Transfer Pricing in Base Erosion and Profit Shifting: Global Impact and China Practice

(Draft)

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Content

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A. Introduction of BEPS and Its Relationship with TP

Introduction of BEPS: The Story So Far

- In June 2012, OECD released Discussion Draft on Transfer Pricing Aspects of Intangibles ("the 2012 Discussion Draft");
- In October 2012, United Nation issued Practical Transfer Pricing Manual for Developing Countries;
- By the end of 2012, multinationals such as Google, Amazon and Starbucks were publicly critized upon their taxation arrangement by the governments of the U.K. and Australia;
- On 12 February 2013, OECD released Addressing Base Erosion and Profit Shifting;
- Since March 2013, research on BEPS was conducted by the U.K., Australia and U.S. governments, and further challenges were raised upon the taxation arrangement such as Apple and Google;
- In June 2013, OECD submitted a report regarding the bilateral information auto-exchange to G8 summit;
- On 19 July 2013, OECD released its Action Plan in regard to BEPS, to coincide with G20 Finance Leaders meeting in Moscow, consisting of 15 specific actions and determining the results of the actions and a timetable;

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Introduction of BEPS: The Story So Far (Cont'd)

- On 30 July 2013, OECD issued a revised Discussion Draft on Transfer Pricing Aspects of Intangibles ("the 2013 Discussion Draft"), it is a key part of BEPS and the Action Plan;
- On 30 Jan 2014, the Country by Country report template was issued by OECD, whereby the requirements were made toward enterprises to disclose their revenue, taxation allocation information on a country by country level to tax authorities;
- In Feb 2014, IMF started gathering research opinions regarding the spillovers effects of international taxation;
- On 9 May 2014, discussion were held in G20 Tokyo Taxation Conference regarding BEPS, so as to facilitate trenchancy and exchange of global taxation information, in order to guarantee developing and lower income countries to benefit from the above actions;
- On 4 June 2014, UN held meetings on the protection of tax bases of developing countries, focusing on digital economy, abuse of tax treaties, taxation stimulation, and taxation of service transactions;
- In Sep 2014, OECD submitted 7 reports to G20, including transfer pricing of intangible assets and country by country transfer pricing documentation report.

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OECD: Why is BEPS Possible?

Jurisdiction to Tax	Transfer Pricing	Leverage
Double non-taxation through the exploitation of § **Taxation on "entity by entity" basis instead of "group-wide" basis** § **Mismatches** between countries, e.g., territorial taxation system vs. worldwide taxation system § **"Aggressive tax planning schemes"**, involving the unintended use of double tax treaties, hybrid entities and instruments, and other financial transactions	Exploiting aspects of the **guidelines that "…put too much emphasis on legal structures (as reflected, for example, in contractual risk allocations) rather than on the underlying reality of the economically integrated group…"** **KEY FACTOR**	Exploiting the **differential treatment of debt (interest tax deductible) versus equity (dividends not tax deductible) in combination with other factors**, such as § Use of tax treaties to reduce or eliminate source country taxation § Mismatch in entity classification: an entity is viewed as corporation in one jurisdiction but not in another

The **existence of low tax jurisdictions** to which profits may be shifted

Continued general **lack of transparency** (to domestic tax authorities) in relation to structures and transactions undertaken by multinational enterprises

Current international tax standards have not kept pace with changes in global business practices, in particular in the area of intangibles and the development of the digital economy

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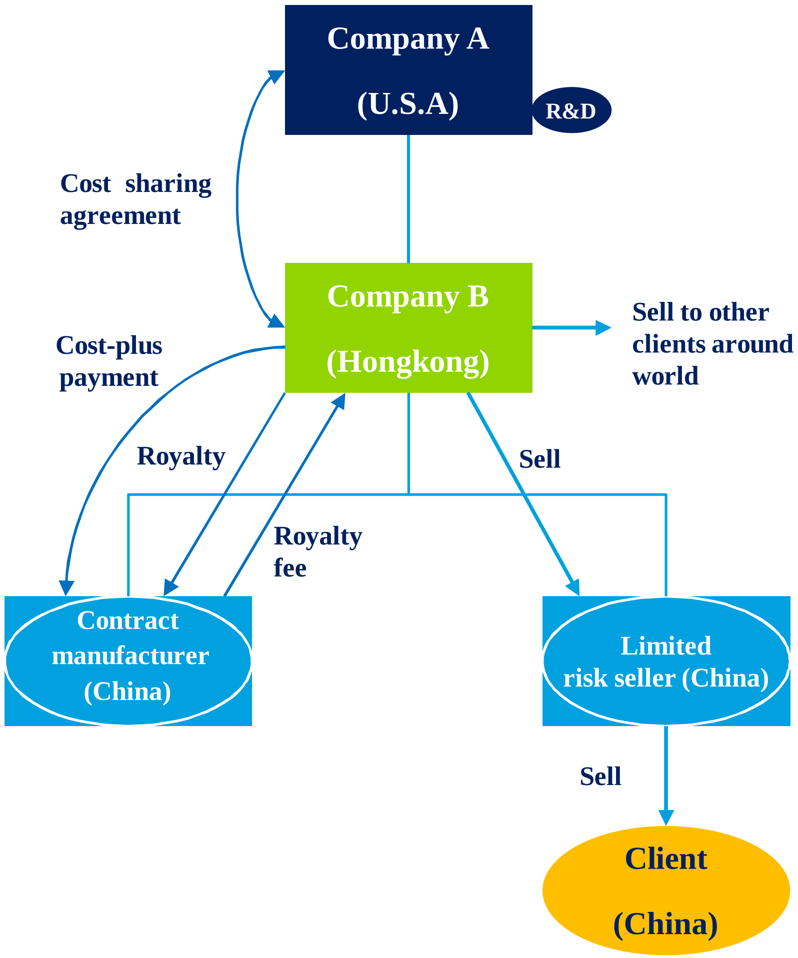
Example of Common Transfer Pricing Arrangement of MNCs



- The original IP developer Company A enters into a cost sharing agreement with Company B (owner of non-U.S. IP); Company B becomes the non-Country A IP rights owner.
- Contract manufacturer is responsible for manufacture of group products, and earns a cost plus return.
- Royalty is charged to contract manufacturer to erode its tax base.
- Limited risk seller takes limited risk and function, and earns a return upon its cost.
- The real management of Company B is not in China.
- The operational place of limited risk seller and contract manufacturer are not under the disposal of Company B.
- Limited risk seller is not allowed to sign a contract on the behalf of Company B.
- Economic analysis will be performed for contract manufacturer and limited risk seller, for them to stay in compliance with the arm's length principle. Most of the residual profit will be retained by Company B.

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B. Global Impact of TP-related Actions

BEPS Action Plan – TP Related

<table>
<tr><td colspan="4">Action 1:
Address the tax challenges of the digital economy</td></tr>
<tr><td>“Gaps”</td><td colspan="2">“Frictions”</td><td>“Transparency”</td></tr>
<tr><td>i. Establishing international coherence of corporate income taxation</td><td colspan="2">ii. Restoring the full effects and benefits of international standards</td><td>iii. Ensuring transparency while promoting increased certainty and predictability</td></tr>
<tr><td>Action 2:
Neutralize the effects of hybrid mismatch arrangements</td><td colspan="2">Action 6:
Prevent treaty abuse</td><td>Action 11:
Establish methodologies to collect and analyze data on BEPS and the actions to address it</td></tr>
<tr><td>Action 3:
Strengthen controlled foreign company (CFC) rules</td><td colspan="2">Action 7:
Prevent the artificial avoidance of PE status</td><td>Action 12:
Require taxpayers to disclose their aggressive tax planning arrangements</td></tr>
<tr><td rowspan="2">Action 4:
Limit base erosion via interest deductions and other financial payments</td><td rowspan="3">Assure that transfer pricing outcomes are in line with value creation</td><td>Action 8:
Intangibles</td><td rowspan="2">Action 13:
Re-examine transfer pricing documentation</td></tr>
<tr><td>Action 9:
Risk and capital</td></tr>
<tr><td>Action 5:
Counter harmful tax practices more effectively, taking into account transparency and substance</td><td>Action 10:
Other high-risk transactions</td><td>Action 14:
Make dispute resolution mechanisms more effective</td></tr>
<tr><td colspan="4">Action 15: Develop a multilateral instrument</td></tr>
</table>

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OECD on Intangible Assets (OECD Discussion Draft 2013)

- The 2013 OECD Discussion did not change the principle that a company can not retain the entire profit from intangible assets based solely on its legal ownership of the intangibles or the fact that it assumes the cost of development of the intangible assets. Though contractual relationships between related parties are a starting point for any transfer pricing analysis, the location where important functions related to intangibles are performed is the key.

- The ultimate allocation of the return attributable to the intangible is accomplished by compensating members of the multinational group for performing and controlling important functions, assets used or contributed, and risks assumed in the development, enhancement, maintenance and protection of the intangible.

- The 2012 draft also mentioned that, the entities entitle to the profit from intangibles, all in essence, perform important functions in relation to the development, enhancement, maintenance and protection (DEMP) of intangible. These functions should be given special consideration while allocating the profit of Intangibles.

- In Discussion Draft 2012 and 2013, key functions include the following aspects:

  – design and control of research and marketing

  – management and control of budgets

  – control over strategic decisions regarding intangible development programs

  – decisions regarding defense and protection of the underlying intangibles

  – ongoing quality control over other functions that are outsourced and may have a material effect on the value of the intangible

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OECD on Intangibles (OECD Discussion Draft 2013) (Cont'd)

- Bearing a funding risk, without the assumption of any further risk, and without control over the use of contributed funds or the conduct of funded activity, generally would entitle the funder to a risk adjusted rate of anticipated return on its capital invested, but not more

- With respect to transfer pricing of intangible assets, thorough and in-depth analysis of the enterprise value chain need to be performed first.

- Focus of the analysis if the important function of the intangible assets.
  - Tax payers need to explain that their intangible asset transactions are reasonable from a independent third party's perspective.
  - A simple contractual relationship does not comprise a decisive factor when considering the return on intangible assets.

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2014 OECD Country by Country Report

- Governments need to perform effective risk assessment and enforce transfer pricing rules
- Need for balance: usefulness and compliance burden
- Reiterates a two-tiered approach based on July 2013 white paper

Master file	Local file
• MNE's business – Organization structure, profit drivers, supply chain, service arrangements, restructuring and functions • MNE intangibles including list, ownership strategy/ development, R&D and transfers • Intercompany financing activities – Identification of members providing central financing function and POEM – Policies of financing arrangements • MNE's financial and tax positions – Consolidated financial statements – List of tax rulings, MAP and APA	• Similar to current local reports with some additions • Descriptions of local entity – The management structure, organizational chart, reporting, principal office details • Effect of business restructurings or intangibles transfer • Annual local entity financial accounts for the fiscal year concerned (statutory GAAP) • Financial data information on applying transfer pricing method to annual financial statements • Requires taxpayers to use local over regional comparable if available

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2014 OECD Country by Country Report (Cont’d)

- “Entity-by-entity” basis, not “country consolidated”
  - PE as separate entity and
  - POEM must be shown
  - Business activities for each entity to be indicated by use of a code
- Other information
  - Revenue in functional currency and cash income tax paid
  - Total amount of withholding tax
  - Stated capital and accumulated earnings
  - Employees including secondment information
  - Book value of tangible assets
  - Royalties, interest and services (paid / received)
- Bottom-up (local country) vs top-down (parent consolidated)

A = research and development	**B = holding intellectual property**
C = purchasing and procurement	**D = manufacturing and production**
E = sales, marketing, and distribution	**F = administrative and support services**
G = finance	**H = insurance**
I = holding company	**J = other: specify the nature of the activity**

J

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C. China Practice of TP-related Actions

BEPS' Influence Upon China

Current legislative position	• A number of BEPS measures already exist – GAAR – CFC provisions – Thin capitalization provisions – Circular 601 • No changes in tax laws specifically related to BEPS • Circular 2 is under revision and will be announced
Perspective of Government	• The Chinese government has not yet indicated their attitude on specific action points. • China is actively involved, in particular in the digital economy task force
Perspective of the public	• There is an awareness; it is "mixed", but the awareness is growing
Unilateral BEPS actions	• China is already applying "BEPS" concepts in relation to TP cases • The PE discussion continues to be a focus area, in particular in relation to agency PE, e-commerce and cross border provision of services. In this connection, China vigorously advanced argument that a services PE (Article 5(3)(b)) may be found even if no physical presence in jurisdiction ("furnishing of services ... within a Contracting State")

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Chinese Tax Authority's Concerns about Intangible Assets

- **Important Aspects of Tangible Assets in Actual Practice**
  - Actively applying marketing intangible assets and location savings concepts etc., in Advance Pricing Arrangement.
  - Economic substance & Transparency
    - Queries about the economic substances, functions, as well as the compatibility of risk and return in related-party transactions in tax heaven.
    - Transparency of global value chain （understanding details about the entire supply chain）
  - Contract R&D is an area where the contribution of developing countries is often underestimated.
  - High-tech enterprise （with core intangible assets）: reasonable profit? TP method?
  - Limited risk distributor undertaking significant sales, marketing and distribution functions, thus possessing local marketing intangible assets?

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Chinese Tax Authority's Application of Location Specific Advantages

- **Still a very controversial concept but coming under increasing focus from tax authorities:**
  - "…to study new ideas and its application methods of the pricing of intangible assets, **cost saving**, **location saving**, and etc…" (Guo Shui Han [2009] No. 106)
  - "During the signing of APA and bilateral negotiation, we have raised new ideas—such as **cost saving**, **market premium**…an overdue tax 544 million in 2009 by only bilateral negotiation…" (Guo Shui Han [2010] No. 84)
  - "…**market premium**, analysis of value chain, **location savings** and allocation of extra profits as key points in future studies." (SAT's 2011 key initiatives on anti-avoidance)
  - "To further emphasize the research on quantitative analysis methods…the focus shall be on hard issues in anti-avoidance such as…**market premium**…**location savings**,…."(Guo Shui Fa [2012] No. 41)

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Chinese Tax Authority's Application of Location Specific Advantages (Cont'd)

- **SAT published 'China Practices' on the UN Transfer Pricing Manual, elaborating its TP standpoint and practices.**
  - **SAT's view on Location Specific Advantages (LSAs)**
    - Location Savings
    - Market Premium
  - **Local marketing intangibles**
  - Encourage the application of Profit Split method when appropriate
  - Contribution analysis approach or global formulary approach may be more realistic and appropriate than TNMM

- **Challenges facing MNCs**
  - In relation to the tax problem in China as well as its emerging market, the number of correlative global cases is limited.
  - Difficulty in segmenting and quantizing related specific advantages precisely.

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SAT's Views on Related Service Fee Charges

- **The SAT submitted a proposal to UN in April 2014 regarding its views on related party services fees and management fee.**

- **SAT generally agrees with the framework of OECD Guideline, but thinks:**

  - When applying the benefit test, it should not only be considered from the service recipient's perspective. Instead, the analysis should be performed from the perspective of both the service provider and the service recipient.

  - When analyzing intra-group services, considerations are required about whether the provision of services from a parent company to subsidiaries are necessarily needed by the subsidiary.

  - When analyzing intra-group services, considerations are required about whether appropriate fee charges have been covered by another related transaction after the parent company provided its service to subsidiaries.

  - The definition of shareholder services in the OECD TP Guidelines is too narrow.

- **Practical difficulties regarding intra-group services in China**

  - Validating the authenticity of the services rendered and the reasonableness of the associated allocation mechanisms

  - Differentiation between royalties and technical service fees.

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The SAT’s 6 Tests on Service Fee Charges

In June 2014, Dr. Liao Tizhong, the chief of SAT international tax department, stated at a seminar held in Washington DC that, related to service fee charging from foreign parent company to its Chinese subsidiaries, the SAT will further enhance management and investigation, while implementing 6 tests on related party service fee to see if TP adjustments are necessary.

Benefit Test

- 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.
- For strategic management services, if the China subsidiary has its own management team, then the parent company should provide services in compliance with and appropriate to China legal requirement, culture background and local needs. This is to ensure the service rendered will create value for China subsidiary.

Need Test

- For manufactures which undertake simple functions, if the parent company does not provide back-office services such as financial and legal function, the manufactures can conduct relevant functions by themselves, then the services received by the parent company is not necessarily needed.

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The SAT’s 6 Tests on Service Fee Charges (Cont’d)

Duplication Test

- China's duplication test addresses the situation where management teams in subsidiaries perform management activities on their own with management decision approvals from the parent companies due to authorization requirements.

Value Creation Test

- An activity provides a benefit if it directly results in a reasonably identifiable increment of economic and commercial value that enhances the recipient's commercial position. Management decision approval from the parent company due to authorization requirements do not create an identifiable increment of economic or commercial value.

Remuneration Test

- The SAT considers whether the provision of services from the parent company to the subsidiary in China already has been remunerated through the transfer pricing policies of other related-party transactions.

Authenticity

- Unless the SAY obtains all the information, it is difficult to validate the authenticity of services rendered and the reasonableness of the associated allocation mechanisms.

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Anti-avoidance Towards Large Scale Service and royalty Fees

The recent Circular 146 brought forward the idea of reinforcing anti-tax avoidance investigation towards large scale service and royalty fees to multiple levels within State Administration of Taxation and Local Tax Bureaus.

The following kinds of susceptible service fee will be the major focus of anti-avoidance investigation:

- Fees for **shareholding services** (including planning, management, monitoring of operational, financial and human resources related affairs for domestic companies).
- Group management fees for **integrated management services** within the group.
- Fees for the reception of **identical services** which could be independently performed by the subsidiary themselves or have already been provided by a third party service provider.
- Fees for the reception of services which are **irrelevant** to functions and risks of the China subsidiary, or services which are related to the functions and risks it undertakes but do not match its operational target/current operational stage.
- When service transactions incur along with other related party transaction, and service fee have been included in other related party transaction' pricing, there should not be **duplicated service fee payment**.

The following kinds of susceptible royalty payment will also be the focus of Anti-avoidance investigation:

- Paying royalties to entities incorporated in **tax heavens**.
- Paying royalties to foreign related party who undertakes **no function or only simple functions**.
- Local companies with **special contributions** to the license IP, or the license value itself has **depreciated**, yet still paying great amounts of royalties to foreign party.

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SAT Jiangsu Office's Action Plan on BEPS for Year 2014-2015

Jiangsu Provincial Office of SAT ("Jiangsu Office") issued an Administration Plan for future works in which they listed several review points on the Base Erosion and Profit Shifting ("BEPS") report,

- Consider fully the role of market in value creation
- The rights to tax are to be aligned with the substance of economic activities
- The location of enterprise's business activities is to be in conformity with the location of its report for tax purpose
- Improve the transparency of transfer pricing documentation
- Revisit the right to tax of the source in the digital economy
- Pay attention to the application of safe harbor rules in transfer pricing
- Enterprises should strengthen their tax governance and internal control

Jiangsu Office then provided tips on the following aspects for risks management of cross-border taxation to enterprises:

- Establish off-shore structure to avoid tax jurisdiction
- Base erosion by cross-border investment or financing
- Erosion of the profit of domestic enterprise by overseas output of intangible assets
- No report or under-report of overseas income by overseas investing enterprises
- Functional restructure and mismatch of economic substance and profit level

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SAT Jiangsu Office's Action Plan on BEPS for Year 2014-2015 (Cont'd)

- Profit transfer by means of associated outbound payment
- Lowering the tax burden of the whole group by off-setting transactions
- Profit transfer by means of purchasing overseas associated enterprise with unreasonable price
- Provide associated R&D service without responding gains or returns
- Benefit the whole group by assuming implicit cost without corresponding compensation
- Tax avoiding transactions by means of shell company in tax heaven or offshore account
- Not report capital gains obtained by taking advantage of start-up period
- Avoid non-resident tax obligation through three-party contract

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Conclusion

Conclusion

- BEPS will probably be the most important topic in international taxation in the next ten years. It is expected that BEPS will have a profound impact upon the existing international taxation system and is worthy the highest attention of for tax practitioners.
- Transfer pricing is considered to be one of the key issues of BEPS.
- Based on the current OECD documents regarding transfer pricing and the practices of countries, TP arrangements of MNCs are required to be more and more related to the value creation and the business nature. Therefore, an overall thorough enterprise value chain analysis will be important.
- MNCs with operations in China will need to review their current Transfer Pricing policy, for instance, whether intangibles and location specific advantages have been given full consideration, as well as whether non-trade term payments are supported by adequate and sufficient documentation.

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