KPMG

China Tax Alert

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SAT Releases the Long-awaited Announcement on Special Tax Investigations, Adjustments and Mutual Agreement Procedures

Regulations discussed in this issue:

- The State Administration of Taxation (SAT) of the People's Republic of China's (PRC) Announcement on Special Tax Investigations, Adjustments and Mutual Agreement Procedures (Announcement 6"), released on 28 March 2017, and with an issuance date of 17 March 2017
- SAT Announcement on the Enhancement of the Administration of Advance Pricing Agreements ("Announcement 64"), issued on October 18, 2016
- SAT Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation ("Announcement 42"), issued on June 29, 2016

Executive Summary

On 28 March 2017 the SAT released its long-awaited Announcement on Special Tax Investigations, Adjustments and Mutual Agreement Procedures ("Announcement 6"). This followed on from the release of China's revised transfer pricing compliance regulations earlier in June 2016. Announcement 6 integrates some of the OECD BEPS work, particularly in relation to intangibles, into domestic regulations. It also consolidates previous regulations on self-adjustments and outbound payments, and writes into regulation some of the existing practices adopted for transfer pricing audits.

With the introduction of Announcement 6, taxpayers will be able to better understand the focus points and the rationale of tax authorities when undertaking transfer pricing investigations. We foresee more standardized transfer pricing investigation practices in the future.

Furthermore, given that Announcement 6 regulates both outbound payments and inbound receipts of royalty and service fees, while prior Chinese transfer pricing regulations focused mainly on outbound payments, it appears that the first steps are being taken to administer the transfer pricing of outbound-investing Chinese multinationals.

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Regulations discussed in this issue:

- SAT Public Consultation Draft of a Circular on Implementation Measures for Special Tax Adjustments (“Discussion Draft”), issued on September 17, 2015
- SAT Announcement on Regulating the Administration of Cost Sharing Arrangements (“Announcement 45”), issued on 16 June, 2015
- SAT Announcement regarding Corporate Income Tax ("CIT") Matters on Outbound Payments to Overseas Related Parties ("Announcement 16"), issued on 18 March, 2015
- SAT Announcement on Monitoring and Administration of Special Tax Adjustment (“Announcement 54”), issued on August 29, 2014
- SAT Announcement on Implementation Measures of Tax Treaty Mutual Agreement Procedures (“Announcement 56”), issued on 24 September, 2013
- SAT Circular on Strengthening the Monitoring and Investigation of Cross-Border Related-Party Transactions, Guoshuihan [2009] No. 363 (“Circular 363”), issued on July 6, 2009
- SAT Circular on Strengthening the Transfer Pricing Follow-up Administration, Guoshuihan [2009] No. 188 (“Circular 188”), issued on April 16, 2009
- SAT Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation), Guoshuifa [2009] No. 2 (“Circular 2”), issued on January 8, 2009
- The Corporate Income Tax Law of the People’s Republic of China promulgated by the National People’s Congress, effective 1 January 2008 (“CIT Law”)

Main contents

Announcement 6 replaces Chapters 4, 5, 11 and 12 of Circular 2, Circular 188, Circular 363, Announcement 54 and Announcement 16, and is effective from May 1st 2017.

Announcement 6 includes 62 Articles and can be broadly divided into the following parts:

Articles 2-14, 23-29 & 37-46	*Special tax investigations*
Articles 15-22	*Comparability factors and transfer pricing methods*
Articles 30-33	*Specific provisions on intangible assets*
Articles 34-36	*Specific provision on services*
Articles 47-61	*Mutual agreement procedures*

Special tax investigations

Announcement 6 notes that the scope of special tax adjustment investigations cover all of the matters set out in Chapter 6 of the CIT Law, including transfer pricing, thin capitalization, controlled foreign companies (“CFC”) and general anti-avoidance rules (“GAAR”). It also unequivocally states that foreign tax residents can be subject to investigation, which is particularly relevant in cases involving controlled foreign companies and general anti-avoidance matters.

Announcement 6 provides that tax authorities shall focus in particular on enterprises with the following characteristics when conducting special tax investigations:

1	*Enterprises with significant amount of related-party transactions or relatively more types of related-party transactions*	*Similar to Circular 2*
2	*Enterprises with continuous losses, low profitability or fluctuating profitability*	*Similar to Circular 2*
3	*Enterprises with profit levels lower than those of other enterprises in the same industry*	*Similar to Circular 2*
4	*Enterprises whose profit levels do not match their functional and risk profiles or whose shared benefits do not match their allocated costs*	*Scope expanded to include enterprises whose shared benefits do not match their allocated costs, which is particularly relevant in a cost sharing arrangement*
5	*Enterprises that engage in transactions with related parties in low tax countries (jurisdiction)*	*Circular 2 focused on enterprises that transact with related parties in tax havens*
6	*Enterprises that fail to file their related-party transaction reporting forms or to prepare contemporaneous documentation*	*Similar to Circular 2*

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Regulations discussed in this issue:

- OECD/G20 Report "BEPS Action 13: Transfer Pricing Documentation and Country-by-Country Reporting" issued on 5 October 2015, ("BEPS Action 13 Report")
- OECD/G20 Report "BEPS Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation" issued on 5 October 2015 ("BEPS Actions 8-10 Report")
- OECD/G20 Report "BEPS Actions 14: Making Dispute Resolution Mechanisms More Effective" issued on 5 October 2015 ("BEPS Action 14 Report")
- The United Nations Practical Manual on Transfer Pricing for Developing Countries, 2013 ("UN TP Manual")
- 2016-2018 Administration Plan for International Tax Compliance, Jiangsu Provincial Office, SAT, Su Guo Shui Fa [2016] No. 125 ("Su Guo Shui Fa [2016] No. 125")

7	*Enterprises whose related-party debt-to-equity ratio exceeds the standard ratio*	*New – thin capitalization*
8	*Enterprises controlled by Chinese tax resident companies, or by Chinese tax resident companies together with Chinese nationals, which are established in a country (jurisdiction) where the effective tax rate is lower than 12.5%, and have failed to distribute profits or reduced distributable profits other than for reasonable operating needs*	*New – controlled foreign companies*
9	*Enterprises who engage in tax planning schemes or tax arrangements that lack reasonable business purposes*	*New – general anti-avoidance*

The penalty regime is generally consistent with Circular 2. Specifically, Announcement 6 provides that an interest payment should be charged for additional tax levied on transactions after 1 January 2008, and this interest payment should be calculated based on PBOC benchmark lending rate plus a punitive rate of 5% from the filing date for the year of assessment being adjusted. The punitive rate though could be waived if the taxpayer prepared contemporaneous transfer pricing documentation and other materials as requested by tax authorities. Late payment charges are applicable at 5% a day (approximately 18.25% per annum) immediately after the payment due date, however, interest is not applicable to this late payment period.

Announcement 6 includes many specific provisions on transfer pricing investigations. It integrates many concepts introduced in earlier regulations and some of the practices that have been followed by tax authorities in conducting transfer pricing audits. These include:

- *"Simple-function" entities:* Announcement 6 provides that companies engaged in the provision of single-function manufacturing (tolling or contract manufacturing), simple distribution or contract R&D shall in principle maintain a reasonable profit level. Such companies shall prepare a Local File if they have incurred losses notwithstanding that the magnitude of their related-party transactions falls under the normal Announcement 42 documentation preparation thresholds. Tax authorities may conduct special tax audits where these companies bear risks and consequential financial losses that should have been borne by related parties due to reasons such as strategic failures, under-utilized capacity and R&D project failures. Similar provisions were previously set out in Circular 363.

- *Payments made to "low-substance" entities:* Announcement 6 provides that tax authorities may make adjustments to the full amount of payments made to overseas related parties that have not performed any functions, borne any risks or carried out any substantive activities that have been claimed for tax deduction, if the payments made are not arm's length. A similar provision existed in Announcement 16, but that provision did not include the condition of "if the payments made

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are not arm's length". Consequently, Announcement 16 had been interpreted to mean that all payments made to "low-substance" entities shall be denied full deduction regardless of the actual facts and circumstances. This newly added condition "if the payments made are not arm's length" is significant as it provides protection to taxpayers to the extent that their outbound payments are at arm's length, despite those being paid to "low-substance" entities.

- *Self-adjustments:* Announcement 6 integrates Announcement 54, providing that tax authorities retain the right to conduct special tax audits notwithstanding any self-adjustments made by taxpayers. Announcement 6 further states that tax authorities shall initiate special tax audit procedures in cases where taxpayers request tax authorities to confirm the principles and methods of the pricing of related party transactions. When taxpayers choose to self-adjust, they will need to complete the newly introduced "Special Tax Adjustments Self-Payment Form"

- *Selection of tested party:* Announcement 6 provides that, following consideration of the function and risk profile of the related parties in a transaction, the simpler party shall be selected as the tested party for transfer pricing analyses. The Chinese tax authorities have, in the past, criticized the practice of always selecting the Chinese taxpayer as the tested party (particularly in a transactional net margin method ("TNMM") analysis). They assert that this is done irrespective of the complexity of the Chinese taxpayer's function and risk profile. The introduction of this provision demonstrates that more technically rigorous transfer pricing analyses are expected of in the future. This provision is also consistent with OECD recommendation which provides that "in a transfer pricing analysis where the most appropriate transfer pricing method is the resale price method, the cost-plus method, or the transactional net margin method, the less complex of the parties to the controlled transaction is often selected as the tested party". (Para 6.198 of BEPS Actions 8-10 Report)

- *Toll manufacturing:* Announcement 6 provides that tax authorities may make adjustments for the value of materials and equipment legally held in the ownership of the offshore principal when determining the appropriate profit for a toll manufacturer, when comparable companies cannot be found. It is worth noting that this provision represents some improvement from the Discussion Draft which had been taken to mean that adjustments for the value of materials and equipment can be made irrespective of the existence of comparable companies. This being said, comparable companies can be difficult to find, and thus the actual effect of this slightly improved provision may not be significant unless the principal employs third party toll manufacturers. Working capital adjustments may also be made if taxpayers provide factual and complete information on their toll manufacturing value chains. However, the adjustment needs to be under 10%, or a reselection of comparable companies will be required. It is also worth noting that Announcement 6 appears to provide no room for working capital adjustments under any other circumstances. This is different from Circular 2, which provided that working capital adjustments can be made subject to SAT's approval.

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- *Location specific advantages ("LSAs"):* The Chinese tax authorities have long been emphasizing the importance of LSAs and their impact on pricing when conducting transfer pricing analysis, as seen in the China Country Practices chapter in the UN TP Manual, Announcement 42 and Announcement 64. Announcement 6 provides that when comparable companies operate in a different economic environment from the taxpayer under audit, tax authorities shall analyze LSAs such as location savings and market premium and select appropriate transfer pricing methods to determine LSAs' contribution to profits (Article 27). The particular manner in which Article 27 is written appears to suggest that there is a presumption that there would be profits attributable to LSAs. This is different from OECD discussion in the BEPS Actions 8-10 Report on local market features, which discusses how location savings may ultimately dissipate, being passed on to independent customers or suppliers. Announcement 6 does not included any detailed guidance on how LSAs and their impact on profit shall be quantified. The only guidance that has been published by the SAT is a simple example on how to calculate the adjusted full cost mark-up for a comparable set comprising of foreign companies, taking into consideration location savings. This was included in the China Country Practices chapter in the UN TP Manual.

Announcement 6 also introduces some new provisions, including:

- *Right to investigate non-resident enterprises and tax authorities' powers:* Announcement 6 explicitly notes that special tax investigations can be performed on non-resident enterprises. Furthermore, tax authorities are empowered to request information from all the other enterprises relevant to the investigation in addition to the audit target and its related parties. For example, third parties such as upstream suppliers or downstream customers may be requested to submit information as tax authorities see fit. In contrast, Circular 2 limited such other enterprises to comparable companies. Tax authorities are even allowed to deduce the whole picture by leveraging whatever data they have on hand should the taxpayer under audit fail to provide the requested information or the provided information be inaccurate or incomplete.

- *Restrictions during special tax investigations:* Tax authorities have the right to forestall a taxpayer filing relating to a change of business address (e.g. for a company looking to change its tax district and in the in-charge tax authority such as when one company merges into another in a different China tax district) or cancellation of tax registration during a special tax investigation period, which further strengthens the ability of the tax authorities to control companies that are under special tax investigations.

- *Statistical methods:* Announcement 6 provides that simple arithmetic means, weighted averages and interquartile ranges can all be used to test the related party transactions, and they can be calculated on a single-year or weighted-average basis. This provides great flexibility to tax authorities in calculating the amount of transfer pricing

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adjustments. In addition, Announcement 6 states that adjustments shall be calculated on a yearly basis, removing any potential opportunity for taxpayers to reduce adjustments by calculating transfer pricing adjustments on a weighted average basis. When an interquartile range has been used, in principle adjustments shall not be made to lower than the median, which is consistent with Circular 2.

- *Hidden or offsetting transactions:* Announcement 6 provides that where transactions are hidden or offsetting and there has been a direct or indirect reduction in national tax receipts, the tax authorities may conduct special tax audits to 'restore' these transactions. Interestingly, Announcement 6 has left out the re-characterisation provision introduced in the Discussion Draft. Although some may argue that restoring hidden or offsetting transactions is tantamount to a re-characterisation, they do appear much narrower in scope.

Alongside these additional provisions, which will largely have the effect of increasing the rigor of transfer pricing investigations going forward, Announcement 6 incorporates some changes which may be considered more positive compared with Circular 2. The notable ones include:

- Qualified taxpayers, who have reached an agreement with tax authorities in an advance pricing agreement ("APA") pre-filing and filed an intention letter with a rollback request, or who have submitted a renewal application for APAs, should not be made audit targets of special tax adjustments. However, this does not apply to those related party transactions that are not covered in the APA.

- Announcement 6 does not require taxpayers under special tax investigation to fill in the Comparability Factor Analysis Form which is a burdensome task for most taxpayers in an audit under Circular 2. This might stem from the fact that plenty of the information requested in this form is generally not available to taxpayers. Therefore, the SAT does not see this form as informative or useful as originally expected.

- Whilst Announcement 6 retains the tax authorities' rights to use non-public information in conducting comparability analysis, it provides that the use of public information shall be prioritized.

- Whilst Circular 2 stated very clearly that taxes paid relating to overseas related party interest, rent, and royalty payments involved in a transfer pricing adjustment will not be subject to a corresponding adjustment, Announcement 6 appears to leave some room by stating that such taxes paid will not be adjusted downwards unless otherwise provided.

- Previously under Circular 2, taxpayers who have been audited are required to undergo a five-year follow-up administration period and must prepare contemporaneous transfer pricing documentation during this period. Such a requirement no longer exists under Announcement 6. This will have the effect of removing such taxpayers' burden to prepare contemporaneous transfer pricing documentation when they do not meet the threshold as prescribed under Announcement 42. Instead, tax authorities will monitor such taxpayers' profit margin in a risk management-oriented manner.

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It is also worth mentioning that the controversial provision in the Discussion Draft which required adjustment to be made to the accounting books following special tax investigations is absent from Announcement 6.

These being said, there are still some concerns stemming from Circular 2 that remain to be addressed. A particular one relates to the audit procedures for domestic related party transactions. Announcement 6 follows Circular 2 to provide that transfer pricing investigations and adjustments need not, in principle, be made between two domestic enterprises whose tax rates are equal, as long as the transactions have not directly or indirectly decreased the overall tax revenue of the country. However, it has not clarified the audit procedures on domestic transactions conducted between related parties whose tax rates are different and which have led to an overall reduction in tax in China.

Some tax authorities have been quite zealous about investigating domestic related party transactions, and we hope that the SAT would issue further guidance on this matter.

Comparability analysis and transfer pricing methods

Announcement 6 includes a significant section on comparability factors and transfer pricing methods.

Some of the more significant additions include:

- *Contractual arrangements:* Although Announcement 6 does not incorporate detailed discussions on the delineation of related party transactions, as provided for in the BEPS Actions 8-10 Report, it has incorporated some of the concepts. This is a welcome clarification compared with the Discussion Draft. In particular, it requires consideration to be made to parties' ability to execute a contract, parties' actual conduct in executing a contract and the reliability of the terms of a contract entered into between related parties in conducting comparability analysis.

- *Synergies:* Similar to the BEPS Actions 8-10 Report, Announcement 6 recognises MNE group synergies as a comparability factor.

- *LSAs:* Announcement 6 adds LSAs such as location savings and market premium as comparability factors. This is consistent with OECD's recognition under the BEPS Actions 8-10 Report as well as Chinese tax authorities' ongoing emphasis on LSAs and their impact on pricing and profits. In the discussion on the use of the profit split method, it is also clearly stated that LSAs such as location savings and market premium shall be considered in determining the appropriate allocation factors to allocate residual profits.

- *Comparable uncontrolled price ("CUP") method:* Following the explicit recognition of transfers of financial assets as a category of related party transactions in Announcement 42, there is now detailed discussion on the comparability factors that shall be considered when using the CUP method to price or evaluate such transactions, including equity transfers.

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- *(In)Appropriateness of the TNMM in the presence of significant intangible assets:* Announcement 6 states that the TNMM is generally used where transacting taxpayers do not possess 'significant intangible assets' in connection with the transfers of the ownership of or rights to use tangible and intangible assets. The term 'significant intangible assets' is not defined, and it is not clear whether the SAT is concerned by possession of such assets by just the potential tested party, or by either party. The BEPS Actions 8-10 Report concedes that where a transacting party possesses 'unique and valuable' intangibles (i.e. intangibles which are not comparable to intangibles used by or available to other parties, so rendering direct comparison impossible) then, unless reliable comparability adjustments can be made, one-sided transfer pricing methods may not be appropriate and non-comparables based methods may need to be used. To this degree, there is some alignment between the BEPS and SAT approaches. However, Announcement 6 makes no distinction between 'unique and valuable' and 'routine' intangibles although the OECD takes the position that where routine intangibles are in point, one-sided methods may still be used. It will not be a surprise if the TNMM loses its prominence as a result of the presence of significant intangible assets, regardless whether they are unique and valuable or not.

- *Valuation methods:* In parallel with the focus on transactions in intangible assets and equity transfers seen in this Announcement and Announcement 42, valuation methods (cost, market, and income methods) are introduced to support transfer pricing analysis of these transactions.

- *Other methods that are in compliance with the arm's length principle:* Announcement 6 states that transfer pricing methods include the CUP method, resale price method, cost plus method, TNMM, profits split method and other methods that are in compliance with the arm's length principle. Other methods that are in compliance with the arm's length principle are defined to include valuation methods and those that can appropriately reflect the principle that profits should be taxed where economic activity takes place and where value is created. This principle is consistent with BEPS Actions 8-10 Report although there are no detailed discussions on other methods in BEPS Actions 8-10 Report. The controversial value chain apportionment method introduced in the Discussion Draft, which was considered akin to formulary apportionment by some, has been removed. Nevertheless, the broadly worded *other methods* does appear to leave room for tax authorities to introduce methods other than CUP method, resale price method, cost plus method, TNMM, profit split method and valuation methods in conducting transfer pricing investigations as long as they are considered to reflect the principle that profits should be taxed where economic activity takes place and where value is created.

Specific provisions on intangible assets

Announcement 6 seeks to integrate the SAT's unique transfer pricing approach to intangible assets, which has been developed over a number of years, and some of the BEPS-updated transfer pricing guidance in this

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area. The SAT's transfer pricing approach to intangible assets, set out in particular in the China Country Practices chapter of the UN TP Manual, is, like the LSA concepts, driven by the SAT position that certain upstream and downstream value chain activities have been over-emphasized in the transfer pricing practices developed in Western countries. The SAT's approach emphasizes that intangible assets, such as technical know-how and marketing intangibles, are created by Chinese subsidiaries of MNE groups in the course of manufacturing and selling, respectively. These intangibles may be regarded as 'economically' owned by the MNE Chinese subsidiaries. Alternatively, the efforts of the Chinese subsidiaries in selling and manufacturing may be viewed to enhance the intangible assets in the legal ownership of overseas MNE entities.

Previously there was little guidance on transfer pricing for intangible assets apart from Announcement 16, which included two specific articles on intangibles. Specifically:

- *Article 5:* "Where an enterprise pays a royalty for the use of an intangible asset provided by an offshore related party, consideration shall be given to the degree of contribution made by all the parties concerned towards the value creation of that intangible asset in determining the economic benefits to be enjoyed by the respective parties. Where an enterprise pays a royalty to a related party that merely has the legal ownership of the intangible asset but has not made any contribution to the creation of the value of the asset, as (or if) such royalty is not in line with the arm's length principle, it shall not be deductible in calculating the taxable income."

- *Article 6:* "Where an enterprise sets up a holding company or financing company outside China for the purpose of listing and pays a royalty to the offshore related party for ancillary benefits arising from the listing activity, such royalty shall not be deductible in calculating the taxable income."

These have been revised and integrated into Article 30 to Article 33 in Announcement 6. In particular, Article 32 now provides that where an enterprise pays or receives a royalty, if [the magnitude of] such a royalty does not match the economic benefit derived to the enterprise and thus has reduced the taxable income of the enterprise or its related party, tax authorities are empowered to initiate special tax investigations. If the licensed intangibles do not bring any economic benefit and if the transactions are not arm's length, tax authorities are empowered to make adjustments up to the full amount of the royalties paid. Article 32 then goes on to state that where an enterprise pays a royalty to a related party that merely has the *ownership* of the intangible asset, and *if the royalties are not arm's length*, tax authorities are empowered to make adjustments up to the full amount of the royalty.

The first part of Article 32 that discusses the matching between royalty paid and the economic benefit derived is consistent with BEPS principles and appears to suggest that adjustments will not need to be made provided the royalty paid matches the economic benefit derived to the

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enterprise. This is different and an improvement from Article 5 of Announcement 16 which has been interpreted by some authorities to mean that royalties should be adjusted in full regardless of the benefit derived as long as they are paid to an offshore related party that merely possesses the legal ownership of the intangible asset.

Another interesting point is that whilst in the past all discussion in this area focused on outbound payments made by Chinese taxpayers to offshore related parties, Articles 31 and 32 of Announcement 6 also regulate those companies that receive royalty payments from related parties. This presents a more well-rounded administration for intangible asset transactions when compared to the previous relevant regulations. As more and more China based groups invest overseas and export intangibles overseas, there may come a time that the Chinese tax authorities will pay more attention to the arm's length nature of the royalties received by Chinese taxpayers who license out intangibles.

Articles 30 and 31 integrate the BEPS Actions 8-10 Report recommendations on intangible assets into Chinese law. These two articles are particularly thin compared with the lengthy discussions dedicated to intangibles transfer pricing discussions in the BEPS Actions 8-10 Report.

Article 30 introduces the DEMPEP (development, enhancement, maintenance, protection, exploitation and promotion) approach. This states that when determining the level of contribution of an enterprise and its related parties to intangible assets, and the consequential economic benefits that should be enjoyed by each entity, several analyses shall be made. These include analyses of the group's operating processes, the parties' contributions to the DEMPEP of the group's intangible assets, how the value of intangible assets is realized, and the correlation between intangibles and the functions, risks and assets of the group's other businesses.

The BEPS Actions 8-10 Report provides that the contributions of MNE group members to the value of intangible assets is to be evaluated by examining DEMPE (development, enhancement, maintenance, protection and exploitation) functions performed, assets used and risks assumed.

The additional P (i.e. promotion) reinforces the historic Chinese emphasis on the importance of China market promotion and Chinese consumer product awareness building as value drivers for marketing intangibles, such as foreign brands.

Article 30 also provides that enterprises that merely possess the legal ownership of intangible assets but which have not contributed towards the value creation of the intangible assets shall not participate in the sharing of the economic benefit arising from the exploitation of such intangible assets. It also provides that enterprises that have only contributed funding but have not performed any related functions or borne any risks in the creation and exploitation of intangible assets shall be entitled to a financing return only. These provisions are consistent with recommendations under the BEPS Actions 8-10 Report.

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Article 31 provides that royalties received or paid as a result of licensing transactions shall be adjusted in accordance with the following conditions, and tax authorities are empowered to conduct special tax investigations otherwise:

(i) The value of intangible assets have changed fundamentally.

(ii) In accordance with usual business practices, there should have been an adjustment mechanism on royalty for comparable transactions between unrelated parties.

(iii) The functions performed, risks assumed and assets used by the enterprise and its related parties have changed during the course of the exploitation of intangible assets.

(iv) The enterprise and its related parties have not been appropriately compensated in the ongoing DEMPEP of intangible assets.

These are generally consistent with recommendations under BEPS Actions 8-10 Report, although discussions there are much more detailed.

Specific provisions on services

Announcement 6 moves to integrate the SAT's approaches, developed through enforcement practice and detailed in Announcement 16, for determining whether and to what extent related party service transactions are arm's length.

Article 34 defines arm's length related party service transactions as beneficial service transactions that are priced according to business practices and fair prices for transactions conducted between unrelated parties under the same or similar circumstances. In determining whether a service is a beneficial service, Announcement 6 requires the service to be able to deliver 'direct or indirect economic benefit', alongside a requirement that the service must be one which an independent enterprise would have willingly paid for it or performed it for itself (the latter is equivalent to the OECD's 'benefit test').

Article 35 provides that the following types of services provided by related parties shall not be considered beneficial services:

(i) A service activity that has already been procured or carried out by the enterprise itself.

(ii) A service activity that is carried out to exercise control, management and supervision of the enterprise with a view to protecting the investment interests of a direct or indirect investor.

(iii) A service activity that is not specifically carried out for the enterprise although the enterprise has obtained an incidental benefit by belonging to a particular group.

(iv) A service activity that has already been paid for in another related party transaction.

(v) A service activity that is not relevant to the functions performed or risks assumed by the enterprise, or does not meet the business needs of the service recipient.

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(vi) Any other services that cannot bring direct or indirect economic benefit to the service recipient, or the service recipient would be unwillingly to pay for it or perform it for itself.

These types of non-beneficial services are consistent with those listed in Announcement 16. Announcement 6 further provides examples for types (ii) to (vi) non-beneficial services to reduce the risk of misinterpretation.

Article 36 introduces the direct and indirect charging methods for related party services. These are consistent with the recommendations provided under BEPS Action 8-10 Report.

A notable omission, compared with the recommendations provided under BEPS Action 8-10 Report, is the simplified approach for low value-adding intragroup group services. This is no surprise given SAT's long-standing position that all related party service transactions are high risk transactions.

Announcement 6, similar to Announcement 16 and the Discussion Draft, has not provided any guidance on the types or extent of the documents that taxpayers should prepare and maintain to support the beneficial services. The lack of such guidance may lead to extra burden of proof on taxpayers in response to tax authorities' inquiries on intra-group services, in particular on finance, tax, HR and legal activities. We hope SAT will issue further guidance on this matter in the near future.

Similar to the relevant provisions relating to intangible assets, Announcement 6 has also put emphasis on the provision of intra-group services and the receipt of service fees by Chinese entities from overseas.

Mutual agreement procedures

SAT Announcement 56, issued in 2013, sets out the implementation measures for mutual agreement procedures ("MAP"). Announcement 6 includes specific provisions on MAP relating to special tax adjustment matters, and clarifies that MAP procedures on the interpretation or implementation of tax treaty articles shall follow the provisions under Announcement 56. It should be noted that Announcement 56 is not abolished by Announcement 6 and is still in force.

Unlike Announcement 56, which states that MAP applications shall be made to the provincial level office of SAT, Announcement 6 provides that MAP applications relating to special tax adjustment matters must be made directly to the SAT. The competent tax authorities responsible for special tax adjustment matters (usually provincial level tax authorities) are responsible for delivering notices to the applicants and monitoring/implementing the collection or refund of the relevant taxes subsequent to the conclusion of MAP negotiations.

While Article 9(vi) of Announcement 56 provides that a Chinese tax resident may apply for MAP assistance in cases where it may or has already been double-taxed, Article 52(v) of Announcement 6 provides that applications may be denied for enterprises undergoing special tax

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investigations or which have not cleared tax payables after the conclusion of special tax investigations. This means a Chinese tax resident will not be able to seek MAP assistance in special tax adjustment matters unless it has actually been double-taxed. This is consistent with Circular 2 under which an application for corresponding adjustments can only be lodged once the enterprise or its related parties have received the transfer pricing adjustment notice. A notable difference though, is that Circular 2 provides that applications must be made within 3 years of receiving transfer pricing adjustment notices whereas Announcement 6 makes general references to double tax treaties signed by China which regulate the specific time limit on MAP applications. Despite OECD efforts to improve the effectiveness of dispute resolutions, Announcement 6 does not provide any indication on the time that the SAT would take to resolve MAP cases.

MAP cases are accepted as of the date the applications have been received. In case of postal applications, taxpayers may wish to obtain some form of written confirmation from the SAT on the receipt of their applications. MAP cases which have been accepted but not resolved will be subject to the provisions in Announcement 6.

KPMG Observations

Announcement 6 is a monumental piece of regulation in China's transfer pricing history. It has incorporated many existing SAT practices and leveraged BEPS-updated transfer pricing guidance into domestic regulations and guidance. Its impact on taxpayers will be profound over the coming years.

Special tax investigations

The provision dealing with payments made to "low-substance" entities is much softer and "reasonable" compared with Announcement 16. Hopefully its application will be more in-line with BEPS-updated transfer pricing guidance, which does not entirely preclude deductions for payments made to "low-substance" entities, but does seek to prevent profits being improperly shifted to "low-substance" entities. It is hope that, making reference to the Announcement 6 regulation , tax authorities will not only look at the substance of the particular "low-substance" entity receiving the payment, but also at any additional substance in other relevant entities when evaluating the arm's length nature of payments made to "low-substance" entities. This approach would help to ensure that the Chinese taxpayers are not unfairly subject to double taxation simply because they have made payments to offshore "low-substance" entities, despite the payments themselves being "arm's length", i.e. they match the economic benefits derived by the Chinese taxpayers and are consistent with what third parties would be willing to pay under comparable circumstances.

Many of the new provisions relating to special tax investigations represent the SAT's practices, developed over the past few years. It is worth noting that some of these provision are not related to BEPS-updated transfer pricing guidance per se, and the application of these provisions may in fact lead to some degree of inconsistency against BEPS-updated transfer pricing guidance.

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The toll manufacturing provision, for example, appears to completely negate the control exercised by the principal, the risks assumed by the principal, and related financial consequences, by requiring a toll manufacturer's remuneration to emulate that of a contract manufacturer, unless comparable companies can be found. In reality, good comparable companies are difficult to find and even if they exist they may not be available in the public domain, which means that many taxpayers will have no choice but to price their toll manufacturing transactions as contract manufacturing transactions to avoid being investigated by tax authorities. BEPS-updated transfer pricing guidance, in seeking to tackle the artificial assumption of risk (and often great profits), emphasize that consideration must be given to a party's control over risk, and its financial capacity to assume risk, in allocating risks and the related financial consequences entities. By contrast, Announcement 6 in its entirety includes no substantive discussion on SAT's approach to the analysis and treatment of risk, nor does it give any indication of what emphasis and weight the SAT would put on the capacity of an enterprise to control the risks that it bears. This in some way is not surprising given SAT has traditionally put more emphasis on functions and the omission of any discussion on risk suggests that the SAT will continue favoring analyzing functions going forward.

Whilst the references to LSAs in Announcement 6 do not appear to be at odds with the discussion on location savings and local market features in BEPS Actions 8-10 Report, the discussion on LSAs in Announcement 6 (and indeed in Announcement 42 and Announcement 64) are far less detailed than in BEPS Actions 8-10 Report, and latitude is left for local authority interpretation and application. Notably, while the BEPS Actions 8-10 Report discusses how location savings may ultimately dissipate, being passed on to independent customers or suppliers, Announcement 6 makes no such observation. The lack of a systematic approach, and SAT's traditional inclination to use the presence of LSAs to reject the use of one-sided transfer pricing methods, may also lead to different results as intended by the BEPS work.

Comparability factors and transfer pricing methods

Announcement 6 writes into regulation valuation methods as appropriate transfer pricing methods to price related party transactions. This is consistent with recommendations under BEPS Actions 8-10 Report which provides that valuation methods can be used to price transactions involving intangible assets.

Although the value chain apportionment method, introduced in the Discussion Draft, has been dropped, the broadly worded 'other methods', i.e. those that can appropriately reflect that principle that profits should be taxed where economic activity takes place and where value is created, do leave plenty of room for SAT to introduce new methods into transfer pricing investigations. Indeed, it will be no surprise if the value chain apportionment method, or equivalent, is used in practice going forward. In fact, the Jiangsu Provincial Office of SAT, a pioneer in transfer pricing in China, has already recommended taxpayers to adjust their mindset and

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attempt using a new transfer pricing method based on value chain analysis (which basically requires allocating value chain profits to participants based on one or a set of core indicators such as assets, sales, expenses and costs), though it did say that the simple use of formulary apportionment should be avoided. This new method would appear very similar to the value chain apportionment method.

The SAT has also tried to restrict the use of one-sided methods by requiring taxpayers to examine the presence of LSAs and/or significant intangible assets in determining the appropriateness of a particular transfer pricing method. One sided methods, in particular the TNMM, have been a long-time favorite of Chinese taxpayers in part due to their ease of application, i.e. the ability to find third parties that conduct broadly comparable functions. The SAT has, in the past, as can be seen in the China Country Practices chapter in the UN TP Manual, expressed their particular concern on finding "good" comparable companies for developing nations. They argue that because of the presence of LSAs, comparable companies found in developed country datasets cannot be simply used without performing appropriate adjustments. In recent years, the SAT has also been questioning or dismissing the use of comparable companies-based approaches on the basis of the presence of local intangibles. Announcement 6 now appears to invalidate the TNMM when significant intangible assets are present in a transaction. As there is no definition of "significant intangible assets" in Announcement 6 and this concept is different from the "unique and valuable intangibles" concept used in the BEPS Actions 8-10 Report, it leaves lots of room for the Chinese tax authorities to invalidate the TNMM whenever intangibles are deemed to be significant regardless of their routine or non-routine nature. Combining this with the LSA concept, it is unlikely that a one-sided method, or at least a one-sided method on its own, will stand up in a transfer pricing investigation on a complex transaction.

Specific provisions on intangible assets

To start off, discussions on transfer pricing aspects of intangible assets are extremely thin, particularly considering that intangibles is such a critical subject in transfer pricing and often the source of many disputes between tax authorities and taxpayers and between competing tax authorities. The lack of detailed discussion, unless supplemented by case studies or official interpretations, will likely lead to varied interpretation and application in practice.

Announcement 6 sets out the DEMPEP approach, adding a final 'P' to the DEMPE approach recommended by the OECD as part of the BEPS project. Whilst it does not differ significantly differ from OECD recommendation, as the final P (promotion) might be considered to be implicitly included in the final E (exploitation) under OECD DEMPE, the explicit inclusion of it does reinforce the historic Chinese emphasis on the importance of China market promotion and Chinese consumer product awareness building as value drivers for marketing intangibles.

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Perhaps one of the most important Announcement 6 omissions compared with the BEPS Actions 8-10 Report, is the OECD discussion in the latter on the more important functions leading to the value creation of intangibles. For example, the BEPS Actions 8-10 Report lists design and control of research and marketing programs, direction of and establishing priorities for creative undertakings, including determining the course of "blue sky" research, control over strategic decisions regarding intangible development programs, and management and control of budgets as the more important functions for self-developed intangibles or for or for self-developed or acquired intangibles that serve as a platform for further development activities. (6.56, BEPS Actions 8-10 Report).

The 'more important functions' are central to the OECD DEMPE approach. These important functions usually make a significant contribution to intangible value and the performance of these more important functions will arguably entitle the entity(ies) of a greater share of returns derived by the MNE group from the exploitation of intangibles compared with those entities that perform more routine functions. The difference in the interpretation of the 'more important functions' can lead to drastically different transfer pricing outcomes. The omission leaves great latitude to the Chinese tax authorities in determining which functions are more important and hence can attract greater share of profits.

The DEMPEP approach and the lack of description of 'important functions' as well as the SAT's historic emphasis on 'middle value chain activities' frequently carried out by MNEs in China (e.g. manufacturing, trial production etc.) and China market-building activities, could readily lead to a divergence between Chinese and foreign tax authorities, with the potential for double taxation this brings. It is also quite possible (drawing on past China enforcement practice) that the Chinese tax authorities will focus on the 'performance' of DEMPEP functions, to a greater degree than on their 'control' (the preference of the OECD).

Another important omission from Announcement 6 is discussions on hard-to-value-intangibles ("HTVI") and in particular the applicability of hindsight when evaluating the pricing of transactions involving HTVIs. Without such guidance, taxpayers could be extremely vulnerable if challenged by tax authorities. The existence of robust documentation at the time of the transactions taking place will be crucial if taxpayers would like to stand a chance against tax authorities' scrutiny.

Specific provisions on services

Article 34 introduces the term "beneficial services", requires a service to be able to deliver 'direct or indirect economic benefit', and be one which an independent enterprise would have willingly paid for it or performed it for itself (the latter equivalent to the OECD's 'benefits test'). There have been indications that, in order for a positive assessment to be reached that a service has generated a 'direct or indirect benefit' for the service recipient, a Chinese taxpayer may have to demonstrate a connection between the service fee payment and an incremental marginal profit. This

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approach would go beyond what the equivalent OECD rules would demand to see. The OECD guidance accepts that anticipated benefits from a service may lie a long time in the future and that a service may, in fact, never produce the benefits originally anticipated. It remains to be seen what would constitute sufficient evidence for demonstrating that a service has met the 'direct or indirect economic benefit' test. An implicit 'incremental profit' approach could make it very challenging for MNE subsidiaries to support their deductions for outbound service fees.

In relation to those services that would be considered non-beneficial in nature, Article 35 of Announcement 6, through examples, does provide more clarification compared with previous guidance under Announcement 16. A particular area of concern voiced by taxpayers has been on Chinese tax authorities' arguably more expansive definition of shareholder activities compared with OECD guidance. To this end, the examples listed in Article 35 are helpful in assisting taxpayers determining types of activities that would be considered shareholder related and thus non-beneficial from a China perspective. It might be noted that while many of the examples listed in Article 35 are such that would fall under the definition of shareholder activity and thus would not constitute services for which charges would be made under BEPS Actions 8-10 Report, there are some departures.

A particular departure arises from the fourth example listed, which states that finance, tax, HR and legal activities carried out for the purposes of the MNE group's decision making, supervision, control and compliance are non-beneficial. In practice, many such activities overlap with a subsidiary's business operations. For example, a US MNE may incur costs in ensuring that all its subsidiaries, including its Chinese subsidiary, comply with a particular piece of US regulation, while the Chinese subsidiary itself also has a business need to comply with that particular piece of US regulation by virtue of its serving US clients. In this case, it would appear rather unfair if activities carried out and costs incurred by the MNE in ensuring that its Chinese subsidiary complies with that particular piece of US regulation were considered non-beneficial, as such activities are clearly those that the Chinese subsidiary would be willing to pay for or perform them for itself.

It would be helpful if the Chinese tax authorities could restrict the non-beneficial activities listed in the fourth example to those that solely benefit the MNE group as a whole to be consistent with the arm's length principle.

SAT's decision not to integrate the 'safe harbour', proposed by the OECD BEPS work, for 'low-value adding services' reinforces SAT's position that all intra-group services transactions are high risk and demonstrate that they will continue to be subject to rigorous scrutiny going forward.

Mutual agreement procedures

Improving dispute resolution mechanisms is an integral component of the work on BEPS issues BEPS issue works. The BEPS Action 14 Report developed a minimum standard with respect to the resolution of treaty-related disputes, and all countries adhering to the outcomes of the BEPS

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Project (including China) must implement the standard and submit to a Peer Review process. One of the minimum standard measures is that countries should ensure that that MAP cases are resolved in a timely manner. Specifically, an average timeframe of 24 months has been recommended and is intended to be written into the Commentary on Article 25 as part of the next update of the OECD Model Tax Convention.

As a G20 member that endorsed the BEPS 2015 deliverables China has committed itself to implement the minimum standard measures introduced in BEPS Action 14 Report. Taxpayers have in the past voiced their concerns on SAT's commitment to resolve MAP cases. Resources have been stretched at the SAT level for many years. This will be alleviated to some extent by the establishment of Anti-Avoidance Division III within SAT's International Tax Department. With a budget of 40 headcount, it would quadruple the resources at the SAT level when fully staffed. This increases the availability of resources for various types of transfer pricing cases in China to some degree.

Future Outlook

With the introduction of Announcement 6, taxpayers will be able to better understand the focus points and the rationale of tax authorities when conducting transfer pricing investigations and we foresee more standardized transfer pricing investigation practices in the future.

Furthermore, given that Announcement 6 regulates both outbound payments and inbound receipts of royalty and service fees, while prior Chinese transfer pricing regulations focused mainly on outbound payments, it appears that the first steps are being taken to administer the transfer pricing of outbound-investing Chinese multinationals.

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