China tax authorities will review all outbound payments to overseas related parties

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In brief

On March 18, 2015, the State Administration of Taxation (SAT) released the *Public Notice Regarding Certain Corporate Income Tax Matters on Outbound Payments to Overseas Related Parties* (SAT Public Notice [2015] No.16, hereinafter referred to as the "Public Notice 16"). The SAT office released its *Interpretation to the Public Notice 16* (hereinafter referred to as the "SAT's Interpretation") the next day, through its official website.

Public Notice 16 states that outbound payments to overseas related parties should follow the arm's length principle, and also specifies various circumstances where payments, service fees or royalties paid to overseas related parties would not be deductible for corporate income tax (CIT) purposes. Substance and documentation are also specifically addressed.

We believe that Public Notice 16 reflects SAT's efforts to protect its tax base and demonstrates China's support to the overall base erosion and profit shifting (BEPS) initiatives with local implementation of measures imposed on Chinese enterprises. Substance and documentary evidence are likely to be key issues in which there will be vigorous debates on interpretation by taxpayers and tax administrations.

In detail

What happened?

Public Notice 16 is the culmination of the SAT's views towards intragroup outbound payments and includes elements that have been drawn from previous guidelines, such as its official Response to the United Nations (UN) in March 2014 on comments regarding intragroup services and management fees, and *Notice of Anti-Avoidance Examination on Significant Outbound Payments* (Shuizongbanfa [2014] No.146, hereinafter referred to as the "Circular 146"), which is an internal guideline from SAT to local-level tax authorities regarding investigations on the intragroup outbound payments.

In March 2014, in response to the UN's request for comments on intra-group services and management fees, the SAT submitted an official Response to express its views. In the Response, the SAT reaffirmed its stance that service fees paid and received by related parties must be in compliance with the arm's length principle. In regards to management fees, the SAT stated that these expenses, in general, related to shareholder activities and therefore shall not be deductible for CIT purposes. For details of this Response, please refer to our Tax Insight dated April 2014. Later on, the SAT released Circular 146, which requested local-level tax bureaus to launch comprehensive tax examinations on taxpayers with significant outbound service fee and royalty fee payments to overseas related parties, and submit the investigation reports to the SAT. For details of our

observations for the Circular 146, please refer to our *China Tax/Business News Flash*, 2014, Issue 19. For details of the local-level tax authorities' examination on the intra-group outbound payments, please refer to our *China Tax/Business News Flash*, 2014, Issue 34.

Arm's length principle and authenticity test

Articles 1 and 2 of Public Notice 16 state that taxpayers must comply with the arm's length principle when making payments to its overseas related parties. Taxpayers will be expected to provide relevant documentation upon request, such as intercompany agreements, documentation that verifies the authenticity of the transaction, and transfer pricing documentation.

The position in Articles 1 and 2 is supported by the SAT's Interpretation, where it states that:

"Outbound payments by an enterprise to its overseas related parties should be regarded as the enterprise's normal business operation, and could be paid without the tax authority's approval. However, for the purpose of examining the arm's length principle of the outbound payments, the in-charge tax authority may require an enterprise making outbound payments to overseas related parties to provide contracts or agreements concluded with its overseas related party, and relevant documentation which can verify the authenticity of the transaction and prove that the transaction complies with the arm's length principle within the certain period. If outbound payments by an enterprise to its overseas related party are not in compliance with the arm's length principle, the tax authorities are empowered to make special tax adjustments."

Article 7 of Public Notice 16 reconfirms China's existing legal framework for the 10 year statute of limitations for special tax adjustments, which include transfer pricing matters.

Types of payments that are not deductible for CIT purpose

Articles 3 to 6 of Public Notice 16 specify the type of payments that are not deductible for CIT purposes:

- *Article 3* – payments to overseas related parties not undertaking functions, bearing risks or having no substantial operations or activities.
- *Article 4* – service fee payments to overseas related parties for services which do not enable the taxpayer to obtain direct or indirect economic benefits.
- *Article 5* – royalty payments, not in compliance with the arm's length principle, paid to overseas related parties that only hold legal ownership rights with no contribution to the value creation of the underlying intangible asset.
- *Article 6* – royalty payments to overseas related parties in compensation for incidental benefits arising from financial or listing activities, where a holding or financing company is established offshore for the main purpose of financing or listing.

Article 3: Unqualified overseas related parties

Article 3 of Public Notice 16 states that "payments to an overseas related party which does not undertake functions, bear risks or has no substantial operation or activities shall not be deductible for CIT purpose." However, neither Public Notice 16 nor the SAT's Interpretation give clear instructions to local tax authorities about how to determine this issue. For example, whether an overseas related party that operates as a clearing centre for intercompany payments between group companies as its sole activity will be captured under Article 3 is unclear. Different outcomes may arise depending on whether a holistic or narrow view of the arrangements is adopted.

Article 4: Unqualified service fee

According to Public Notice 16 and SAT's Interpretation, taxpayers should receive services that enable them to obtain direct or indirect economic benefits in return for service fees paid to overseas related parties. Expenses related to the beneficial services received by the enterprise can be paid based on the arm's length principles and payments for non-beneficial services are not deductible for CIT purpose.

Article 4 outlines the situations where service fee payments to overseas related parties in compensation for the following services would not be deductible for CIT purpose:

i) *Services that are unrelated to the functions and risks borne by the enterprise or operation of the enterprise.* Insights on what this situation may entail can be gained from reference to Circular 146 (e.g. suspicious service payments)[1] or the SAT's official Response to the UN (e.g. necessity test). For example, various advisory and legal services provided by a parent

[1] "Fee paid for services that are unrelated to the domestic enterprise's function and risk profile, or even though related but not suitable for its current operation phase".

company may indeed confer some benefit to a manufacturing subsidiary in China. However, these high-end services may not be needed from the perspective of the subsidiary given its functions and a cost-benefit analysis.

ii) *Intra-group services relating to the protection of the investment interests of the direct or indirect investor of the Enterprise, including control, management, supervising activities for the Enterprise*. This situation mainly focuses on shareholder activities based on explanations in the SAT's official Response to the UN[2] and Circular 146[3]. From our practical experience, the SAT's interpretation of shareholder activities has been more stringent than what is generally regarded as shareholder activities under the Organisation for Economic Co-operation and Development's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines).

iii) *Intra-group services that have already been purchased from a third party or have been undertaken by the Enterprise itself*. This situation refers to duplicative activities which are also covered under Circular 146 and in the OECD TP Guidelines. However, the OECD TP Guidelines also provide two exceptions when determining if a service is duplicative. It is uncertain whether China tax authorities will accept the exceptions described in the OECD TP Guidelines when they are determining whether a service provided to the taxpayer is duplicative or not.

iv) *Services where the Enterprise obtains additional benefits solely for being part of a corporate group, and the enterprise has not received any specific services from related party within the group*. This situation is similar to the concept of "incidental benefits"[4] and "passive association"[5] discussed in the OECD TP Guidelines. How and when the China tax authorities determine that this situation arises will be of interest, as it is the first time that this language has appeared on any official China tax legislation or guidance. It is uncertain how the China tax authorities will interpret this Article in practice.

v) *Services that have been remunerated through payments for other related party transactions*. This situation refers to the remuneration test which is consistent with the provisions set in Circular 146.

[2] Certain types of management services (using SAT's example, management decision approvals from the parent company when the subsidiary has their own management team) are likely to be duplicative activities or shareholder activities and hence should not be charged.

[3] The services of shareholder include planning, management, supervising activities regarding the operation, finance, human resource etc. for the domestic enterprises.

[4] "There are some cases where an intra-group service performed by a group member such as a shareholder or coordinating centre relates only to some group members but incidentally provides benefits to other group members. Examples could be analysing the question whether to reorganise the group, to acquire new members, or to terminate a division. These activities could constitute intra-group services to the particular group members involved, for example those members who will make the acquisition or terminate one of their divisions, but they may also produce economic benefits for other group members not involved in the object of the decision by increasing efficiencies, economies of scale, or other synergies. The incidental benefits ordinarily would not cause these other group members to be treated as receiving an intra-group service because the activities producing the benefits would not be ones for which an independent enterprise ordinarily would be willing to pay." ("OECD Guidelines", §7.12)

[5] "An associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefitted from the group's reputation deriving from global marketing and public relations campaigns." ("OECD Guidelines", §7.13)

vi) *Other services that have not provided the enterprise with any direct or indirect economic benefits*. This situation can be regarded as a "catch all" clause to capture all the other situations where service fee payments may have been made for non-beneficial services and which would not be deductible for CIT purpose.

Article 5: Royalties paid to an overseas related party which only owns the legal rights of the intangible asset but having no contribution to its value creation, not in compliance with the arm's length principle

Article 5 of Public Notice 16 states that:

"For royalties in compensation for usage of intangible assets provided by an overseas related party, the contribution of each party to the value creation of the intangible assets should be considered to determine the economic benefits that each party is entitled to. Royalties paid to an overseas related party which only owns the legal rights of the intangible asset but having no contribution to its value creation, not in compliance with the arm's length principle, is not deductible for CIT purpose."

According to the SAT's Interpretation of this article:

"Enterprises, who are required to make royalty payments about technology, brand and other intangible assets, they should analyse each party's functions performed, assets employed and risks assumed in the intangible assets development, enhancement, maintenance, protection, application and promotion to decide the contributions made by each party to the value creation of the intangible assets, to further confirm the economic benefits that each party is entitled to. Furthermore, complying with the arm's length principle, whether it is necessary to make royalty payments to overseas related parties and the amount of payments would be ascertained. Royalties paid to an overseas related party which only owns the legal rights of the intangible asset but having no contribution to its value creation, not in compliance with the arm's length principle, is not deductible for CIT purpose. For example, the domestic real estate enterprise utilizes overseas related party's brand or trademark for real estate development, if the brand or trademark is gradually being recognized during the domestic real estate development process and being promoted and maintained by the domestic enterprise to realize the brand valuation, the royalties paid should be regarded as not in compliance with the arm's length principle, and therefore, the payment is not deductible for CIT purpose."

We believe that Article 5 of Public Notice 16 directly expresses the BEPS Action 8: *Guidance on Transfer Pricing Aspects of Intangibles* and reflects the SAT's sentiment to the concepts of ownership and valuation towards intangible assets and associated rights. Considering the royalties in compensation for usage of intangible assets, Public Notice 16 requires taxpayers to analyse each party's functions performed, assets employed and risks assumed in the intangible assets development, enhancement, maintenance, protection, application and promotion, which is consistent with the descriptions relating to "transactions involving the development, enhancement, maintenance, protection and exploitation intangibles" in BEPS Action 8.

The OECD's framework for intangibles under BEPS Action 8 allows scope for a legal owner to charge fees to the licensee based on legal or contractual rights. However, Public Notice 16 reveals SAT's stricter attitudes towards this issue: royalties paid to an overseas related party who is only the legal owner of the intangible asset but has no contribution to its value creation (i.e. not an economic owner), might not be deductible for CIT purpose. In practice, some multinational enterprises may have sub-license or multi-license arrangements to use certain intangible assets. For example, MNE group headquarters may license the intangible to a MNE group member, Company A, and Company A will further license the intangible to other group subsidiaries. After Company A receives the royalty payments from related parties, it will transfer the payment to the headquarters. Based on this situation, it is uncertain whether the tax authorities will consider such an arrangement to fall directly under Article 5 and disallow the royalty payments from Company A, being not deductible for CIT purpose.

It is challenging to evaluate the contributions of each party to the value creation of the intangible assets. Public Notice 16 does not provide clear guidance about the contribution analysis. However, without any doubt, outbound payments to overseas related parties who only own the legal rights of intangible assets, and are located in tax havens or low tax jurisdictions, will very likely be targets of tax investigations and audits in the future. Public Notice 16 requires the analysis of contributions made by each party to the value creation of the intangible assets, which indirectly reveals that the tax authorities will apply the Profit Split Method more frequently in conducting taxation evaluation in the future.

Article 6: Royalties paid to an overseas related party in compensation for incidental benefits arising from the financing or listing activities

Article 6 of Public Notice 16 states that:

"Where a holding or financing company is established offshore for the main purpose of financing or listing, royalties paid to an overseas related party in compensation for incidental benefits arising from such financing or listing activities is not deductible for CIT purpose."

We believe that this Article may have implication for taxpayers whose parent entities or related party entities are listed abroad with their main business(es) within the territory of China. The tax authorities may consider that the overseas related party has no reason to receive the royalty payment merely because of the overseas companies' names, stock code and related information listed on the publicity materials. As a result, the relevant payment would not be deductible for CIT purpose.

The takeaway

Public Notice 16 was only issued a week ago and at this stage it is uncertain if the China tax authorities must launch a formal transfer pricing investigation procedure in order to make the special tax adjustments for the types of payments outlined in Public Notice 16. It will not be a surprise that there will likely be different views between the China tax authorities and taxpayers on the deductibility of an outbound payment to overseas related parties. It is still probable that local-level tax authorities may require taxpayers to make self-evaluation and self-adjustments to their corporate income tax returns, rather than deal with these issues under a formal tax investigation or audit.

It should be noted that, according to China tax regulations, corresponding adjustments will not be applied to situations where the transfer pricing adjustments made by China tax authorities apply to intercompany transactions where taxes are already withheld in respect of the payment, e.g. interest, rental or royalty payment to overseas related parties (i.e. withholding income tax). Therefore, the taxpayers may need to consider whether it is possible to request Mutual Agreement Procedures (MAP) to resolve international double taxation issue. However, a potential approach taken by tax authorities could be that the tax authorities directly conclude that the relevant payment to overseas related parties is not deductible for CIT purpose based on the corporate income tax regulations, rather than making a special tax adjustment through a transfer pricing investigation. Under such situation, whether an enterprise and its overseas related parties are still eligible to apply for MAP in accordance with tax treaty, should be analyzed case by case.

At an operational level, it is uncertain at this stage how the local-level tax authorities will enforce the guidelines provided in the Public Notice 16. However, there is no doubt that the SAT's aim is to strengthen the tax administration of outbound payments to overseas related parties. Therefore, we consider that the following actions are critical in monitoring the tax risks of an MNC's Chinese local subsidiary's intra-group outbound payments:

- As a good starting point, a comprehensive tax health check is necessary to identify the status and risks for a subsidiary and the group based on its current intragroup outbound charges. Immediate actions should be taken to rectify any issues identified and build up a sustainable intragroup charges structure and system which may involve both the overseas parent company/related parties and Chinese local subsidiaries.
- Taxpayers should be ready for a potential transfer pricing investigation by the tax authorities, focusing on thorough and proper tax and transfer pricing documentation and adequate justification of intragroup outbound service charges. During a transfer pricing investigation, taxpayers should evaluate whether the overseas related party has substantial operation or activities or not, the tax authorities may request the enterprise to disclose the detailed information of its overseas parent company / related parties.
- Effective and efficient communication should be maintained between taxpayers and local-level tax bureaus to resolve any potential disagreements early on, so as to mitigate the potential for surprises in a tax investigation or audit.
- Sound ongoing internal tax risk control and update/improve the intra-group outbound service charges mechanism to ensure timely and effective tax compliance.

Let's talk

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