

Tax Analysis

PRC Tax

China Issues Regulations on Cost Sharing Agreements

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China's State Administration of Taxation recently changed its rules on cost sharing agreements (CSAs), which now require Chinese taxpayers that enter into a CSA to register the agreement with the local tax authorities within 30 days of entering into the agreement.

China's State Council on 14 May released Guofa [2015] No. 27, "Decision of the State Council on Cancelling Items Requiring Non-administrative Approval." Further to a series of previous circulars, Circular 27 cancelled 49 items in total that previously required non-administrative approvals, including approval of CSAs.

Soon after Circular 27 was issued, China's State Administration of Taxation (SAT) promulgated SAT Bulletin [2015] No. 45, Bulletin on Standardizing the Administration of Cost Sharing Agreements, effective 16 July 2015, to implement the decisions of Circular 27 from the perspective of the tax administration.

Key Changes to Regulations

Approval authority: The prevailing CSA regulations before Circular 27 and Bulletin 45 entered into effect primarily referred to the relevant articles in Guoshuifa [2009] No. 2 (Circular 2) and the Enterprise Income Tax Law. Article 69 in Chapter 7 of Circular 2 regulated the approval authority of CSAs, and stated as follows:

Article 69: Enterprises must submit a CSA to the SAT level by level for recording within 30 days of concluding the CSA. Tax authorities must report level by level to the SAT for approval to determine whether the CSA complies with the arm's length principle.

In Circular 27, Item No. 46 in the list of cancelled non-administrative approvals refers to "the approval of whether a CSA complies with the arm's length principle." Effective 16 July 2015, Bulletin 45 repealed Article 69 of Circular 2.

From ex-ante approval to ex-post supervision: As stated above, prior to the release of Circular 27 and Bulletin 45, taxpayers had to submit a CSA to the SAT for recording and to obtain the SAT's formal approval regarding the agreement's compliance with the arm's length principle. Approval from the SAT was necessary for taxpayers to implement a CSA and to enjoy the corresponding tax treatments associated with CSAs, including withholding income tax, turnover tax, etc. from the perspective of China taxation.

The issuance of Circular 27 and Bulletin 45 resulted in the repeal of the SAT's administrative responsibility or power of ex-ante approval of CSAs regarding whether relevant arrangements comply with the arm's length principle. However, Bulletin 45 requires China's tax authorities to strengthen ex-post supervision and follow-up administration of CSAs. Note that, under the current Chinese transfer pricing regulations, the statute of limitation for transfer pricing adjustments in China is 10 years.

The SAT's supervisory measures include:

- Audit investigations and special tax adjustments will be carried out against CSAs that do not comply with the arm's length principle, or if the CSA's costs are not commensurate with the benefits accrued; and
- During the execution of a CSA, if the actual benefits accrued by the participants do not match their respective share of the costs, balancing adjustments should be performed, and the tax authorities will conduct a tax investigation and special tax adjustments in cases when the necessary balancing adjustment is not performed.

Bulletin 45 further strengthened the compliance obligations of taxpayers participating in CSAs, including but not limited to the following:

- An enterprise must submit copies of a CSA to its local in-charge tax authority within 30 days from the date the CSA is signed or amended;
- An enterprise that signed or amended a CSA with its related party(ies), regardless of whether the CSA is executed or not, must submit PRC Annual Related Party Disclosure Forms regarding its transactions with related party(ies) as an addendum to its annual enterprise income tax filings.

In addition, according to Article 74 of Circular 2, during the execution of a CSA an enterprise must prepare and maintain contemporaneous documentation, which should include total annual costs within the scope of the CSA, with breakdown, actual cost allocation of each participant in the CSA, update analysis of reasonably anticipated benefits (RABs) against the actual costs and benefits outcome, as well as corresponding balancing adjustments.

Overall, the newly released regulations aim to simplify and facilitate the CSA administration process, and to govern taxpayers' compliance regarding their participation in and execution of CSAs. Nevertheless, it should be pointed out that the SAT has not yet released any clear regulation as to whether and how an enterprise is to receive the relevant tax treatments during the execution of CSAs in respect of shared costs and balancing adjustments, including the treatment of withholding tax and turnover tax.

Commentary

Bulletin 45 was promulgated to implement Circular 27 from the perspective of the tax administration, in the context of government transformation to streamline the administration of CSAs and delegate power. Bulletin 45 clarifies the procedural administration of CSAs, and the transition from ex-ante approval by the SAT to ex-post supervision.

There is no doubt that the newly released regulations will facilitate taxpayers' participation in CSAs from a procedural perspective, in accordance with China's transfer pricing regulations, while requiring taxpayers to prepare corresponding supporting files, technical analyses, and ex-post compliance documents. However, based on our understanding of the relevant tax practice in China, potential risks and uncertainties in practice are worthy of taxpayer consideration, including the following issues.

Outstanding Regulatory Issues

Although Bulletin 45 stresses the arm's length principle and the commensurate-with-income principle, it merely repeats statements of the two principles stipulated in the current Circular 2.¹ However, Bulletin 45 does not include discussions of some key technical issues in practice, for example, how to determine the RABs, and the pricing of buy-in and buy-out payments. These technical issues are crucial to relevant transfer pricing analysis and have significant impact on determining the arm's length nature of CSAs.

More detailed guidance and regulations on outstanding issues may be provided in the forthcoming revised Circular 2, which is now under review by the SAT.

¹ See Article 66, Article 75 *etc.* of Circular 2

Potential Transfer Pricing Audit Risk

From the aforesaid changes to the CSA regulations, it may be concluded that the repeal of ex-ante approval of CSAs by the SAT is closely associated with an increase in ex-post supervision and administration of CSAs. In the future, the Chinese tax authorities may be expected to supervise and monitor taxpayers' execution of CSAs more closely through the review of the PRC Annual Related Party Disclosure Forms and contemporaneous documentation for CSAs under execution.

The Chinese tax authorities would have the legal right to review and challenge the transfer pricing analysis in the CSA-related compliance documents mentioned above. Therefore, it is imperative for taxpayers to actively manage and arrange the relevant compliance work to ensure the ongoing and effective recognition of their CSAs by the Chinese tax authorities. Also, because some of these issues regarding the application of the arm's length principle to CSAs, especially technical issues such as the analysis of RABs and the pricing of buy-in and buy-out payments, may still be new for most local tax authorities in China, we foresee that the Chinese tax authorities may raise inquiries and even challenges in their review and examination of actual CSA cases. The tax authorities may defend their taxation positions from technical perspectives with reference to recent international opinions, such as relevant discussion drafts issued under the OECD's base erosion and Profit Shifting (BEPS) action plan. Hence, in practice, taxpayers may encounter stricter compliance requirements and ex-post investigation risks.

In consideration of the above, we believe taxpayers must prepare all supporting materials for the entire lifespan of the CSAs, covering the arrangement period and subsequent CSA execution period, documenting CSA contents and particular articles, analysis of whether the arrangement of a CSA is in compliance with the commensurate-with-income principle and the arm's length principle, as well as the consequent balancing adjustments in case the costs shared do not match the actual benefits received. For large CSAs, taxpayers may consider applying for an advance pricing arrangement (APA) under China's transfer pricing regulations, to effectively mitigate ex-post investigation risks.

Relevant Tax Treatments and Non-trade Outbound Remittance

As discussed, the above changes to the regulations abolished the SAT's administrative authority to ex-ante approval of whether a CSA complied with the arm's length principle. However, as stated above, without further clarification and regulations, local tax authorities may not respond actively to taxpayers with regard to the grant of relevant tax treatments relating to CSAs, so that taxpayers may not receive and enjoy the relevant tax treatments in a timely manner. In fact, whether the CSA-related tax treatments could be timely and continuously enjoyed by taxpayers throughout the entire CSA execution period is probably the most critical concern for taxpayers when they consider whether to participate in a CSA.

It is also uncertain whether local tax authorities would provide to taxpayers in a timely basis the relevant tax clearance certificates or similar documents for purposes of outbound remittances during the CSAs' course of execution. Therefore, Circular 27 and Bulletin 45 may still leave the aforesaid obstacles to taxpayers in aspects of relevant tax treatments as well as non-trade outbound remittances.

To sum up, Circular 27 and Bulletin 45 aim to streamline the administrative process of CSAs in China, while taxpayers contemplating to participate in CSAs should pay attention to the remaining uncertainties and practical obstacles, plan and prepare ex-ante and ex-post compliance work, keep pace with updates of related laws and regulations, and seek professional advice when necessary.

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

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