

**Mutual Agreement Procedure and Advance
Pricing Arrangement:
China's Implementation and Application**

1. Introduction

Transfer pricing (“TP”) is becoming a critical issue to tax authorities with economic globalization and expansion of Multinational Enterprises (“MNEs”). In order to protect the tax benefits, tax authorities all push forward harsh measures to the TP issues by way of legislation and administration. On the other hand, in order to protect the taxpayers from international double taxation, tax authorities shall cooperate with others to resolve disputes by way of negotiations. Mutual Agreement Procedure (“MAP”) and Advance Pricing Arrangement (“APA”) become more and more important in today’s international taxation.

China defines MAP and APA as a kind of service provided to the taxpayers, as well as a way of prevention of TP issues. China encourages collaborative instead of confrontational approach to resolve disputes and avoid international double taxation.

2. Development in Legislations and Regulations

2.1. APA History

China began using APAs on a trial basis in the late 1990s. In 1998, an APA was included as one of “other reasonable methods of transfer pricing adjustments” in Article 28 of “The Regulation on the Taxation of Transactions between Related Parties (Trial)” (Guoshuifa (1998) No. 59). In 1998, the first unilateral APA was reached.

In 2002, the APA program was formally introduced in Article 53 of “The Implementation Rules of the Tax Collection and Administration Law of the People’s Republic of China”(Guowuyuan Ling No. 362), and APAs were elevated from an adjustment method to a program.

In 2004, the SAT promulgated “Implementation Rules on Advance Pricing Arrangements for Transactions between Related Parties (Trial Version)”

(Guoshuifa〔2004〕No. 118), which provides details of the APA program and specific procedures such as negotiation and conclusion procedures, requirements, follow-up execution and monitoring, as well as guidance on APA administration in China.

In order to standardize and ensure consistency of China's APA administration across the country, the SAT has implemented rules for APA monitoring and administration since 2005, requiring the local tax authorities to submit the draft unilateral agreement to the SAT for review and approval before its conclusion. Meanwhile, local tax authorities are required to steadily promote APA programs and strictly conform to the relevant regulations to improve the administrative soundness of the APA program. China's APA administration has since stepped into a new stage of well-founded regulation.

In 2008, in order to better adapt to the changing economic environment, the new Corporate Income Tax Law was published with a new Chapter 6 named Special Tax Adjustments, on the basis of practical experiences, both domestically and internationally. It is a relatively comprehensive legislation on anti-avoidance issues, which not only completes laws of Transfer Pricing and regulations of Advance Pricing Agreement, but also introduces many new concepts such as Cost Sharing Arrangement, Thin Capitalization, and General Anti-avoidance Rules into China.

In 2009, the SAT issued "Implementation Measures of Special Tax Adjustments (Trial Version)" (Guoshuifa〔2009〕No. 2) (always referred to as "Circular 2"), followed with several corresponding documents, all of which set up the legislation framework and guideline for China's anti-avoidance work.

2.2. MAP

MAP mainly bases on the treaty or arrangement for the avoidance of double taxation between the government of China and the government of the

corresponding country (region). Chapter 11 of Circular 2 states detailed rules for corresponding adjustments and international consultation.

2.3. Existing Legal Basis

The legal basis and relevant laws, regulations and implementation rules governing MAP and APA primarily include the following:

- a) Treaty or arrangement for the avoidance of double taxation
- b) The Corporate Income Tax Law of PRC
- c) The Implementation Regulations of the Corporate Income Tax Law of PRC
- d) The Implementation Regulations of Tax Collection and Administration Law of PRC
- e) The Implementation Measures of Special Tax Adjustments (Trial Version) (Guoshuifa (2009) No. 2)

3. Recent Improvements in Practice

Recently China raises its principle in treating anti-avoidance issues, that is, integrated administration, service and investigation with equal emphasis on prevention and investigation.

For administration, China pushes hundreds of taxpayers to changing their TP policies and tax planning schemes by way of mandatory related party transaction reporting requirement, examination of cotemporaneous documentation and follow-up administration.

For service, China encourages taxpayers to take collaborative attitudes and provides MAP and APA services to help to save taxpayers from international double taxation. Administration and service are both aimed at prevention, to eliminate potential TP issues in advance.

For investigation, China emphasizes on industry investigation, which means that a series of cases could be concluded in a relatively similar level, which helps to

save manpower and enhance deterrence of TP work in China, pushing other enterprises in that industry to do self-examination and self-adjustment. Similarly, group investigation will help to resolve the TP issues for those taxpayers within the same group of companies. China emphasizes quantified methods and economic analysis, and pays more attentions to functional analysis and value chain study, location specific advantages (LSAs, including location / cost savings, market premium), intangibles (R&D intangibles and marketing intangibles), business restructuring, etc.

3.1. Improvements in Administration

3.1.1. Monitoring and Administrating System

Since March 2005, China has adopted a central management system to monitor and administrate all anti-avoidance cases, asking local tax authorities to make initial and conclusive reports when initiate and conclude a case for SAT's approval. The system is good to regulate TP issues, improve quality of cases, coordinate work between state and local tax bureaus, and bind the country as a whole. The Unilateral APAs which can be conducted by the corresponding local tax offices shall be reported through this system to be reviewed by SAT before conclusion.

3.1.2. Expertise Group Examination (Panel Review Mechanism)

The Monitoring and administrating system is proved to be suitable based on many years' practice. However, there are still several shortages. Firstly, SAT is lack of manpower, with only 8 staff in the anti-avoidance division, in charge of monitoring and administrating TP cases, APA, and MAP, etc.. Secondly, coastal cities in the eastern part of China are more developed than the western, which leads to the fact that staff in anti-avoidance system is more experienced in the

eastern part than the western. The contradiction appears with the Western Development strategy. Enterprises move to the western part for the preferential policies. Lack of anti-avoidance experiences becomes the weak point for staff in the western part.

Considering all above, SAT initiates a proposal to introduce the new working system called Expertise Group Examination (Panel Review Mechanism), on purpose to guarantee the quality of cases concluded, and balance experiences between eastern and western staff. The Expertise Group Examination system is an international common practice and also suitable to China's reality. By appointing several experts in charge, weakness of lack of manpower and imbalance of experiences could be overcome. The administration process would be more transparent, fair and just. Now China has appointed some places to do experiment and achieve greatly.

3.2. Improvements in MAP

MAP includes APA and mutual agreement of TP corresponding adjustment, and is the most straightforward way to cut the international tax revenue cake between countries. Since 2005, China has gradually developed MAP relationship with Japan, USA, Korea and Denmark etc. and has regular MAP meetings with Japan, 3-5 times a year of nearly 10 cases. Up to now, China has concluded 16 BAPA, 7 mutual agreements of TP corresponding adjustment and still has about a lot of MAP cases under examination, regarding USA, Japan, Switzerland, Sweden, Korea, and Singapore. China released its first annual APA report in December 2010, to describe the mechanisms, procedures and implementation of the APA program in China. The first report covers the statistics from 1 January 2005 to 31 December 2009. The third report, 2011 report, will be released soon. Maybe in the near future, China will release MAP reports.

3.3. Improvements in New Concepts

China introduces international common practice into the new legislation, adding many new concepts which still need more practice, such as Thin Capitalization, CFC and CSA. Besides, China asks taxpayers to abide by new liabilities, such as contemporaneous documentation, and third party related documentation supply liability, which help to lower tax administration cost. Thirdly, China develops new concepts such as Market Premium, and Cost Saving, asking other countries to recognize value of China's special factors. In MAP and APA, above mentioned contents reflect in the negotiation.

3.4. Practically Difficulties

In the UN subcommittee meeting which was held this June in Shanghai, China submitted a report regarding the practical difficulties in applying the OECD guidelines for developing countries.

3.4.1. Challenge of a Lack of Reliable Comparables

For a developing country, there are usually only a small number of public companies, and information on domestic private companies is lacking or inadequate, hence limiting the amount of publicly available information on domestic companies that can be used for transfer pricing analysis. Particularly for companies who are first movers in an industry not yet fully exploited, there would be a lack of comparables. In practice, foreign companies are often used as an alternative to domestic comparables. As a result, comparables sets are often dominated by companies in developed countries, simply because there are usually a much larger number of public companies in these countries, which means that the comparables are not really comparable.

One of the most common adjustments in China is accounting for the differences

in geographic comparability when applying profit based transfer pricing methods, such as the transactional net margin method (“TNMM”), to determine an arm’s length price. For example, when an Asia Pacific set of companies is used to benchmark the transfer prices of a Chinese taxpayer, as often being the case, it often includes companies from both developed countries (such as Japan and Korea), as well as developing countries (such as Indonesia and Vietnam). Generally speaking, the Asia Pacific set is more likely to contain companies from developed countries due to a greater amount of listed companies in those countries and hence there is a greater volume of publicly available financial information.

Our view is that there may be instances where the differences in geographical markets are so material that it warrants comparability adjustments to bridge the differences. By making such comparability adjustments, taxpayers in developing countries can overcome the practical difficulties in applying the arm’s length principle to their transfer pricing analysis.

3.4.2. Location Specific Advantages

Location Specific Advantages (“LSAs”) mainly include location savings and market premium now, and maybe will have new contents in the future.

Location savings are the net cost savings derived by a multinational company when it sets up its operations in a low cost jurisdiction. Net cost savings are commonly realized through lower expenditure on items such as raw materials, labor, rent, transportation and infrastructure even though additional expenses (“dis-savings”) may be incurred due to the relocation, such as increased training costs in return for hiring less skilled labor.

Market premium relates to the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product.

In our dealings with Chinese taxpayers, we have adopted a four step approach on the issue of LSAs:

- a. Identify if an LSA exists.
- b. Determine whether the LSA generates additional profit.
- c. Quantify and measure the additional profits arising from the LSA.
- d. Determine the transfer pricing method to allocate the profits arising from the LSA.

3.4.3. Other Issues

When dealing with intangibles, we will face the issues like the owner of IP, the type of IP, the profit split ratio, etc. When dealing with marketing function, we will face the issues like whether there exists a marketing intangible, or only simple distribution. We emphasize functional analysis and value chain study, and try our best to match the function, risk and profit.

When dealing with cases which are difficult to apply the traditional TP method stated in the OECD guidelines, we will try to find more appropriate method for that specific case. China emphasizes quantified methods and economic analysis as well as industry analysis. We believe when we understand the industry as a whole, the tax planning scheme for that industry will lose its mysterious veil. An industry wide or a multinational group wide audit has been a very effective and efficient way for the tax administration to make use of its limited resources to maximize its benefits.

4. Capacity Building Program

One of the key issues that faced by developing countries is the lack of experience and knowledge on how multinational companies operate and on a particular industry. Our experience has been that a dedicated team, with accounting, economics, and industry background would be very critical.

We expand our head office of SAT from 6 to 8 staff and is expanding our national team from 200 to 500 in the near future. However, the team would not be skilled and experienced enough to deal with all the sophisticated cases. We still need time to train our people to be qualified.