

China Tax Alert

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Shenzhen takes the lead in launching China's first Customs and Tax Collaborative Transfer Pricing Management Mechanism

Abstract :

Under China's current tax and customs management systems, enterprises could face challenges on their related-party imports, and they could be subjected to import price adjustments concurrently by two separate authorities. On 18 May 2022, Shenzhen Tax Bureau and Shenzhen Customs jointly issued "Notice of Shenzhen Customs and Shenzhen Tax Bureau of the State Taxation Administration on Matters Regarding the Collaborative Management of Transfer Pricing of Related-Party Imported Goods" (the "Notice"). The Notice introduces a framework for collaborative management of transfer pricing of goods imported from related party in the form of cross departmental co-operation between customs and tax authorities. The promulgation of the Notice aims to resolve the issue of double recognition and double taxation of related-party imports between customs and tax that has long plagued many multinational enterprises (MNEs) and further bring certainty to the management of MNEs' transfer pricing policies. This latest development is a landmark innovation in China as well as internationally.

KPMG China had the opportunity to assist an MNE in Shenzhen whereby we successfully concluded China's first collaborative transfer pricing management case with Shenzhen Customs and Shenzhen Tax Bureau. The pilot case provides vital practical reference on the feasibility, policy formulation and specific implementation matters regarding the collaborative management system. The case solves a number of long-standing issues for the enterprise with respect to the management of related-party import price, thereby reducing the enterprise's tax compliance costs. KPMG China, as the only representative from professional services advisors, was invited to participate in a ceremony held by the two authorities to launch the collaborative transfer pricing management mechanism as well as to witness the official signing of the first tripartite agreement among the tax bureau, customs, and the enterprise.

Background

As the global economy becomes more integrated, MNE groups tend to allocate and optimize their global supply chains whereby cross-border related-party transactions become more common. Meanwhile, as China's customs and tax authorities change their tax collection and management methods from ex-ante review to ex-post management, the reasonableness of related-party import pricing has become the review focus of both the customs and tax authorities. In recent years, a growing number of MNEs face the issue of being challenged on their related-party import transactions and it resulted in these transactions being subjected to import price adjustments by the two authorities at the same time.

Additionally, to cope with the continuous changes and challenges of internal and external business environment, MNEs often need to review and adjust their business policies and models. Adjustments to the pricing policies of related-party transactions and the resulting changes in the related-party import prices and profit levels are often important triggers for the customs and tax authorities to launch a transfer pricing review.

Under China's current government management system relating to related-party import transactions, both the customs and tax authorities can review whether the transaction price has complied with the arm's length principle. However, under the existing regime, they have differing focus:

- ❑ **Customs:** The transaction price of imported goods is the main basis for the customs authorities to collect import duties. Therefore, customs officials are concerned with low import price that would result in a loss of import duties.
- ❑ **Tax authorities:** The importer's profits, calculated by reference to its revenue less cost of goods and expenses, are the basis for tax authorities to collect corporate income tax. Therefore, tax authorities would focus on whether the import price is too high such that it reduces the profit level of the Chinese importer and the corresponding corporate income tax collection.

As can be seen from the above, the customs and tax authorities have different concerns when reviewing the same related-party transactions, and both sides exercise their functions independently under the existing customs and tax legal frameworks. In the event that an adjustment is made to an importer's import price which subsequently affects the corresponding profit level, double recognition and double taxation may occur, especially if there is a lack of communication and mutual recognition between the customs and tax authorities. The lack of coordination between both the authorities is also common in other jurisdictions and could have a certain impact on the development of transnational investment and trade.

As such, if a set of effective customs and tax collaborative management system on related-party import transaction price could be introduced, where the customs and tax authorities can agree to provide an overall consistent review results on the related-party import prices as well as profit margins of an enterprise, it will undoubtedly alleviate the issue of double taxation of the enterprise, improve certainty of transfer pricing management by the enterprise and reduce tax compliance costs.

Key points regarding the collaborative management system between customs and tax authorities

On 18 May 2022, Shenzhen Customs and Shenzhen Tax Bureau jointly issued the Notice to implement a harmonized approach to managing related-party import transactions. The Notice provides for both the authorities and the applicant enterprise to jointly sign and implement a memorandum. The memorandum would ensure a consistent implementation of related-party import pricing as has mutually been agreed by Shenzhen Customs and Shenzhen Tax Bureau. Details of the Notice are as follows:

Legal basis

Under the administrative procedures of China's customs and tax authorities, customs shall follow the administrative procedures of advance ruling on import prices as provided for under the "Interim Administrative Measures on Advance Rulings of Customs of the People's Republic of China" (Order No. 236 of the General Administration of Customs). Tax bureaus, meanwhile, shall abide by the relevant procedures with respect to advance pricing arrangements as set forth in the "Announcement of the State Administration of Taxation on Improvements to Matters Relating to Administration of Advance Pricing Agreement" ("Announcement No. 64").

Application requirements

According to the Notice, enterprises are eligible to apply for the collaborative transfer pricing management as long as they meet the application requirements for advance ruling under Article 4 of Order No. 236 of the General Administration of Customs and the application requirements for an advance pricing arrangement under Article 4 of Announcement No. 64.

- **Application requirements for customs advance rulings:** Applicants for advance rulings shall be foreign trade business operators that have actual import and export activities and are registered with Customs.
- **Application requirements for advance pricing arrangement:** APAs are generally applicable to enterprises whose related party transaction amounts are more than RMB 40 million in each of the three years preceding the tax year on which the competent tax authorities deliver to the enterprise the "Notice of Taxation Matters" on to the authorities' intention to negotiate and sign an APA.

Based on the above application requirements, enterprises registered in Shenzhen engaging in the general trade import activities, have high transfer pricing compliance, and meet the relevant provisions of Order No. 236 of the General Administration of Customs and Announcement No. 64 can apply for customs and tax collaborative transfer pricing management.

Application procedures

- **Application and acceptance:** An enterprise shall simultaneously submit the "Application Form for the Collaborative Management of Transfer Pricing of Related-Party Imported Goods" to the general operation department of the local in-charge Customs authority (subordinate customs of Shenzhen Customs) and the in-charge authority of Branch Four of Shenzhen Tax Bureau. After receiving the application from the enterprise, the relevant departments shall jointly determine whether the enterprise meets the acceptance criteria **within 10 days**. They shall provide their acceptance opinions in the collaborative management application form, after which the acceptance department shall deliver the application form back to the enterprise. If during the evaluation the departments find that information provided by the enterprise is incomplete, the enterprise shall receive a one-off notification to make corrections **within 5 days**.
- **Evaluation and consultation:** After an enterprise's application is accepted, Shenzhen Customs and Shenzhen Tax Bureau shall begin a joint evaluation **within 15 days** of acceptance of the application and negotiate with the enterprise on the related-party import price. The parties may jointly or independently carry out on-site inspections and/or any specific consultations after which they can reach a preliminary intent with the enterprise.
- **Signing of memorandum:** If Shenzhen Customs and Shenzhen Tax Bureau reach a consensus through negotiation, the legal representatives of the three parties or their authorized representatives shall jointly **sign a "Memorandum of Collaborative Management"**. Concurrently, Shenzhen Customs shall make an **advance price ruling** on the enterprise, and Shenzhen Tax Bureau shall sign an **advance pricing arrangement** with the enterprise.
- **Implementation of memorandum:** During the covered period of the collaborative management memorandum, the enterprise shall submit an annual report on the implementation to Shenzhen Customs and Shenzhen Tax Bureau within **6 months** after the end of each financial year. If the enterprise adjusts the price of goods according to the terms of the memorandum, Shenzhen Customs and Shenzhen Tax Bureau shall then perform corresponding procedures to confirm the adjustments according to the prevailing customs and tax regulatory frameworks. If the enterprise fails to comply with the agreed terms, or the terms cannot be applied due to substantial changes to the business or to the covered transactions themselves, or upon the application of the enterprise, Shenzhen Customs and Shenzhen Tax Bureau may negotiate to revise or terminate the memorandum.
- **Expiry and renewal:** The memorandum of collaborative management will automatically expire after the covered period expires. Enterprises can apply for renewal to Shenzhen Customs and Shenzhen Tax Bureau **within 90 days before the expiry** of the memorandum.

Main terms of collaborative management memorandum

The collaborative management memorandum jointly signed by the three parties includes twelve main areas, such as the general definition, application scope, application period, key assumptions, transfer pricing method and customs valuation method, imported goods price adjustments, annual reports, etc. The following is particularly noteworthy:

- **Applicable covered period:** Three calendar years.
- **Transfer pricing method and customs valuation method:** It is necessary to clarify the transfer pricing method and customs valuation method, as well as the adopted financial indicators and fair transaction value range, in the memorandum.
- **Adjustment of the import price:** The enterprise shall ensure that the actual financial indicators of any year are implemented according to the median value of the agreed arm's length range. **If it is lower or higher than the median value, the enterprise shall adjust the price to the median value.** The competent customs and tax bureau shall then review the adjustments respectively.
- **Key assumptions:** The text of the memorandum makes reference to the relevant provisions of the advance pricing agreement with the tax bureau and makes key assumptions on the internal and external business environment and other factors that may have a significant impact on the implementation of the collaborative management. When there is a change to the key assumptions, the enterprise is required to report in writing to the competent customs and the competent tax bureau within 30 days, and the parties may revise or terminate the memorandum through negotiation as appropriate.

KPMG's observations

The collaborative transfer pricing management system introduced in Shenzhen provides a much-needed solution for Shenzhen based enterprises which encounter difficulties in balancing the implications of related-party transactions between customs and tax and wishing to avoid being investigated and having the related-party import transactions being adjusted by either or both of the authorities.

i. Breaking through the system barriers: the first combination of customs advance ruling system and tax advance pricing arrangement system

Although the Organization for Economic Co-operation and Development (OECD) and World Customs Organization (WCO) have put forward principled guidelines for the application and coordination of the review of related-party pricing for tax and customs purposes, there are only a handful of countries and cases globally where both customs and tax authorities would collaborate on the review of import prices.

The new system launched in Shenzhen is based on the customs' advance ruling system and the tax authorities' advance pricing arrangement system. Without overstepping the limits of the existing tax and customs regulatory frameworks, the roll-out of the Notice was a novel attempt to combine the regulations of the two departments in China. In addition, procedures for collaborative management were laid out for the two departments to jointly review, and to mutually recognize and confirm the negotiation results in advance in a tripartite memorandum signed by the enterprise, tax bureau and customs authorities.

Shenzhen's move to launch the first collaborative management system is a significant milestone in China and internationally.

ii. Institutionalizing and streamlining collaborative management: practically serving more enterprises

Through a joint issuance of the Notice, Shenzhen Tax Bureau and Shenzhen Customs' innovative measures spelled out the specific requirements and procedures that enterprises should fulfil when applying for the collaborative management. According to the Notice, Shenzhen Customs and Shenzhen Tax Bureau have not set an excessively high threshold for the application of collaborative transfer pricing management. A Shenzhen-based enterprise which meets the existing application requirements for a customs advance ruling and an advance pricing arrangement is eligible to apply. The clear application procedures and acceptance time limit as provided in the Notice will also make it possible for enterprises to make use of the innovative system more efficiently. We expect more Shenzhen enterprises to benefit from the promotion and implementation of this system, and we eagerly look forward to the trial implementation and promotion of similar systems outside of Shenzhen.

iii. Innovation of customs advance ruling: giving enterprises "quantifiable" ruling results on the reasonableness of import price

Under China's current customs advance ruling system, enterprises can obtain customs' written opinion on the reasonableness of import prices by applying for advance price rulings. However, based on past practice, customs authorities often only conducted "qualitative" review, i.e., from the aspects of the completeness of price elements and whether the related-party transactions affect the transaction price, etc. It was uncommon for customs to issue advance ruling based on a quantitative review of the reasonableness of an enterprise's specific import prices and profit levels.

However, through the newly promulgated Notice coupled with the advance ruling system, Shenzhen Customs does not only provide "qualitative" judgment opinions on the import price of the enterprise, but also provides specific quantitative and executable advance ruling conclusions based on the negotiation results with the tax authorities. Such a move is a major breakthrough in the application of the customs advance ruling system, enabling enterprises to make more use of the advance ruling system in the future to resolve any customs issues that may arise out of their related-party transactions.

Case sharing by KPMG

Before the introduction of this system, Shenzhen Customs, Shenzhen Tax Bureau and an MNE had negotiated and concluded a collaborative management of related-party import pricing on a trial basis. KPMG China is pleased to have been engaged to assist the enterprise in the whole process of application and negotiation. The enterprise signed a tripartite memorandum with Shenzhen Tax Bureau and Shenzhen Customs at a ceremony to launch the collaborative transfer pricing management mechanism on 19 May 2022. KPMG China, being the only professional services advisor, was invited to participate in a ceremony the new innovative system and witnessed the successful signing of China's first case under the collaborative management.

The MNE was challenged by a non-local customs A on the reasonableness of the price of goods imported from the enterprise's overseas related party. Every year since then, the enterprise had to adjust its import price and pay import duties in accordance with the requirements of customs A. Additionally, the enterprise had also been questioned by another non-local customs B on the royalties paid by the enterprise whether they were related to the imported goods (and hence dutiable). Custom B dictated that the enterprise included the royalty amount in the price of imported goods and pay additional duties. As a result, the enterprise faced the issues of double recognition and double taxation by the customs and tax authorities.

To solve the above difficulty faced by the enterprise and in the absence of any precedents, all parties (i.e., Shenzhen Tax Bureau, Shenzhen Customs, and the enterprise with the assistance of KPMG China) closely co-operated by leveraging on China's existing customs and tax supervision systems and effectively reached an agreement on the enterprise's transfer pricing of imported goods

The pilot case highlights a number of important innovations, and the success of this case also provides an important practical reference in terms of feasibility assessment, formulation of transfer pricing policies and other specific implementation issues under the collaborative management system. The highlights amongst others include:

- In the pilot case, the customs and tax authorities created a channel for negotiation and cooperation between the two parties where both would mutually recognise the final results of the negotiation. Through this trial case, Shenzhen Customs and Shenzhen Tax Bureau have successfully formalised a cross-departmental working mechanism for taxpayers. This is a major innovation within a limiting administrative system and procedures.
- During the negotiation between Shenzhen Customs and Shenzhen Tax Bureau, the inventive solutions adopted by both authorities on the application of transfer pricing methods, the determination of the audit scope of imported goods, the use of the audit results to solve royalty transactions, and the implementation of the outcome of the negotiation, etc. are valuable precedents for future cases.

In addition, through the implementation results of this pilot case, the enterprise has effectively solved its double taxation issue that has plagued the enterprise for many years, reduced its overall tax costs, improved compliance efficiency, as well as enhanced the stability and predictability of its transfer pricing policy implementation. The collaborative transfer pricing management system pioneered by Shenzhen Customs and Shenzhen Tax Bureau will provide vital references for China and for the global community to a large extent. We look forward to the trial implementation and promotion of similar negotiation systems in other regions of China so that more taxpayers can stand to benefit.

If you are interested in the newly promulgated collaborative management system in Shenzhen and the details of the first trial case, please contact KPMG's relevant tax experts for further in-depth discussions.

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