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SAT Releases New Bulletin to Strengthen Transfer Pricing Administration on Intra-group Outbound Charges

China's State Administration of Taxation ("SAT") released its Bulletin on Enterprise Income Tax Issues concerning Outbound Payments to Overseas Related Parties (Bulletin [2015] No. 16, "Bulletin 16" or "the Bulletin") on 18 March 2015. This Bulletin formalizes several previously announced positions for dealing with service fees and royalties being paid to overseas related parties.

Bulletin 16 is intended to reaffirm basic principles and clarify administrative requirements for intra-group outbound charges, and is one of China's initiatives to align with global efforts to combat tax avoidance.

Background

The SAT has been paying special attention to offshore intra-group service fees and royalties since 2012. After several preliminary measures in 2014, the SAT has now taken the significant step of formalizing its position.

The SAT expresses its views on royalties in the "China Country Practice" session of the *United Nations Practical Manual on Transfer Pricing ("TP") for Developing Countries.*	October 2012
The SAT submits a comment letter to the United Nations, illustrating four issues and stressing practical difficulties for intra-group services and management fees.	April 2014
It is reported that Mr. Liao Tizhong, Director of International Taxation Department of the SAT, delivered a speech at an international conference, conveying messages that China would introduce a "six-test" approach to investigate the arm's length nature of the intra-group service fees.	June 2014
The SAT releases an internal document, *Notice of Anti-Avoidance Examination on Significant Overseas Payments* ("Circular 146") to launch a nationwide scrutiny on significant intra-group service fees and royalties.	July 2014
The SAT issues Bulletin 16 to formalize its position on the "six-test" principle and give guidance on deductibility of non-trade payment to overseas related parties.	March 2015

At least some elements of Bulletin 16 can be seen as a Chinese effort to implement parts of the Base Erosion and Profit Shifting ("BEPS") action plan domestically, in addition to previous announcements introducing the new General Anti-Avoidance Rule ("GAAR") procedures and promulgation of new regulations on indirect equity transfer.

Highlights of Bulletin 16

Bulletin 16 reaffirms the arm's length principle for intra-group service fees and royalties -- a positive move. There is also a clear emphasis on substantiating the authenticity and arm's length nature of service and royalty transactions with intercompany agreements and other supporting information.

Based on different features of service fees and royalties, the Bulletin illustrates four types of intra-group payments that are not in compliance with the arm's length principle and are not deductible for Enterprise Income Tax purpose:

Payments to overseas related parties that neither assume functions and risks nor have economic substance

Service fee

Payments for services that are not able to bring to the service recipient direct or indirect economic benefits, such as:

- Services that are irrelevant to the functions and risks undertaken or business operated by the service recipient;
- Control, management and supervision activities undertaken by related parties to oversee direct or indirect investments in the service recipient;
- Services that have already been purchased from third parties or provided in-house by the service recipient;
- No services were specifically provided to the service recipient, although the service recipient may benefit incidentally from a wider group benefit;
- Services that have been remunerated through other related party transactions;
- Other services that fail to produce direct or indirect benefits to the service recipient

Royalty

For royalties needing to be paid to an overseas related party, consideration must be taken as to the contribution to the intangible made by relevant related parties, in order to determine the economic benefit each is entitled to. Royalty payments to related parties who merely possess the legal ownership but fail to contribute to the value creation of the intangibles are not deductible.

Royalties for incidental benefits from financing activities paid to overseas holding companies or financing companies for the purpose of financing and listing may not be deductible.

Deloitte's Observation

Bulletin 16 has formalized positions that have been taken by China's tax authorities over several years. Furthermore, as China's participation in BEPS initiatives continues we expect there will be further announcements to incorporate BEPS actions into domestic Chinese regulations. In addition to the specific rules around the non-deductibility of service fees and royalties there are a number of guiding principles which are addressed in more detail below.

Non-deductibility vs. special tax adjustment

Bulletin 16 has taken a clear position that service fees and royalties may be non-deductible for tax purposes under certain circumstances -- this has been regarded as a major development across the industry. It even raises questions on the legal grounds of the Bulletin, as Bulletin 16 refers to Article 41 of the Enterprise Income Tax Law ("EIT Law") regarding "special tax adjustment" instead of Article 8 regarding "non-deductibility" -- this could imply that the real legislative intention did not contain "non-deductibility".[1] A practical issue arises as TP investigations usually result in adjustments based on the arm's length principle, not outright denial of deductions. However, given some of the comments in the OECD's BEPS initiatives, a tax authority could possibly satisfy the arm's length principle by entirely disregarding transactions -- as contemplated by the "non-recognition" treatment in BEPS.[2]

There are potential issues around double taxation in these circumstances if the foreign tax authority considers the charges to be income irrespective of whether the China tax authority allows the deductions. Chinese tax authorities have already used non-deductible treatments in some recent cases -- affected enterprise groups need to manage this risk by being proactive in self-review of the transactions before the payments are arranged to mitigate the risks of having the payments considered non-deductible.

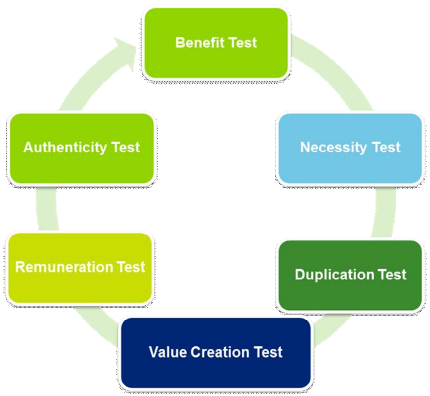
There are also different interpretations on some practical issues. For example, it is unclear whether the non-deductible treatment on a specific payment should be reflected on the annual tax filing as a regular upward adjustment item to taxable income or should be subject to tax adjustment during a TP audit (requiring SAT approval). Further, it is unknown whether Mutual Agreement Procedures ("MAP") could apply to resolve the double taxation issue once a "non-deduction" treatment is made against a PRC entity. How the SAT applies these new rules remains to be seen -- although there are concerns on how the rules may be applied by some more aggressive tax bureaus.

Benefit Test on Service Fee

The SAT has at last formally introduced the benefit test to analyse the reasonableness of service fees -- as has long been the OECD and international approach for service fees. The language being used is consistent with the OECD's comments in BEPS Action 10 regarding intra-group service, setting out that a benefit test shall be performed to evaluate whether "*the activity provides to a respective group member with economic or commercial value to enhance or maintain its commercial position….*"[3]

An effect of introducing the benefit test will be to change the focus of service fee reviews. For a long period of time, when examining service fees, some tax authorities paid more attention to the mark-up rate, and as long as the mark-up rate was not too high, the service fee payment would not be challenged. But when applying the benefit test, the tax authorities' focus will clearly extend to the substance and chargeability of the service fee itself. If the service fails to pass the benefit test, regardless of the mark-up rate, the service fee could be totally disallowed for deduction before income tax. Given the sometimes subjective nature of service fee charges, this may lead to more disputes for previously straightforward transactions.

The Bulletin has also formalized the "six tests" introduced and elaborated by the SAT in 2014 in a comment letter submitted to the United Nations ("the comment letter") -- although some controversial aspects have not been carried over. The following recap of the issues raised by the SAT for the "six tests" in the comment letter is helpful to better understand Bulletin 16.



Benefit Test

In the comment letter, the SAT approaches the benefit test from the perspective of both the service recipient and provider. It could be inferred that, in the SAT's view, service fees shall not be charged if the benefit is incidental.

Article 4 of Bulletin 16 confirms that view, treating payments for "incidental" benefits as "non-deductible". This is aligned with the current OECD view on services that is coming out of BEPS.

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[1] Article 8 of Enterprise Income Tax Law stipulated that *"reasonable expenses actually incurred by an enterprise in connection with the earning of revenue, including costs, expenses, taxes, losses and other expenses, are deductible in arriving at taxable income for enterprise income tax purposes."* Article 41 of Enterprise Income Tax Law stipulates that *"If a business transaction between an enterprise and its related parties does not comply with the arm's length principle, thus reducing the taxable income or revenue of the enterprise or the related parties, the tax authorities shall be empowered to make adjustments using reasonable methods."*

[2] *BEPS Actions 8, 9, and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Re-characterization, and Special Measures, OECD, December 2014*

[3] *BEPS Action 10: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines relating to Low Value-Adding Intra-group Services, OECE, November 2014*

Article 6 also denies the deductibility of royalty payments to overseas related parties for “incidental benefits” derived from the financing and listing of the holding company -- i.e. where the listed company charges its subsidiaries for a perceived reputational gain from being publically listed. We have seen some real cases where the Chinese tax authority challenged the deductibility of royalty payments to overseas listed company which claimed that the listing of the group enhanced the reputation of the PRC subsidiaries.

Necessity Test

The SAT advocated that consideration should also be given to whether the services are needed by the subsidiary. For example, the SAT states that a manufacturing subsidiary might not need any high-end intra-group services like consulting or legal services, due to its functional profile. However, it is accepted that if the manufacturing subsidiary had a complicated function and risk profile and was in need of services, it may be willing to engage an independent entity to provide such service or perform it in-house. This position is somewhat unorthodox, as even limited function entities will sometimes need so called "high-end" services.

Value Creation Test

According to the comment letter, services will create value when they are able to bring in identifiable enhancements of economic and business value -- improving the service recipient’s operating performance.

Of particular concern to the SAT are service payments to parent companies just for providing authorization services to the local country management. In these situations, the SAT believes these are simply management services that serve as a procedure instead of creating identifiable economic or commercial values. Therefore they should not be charged.

Duplication Test

The SAT considers that many management services (such as those illustrated in the value creation test) are likely to be duplicative activities or shareholder activities, and therefore should not be charged. This test also appears in a BEPS discussion draft issued by the OECD - “*no intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party*”. [4]

Remuneration Test

In the comment letter, the SAT points out that when analysing intra-group services, consideration should be given to whether the provision of various services has already been remunerated through other related party transactions.

For example in the comment letter, a situation where the subsidiary purchases raw materials from its parent company and resells the finished goods back is considered. In this situation, the SAT holds the view that the parent company is the ultimate beneficiary of the centralized procurement (through a lower finished goods price) and it is not appropriate to charge a procurement service fee to the subsidiary.

Authenticity Test

In the comment letter, the SAT outlined its concern that it is difficult to verify the authenticity of intra-group services. Now, under Bulletin 16, the in-charge tax authority has the right to request relevant documents to substantiate the authenticity and arm’s length nature of a service transaction. Enterprises can be challenged if they do not have the relevant information and documents prepared and filed in advance. This may be an extra hurdle for many taxpayers in China.

Value Creation and Contribution Test on Royalty Payments

Bulletin 16 goes further in aligning with the BEPS actions in the explanatory notes. These outline that when determining the arm’s length nature of a royalty payment it is necessary to analyse the functions performed, risks assumed and assets used in the development, enhancement, maintenance, protection and exploitation of the intangibles by each of the related parties. This will determine which entity or entities made contributions to the value of the intangibles and the parties that should be entitled to a return derived from the use of the intangibles. This is a clear reflection of the OECD guidelines on intangibles released in September 2014 as a deliverable of the BEPS action plan.

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[4] *BEPS Action 10: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines relating to Low Value-Adding Intra-group Services, OECE, November 2014*

Taxpayers will need to clearly evidence the contribution of the overseas related parties to the intangible property ("IP") development. There is also an expectation that Chinese contributions are identified, entitling the China entity to the intangible returns and reducing any outbound royalty rates. Although the SAT has not provided guidance on how it wants the contribution analysis to be performed, it will likely refer to the OECD's guidelines at the conclusion of the BEPS project.

In the past, we have seen the tax authorities challenge royalty payments made by loss-making companies. After the release of Bulletin 16, loss-making companies paying royalties to overseas related parties will face more stringent challenges from tax authorities and have more difficulties in justifying the value of IP.

The Bulletin will deny the deductibility of royalties paid to overseas entities that merely possess legal ownership but have failed to contribute to the intangibles -- an approach that is consistent with the OECD's current thinking. This will increase the difficulty of having a licensor incorporated in a tax haven own IP and charge royalties to Chinese licensee. There is also no comment on how sublicensing may be addressed.

There is an example in the SAT's explanatory notes to illustrate the non-deductibility of a royalty payment. It is focused on IP in connection with real estate development that is licensed by an overseas related party. The SAT states that if the relevant trademark or brand name obtains market recognition through the domestic entity's operations, and the maintenance, promotion and value enhancement of the intangible are the responsibility of the domestic entity, then the royalty paid to the overseas related party by the domestic taxpayer is not deductible.

In reality, apart from the relatively unique circumstances of the real estate industry, it is common that brands are famous in foreign markets, but have limited brand recognition in China. If all or most of the Chinese or global brand enhancement and promotion have been carried out by the Chinese entity -- notwithstanding global efforts, the China tax authority will expect that the China entity is remunerated for its contribution. In an extreme case, if an overseas IP holding company undertakes no functions or risk, the tax authority is likely to re-characterize the whole royalty arrangement. This approach is already being followed in China -- in a recently reported case in Chengdu, the tax authority disallowed all the royalties paid to an IP holding company registered in the British Virgin Islands, on the basis that the China entity made almost all of the contribution to the value of the intangible.

Burden of Proof

Bulletin 16 and its interpretation make it clear that there is no need to get pre-approvals from the tax authorities for overseas remittances of service charges or royalties. However, upon request by the tax authorities, the domestic payer is required to submit the intercompany agreements and other supporting evidence to substantiate the authenticity and arm's length nature of the transaction. There is a clear emphasis on being able to prove the authenticity of the service being provided, something which can be difficult for certain types of services. The tax authorities will have the right to perform a tax adjustment on any non-complying transactions within a period of 10 years and evidence of services should be maintained contemporaneously.

Tax Authorities' New Angles in Examination

High profit is no longer safe harbour for TP audit

It is generally accepted that a loss making or low profit enterprise is vulnerable to TP audit. However, in a recently published case concluded in Guangzhou, we noticed that the tax authority is trying to move away from its traditional approach for target selection and review. Their attention has been extended to high profit companies, and they have identified service transactions being paid to overseas related parties that were obscured by high profits. Through investigation, some service fees have not been allowed to be deducted, and adjustments were made to other significant service fees.

Payment to Tax Havens/Low-tax Jurisdictions

Bulletin 16 denies the deductibility of payments to overseas related parties that do not assume functions and risks or have economic substance. Service charges and royalty fees flowing out to the tax havens and low-tax jurisdictions are usually easy targets for the tax authorities' examination. Due to the low effective tax rate in those jurisdictions, multinational groups have had the motivation to transfer profits to these locations through service charges and royalties. However, the actual functions are seldom carried out by the entities within these jurisdictions, leading to a mismatch between profit allocations and function and risk profile. This kind of arrangement has been and will be more vulnerable to tax authorities' challenges as time goes on. Actions have already been taken -- for example, when Circular 146 was released, the tax authority in Beijing launched a special examination on service charges/royalties paid to a list of tax havens and low-tax jurisdictions, including 40 countries/regions.

Recommendations

Through Circular 146 and the following nationwide scrutiny, the tax authorities have collected a lot of information for target selection and TP audit. The release of Bulletin 16 has provided the tax authorities with a solid legal basis for the specific positions they had announced, and it is expected that follow-up actions will be taken by local tax authorities. In this changing legislative environment and following tax authorities' tightening focus on intra-group services charges and royalties, taxpayers should pay specific attention to the associated TP risks and take proactive action to prepare for possible inquiries and challenges from the tax authorities. In particular, the following measures are recommended:

- Prepare supporting information for intra-group services and royalty transactions, including the transaction flow, legal documents, transaction amounts, and pricing policy;

- Analyze the substance, necessity and reasonableness of the service fees and royalty payment based on business needs and economic substance, including:
  - Business needs when the transactions were implemented, and the continuing requirement;
  - Examine the economic substance of each type of service fee and identify any areas of potential duplication; and
  - Review the group pricing policy and the reasons for any changes over time.

- Review the legal and economic ownership of intangibles, and prepare relevant supporting documents to substantiate the contribution of value creation to the intangibles;

- Communicate with the central finance and tax departments in the group and request information, assistance and integrated solutions at the group level. Dealing with these issues requires open collaboration between the local company and the parent company; and

- Provide training to management and operational leaders on basic transfer pricing requirements to help identify issues early, and ensure there are internal TP guidelines to manage new and changing transactions.

The new regulation and measures will force taxpayers to focus on intercompany service charges and royalties. There are potentially large tax exposures in China if a tax adjustment is performed or entire service fees are treated as non-deductible.

The classical way to mitigate TP risk management is to prepare contemporaneous documentation or to ensure that the profitability falls within a reasonable range may no longer be appropriate. This is no longer enough. Taxpayers need to be more proactive in order to adapt to the new environment, and manage their tax risks in the future.

Note: Contents discussed in this Tax Analysis pertain to Deloitte Transfer Pricing Services.

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