

Tax

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Tax Analysis

Observations and Recommendations on Recent Trends in Macau Transfer Pricing

The Macau Special Administrative Region ("Macau"), being located in the core area of the Guangdong-Hong Kong-Macau Greater Bay Area ("the GBA"), is closely connected with the People's Republic of China ("China") and the Hong Kong Special Administrative Region ("Hong Kong"). As an international free trade zone with a relatively simple and stable taxation without any foreign exchange control policies, Macau is favoured by many multinational enterprises ("MNEs"), making it one of the popular destinations for foreign investments.

Whilst Macau has to date not yet issued any formal transfer pricing ("TP") regulations, it is however committed to improving its tax regulatory system with reference to international standards - which include joining the OECD/G20 Inclusive Framework on BEPS in 2016 and abolishing the tax exemption rules for offshore business with effect from 1 January 2021.

Recently, we have observed that the Macau Financial Services Bureau (i.e., Macau Tax Authority, the "FSB") is increasingly interested in and has been conducting tax enquiries and investigations in relation to related party transactions conducted by taxpayers as well as the TP policies, in particular on local Macau subsidiaries of an MNE group. This article highlights the Macau tax regulations related to TP and summarizes our observations on the practical application of such, as well as our recommendations thereto.

Overview – Development of TP Regulations in Macau

Macau officially joined the OECD/G20 Inclusive Framework on BEPS in November 2016, and is committed to implementing four BEPS minimum standards, including:

- **Action 5:** Harmful tax practices
- **Action 6:** Prevention of tax treaty abuse
- **Action 13:** Country-by-Country Reporting ("CbCR")
- **Action 14:** Mutual Agreement Procedure ("MAP")

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Specifically Macau has released relevant regulations and guidelines in response to Action 13: CbCR and Action 14: MAP which are closely related to TP, a summary of which is set out as follows:

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BEPS Action	Implementation in Macau
Action 13: CbCR	<ul style="list-style-type: none"> Based on Administrative Regulation No. 1/2020 "Regulation of MNE Operating Activity Record" released in January 2020, the ultimate parent entity¹ ("UPE") of a MNE group with total consolidated revenue exceeding the stipulated threshold, is required to prepare three-tier TP documentation, which includes the Master File, Local File and CbCR.
Action 14: MAP	<ul style="list-style-type: none"> The effective Double Taxation Agreements ("DTA") signed by Macau have included relevant procedures to resolve tax disputes, including MAP. The FSB also released the MAP Guidelines (latest version dd June 2021).

Introduction of the Macau CbCR

According to the Administrative Regulation No. 1/2020 "Regulation of MNE Operating Activity Record" and Law No. 21/78/M "Regulation of the Complementary Tax", the requirements for the three-tier TP documentation in Macau are summarized as follows:

Specific Regulations	
Entity in scope	<ul style="list-style-type: none"> The UPE of a MNE group with total consolidated revenue exceeding MOP7 billion in the immediately preceding financial year.
Three-tier documentation	<p>TP</p> <ul style="list-style-type: none"> Master File: Providing a high-level overview of the global business structure and information of a MNE group. Local File: Providing detailed TP information of the local entity of each tax jurisdiction, such as TP policies on related party transactions (including financial arrangements). CbCR: Providing information relating to the group's income, profits and tax data in each relevant tax jurisdiction, together with other data of specific economic activity.

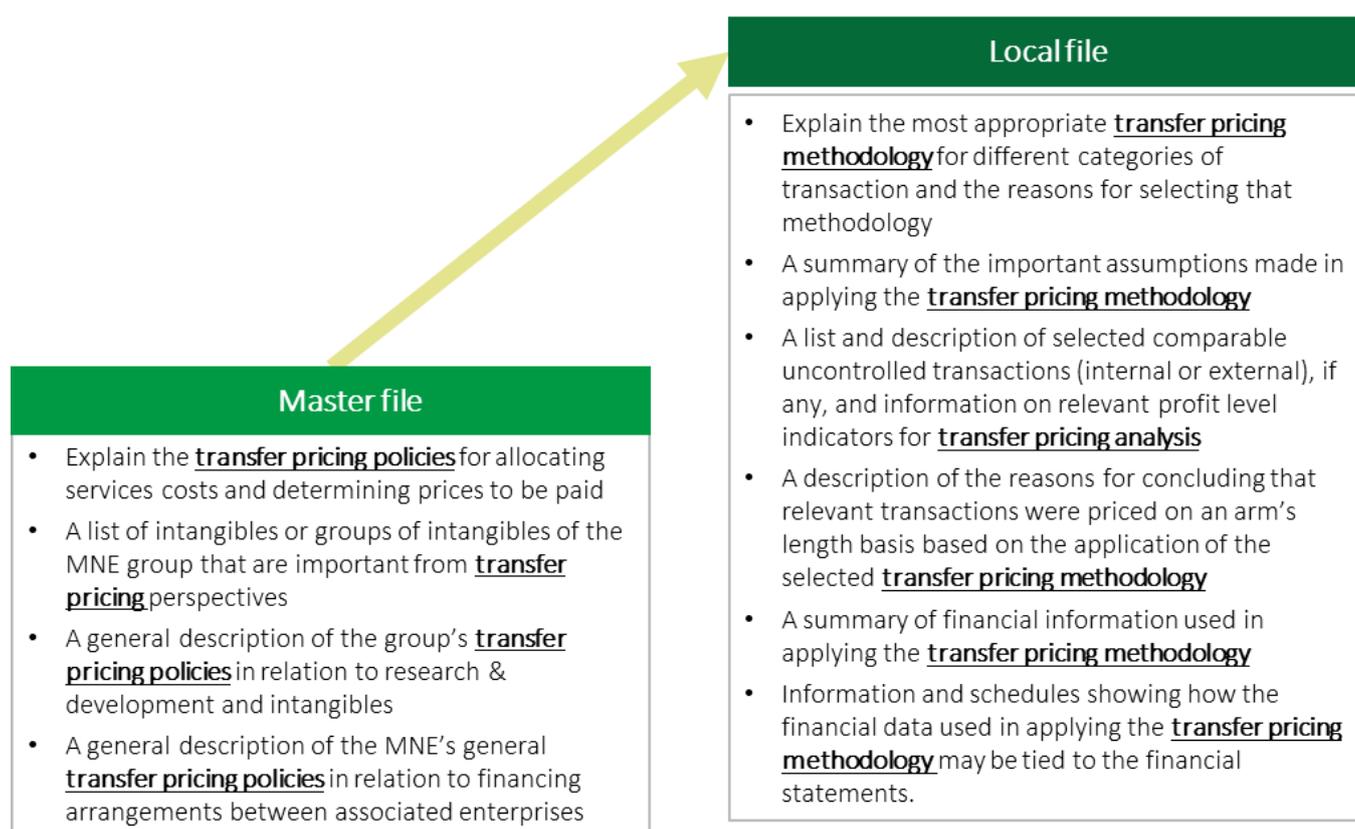
¹ The term "ultimate parent entity" is defined in Law No. 21/78/M "Regulation of the Complementary Tax" Article 1-A Item 1: (1) it owns directly or indirectly a sufficient interest in one or more other Constituent Entities of such MNE Group such that it is required to prepare Consolidated Financial Statements under accounting principles generally applied in its jurisdiction of tax residence, or would be so required if its equity interests were traded on a public securities exchange. and; (2) there is no other Constituent Entity of such MNE Group that owns directly or indirectly an interest described in subsection (1).

Specific Regulations (Cont'd)

Obligations

- **Preparation Obligation:** the UPE must prepare the documents of its MNE for the relevant financial year, and notify the FSB of its obligations, within 3 months after the end of the relevant financial year.
- **Reporting Obligation:** the UPE is required to submit the CbCR in accordance with the electronic encryption and file format as specified by the FSB, within 12 months after the end of the relevant financial year.
- **Retention Obligation:** the UPE should properly keep the documents for at least 7 years, from the end of the relevant financial year.

The TP policies and TP methods are required to be documented in both Master File and Local File:



At present, the three-tier TP documentation requirements of Macau only apply to UPEs that are Macau Complementary Tax taxpayers.

As of the date of issuance of this article, Macau has not formally released any TP regulations to further clarify the arm's length principle and the TP policies and methods as accepted by the FSB. Since the information required for preparing the Macau three-tier TP documentation are basically consistent with the arm's length principle emphasized in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines"), it is likely that the FSB would also take into consideration the TP policies and methods stated in the OECD Guidelines in assessing the TP policies adopted by MNEs in Macau.

Macau MAP

To date, Macau has signed seven DTAs with other tax jurisdictions (except for the Air Services DTA), all of which provide for corresponding TP adjustments (per Article 9 paragraph 2). Taking the DTA between Macau and Mainland China as an example:

"Article 9 Associated Enterprises

2. Where One Side includes in the profits of an enterprise of that Side—and taxes accordingly—profits on which an enterprise of the Other Side has been charged to tax in that Other Side and the profits so included are profits which would have accrued to the enterprise of the first-mentioned Side if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that Other Side shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Arrangement and the competent authorities of both Sides shall, if necessary, consult each other."

If one of the tax competent authorities impose adjustments on the TP arrangement between associated enterprises in accordance with the provisions in Article 9 paragraph 1 of the DTA, the part of profits that has been adjusted may be subject to double taxation. To avoid such double taxation and to provide relief to taxpayers, the Article 9 paragraph 2 of the DTA stipulates that the other competent authority shall make the corresponding adjustments to the part of profits which was taxed previously. This paragraph should not be simply interpreted that the other competent authority shall make adjustments automatically. Rather the corresponding adjustments to the profits of associated enterprises will only be made upon agreement by the other competent authority on the arm's length principle for the adjustment made by the tax authority of the jurisdiction in which the associated counterparty resides. If there are disputes over the bases, causes and amounts of adjustments between the competent tax authorities, both parties may negotiate and conclude in accordance with the MAP stipulated in Article 25 of the DTA.

Based on the MAP guidelines issued by the FSB in June 2021, it is further clarified that MAP is applicable to *TP adjustments that have occurred or will occur between associated enterprises* and that *the FSB will consider the OECD guidelines re application of the arm's length principle.*

Macau has so far entered into comprehensive DTAs with seven tax jurisdictions, including Mainland China, Hong Kong SAR, Portugal, Republic of Mozambique, Republic of Cape Verde, Vietnam and Cambodia. Due to the limited DTAs, MNEs headquartered in other jurisdictions such as Europe, United States, Japan, South Korea and other countries would not be able to seek protection via MAP for double taxation arising from TP adjustments, due to the absence of DTA. To mitigate such risks, it is advisable that MNEs with operations in Macau should proactively review the TP policy applicable to its Macau entity, in accordance with arm's length principle. In addition, taxpayers may consider to take the initiative to consult the FSB on their TP arrangement, in order to obtain certainty on the tax implications and to mitigate the risk of future TP adjustments. Such consultation with FSB may cover areas such as TP method applied, target profit level for the Macau entity based on its TP arrangement, as well as the year-end upward / downward TP adjustments and the relevant tax implications, to mitigate potential enquiry and investigation from the FSB.

Transfer Pricing in Macau Tax Code

At the plenary session of the Macau Legislative Assembly held on 5 November 2021, the draft law "Approval of the Tax Code" (the "draft Tax Code") was generally passed by the Macau Legislative Assembly after discussion. Whilst the draft Tax Code is currently under the detailed review stage and has not yet been passed, the article in relation to TP² in the draft Tax Code does provide a reference to the Macau taxpayers for their future TP planning. Based on Article 113 of the draft Tax Code:

² The content is extracted from the draft Tax Code and the Macau Legislative Assembly may amend the article during the detailed review stage.

"Transfer pricing

The taxpayers could approach the FSB in advance to have an advance agreement on transfer pricing and request an approval from FSB on the transfer pricing determined. It serves as a direct assessment method for determining the tax basis.

If the taxpayers have not applied the transfer pricing advance agreement with the FSB, or the agreement has not been approved by the FSB, the taxpayers should disclose the pricing that would generally be accepted and implemented in similar transactions between independent entities during the submission of their annual income declaration, otherwise the FSB may make a corresponding adjustment by applying an indirect assessment method."

Based on the above draft Tax Code, we expect that taxpayers may consult the FSB on their TP arrangements to have an advance agreement in the future, or disclose related party transactions and TP policies and methods during tax filing based on the forthcoming TP regulations.

In recent years, we have observed that MNEs have taken the initiative to consult the FSB on TP arrangements and policies of their Macau operations due to the increasing number of enquiries and investigation made by the FSB, in particular on TP related matters. We have also successfully assisted some MNEs to consult the FSB for TP advance agreement to obtain certainty on the tax treatment of related party transactions.

Observations on Recent Trends

Macau, as an export-oriented micro-economy, is currently adopting the "1+4" adequate economic diversification strategy³: "1" refers to promoting a diverse tourism and leisure development in accordance with the objective of building a world tourism and leisure centre, and improving the integrated tourism and leisure industry; "4" refers to continuously facilitating the development of the four major industries of big health, modern financial services, high technology, exhibitions and conventions, commerce and trade, and culture and sports.

The businesses carried out by MNEs in Macau are also closely related to the key industries in Macau, such as retail (including clothing and luxuries, jewellery, consumer electronics, beauty makeup, etc.), pharmaceutical, finance, high-tech, tourism and leisure, as well as trading operations carried out by Macau Offshore Companies⁴. In general, subsidiaries set up by MNEs in Macau usually undertake very limited functions, assume limited risks and utilize limited assets; whereas the overseas principal entities would hold the core intangible assets and are responsible for the key value drivers of the group. Under such arrangement, MNEs tend to consider that the Macau subsidiaries only undertake limited functions and risks, and should thus be compensated with a relatively limited but stable profit. The residual profit (or loss) would thus be allocated to the overseas principal entities which undertake the more significant functions and risks and own intangible assets.

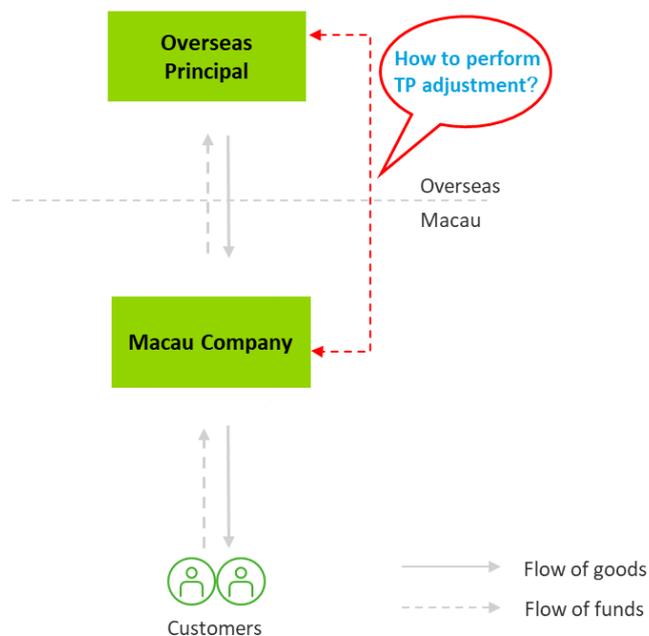
³ Page 25 of Macau Policy Address for the Fiscal Year 2023

⁴ The Macau Offshore Regime has been abolished since 1 January 2021

For the Macau company with limited functions and risks, the commonly adopted TP method is the transactional net margin method (the "TNMM"), which establishes an arm's length range by selecting independent comparable companies with similar functional profile as the Macau entity, bearing similar functions and risks. The MNEs would refer to the arm's length range as established by the benchmarking study to determine the target profit margin of the Macau entity. If the actual profit margin of the Macau company for the year is higher than the target profit margin, a downward TP adjustment is required, and vice versa.

The TP adjustments in both directions (upward and downward) can be made freely given the absence of foreign exchange control policy in Macau. However, based on our observation, in practice, there are still some controversies regarding the above TP arrangement from Macau perspective, including:

- Whether the TP method selected, and the target profit margin of Macau entity determined by the MNE are acceptable?
- Whether the downward TP adjustment made to the Macau entity is tax deductible in accordance with the Regulation of Macau Complementary Tax?



Focus 1: Selection of Target Profit Margin

In general, tax authorities would closely scrutinize situations where substantial profits are allocated to a low-tax jurisdiction by a MNE group, and with the prevailing Complementary Tax rate of 12%, Macau may come under the radar. To mitigate such risks, some MNEs may set the target profit margin of their Macau subsidiaries at a lower level. In turn, some Macau entities may be reporting low profit or even losses over a sustained period. Such factors would usually trigger the attention of FSB to conduct tax enquiries and investigations.

Macau, as a world-class leisure and tourism centre and located in the core area of the GBA, has always been an attraction for tourists from Mainland China. Therefore, the FSB may perceive that the Macau market has its unique value and should thus be appropriately remunerated especially in the tourism related industries. Hence it is generally difficult for the FSB to accept the relatively lower target profit margin for the Macau subsidiaries of a MNE group without advance communication and explanation on the rationale behind.

In addition, the FSB would also assess the profit margin of Macau entities based on the prevailing market data of relevant industries. For some industries with distinct characteristics and similar operations, the FSB can easily retrieve the economic data of Macau companies in the same industry for further analysis. This also sets higher requirements for the quality of the TP analysis conducted by MNEs and the rationale on selecting the appropriate comparable companies.

Focus 2: Tax Deductibility on Downward TP Adjustments

It is quite common for MNE groups to put through TP adjustments in order to achieve the target TP results for their subsidiaries. Essentially a downward TP adjustment is the transfer of surplus profits out of the Macau entity to its overseas related parties. In practice, we have seen different forms of downward TP adjustments made by the Macau entities. From the Macau Complementary Tax perspective, the factors that need to be considered for the purpose of tax deduction are also different with respect to different forms of downward TP adjustments:

	Overview of adjustment methods	Supporting documents	Considerations for tax deduction
Debit/Credit Note	After determining the target profit margin, the transactional price would be adjusted by issuing credit or debit notes.	Debit/credit notes, contracts, invoices, bank payment receipts	<ul style="list-style-type: none"> Whether the additional transactional price adjustments can be considered as part of the cost?
Service Fee	Compensation by way of service fee	Service fee invoices, contracts, bank payment receipts	<ul style="list-style-type: none"> Is the service provider registered in Macau? Are the services provided in Macau? Any personnel sent to Macau? Whether the scope of services is commensurate with the service fee?
Royalty Fee	Compensation by way of royalty fee	Royalty invoices, contracts, bank payment receipts	<ul style="list-style-type: none"> Has service fee been considered if the licensor has provided services?

In recent cases, the FSB have been focusing their enquiries into these two key areas identified – i.e., whether the TP between related parties is reasonable; and whether the transactional arrangements satisfy the tax regulations. MNEs should therefore take heed to determine the reasonable TP arrangement for transactions between related parties and to ensure proper procedures are in place in order to satisfy the Macau tax regulations to achieve the predetermined TP outcome.

Deloitte Recommendations

In recent years, the FSB has been paying increasing attention on TP related matters and based on our observation, FSB may target and enquire into Macau taxpayers with the following conditions:

- Large revenue scale but with long-term losses or minimal profits
- Significantly lower profit as compared to the profit level of entities in the same industry
- Significant fluctuation in profit level in a certain year
- Mismatch between the business scale of an entity versus its profit level

MNEs should thus take precaution and to conduct regular reviews on the reasonableness of the TP arrangement for their Macau entities, the appropriateness of selecting the appropriate comparable companies and establishing the arm's length range, in order to mitigate the risks of double taxation resulting from TP enquiry and investigation conducted by FSB. Also, taxpayers should take note of tax implications on TP related matters, as per the Regulation of Macau Complementary Tax, especially in absence of an extensive DTA network with Macau.

If the related party transactions are complex in nature or the amounts involved are significant in size, rendering them to be of material consideration, taxpayers may also wish to communicate with the FSB in advance and reach for an advance agreement to obtain certainty on the tax implications of such related party transactions.

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