



The STA released the 2019 Advance Pricing Arrangement Annual Report – The number of signed APAs in 2019 hit a historical high

Executive Summary:

- The *China Advance Pricing Arrangement Annual Report (2019)* (“2019 APA Annual Report” or “the Report”) recapitulates the progress of the APA program in China, and at the same time highlights the determination of the State Taxation Administration (“STA”) to steadily promote the APA program and to improve the quality of the tax authorities’ services to taxpayers. The number of agreed and signed APAs in 2019 hit a historical high and the Report also reveals new trends in terms of industry types, transaction types and transfer pricing methods involved in the concluded APA cases.

Background



On 29 October 2020, the STA published the 2019 APA Annual Report, which summarises the latest implementation status of the APA program in China, and provides statistics on concluded APAs covering the period from 2005 to 2019.

The Report recapitulates the progress of the APA program in China, and at the same time highlights the determination of the STA to steadily promote the APA program and to improve the quality of tax authorities’ services to taxpayers, despite facing various challenges internally and externally.

Overview of the Report



Number of signed APAs: The Chinese tax authorities signed a total of 21 APAs in 2019, including 12 unilateral APAs and 9 bilateral APAs, with both achieving historical record high since 2009. The 2019 statistics illustrates that more multi-national enterprises (“MNEs”) go through the route of applying for APAs which serve as an effective tool to obtain tax certainty and avoid double taxation. The 2019 statistics also reflects that the STA regards the APA program as an important measure to serve taxpayers and has accordingly invested further resources to promote the program.

Industry covered by signed APAs: Of the total APA signed between 2005 and 2019, 141 APAs are related to the manufacturing industry, accounting for 80% of the total. While the manufacturing industry forms a big chunk of the APA tally, we observe that, in the past two years, there are an increasing number of enterprises signing the APAs operate in the wholesale and retail industry, i.e. 19 or 10% of the signed APAs between 2005 and 2019. With the diversification of China’s economy and further opening-up of the market, we expect that the number of APAs involving the service industry and other types of industries will increase further in the future.

Transaction types involved in the APAs: Between 2005 and 2019, 148 signed APAs relate to the transfer of the right to use or the ownership of tangible assets, accounting for 61% of all transactions types. An upward trend is seen in the number of signed APAs that involve the transfer of the right to use or ownership of intangible assets and services transactions, accounting for 96 signed APAs or 39% of the total. The promulgation of the *Announcement of the State Administration of Taxation on the Administrative Measures on Special Tax Investigations, Adjustments and Mutual Agreement Procedures* [2017] No. 6 (“Announcement 6”) requires taxpayers to emphasise on the analysis of services and intangible assets related transactions and this prompts the Chinese tax authorities to further tighten the scrutiny on these related party transactions. This, in turn, encourages taxpayers to apply for APAs to secure tax certainty on these transactions regarded as medium to high-risk.

Time taken to conclude the APAs: Generally, the Chinese tax authorities aim to conclude unilateral and bilateral APAs within 12 and 24 months of the submission of formal applications, respectively. Most unilateral APAs (89%) and bilateral APAs (62%) signed between 2005 and 2019 were concluded within two years of formal application. In 2019, most of the newly signed APAs were also concluded within two years of formal application. It is noteworthy that five of the nine newly signed bilateral APAs in 2019 were concluded within only one year of formal application. This goes to show the commitment of the STA in ensuring efficient APA negotiation and conclusion through building sufficient resources to manage the APA cases.

Transfer pricing methods applied in the APAs: We note from the Report that five of the newly signed APAs in 2019 adopted the profit split method, which is equal to the total number of the APAs applying the same method from 2005 to 2018. It demonstrates that the Chinese tax authorities are actively trying to and have succeeded in applying the profit split method during the APA negotiation process, especially in cases where both parties to the transactions make significant contributions to value creation or cases involving location specific advantages (“LSAs”).



Looking ahead, the uncertainty in the global economy due to the disruptions caused by the Covid-19 pandemic as well as the challenges of trade liberalization prompts governments around the world to increasingly compete for tax revenues. Under such uncertainties, taxpayers yearn for an environment which provides a fair and certain tax administration to facilitate cross border investments. In this regard, the Chinese tax authorities continue fulfil their commitment to improve business environment and to promote unimpeded trade and investments in China. This is evidenced in their efforts to steadily advance the APA program providing certainty to taxpayers and help avoid and prevent double taxation.

We would like to highlight that the following categories of enterprises could consider applying for an APA to manage their transfer pricing risks:

Enterprises undergoing value chain or business restructurings:

Significant changes may occur to the business operations, functional profiles, distribution of intangible assets, corresponding related party transactions, and profit levels of the parties to a business restructuring. Unsurprisingly, such changes could likely become the focus of local tax authorities and even the target of transfer pricing investigations. In particular, with the adoption of the profit monitoring mechanism on MNEs across China, the possibility of relevant transfer pricing risk being identified by the tax authorities will further increase. Hence, enterprises, which have undergone business restructurings, can apply for APAs to manage their transfer pricing risk. The APA process provides taxpayers with the opportunity to communicate more transparently with the tax authorities on the changes as a result of the business restructurings, thereby ensuring that the tax authorities obtain a more comprehensive understanding of the corresponding tax impact, and ultimately obtain tax certainty.

Enterprises with significant amount of related-party goods import:

For enterprises importing significant amount of tangible goods, the tax authorities' main focus would be on whether the related-party import prices are too high resulting in the erosion of China's tax base. Conversely, the Chinese customs authorities would pay attention to whether the related-party import prices are too low resulting in lower import duties. The contrasting concerns of the two authorities add further difficulties to the management of transfer pricing arrangements of these enterprises. Of late, the Chinese tax and customs authorities are actively exploring service innovation and are working towards establishing a cooperation framework to address these concerns. Enterprises could therefore take advantage of this co-operation by applying for an APA to manage the positions of the tax and customs authorities so as to avoid and reduce domestic double taxation.

Enterprises with substantial related-party services and intangible assets transactions:

Announcement 6 reflects tax authorities' relentless focus on related-party services arrangements and intangible assets related transactions. Generally, enterprises with large scale and complex arrangements involving these types of transactions are usually regarded as facing elevated transfer pricing risks. By proactively applying for APAs, these enterprises have the opportunity to fully explain the business background, transaction structure and pricing policy of these transactions to the tax authorities, thereby they are able to effectively manage the associated transfer pricing risks.

Enterprises whose businesses are affected by the Covid-19 pandemic:

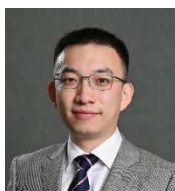
Some industries such as retail, catering and tourism, are directly affected by the Covid-19 pandemic. Business performance of many enterprises in these industries fluctuates wildly, thus casting a cloud of uncertainty over their future operations. Unfortunately, these enterprises with significant profit fluctuations would more likely be under the radar of the tax authorities, particularly if they operate as limited risk entities. Under such circumstances, affected enterprises can consider applying for an APA so that they can communicate and explain the impact of Covid-19 on their businesses to the tax authorities and reach an agreement on the transfer pricing arrangements through the APA. Once tax certainty is secured, enterprises can then focus on their business recovery and future expansion.

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