NOVEMBER 2014
www.bdo.com

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

BDO KNOWS: INTERNATIONAL TAXATION

SUBJECT

CHINESE, U.S. POSITIONS ON MANAGEMENT FEES ARE GETTING CLOSER

BACKGROUND

Recent statements by an official of the Chinese State Administration of Taxation ("SAT"), in conjunction with prior guidance issued by the Internal Revenue Service, as set forth in Technical Advice Memorandum ("TAM") 8806002, suggest that the two tax authorities may not be far apart in how management and service fees are treated. As a result, analyzing these expenses under the approach outlined in the TAM may help United States multinationals in dealing with tax audits in China.

A review of the SAT's current position in comparison to the Service's historical guidance on subsidiary expenses, stewardship expenses, and apportionment demonstrates the proximity in views between the two tax authorities as outlined below.

Subsidiary's Expenses

When employees of a parent company train employees of their Chinese subsidiaries, it is the SAT's view that the Chinese entity benefits from the training because its employees advance their skills; therefore, the services are properly chargeable to the Chinese subsidiaries at an arm's-length price.

In its TAM, the Service's position regarding a subsidiary's expenses is that they "are for the direct benefit of one or more of the subsidiary corporations." Such expenses that "proximately and directly benefit" a group of subsidiaries are properly chargeable against the operating income of the subsidiaries.

CONTACT:

ROBERT PEDERSEN
International Tax Practice Leader
212-885-8398 / rpedersen@bdo.com

BOB BROWN
Partner
412-281-6018 / rmbrown@bdo.com

JERRY SEADE
Principal
713-986-3108 / jseade@bdo.com

HOLLY CARMICHAEL
Partner
408-352-1985 / hcarmichael@bdo.com

CHIP MORGAN
Senior Managing Director
310-557-7517 / cmorgan@bdo.com

FABRIZIA HADLOW
Senior Manager
312-239-9224 / fhadlow@bdo.com

WILLIAM F. ROTH III
Partner
616-776-3761 / wfroth@bdo.com

SCOTT HENDON
Partner
214- 665-0750 / shendon@bdo.com

BRAD RODE
Partner
312-233-1869 / brode@bdo.com

DAVID ZHANG
Partner
408-278-0220 / dzhang@bdo.com

GORDON GAO
Partner (BDO China)
+86 021 3331 2129 /gordon.g@bdo.com.cn

Stewardship Expenses

Both nations apply a benefit test in determining whether a United States parent is appropriately charging management fees to its Chinese subsidiaries or whether such fees are the stewardship expenses of the United States parent.

Under Chinese law, related-party management fees attributable to shareholder activities and charged on the basis of an associated relationship between "investors and investees" are chargeable to the Chinese subsidiaries. However, the SAT's view is that when a parent company provides services to its subsidiary associated with the parent's own strategic management, but not classified as shareholder activities, the parent may benefit more from the services than the subsidiary. "Therefore, the parent company should not charge service fees to the subsidiary merely because the subsidiary may benefit from such service." If the management strategy and approval process benefits both the parent and the branch "it is deductible, but no margin plus."[1]

In the TAM, the Service defines stewardship expense, which is deductible by the parent, as "an expense which is generally limited to items that do not benefit an affiliate in the conduct of business operations." Stewardship expenses include the costs of:

1. Duplicate review, or performance, of activities already undertaken by the subsidiary;
2. Periodic visitations and general review of the subsidiary's performance;
3. Meeting reporting requirements or other legal requirements of the parent shareholder that the subsidiary would not incur but for being part of the affiliated group; and
4. The cost of financing or refinancing the parent's ownership participation in the subsidiary.

The TAM further states that the parent's expenses that "are not properly includible as stewardship expenses" belong to the United States parent. The Service cited the costs of investigating certain new business activities as an example of an expense that is not a stewardship expense because it does not relate to current investments.

Apportionment

During transfer-pricing audits, the SAT will decide as a threshold issue whether the related-party service at issue benefits both the United States parent and its Chinese subsidiary from both the perspective of the service provider and the service recipient.

The Service also stated in the TAM that an apportionment of stewardship expenses is necessary when "the benefits derived from a single, indivisible activity are proximate and direct" to both the businesses of the parent and the subsidiary. Such expenses are those that benefit the operating members of the group as a whole.

▶OBSERVATION

Recent statements by a Chinese official reflect positions in the SAT's recent letter to the United Nations' tax committee which described several situations where service fees should not be charged to subsidiaries:

- When a parent company provides services associated with its own strategic management, even if they are not classified as "shareholder activities" (a category for which no charge applies under OECD services guidelines), the subsidiary may benefit, but "the parent company will benefit more." Therefore, the parent should not charge service fees to the subsidiary merely because it also benefits.
- Advisory and legal services from the parent may confer some benefit to a manufacturing company in China, but these high-end services may not satisfy a cost-benefit analysis from the subsidiary's perspective.

---

[1] Remarks of Liao Tizhong, Director General of the SAT's International Taxation Department, at a conference held in Washington, D.C. on June 4, 2014. 23 Transfer Pricing Report (Bloomberg BNA) 273 (June 12, 2014).

- When a parent company provides intangible assets to its Chinese subsidiary and shares the associated residual profit by receiving a royalty, the parent "should not separately charge the subsidiary additional management fees."
- Most of the subsidiaries in developing countries have their own management teams and need only approval of decisions from their parent companies. "In this situation, we believe that these types of management services are likely to be duplicative activities or shareholder activities and, therefore, should not be charged."[2]

CONCLUSION

Intragroup management and service fees will continue to be a hot button issue in China and, accordingly, United States multinationals should continue to evaluate any new or existing service fee structures to take into account the SAT's preferred treatment of these transactions. The SAT's position on management and service fees is generally in line with the TAM, which was arguably superseded by the 2009 intercompany service fee regulations. However, this position provides detailed guidance on the transfer-pricing treatment of these fees and may serve as a useful reference in Chinese transfer-pricing audits.

HOW BDO CAN HELP

BDO's Transfer Pricing and International Tax professionals in the United States and in China have the knowledge and expertise to help clients in all matters related to transferring pricing strategies, documentation and audit assistance in the United States and China. Whatever the nature of your business and whatever your industry, BDO has the tools, local presence, and regulatory knowledge to help you stay ahead of the changing transfer-pricing landscape.

[2] Letter dated January 16, 2014, to the United Nations' Committee of Experts on International Cooperation in Tax Matters, cited in 23 Transfer Pricing Report (Bloomberg BNA) 441 (July 24, 2014).