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Shenzhen customs and tax authorities announce transfer pricing collaboration

On 18 May 2022, the city of Shenzhen in the Guangdong Province of Mainland China announced a collaboration between Shenzhen's customs and tax authorities on transfer pricing administration. The program, which became effective upon announcement, allows qualifying businesses in Shenzhen to have their transfer pricing arrangements for the importation of goods from related parties agreed to by both Shenzhen customs and tax authorities.

It has long been difficult for multinational groups to manage their transfer pricing on related party imports from both customs and income tax perspectives. The customs authorities normally are concerned as to whether the import price declared by an importer is lower than the arm's length range, which would result in lower customs duty and other import taxes. On the contrary, the tax authorities normally are concerned as to whether such import price is higher than the arm's length range, which would erode the taxable profits of the importer. The lack of coordination between the customs and tax authorities makes it cumbersome for businesses to obtain agreement from both authorities simultaneously on such import prices. The launch of the Shenzhen program marks the first time for the customs and tax authorities in China to formally collaborate on transfer pricing administration to address this lack of coordination.

The Shenzhen program essentially consolidates two existing procedures, i.e., advance rulings on customs pricing and advance pricing arrangements (APAs). A qualifying business that participates in the program must meet the requirements of both procedures.

Authors:

Customs and Global Trade

Janet Zhang Partner

Tel: +86 20 2831 1212

Email: jazhang@deloitte.com.cn

Dolly Zhang Partner

Tel: +86 21 6141 1113

Email: dozhang@deloitte.com.cn

Shelly Ma Director

Tel: +86 755 3353 8751

Email: shelma@deloitte.com.cn

Transfer Pricing

Edison Zuo Partner

Tel: +86 20 2831 1309 Email: <u>ezuo@deloitte.com.cn</u>

Martin Que Partner

Tel: +86 755 3353 8139 Email: mque@deloitte.com.cn

Xiao Xiao Mo Senior Manager

Tel: +86 755 3637 6814 Email: smo@deloitte.com.cn

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Application

To initiate the program, an applicant must meet the following conditions:

Customs advance ruling

- The applicant must be engaged in a foreign trading business and registered with the Shenzhen customs office; and
- The application generally should be submitted at least three months before the date of the proposed import.

APA

- The applicant must be registered with Shenzhen tax office;
- The amount of related party transactions of the applicant must reach CNY 40 million in each of the three calendar years prior to the year in which the Shenzhen tax office sends the notice to the applicant accepting the letter of intent for an APA; and
- The applicant must have good compliance records on transfer pricing without situations that are listed in the APA rules where an APA application may be rejected by the tax authorities (e.g., an applicant fails to prepare transfer pricing documentation according to the enterprise income tax law or a transfer pricing investigation is already initiated against the applicant).

For more information, please contact:

Tax and Business Advisory Transfer Pricing National Leader

Liantang He Partner

Tel: +86 10 8520 7666 Email: <u>lhe@deloitte.com.cn</u>

Northern China

Sophie Wei Partner

Tel: +86 10 8520 7622 Email: swei@deloitte.com.cn

Fastern China

Jerry Wang Partner

Tel: +86 512 6289 1308

Email: jerrywang@deloitte.com.cn

Southern China

Edison Zuo Partner

Tel: +86 20 2831 1309 Email: ezuo@deloitte.com.cn

Western China

Frank Tang Partner

Tel: +86 23 8823 1208 Email: <u>ftang@deloitte.com.cn</u>

An applicant must submit the following to the Shenzhen customs office and the Shenzhen tax office respectively:

Customs advance ruling

- An application form to initiate the program;
- An application letter for a customs advance ruling; and
- Other materials to explain the relationship between the foreign seller and domestic importer and whether such relationship impacts the import price, e.g., relevant entity's audited financial statements, explanations on transfer pricing arrangement, etc.

APA

- An application form to initiate the program;
- An application letter to initiate an APA pre-filing meeting; and
- Other materials about the transfer pricing arrangement, e.g., contemporaneous transfer pricing documentation, annual reporting forms of related party transactions, audited financial statements, etc.

Within 10 days after receiving the application materials, the Shenzhen customs and tax offices will jointly determine whether to accept the application to initiate the program. They would each issue an acceptance letter to the applicant if they agree to accept the application.

Evaluation and negotiation

After the application is accepted, the Shenzhen customs and tax offices will jointly start the evaluation and negotiations within 15 days.

After the Shenzhen customs and tax offices and the applicant have reached a consensus on the pricing arrangement of the imports of goods, the three parties will sign a memorandum accordingly. Based on the memorandum, the Shenzhen customs office will issue a customs advance ruling to the applicant, and the Shenzhen tax office will conclude an APA with the applicant. If the three parties cannot reach a consensus, the Shenzhen customs and tax offices may terminate the program by notifying the applicant in writing.

Execution and monitoring

Pricing adjustments

For each calendar year during the term of the memorandum, the applicant must make pricing adjustments according to the median of the relevant financial indicator's arm's length range, if the applicant's actual financial indicator deviates from the median. The applicant then must report the adjustments to the Shenzhen customs and tax offices.

Annual reporting

For each calendar year during the term of the memorandum, the applicant must prepare and submit an annual report (in both paper and electronic form) to the Shenzhen customs and tax offices within six months after the end of the calendar year. The applicant must disclose the operating information and the implementation status of the memorandum in the annual report.

Amendment and termination

The Shenzhen customs and tax offices may initiate discussions with the applicant to amend or terminate the memorandum in the following situations:

- The applicant did not implement the memorandum;
- There were substantial changes so that the memorandum cannot be implemented (e.g., changes to key assumptions); or
- The applicant proposed to amend or terminate the memorandum.

Indirect Tax National Leader

Lily Li Partner

Tel: +86 21 6141 1099

Email: <u>lilyxcli@deloitte.com.cn</u>

Deputy National Leader

Shu Tian Partner

Tel: +86 10 8534 2338

Email: shutian@deloitte.com.cn

Customs and Global Trade National Leader / Northern China

Yi Zhou Partner

Tel: +86 10 8520 7512

Email: jchow@deloitte.com.cn

Eastern China

Li Qun Gao Partner

Tel: +86 21 6141 1053 Email: <u>ligao@deloitte.com.cn</u>

Southern China

Janet Zhang Partner

Tel: +86 20 2831 1212

Email: jazhang@deloitte.com.cn

Western China

Frank Tang Partner

Tel: +86 23 8823 1208 Email: <u>ftang@deloitte.com.cn</u> According to the memorandum sample jointly issued by the Shenzhen customs and tax offices, key assumptions for the memorandum include that there are no substantial changes to the applicant's business activities, business models, function/risk allocation and asset deployment, financial accounting rules being applied, or tax and customs regulatory environment, there are no significant legal disputes emerging, etc. An applicant is required to report to the Shenzhen customs and tax offices, respectively, within 30 days if there are changes to the key assumptions.

Term and renewal

The memorandum is valid for three years and terminates upon expiration. The applicant may apply for renewal of the memorandum by submitting renewal applications to the offices, respectively, at least 90 days before the expiration date.

Comments

Businesses and tax practitioners likely will welcome the introduction of the Shenzhen program, which should provide a useful tool for businesses to increase the certainty and predictability of the application of the transfer pricing rules from both customs and tax perspectives. The program may save businesses' efforts to separately negotiate with customs and tax authorities on future imports. The joint evaluation mechanism provided by the program can make it easier for businesses to reach agreements simultaneously with the two government authorities.

More collaboration between customs and tax authorities in transfer pricing administration seems to be a global trend, as the World Customs Organization has published documents and cases discussing how to leverage transfer pricing documentation for customs administration purposes. We expect more local Chinese customs and tax authorities to consider the introduction of similar programs aiming to improve their local business environment.

Although the Shenzhen program basically consolidates the existing rules of customs advance ruling and APAs, it is worth noting that the two set of rules still have different features (see below for a few examples). It is left to be seen how these differences would be reconciled in practice. In addition, how the program would be implemented in certain more complex cases (e.g., if a bilateral or multilateral APA is involved) is still unclarified.

- Customs advance ruling A customs advance ruling is valid for three years and can be applied
 nationwide. The ruling only can be applied to future imports and may not be applied to goods that
 have been imported before a ruling is issued. When reviewing the pricing arrangement, customs
 may tend to put more emphasis on the import transaction itself.
- APA An APA can be applied to related party transactions in the following three to five years after
 the tax authorities notify the applicant of the receipt of the APA letter of intent. Upon separate
 application, an APA also may be retroactively applied for a maximum of 10 years. Unlike the
 customs authorities' focus on the transaction itself, tax authorities may review more about the
 overall impact of the related party transactions on taxable profits.

In considering the program, businesses should:

Evaluate the impact of the program – Groups with Shenzhen businesses importing goods from foreign related parties should evaluate the program impact and analyze the feasibility and pros and cons to determine whether to apply for the program to improve the efficiency of their transfer pricing management.

Start to prepare the application package – For businesses that have decided to apply for the program, it is advisable to start the relevant preparation work as soon as possible. The relevant work may include preparation or review of the transfer pricing analysis to support the proposed pricing arrangement, etc.

Monitor the practice and regulatory development – Businesses in other regions that want to apply for such a program should continue dialogues with customs and tax authorities, closely monitor whether any similar local programs will be introduced, and start the relevant application work once such program is announced.

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Country Leader of Tax and Business Advisory services, Deloitte China

Victor Li Partner

Tel: +86 755 3353 8113 Fax: +86 755 8246 3222 Email: vicli@deloitte.com.cn

Northern China

Xiaoli Huang Partner Tel: +86 10 8520 7707 Fax: +86 10 6508 8781

Email: xiaolihuang@deloitte.com.cn

Western China

Frank Tang Partner

Tel: +86 23 8823 1208 Fax: +86 23 8857 0978 Email: ftang@deloitte.com.cn

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National Tax Technical Centre

Email: ntc@deloitte.com.cn

National Leader/Northern China

Julie Zhang Partner

Tel: +86 10 8520 7511 Fax: +86 10 6508 8781

Email: juliezhang@deloitte.com.cn

Southern China (Mainland)

German Cheung Director

Tel: +86 20 2831 1369 Fax: +86 20 3888 0115

Email: gercheung@deloitte.com.cn

Eastern China

Eastern China

Tel: +86 21 6141 1059

Fax: +86 21 6335 0003

Email: mliang@deloitte.com.cn

Maria Liang

Partner

Kevin Zhu Partner

Tel: +86 21 6141 1262 Fax: +86 21 6335 0003 Email: kzhu@deloitte.com.cn

Southern China (Hong Kong)

Doris Chik Director

Tel: +852 2852 6608 Fax: +852 2543 4647

Email: dchik@deloitte.com.hk

Southern China

Jennifer Zhang Partner

Tel: +86 20 2885 8608 Fax: +86 20 3888 0115

Email: jenzhang@deloitte.com.cn

Tony Zhang Partner Tel: +86 28 678

Western China

Tel: +86 28 6789 8008

Fax: +86 28 6317 3500

Email: tonzhang@deloitte.com.cn

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify national marketing team of Deloitte China by email at cimchina@deloitte.com.hk.

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