAT Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation ("Announcement 42"), issued on 13 July 2016
- SAT Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation), Guoshuifa [2009] No.2 ("Circular 2"), issued on 8 January 2009

Background

On 18 October 2016 an SAT Announcement on the Enhancement of Administration of Advance Pricing Arrangement (APA) ("Announcement 64") was published on a public information platform. Announcement 64 replaces the current relevant regulations on APA administration as prescribed under Chapter 6 of the Implementation Measures for Special Tax Adjustments (Trial Implementation), Guoshuifa [2009] No.2 ("Circular 2"). It will come into effect beginning on 1 December 2016 and be applicable to APA applications that are not yet formally accepted by the tax authority before the announcement's implementation.

Since the SAT released Circular 2's revised version, Public Consultation Draft of Implementation Measures for Special Tax Adjustments ("Discussion Draft"), in September 2015 (see [China Tax Alert - Issue 25, September 2015](#)), finance and tax professionals and entrepreneurs have been expecting significant revisions to the regulations for special tax adjustments. After the SAT issued the Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation ("Announcement 42") in June 2016 (see [China Tax Alert - Issue 23, July 2016](#)), making the first step to localise Base Erosion and Profit Shifting (BEPS) action plans, we now finally witness the arrival of the updated APA administration requirements.

This alert examines the changes to APA administration requirements and analyses their implications to the taxpayer.

Regulations discussed in this issue:

- SAT Public Consultation Draft of Implementation Measures for Special Tax Adjustments (“Discussion Draft”), issued on 17 September 2015
- OECD/G20 Report “BEPS Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance” (“BEPS Action 5 Report”), issued on 5 October 2015

Main Changes

APA, including unilateral, bilateral and multilateral APA, refers to an arrangement whereby an enterprise applies in advance to negotiate and reach agreement with the tax authority in respect of the transfer pricing methods and corresponding calculation methods to be applied to its related party transactions for future years in accordance with the arm's length principle. In Circular 2, the APA consisted of six stages: pre-filing meetings, formal application, examination and appraisal, negotiation, signing of arrangement, and supervision of implementation. Announcement 64 follows this classification; however, some detailed contents in each stage are differed from Circular 2, described as:

- Pre-filing meeting
- Intention
- Analysis and appraisal
- Formal application
- Negotiation and signing
- Supervision of implementation

In comparison with Circular 2, more preparation work will be completed prior to the formal application stage. It may imply that with the implementation of a higher threshold, more efficient and rigorous work become preconditions to success in APA application. We have analysed the administrative regulation changes of each stage in the following content:

Pre-filing meeting

According to Announcement 64, the enterprise that has the intention to apply for an APA should submit an application for pre-filing meeting to the tax authority. At pre-filing meeting stage, the enterprise should submit a written “APA Pre-filing Application.” A brief description of the target APA includes the applicable years of APA, the related party transactions involved, the organisation structure of the relevant enterprise and group, the enterprise's business operations and contemporaneous documentation for the most recent three to five years, an explanation of the functions and risks of the related parties involved in the arrangement (including the allocation criteria used in allocation of functions and risks among related parties, such as operation structures involved, personnel, expenses, and assets, etc.), description of market conditions (including industry development trends and competitive environment, etc.), the existence of location specific advantages such as cost savings and market premium, whether adopted retroactive application to prior years, and any other related items requiring explanation. If the enterprise applies for a bilateral APA or multilateral APA, in addition to the items above, the enterprise shall disclose the status of the application filed with competent tax authority or authorities of counter-party country of the treaty, an overview of business operations of related parties involved in the APA and their related party transactions for the most recent three to five years, and statement of the international double taxation if any.

In the view of breadth and complexity of materials submitted at this stage, Announcement 64 includes more requirements compared to the prevailing Circular 2—under the current system, quite a number of materials abovementioned are not required to be submitted until the formal application stage. In addition, newly added requirements reveal emphasis on issues related to location specific advantages, which is consistent with the emphasis that the Chinese tax authorities have demonstrated in recent transfer pricing audits and APA practice. Compared to the prevailing procedure, Announcement 64 eliminates the possibility of requesting pre-filing meetings anonymously, thus under the new requirements, decisions and preparation made by the enterprise will need to be thorough and deliberate.

Intention

On the premise that the tax authority and the enterprise are nearing agreement in the stage of pre-filing meeting, the tax authority will issue a “Notice on Tax Matters”. The enterprise shall submit an “APA Letter of Intention” and the APA Application Draft (“Application Draft”). On top of the requirements raised at the pre-filing stage, the Application Draft contains the following contents:

- Proposed transfer pricing methodology and calculation method to be used in the APA, and the functional and risk analysis, comparability analysis and assumptions used for supporting such methodology and method;
- Value chain or supply chain analysis, with focus on the consideration of location specific advantages such as cost savings and market premium;
- Annual information on business scale, business performance forecasts and business plans for the period covered by the APA.

In particular, Announcement 64 points out that if the enterprise does not fill in and submit the “Annual Reporting Forms of Related Party Transactions” or Contemporaneous Documentation in accordance with relevant regulations, the tax authority could refuse the enterprise’s submission of application intention. In addition, where the tax authority has started special tax audit or any other tax related investigation on the enterprise, the tax authority could refuse the application intention as well. This rule will no doubt improve the threshold required for the APA.

Analysis and appraisal

According to Announcement 64, through analysis and appraisal (including site interview) and further discussion with the enterprise, the tax authority will verify whether the Application Draft is consistent with the arm’s length principle. Announcement 64 has made suggestions to the tax authority in terms of the aspects of analysis and appraisal, which is very similar to the requirements provided in Circular 2 and its revised version of Discussion Draft. Announcement 64 specifically introduces value chain analysis and

contribution analysis, and requires the tax authority to evaluate whether the enterprise's analysis fully considers location specific advantages such as cost savings and market premium; whether the local enterprise makes contribution to value creation. However, similar to the requirements in Announcement 42 in respect of Contemporaneous Documentation, Announcement 64 does not provide concrete guidance on the method to conduct analysis and quantification regarding the above factors. It would be a significant challenge to the enterprise to devise an APA approach that balances each stakeholder's interest and effectively satisfies the requirements prescribed in Announcement 64.

During the evaluation process, in those circumstances where the Application Draft is determined to be inconsistent with arm's length principle, the tax authority will negotiate with the enterprise and ask them to make adjustment until the Application Draft can be deemed as compliant with the arm's length principle or until such a point where the enterprise refuses to make further adjustments.

Formal application

The tax authority will issue a "Notice on Tax Matter" when the Application Draft is deemed as consistent with the arm's length principle, and then the enterprise will be allowed to submit a "Formal Application Letter for APA" together with a formal application report for APA. For the bilateral or multilateral APA, the enterprise shall simultaneously initiate the application for special tax adjustment mutual agreement procedures.

Negotiation and signing

Based on the APA formal application, the tax authority will carry out unilateral negotiation with the enterprise, or carry out bilateral or multilateral negotiation with the respective competent tax authority of counter-party country of the treaty. If all parties agree, the APA will be drafted and arranged for signing.

It can be anticipated that, since the tax authority and the enterprise have carried out sufficient negotiation and revisions before the generation of a formal application during the previous stages, the formal negotiation and signing stage of unilateral APA will be fairly simplified. For the bilateral or multilateral APA, the Chinese tax authority will take a relatively favourable position in the negotiation with competent tax authority of counter-party country of the treaty.

Supervision of implementation

Announcement 64 requires the enterprise to file an annual compliance report in relation to the implementation of the APA to the tax authority within six months after the end of each taxable year during the implementation period of APA. (According to the Announcement 42, related party transactions covered under the APA is exempt from contemporaneous documentation requirements). Correspondingly, the cycle that the competent tax authority monitors the enterprise's implementation status is

extended from every six months (as required by Circular 2) to every year. The inspection should address the following issues: whether the enterprise complies with the provisions and requirements of the APA, whether the annual report reflects the actual operations of the enterprise, and whether the assumptions stated in the APA remain effective, etc. The specific reporting and inspection requirements basically follow those outlined in Circular 2.

As noted under Announcement 64, if the APA applies an inter-quartile method to determine a price or profit level, and the actual operating result of the enterprise falls outside of the inter-quartile range during the implementation period of the APA, the tax authority is empowered to adjust the actual operating result to the median of the inter-quartile range. After the end of the implementation period, if the weighted average operating result falls below the median and is not adjusted to the median, the tax authority will no longer accept any application of APA renewal. In practice, the Chinese tax authority has already adopted such approach and the Announcement 64 has provided legal basis for the tax authority's such practice.

Other Changes

Compared to Circular 2, Announcement 64 also has the following changes:

Fundamental timing

- Covered period: Announcement 64 stipulates that the APA is applicable to related party transactions that are undertaken in the three to five years commencing in the taxable year when the competent tax authority issues the Notice of Tax Matters to the enterprise signalling the acceptance of the enterprise's application intention. In comparison, Circular 2 stipulates that the APA is applicable to related party transactions for the three to five consecutive years from the year following the submission of the formal written application.
- Retroactive period: Announcement 64 stipulates that the maximum retroactive period of the APA shall be 10 years. Circular 2 only provides that the APA can be applicable to previous years without a definite term.
- Annual reporting: Announcement 64 stipulates that the enterprise should submit an annual report (both printed version and electronic version) of an in-force APA to the competent tax authority within six months following the end of the taxable year, and the competent tax authority should email the electronic version to the SAT. When it comes to the bilateral or multilateral APA, the enterprise should submit the annual report (both printed version and electronic version) of the in-force APA to the competent tax authority and email the electronic version to the SAT. Circular 2 stipulates that the enterprise shall submit the annual report of the in-force APA to

tax authority within five months following the taxable year.

New administration mechanism

- Paying additional tax and tax refunding: A new requirement under Announcement 64 is that the tax authority should calculate the additional tax to be paid or refunded on a taxable year basis for the years covered or retroactively applied in the APA, and issue Notice of Additional Tax to be Paid / Tax Refund in APA to the enterprise. This is the first time that the Chinese transfer pricing regulations have required that tax shall be refunded due to transfer pricing issues. It remains to be seen how tax authority would implement and execute such mechanism in the future.

- Information exchange for unilateral APA: The clause of information exchange for unilateral APA is added into the APA as prescribed in the Announcement 64. Another new rule is that SAT is empowered to exchange information of unilateral APA that are signed after 1 April 2016 with tax authorities in other countries (regions) in accordance with the international conventions and agreements signed with overseas parties, unless national security information is involved. This provision is consistent with the recommendations in BEPS Action Plan 5 issued by Organisation for Economic Co-operation and Development (OECD)/G20, i.e. “countering harmful tax practices more effectively, taking into account transparency and substance”, and provides domestic legal basis to execute the information exchange for the rulings post 1 April 2016 under this framework. Moreover, Announcement 64 echoes the recent Announcement 42, which requires the disclosure of unilateral APA signed among group members in the group master file.

KPMG Observations

Announcement 64 is another key regulation released by the SAT in the area of special tax adjustments administration following the Announcement 42. It has incorporated the experiences accumulated and systematic process and approach developed since the release and implementation of Circular 2. It can be observed from the updated APA negotiation procedure that the tax authority will issue official “Notice of Tax Matters” during each stage, from accepting taxpayer’s intention of application to agreeing taxpayer to submit formal application and eventually entering into an agreement. Such updates indicate that China’s tax authority is standardising the administration of taxation in accordance with the rule of law, reflect service concept of the administration of taxation, and thus help the taxpayer to better understand the negotiation process and application status. However, we have also noticed that the timeline for the tax authority to respond in each stage has not been included in Announcement 64 and it remains to be seen whether uncertainty regarding application timeline will be increased. Nevertheless, overall, as the regulation to govern the legal procedure of China’s

APA administration, Announcement 64 will provide clearer guidance to taxpayer's APA application.

Against the international backdrop of OECD/G20 BEPS initiatives and domestic changing landscape in the taxation domain in China, Announcement 64 represents the consistent views and stance held by the Chinese tax authority. For example, value chain or supply chain analysis, and location specific advantages analysis including cost savings and market premium are repeatedly emphasized in the stages when the taxpayer submits pre-filing package and draft application, as well as when the tax authority prioritises to accept and assesses the APA application; adjustments shall be made based on the median when the tax authority monitors the APA implementation. In addition, Announcement 64 reflects that the tax authority attaches importance to taxpayer's reporting compliance and this heightened attention is consistent with the trend to enhance taxation transparency. For example, included in the provisions addressing taxpayer's pre-filing package, tax authority's acceptance of intention of application and formal application as well as cases of prioritised acceptance, etc., Announcement 64 makes reference to taxpayer's obligations of related party transactions reporting, contemporaneous documentation and preparation of other relevant materials. These requirements are in consistence with the enhancement of the reporting of related party transactions and administration of contemporaneous documentation raised by the Announcement 42, which urges the taxpayer to prepare and provide high quality materials, such as related party transactions reporting and analysis.

Announcement 64 covers APA applications that are not yet formally accepted by the tax authority. For those in-process and upcoming applications, we recommend that the taxpayer re-evaluate the application materials with reference to Announcement 64. This ensures that the taxpayer will meet the requirements as outlined under the new regulations and to push the tax authority to prioritise the acceptance of the application and reach a successful agreement.

