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AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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SUBJECT

CHINA'S SAT VIEWS TRANSFER PRICING AS THE MOST IMPORTANT ACTION ITEMS IN BEPS PLAN

BACKGROUND

The United Nations ("UN") subcommittee on Base Erosion and Profit Shifting ("BEPS") Issues for Developing Countries has recently released China's responses to its questionnaire about countries' experiences regarding BEPS issues, along with responses received from other developing countries.

BEPS refers, in part, to tax planning techniques by companies that exploit gaps in international and domestic tax laws, as well as mismatches between different domestic tax systems, to shift profits. As a result, corporate tax rates are often unduly low and not necessarily reflective of the realities of the underlying economic transactions.

In 2013, the Organization for Economic Cooperation and Development ("OECD") and the Group of Twenty industrialized nations ("G20") jointly established the BEPS project to address global concerns about BEPS. In its plan to address BEPS, the OECD set forth 15 action items in areas such as transfer pricing, permanent establishment, harmful tax practices, and treaty abuse.[1]

In response to the UN questionnaire in late 2014, the Chinese State Administration of Taxation ("SAT") said that it views the transfer pricing actions of the international project to combat base erosion and profit shifting as the most important items in the project. We have summarized the SAT's responses below.

[1] More detailed information on the background and content of the BEPS Action Plan can be found in BDO Tax Alert, "OECD Releases Action Plan on Base Erosion and Profit Shifting (BEPS), issued in August 2013 and available at www.bdo.com/download/2770.

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Common Practice and Structure

The SAT identified certain BEPS practices and structures used by multinational enterprise (“MNE”) groups in China to lower the profits of its Chinese subsidiaries, in its response to the UN’s questionnaire. These practices and structures include the use of transfer pricing principles and methods involving related-party purchase and sale transactions, equity transfer transactions, financing transactions, and service provision transactions. In addition, the use of shell companies with no genuine economic substance in the low-tax jurisdictions and tax havens are commonly seen.

Transfer Pricing and BEPS Data Analysis

The SAT views transfer-pricing-related actions as most important to China. BEPS Actions 8, 9, and 10 exist to ensure that transfer pricing outcomes are in line with value creation, with Action 8 focusing on intangibles, Action 9 focusing on risks and capital, and Action 10 focusing on other high-risk transactions.

In addition, the SAT believes that Action 11, Establishment of Methods to Collect and Analyze Data on BEPS, “will be increasingly important to us” and “is something that developing countries should work hard on.” The SAT said China currently does not have a system which quantitatively analyzes the base erosion in China.

Other Important BEPS Actions for Developing Countries

The SAT stated that other BEPS actions that are important to developing countries include Action 14, which seeks to make dispute resolution mechanisms more effective. “With the increase in disputes between tax jurisdictions resulting from a rise in transfer pricing audits, more [mutual agreement procedure (’MAP’)] cases have emerged in bilateral negotiations.” Therefore, the SAT advised laying out an action plan on how to resolve MAP cases during bilateral negotiations.

The SAT states that another important action is Action 1, which addresses the tax challenges of the digital economy. The increase in online transactions causes difficult questions about how to tax these transactions. The SAT suggested the BEPS plan to “consider how to tackle the challenges of digital economy on the existing tax systems and the revenue base.”

General Anti-Avoidance Rules (“GAAR”)

In addition to the 15 BEPS actions, the SAT has suggested that developing countries establish GAAR to combat BEPS, to close out tax loopholes and deal with business activities with no genuine substance.

Primary Obstacles

To determine whether the appropriate amount of profit is reported in China, the SAT said China will audit the MNE group’s annual filing, review contemporaneous documentation, consider the profit levels of the industry and comparable companies, and perform functional analysis.

China is facing two major obstacles in assessing whether the appropriate amount of profit is reported in China and assuring that tax is paid on such profit. First, the SAT has said, China has a lack of comparable companies. China’s domestic legislation requires listed companies to make disclosures, but unlisted companies are not required to do so. The SAT said that it is not realistic to find comparables from the 2,000 listed companies in China. Second, companies are not cooperative. The SAT has said companies are not willing to provide the tax authorities with necessary information, such as resale prices. The companies’ reluctance to cooperate makes it more difficult to conduct tax audits in China.

OBSERVATION

Transfer-pricing strategies involving related-party transactions will continue to be a hot-button issue in China and is likely to receive greater scrutiny. The Chinese tax authorities are likely to demand that a greater portion of the profits in the value chain to be allocated to China. Multinational groups should continue to evaluate any new and existing tax structures to take into account the SAT's preferred treatment of these transactions.

HOW BDO CAN HELP

BDO United States-China Desk members are constantly aware of the BEPS status and the Chinese tax authorities' reaction to the developments. We have the knowledge and expertise to assist you in reviewing your current structure in light of BEPS action points and developing viable long(er)-term planning strategies.