



China Tax Alert

Issue 2, January 2019

China Tax Authority APA Report highlights commitment to taxpayer certainty

Regulations discussed in this issue:

- China Advance Pricing Arrangement Annual Report (2017) issued by the SAT on 6 December 2018
- SAT Announcement of the Enhancement of Administration of Advance Pricing Arrangement (APA) ("Announcement 64"), issued on 18 October 2016

Background

On December 6, 2018, China's State Administration of Taxation ("SAT") published the *China Advance Pricing Arrangement Annual Report (2017)* ("2017 APA Annual Report"). It describes the latest state of play with the implementation of the APA program in China, and contains data covering the period from 2005 to 2017. Highlights of the Report are set out in this Alert.

The progress made in the last year with the APA program, documented in the Report, is in line with the SAT's commitment to preventing double taxation and providing certainty to taxpayers. While the number of APAs signed in 2017 was somewhat lower than in 2016, there was a significant increase in SAT resources for APA and mutual agreement procedure ("MAP") work in 2017 and 2018, meaning that more Chinese and foreign multinational taxpayer APA/MAP arrangements be facilitated, going forward.

Statistics: Evolving Landscape of China APA Program

APAs, including unilateral, bilateral and multilateral APAs, refer to arrangements under which an enterprise negotiates and agrees (in advance), with the tax authority, on the transfer pricing ("TP") methods and corresponding calculation methods to be applied to its related party transactions for future years, in accordance with the arm's length principle.

The China APA history can be dated back to the late 1990s (the program was at that stage on a trial basis). 2005 witnessed the standardisation of China's APA program and the beginning of well-regulated APA practices. A majority of the APAs concluded between 2005 and 2008 were unilateral APAs (36 unilateral APAs out of 41 in total). 2009 saw a jump in the number of concluded bilateral APAs from one in 2008 to seven in 2009. From 2010 to 2017, the SAT managed to

maintain the momentum of concluding an average of eight bilateral APAs annually (inclusive of bilateral APA renewals), with some fluctuation. In 2017 alone, the conclusion of bilateral TP cases resulted in an elimination of approximately RMB 1.2 billion of double taxation for taxpayers.

The current APA administration requirements are laid out in the SAT Announcement of *Administration of Advance Pricing Arrangements [2016] No. 64* ("Announcement 64"), issued in October 2016. As provided under Announcement 64, the APA process consists of six stages: pre-filing meetings, intention, analysis and appraisal, formal application, negotiation and signing, and supervision of implementation. The enhanced guidance in Announcement facilitates more efficient and effective conduct of the APA process. Further details are set out in *China Tax Alert* ([see China Tax Alert - Issue 28, October 2016](#)).

The key statistics set out in the 2017 APA Annual Report are summarised below.

APAs Signed – 2005 to 2017

The SAT has, since the initiation of the program in 2005, concluded and signed a total of 147 unilateral and bilateral APAs (see Figure 1 below). The SAT has not signed any multilateral APA with any competent authorities to date.

Figure 1 – APAs Signed by Year (2005-2017)

Year	Unilateral APAs	Bilateral APAs	Total
2005	13	1	14
2006	10	0	10
2007	7	3	10
2008	6	1	7
2009	5	7	12
2010	4	4	8
2011	8	4	12
(Renewals in 2011)	(4)	(0)	(4)
2012	3	9	12
(Renewals in 2012)	(1)	(6)	(7)
2013	11	8	19
(Renewals in 2013)	(0)	(4)	(4)
2014	3	6	9
(Renewals in 2014)	(1)	(0)	(1)
2015	6	6	12
(Renewals in 2015)	(0)	(2)	(2)
2016	8	6	14
(Renewals in 2016)	(0)	(2)	(2)

2017	3	5	8
(Renewals in 2017)	(0)	(3)	(3)
Total	87	60	147

The China APA program still primarily deals with inbound MNE applicants and there has been a slow uptake among outbound Chinese MNEs. However, as the SAT has started paying attention to tax leakages due to Chinese MNE parents not charging out service fees or royalties to overseas affiliates, and given the expectation that Chinese outbound investment will face more TP challenges from overseas authorities in future, we anticipate an increase in Chinese MNE demand for APA/MAP going forward.

APAs by Industry

As illustrated in Figure 2 below, 83.7% of the APAs signed from 2005 to 2017 involved manufacturing industry. This generally reflects the type of investment China historically received from inbound MNEs. Nonetheless, as China's economy diversifies, we can expect to see more APAs involving other industries.

Figure 2 – Industries Covered (for APAs signed 2005-2017)

Industries Involved	Number
Manufacturing	123
Leasing and Commercial Services	5
Wholesale trade and retail	9
Transportation, warehousing, and postal services	4
Scientific and technical services	2
Information transmission, software and information technology services	2
Electricity, thermo, gas and water generation and supply	1
Construction	1
Total	147

APAs by Transaction Type

As shown in Figure 3, transfer of the right to use, or ownership of, tangible assets accounts for the largest portion of transactions covered by China's APA program; 65.1% of the total to-date. While this may be the case, we are aware that the SAT's focus is gradually shifting towards accepting applications involving intangibles and services transactions.

Figure 3 – APA by Transaction Type (2005-2017)

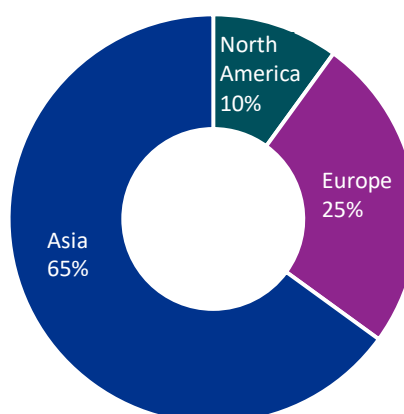
Transaction Type	Concluded APAs	
	Number of APAs	Percentage
Transfer of the right to use or ownership of tangible assets	127	65.1%
Transfer of the right to use or ownership of intangibles	31	15.9%
Services	37	19.0%
Total	195	100.0%

Bilateral APAs by Region

From 2005 to 2017, China has signed 39 bilateral APAs with Asian countries, 15 with European countries and 6 with North American countries. The bulk of the Asian APAs were signed with Japan and Korea. This can be attributed to the fact that the SAT first concluded bilateral APAs with Japan, followed by Korea, and effective APA negotiation processes have been established with these countries. This also reflects the importance of Japanese and Korean companies in China.

The percentage breakdown by region is as below.

Figure 4 – Bilateral APAs by Region (2005-2017)



APAs by Time Taken

The time required to complete the entire APA depends on many factors including the type of APA requested (i.e. unilateral, bilateral, or multilateral), the complexity of transactions involved, the quality of the documents provided by the taxpayer, the logistics of the review process performed by tax authorities, etc. The Chinese tax authorities generally aim to complete the review and negotiation process within 12 months for unilateral APAs and within 24 months for bilateral APAs. Bilateral APAs involve negotiations with relevant competent authorities through the MAP process and therefore more time is required to reach a consensus on them than that of unilateral APAs. The 24

month timeline to resolve bilateral APAs is in line with the timeline set out in the Base Erosion and Profit Shifting (“BEPS”) Action 14 report for the resolution of MAP cases.

As indicated in the Figures below, a majority of the unilateral APAs (approximately 94%) and bilateral APAs (approximately 65%) signed between 2005 and 2017 were concluded within two years of application.

Figure 5 – APAs by Time Taken (2017)

Type	From Application to Conclusion				
	<1 Year	1-2 Years	2-3 Years	> 3 Years	Total
Unilateral	1	2	0	0	3
Bilateral	3	0	0	2	5

Figure 6 – APAs by Time Taken (2005-2017)

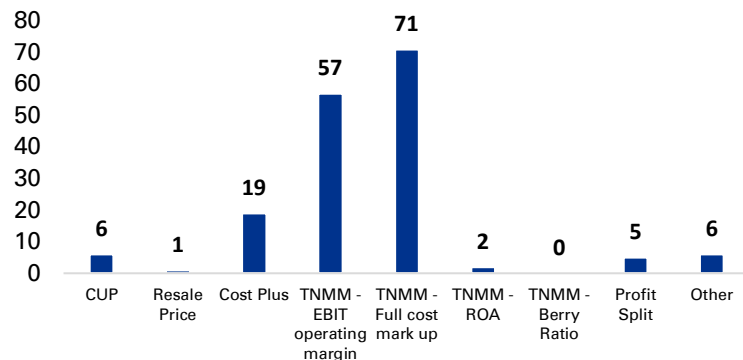
Type	From Application to Conclusion				
	<1 Year	1-2 Years	2-3 Years	>3 Years	Total
Unilateral	49	33	4	1	87
Bilateral	30	9	9	12	60

APAs by Transfer Pricing Method

The transactional net margin method (“TNMM”) is the most commonly used TP method, with the Earnings before Interest and Tax (“EBIT”) margin and the full cost mark-up as the most commonly used profit level indicators. The second most popular TP method is the cost plus method.

It is also noteworthy that the Chinese tax authorities have been exploring the use of profit split method especially in dealing with transactions where both transacted parties have made significant contributions to the value creation or location specific advantages have been present.

Figure 7 – TP Methods Applied in APAs Signed from 2005 to 2017



APA Application in Practice

Announcement 64 provides that access to an APA is available to enterprises with an annual related party transaction amount exceeding RMB 40 million for the three years prior to the year in which the “Notice on Tax Matters” is issued by the in-charge tax administrative authorities, notifying the acceptance of enterprise’s intent for the application to commence the APA negotiation. As noted in the 2017 APA Annual Report, the tax administration may prioritise APA requests from an enterprise that meets one or more of the following conditions.

- The enterprise’s annual reporting forms for related party transactions and contemporaneous TP documentation provide adequate disclosures.
- The enterprise’s tax compliance rating is "A".
- Where the enterprise was previously subject to a special tax adjustment investigation (i.e. audit on TP or tax avoidance matter), this has already been closed.
- The enterprise is applying for a renewal of an existing APA that is about to expire provided that there has been no substantial changes to the facts and operating environment specified in the existing APA.
- For the APA request, the enterprise has provided complete and adequate information including but not limited to clear and thorough value chain / supply chain analysis taking into account of location specific advantages, and appropriate pricing methodologies and calculation process.
- The enterprise has been cooperative with the tax administrations during the APA process.
- For a bilateral / multilateral APA, the competent authority(ies) of the other contracting state(s) of treaty(ies) have displayed strong intention to move forward with the APA negotiation or attached a high importance to the APA.
- Any other factors facilitating the APA process is present.

KPMG Observations

The progress made in the last year with the APA program, documented in the 2017 APA Annual Report, is in line with the SAT’s commitment to preventing double taxation and providing certainty to taxpayers. While the number of APAs signed in 2017 was somewhat lower than in 2016, there was a significant increase in SAT resources for APA and MAP work in 2017 and 2018, meaning that more Chinese and foreign multinational taxpayer APA/MAP arrangements will be facilitated, going forward.

In particular, the SAT had set up a third MAP/APA division in 2016, to assist divisions 1 and 2 which primarily handle MAP and APA cases. Previously, SAT resources for these matters

were stretched, due to the commitment of relevant personnel to BEPS meetings from 2013 to 2015.

Against the backdrop of concern about uncertainty drawn out by the universal implementation of BEPS projects and the increased TP scrutiny by tax administrations, it is expected that the number of APA requests will rise. APA can serve as an effective mechanism to enhance understanding, strengthen collaboration, and mitigate disputes between enterprises and tax authorities, thereby provide certainty on TP issues for future years and mitigate the risk of double taxation risks in two or more jurisdictions.

The APA process could be time and resource consuming in some cases (as illustrated in Figures 5 and 6) where there could be prolonged evaluation / negotiation to conclude an APA. However, there are some key takeaways for those interested in APA application as emphasised in the 2017 APA Annual Report, since the tax authorities have openly expressed the determination to prioritise certain APA requests, such as requests involving intangibles related and services transactions.

(1) First come, first served. Therefore make early preparations and get a head start if interested in an APA arrangement.

(2) The quality of the submission package really matters. Example questions may include: Have all the required documents been submitted? Has sufficient documentation clearly evidencing the transactions throughout the entire value chain has been provided? Is the proposed TP policy and methodology reasonable and justifiable? Is all the calculation correct?

(3) Whether the applicant is in a specific industry or located in a specific region that merits prioritised attention.

(4) For a bilateral APA request, whether the bilateral APA partner country (or region) has the intention to accept the case and pursue the bilateral APA will also be an important factor for consideration.

Among the four factors above, tax authorities value the quality of the submission package the most. Furthermore, the tax authorities have been exploring other appropriate TP methods apart from the traditional and widely adopted TNMM. In this regard, a submission that presents innovative application of TP methods or high quality quantitative analysis for intangibles, cost savings or market premiums are also likely to merit the SAT's prioritised attention.

In addition, APA practices can also help reduce international disputes and the number of MAP cases. During the past two years, due to the strengthening administration of tax authorities, MAP cases have been increasing dramatically worldwide. According to the OECD statistics, the start

inventory of TP related MAP cases in 2017 was 576 cases (exclusive of backlog cases received prior to 1 January 2016); with 779 cases newly started in 2017 and 251 cases closed, the end inventory of TP-related MAP cases was 1,104 cases. At the same time, we have witnessed that many tax authorities have sped up their negotiation and conclusion of MAP cases to fulfil the minimum standards under BEPS Action 14. China is one of them. A critical aspect of BEPS Action 14 is the peer review process, where effectiveness and efficiency of a jurisdiction's MAP are assessed by its peer jurisdictions. It is worthwhile to note that the seventh batch of dispute resolution Stage 1 peer reviews was launched at the end of 2018 and it includes China, among seven other jurisdictions. The OECD requested that taxpayers submit input on specific issues relating to access to MAP; clarity and availability of MAP guidance; and the timely implementation of MAP agreements for each of these jurisdictions. Comments were due on 13 December 2018. Following this, the peer review on China will be conducted in the first half of 2019.

An MAP case completed by China and India tax authorities in mid-2018 provides a good example. The taxpayer in question was a large-scale outbound investing Chinese MNE, which had been operating in India for more than ten years. The Indian local tax authorities asserted that the Chinese MNE had an Indian Permanent Establishment ("PE") and sought a significant tax liability on the basis of significant attributed profits. Through successful MAP negotiation, the final adjustment agreed by both Competent Authorities was significantly reduced. The MAP case resolution only took one round of negotiation and four months from the application to open the MAP to the conclusion of the case. The successful conclusion of the MAP had crucial impact for the client by effectively safeguarding its rights and interests for its existing Indian operations, as well as setting a solid basis for the future development of its Indian operations. The availability of an effective tool is increasingly important as data based compliance programs employed by the Chinese tax authorities could potentially lead to greater examination and disputes.

The statistics disclosed in the 2017 APA Annual Report shows China's continuous transparent commitment to the international cooperation agendas. The changes to the organisational structure of the SAT and the availability of more resources for APA and MAP work, will likely see the SAT providing the necessary support in facilitating more Chinese and foreign multinational taxpayer APA/MAP arrangements, going forward.

Additionally, spurred by the BEPS Action 14 minimum standards on dispute resolution, the SAT places particular emphasis on ensuring international TP disputes are resolved effectively and expeditiously. The speedy conclusion of a recent MAP case involving China and India provides a good example of how the MAP and APA programs can now be an effective tool for dealing with TP challenges in China.

Taxpayers facing TP challenges and potential double taxation are encouraged to consult their advisors. KPMG China's TP practice has strong credentials in assisting taxpayers navigating the China MAP/APA process successfully.

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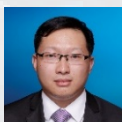
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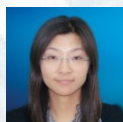
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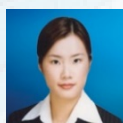
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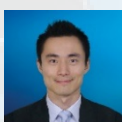
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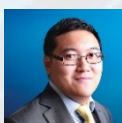
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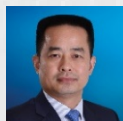
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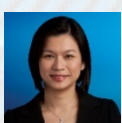
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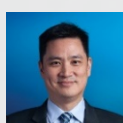
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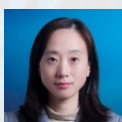
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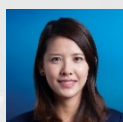
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