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Client Alert

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China: 2022 (Q2)Tax Update

August 2022

In brief

In this issue of China Tax Update, we will discuss the major China tax developments in the second quarter of 2022, including the following:

1. Latest development in the "aligned arrangement" for customs valuation and transfer pricing
2. MLI update: China deposited its instrumental of approval for the multilateral convention with the OECD
3. Implementation guidance for certain stamp duty policies under Stamp Duty Law

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1. Latest development on the aligned arrangement of customs valuation and transfer pricing

- In brief

On 18 May 2022, the Shenzhen Customs and Shenzhen State Taxation Administration (STA) jointly issued Shenzhen Customs Bulletin [2022] No. 62 ("**Bulletin 62**")[1] which calls for better coordination and information exchange between customs valuation and transfer pricing administration. Bulletin 62 applies to companies in Shenzhen on a pilot basis, and it may ultimately be replicated elsewhere in China if it proves successful. Bulletin 62 represents a significant step forward taken by the local customs and tax authority in coordinating and aligning customs valuation and transfer pricing administration. Multinational companies (MNCs) in China are encouraged to consider and evaluate the implication of, and how they may benefit from, the implementation of the policy.

- Background and current state of play

In recent years, in implementing the Organization for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) initiatives, the China STA has issued a number of important transfer pricing policies,[2] under which MNCs in China are required to prepare annual transfer pricing documentation disclosing operational and financial information with respect to their operation in China and establishing that intercompany price is at arm's length. Meanwhile, as part of the annual enterprise income

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[1] Bulletin of Shenzhen Customs and STA on Aligned Arrangement of Customs Valuation and Transfer Pricing, Bulletin 2022 No. 62, issued on 18 May 2022.

[2] Bulletin of STA on Improving Matters Relating to the Filing of Related Party Transactions and the Management of Contemporaneous Documentation, Bulletin 2016 No. 42, issued on 29 June 2016.

Bulletin of STA on Improving Matters Relating to the Administration of Advance Pricing Arrangements, Bulletin 2016 No. 64, issued on 11 October 2016.

Bulletin of STA on Issuing the Administrative Measures for Special Tax Audits and Adjustments and the Mutual Agreement Procedure, Bulletin 2017 No. 6, issued on 17 March 2017.

tax (EIT) compliance, MNCs are also required to prepare intercompany transaction forms. Such intercompany price is also subject to scrutiny by customs.

The two sets of rules governing the way in which the intercompany price is set currently lack alignment and apply in significantly different ways. In some respects, the tax authority and customs are in fact working toward competing objectives to maximize their respective tax/duty collection. More importantly, under the existing customs valuation rules and practices, there is no official mechanism to allow for adjustments and retrospective amendments to customs declaration forms previously filed. For MNCs engaged in the import and trade of goods, this presents practical difficulties when making retrospective transfer pricing adjustments to the purchase prices of imported goods to meet the targeted profit level under their transfer pricing policy. Consequently, MNCs often try to avoid such adjustments and typically only accept such adjustments as a result of customs audits that require them to upwardly adjust their prices for the sole purpose of recovering 'underpaid' import duties and taxes. In some cases, given the practical challenges in meeting transfer pricing requirements, MNCs may approach customs on an ad hoc basis to negotiate and agree on practical solutions on a case-by-case basis. In those circumstances, even if the adjustment is granted by customs, MNCs may still not be allowed to amend their customs declaration forms or process foreign exchange payment in and out of China for the adjusted import price.

Given the above challenges, MNCs currently face considerable practical difficulties in making any retroactive transfer pricing adjustment, which is sometimes important to meet transfer pricing requirements.

- In more detail

The major breakthrough offered by Bulletin 62 is that it provides an aligned approach for customs and the tax authority to allow a company that has an advanced pricing arrangement (APA) with the tax authority to make retrospective adjustment to its import price of goods, most likely on a yearly basis, to ensure that the actual price meets the targeted income level, or more specifically, the median of the comparable range, set by the APA. Such adjustment, according to Bulletin 62, may either be upward or downward, depending on the actual financial performance (e.g., profit margin) of the company, as compared to the targeted income level.

To participate in the program, a company should simultaneously submit the required package, which consists of: (1) an application for customs advanced ruling; (2) an application for APA; and (3) an application for the "aligned arrangement" to both Shenzhen Customs and Shenzhen STA to initiate the negotiation process with both authorities. The customs and tax authority will conduct a joint interview with the applicant and align on the agreed approach. That means the authorities are expected to communicate with each other and to reach an agreement on the key considerations, including the applicable transfer method, benchmark, profit target and comparable range, etc. If the authorities cannot align on these key considerations, the application for the "aligned arrangement" should be rejected.

Once the customs and tax authority have aligned on these considerations, the customs, tax authority and the company will enter into a tripartite memorandum to memorialize the key terms, such that they become formalized and enforceable amongst the parties. Once signed, the memorandum would be binding for a period of three calendar years, unless the key assumptions are no longer applicable or otherwise revoked by the company.

- Our observation

  a. Gaps to fill

  Currently, Bulletin 62 still lacks the necessary implementing details. In this regard, we take note of at least the following gaps to be bridged by the authorities in the practical implementation of the "aligned arrangement."

    i. Transfer pricing adjustment procedure

    An important area that needs further clarification is the procedure that companies should follow to make the retroactive price adjustment — in particular, whether companies are allowed to amend previously filed customs declaration forms. Under the current regulations, customs declaration forms are the key supporting documents that enable companies to make or receive foreign exchange payments in order to actually implement transfer price adjustments. Therefore, the amendment to the customs declaration forms would be necessary for companies to repatriate cash in or out of China to account for the adjusted import price, unless other foreign exchange mechanisms would be introduced to ease the process.

    Further, Bulletin 62 does not clarify whether the import price declared to customs at the time of import should be considered a provisional declaration as it is subject to year-end adjustment. It is also unclear whether customs would refund any overpaid customs duties (as well as allow the recovery of any import taxes) where a downward retrospective price adjustment is made, and if so, the mechanism for computing the refund, whether on a weighted average basis or otherwise.

ii. Financial benchmark

According to Bulletin 62, a key consideration on which the customs and tax authority should reach alignment is the appropriate financial benchmark to be adopted by companies. Based on our discussion with the Shenzhen Customs, it is likely that the customs and tax authority would ultimately be aligned on a profit margin based transfer pricing method, according to which companies can make the annual true-down or true-up adjustment to achieve the targeted profit level. If so, the adjustment methodology would impose an obligation on companies to conduct a transfer pricing adjustment where the actual profit level deviates from the target level, once the benchmark is confirmed under the "aligned arrangement."

Further, if the customs and tax authority would only accept a profit-based transfer pricing method, the question then would be whether companies in the manufacturing sector, i.e., full-fledged manufacturers or licensing manufacturers (manufacturers that license in IP from overseas related party IP owners and bear the market risk in selling its products manufactured in the domestic market) that import components from overseas affiliates, can benefit from this new mechanism. For these companies, the transfer price for materials or components imported from related overseas suppliers are generally on a cost-plus basis (based on the production costs of the overseas related party suppliers), while the profit levels of the domestic manufacturers are subject to the market supply and demand fluctuation. There can also be challenging in the alignment between the transfer pricing method implemented and the financial level indicator selected in the arrangement. At the moment, it remains unclear how the authorities, particularly customs, view this issue, and to what extent financial information of overseas related parties would be required for the "aligned arrangement"

iii. Implication arising from a change in aligned transfer pricing methodology and valuation method

If the transfer pricing methodology and valuation method ultimately agreed upon are different from the applicant's existing practices under the "aligned arrangement," it is unclear at this point whether the customs and tax authority will conduct further scrutiny into the applicant's past practices and seek to recover or refund customs duties or taxes underpaid or overpaid to the relevant authorities. A welcome move that would encourage participation in the program would be some assurance from the authorities that companies applying for the "aligned arrangement" would be treated with leniency (e.g., waiver of penalties) with respect to any past non-compliances discovered during the application process.

iv. Transfer pricing considerations under Bulletin 62

In 2021, the STA released Bulletin 24,[3] which lays out the simplified unilateral APA procedure (UAPA). The simplified UAPA procedure reduces the UAPA application process from six steps to three. It also requires tax authorities to conclude the APA process within nine months and greatly increases the efficiency of the UAPA process. Even though Bulletin 62 is generally adaptable to all forms of APA, the UAPA is anticipated to account for a significant portion of the "aligned arrangement." Bulletin 62 does not specify whether the simplified APA procedure would still be applicable in the "aligned arrangement" application, but with the involvement of customs, an extended application period should be expected.

Both Bulletin 64 and Bulletin 24 also require a transfer pricing audit to be launched before the APA procedure starts. A similar tax investigation on transfer pricing would also be a prerequisite for the "aligned arrangement." Thus, companies should ensure the robustness of their transfer pricing policy and its implementation prior to initiating the coordination arrangement application.

The authorities have indicated that there is no universal mechanism for the "aligned arrangement." In order for a particular case to work, a customized mechanism must be formulated in the APA that customs and the tax authority can rely on. This makes it possible for companies to proactively design a model and mechanism that provide assurances to customs, the tax authority and, most importantly, to themselves.

The specific "aligned arrangement" mechanism would depend on multiple factors, including the business model of the tested entity, external market risk, the entity's function and risk profile, the related transaction pattern and structure, etc. It is anticipated that companies with a relatively simple business model, simple related party transaction structure, and limited risk exposure to both related transactions and external market change would have better chances of deriving a

[3] Bulletin of STA on Issues Concerning the Application of the Simplified Process for Unilateral Advance Pricing Arrangements, Bulletin [2021] No. 24, issued on 26 July 2021.

functional "aligned arrangement". Companies with more complicated fact patterns would probably need more careful design in their "aligned arrangement."

For instance, it could be relatively easy for controlled contract manufacturers that import the vast majority of their raw materials/components from overseas related parties, and export finished products to overseas related parties, to enter into the "aligned arrangement." In this case, the operating profit level and import price of the entity are highly correlated and relatively easy for the company to manage. Thus, all parties could ensure sufficient certainty out of this arrangement. In the case of a full-fledged manufacturer or licensing manufacturer indicated above, however, it could be more challenging to reach an agreement among different parties basing on a single profit level indicator.

If the importer is a distributor in China that resells products purchased from overseas related parties to domestic third parties/customers in China, it would need to consider the impact of external market variation on the product price and company profit level in designing the "aligned arrangement," even though the transaction structure is fairly simple. As these foreign controlled distributors/retailers are often exposed to risk from both the transfer pricing and customs sides, it should be rewarding for these companies to enter into such coordination arrangement.

In cases where the company has a more complicated operation and transaction structure, it could be more challenging to connect the dots between the focus on the tax authority, which could be the combined impact of multiple related-party transactions, and the focus of customs, which is the import price of the tangible products. Such cases would require more creativity to make the coordination mechanism work.

- Conclusion

In conclusion, although further details on the implementation of Bulletin 62 are expected, this program represents a significant and meaningful move by the relevant authorities to resolve the challenges that businesses have long faced in ensuring compliance with customs valuation and transfer pricing. Although the scope of implementation for Bulletin 62 is currently limited to companies operating in Shenzhen, it is hoped that the regime can ultimately be implemented nationwide once it proves successful.

The implementation of Bulletin 62 also clearly underscores the benefits for MNCs with operations in China of considering putting an APA in place. From a customs perspective, Bulletin 62 provides an additional reason for MNCs to consider obtaining an APA as a viable long-term solution to ensure full compliance with the tax and customs rules. Before submitting such application, however, companies should at least carefully weigh the risk and implication in selecting certain benchmarks for its transfer pricing documentation against the resulting customs valuation implication and ensure that existing transfer pricing and customs approaches are anchored on a robust defense documentation in case they are subject to scrutiny during this process.

2. China deposits its instrument of approval for the multilateral convention with the OECD

- In brief

On 25 May 2022, China deposited its instrument of approval for the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) with the Organization for Economic Co-operation and Development (OECD).[4] The MLI will enter into force on 1 September 2022 for China.[5]

- In more detail

The MLI was developed under the 2013 Base Erosion and Profit Shifting (BEPS) Action Plan 15 as a mechanism to simultaneously update existing bilateral double tax agreements (DTAs) between relevant jurisdictions. The OECD released the MLI on 24 November 2016, and China was one of the jurisdictions that endorsed the MLI. The MLI incorporates many measures proposed by the BEPS action plans, including hybrid mismatch rules dealing with tax-transparent entities and dual-resident entities, treaty abuse rules preventing treaty shopping activities, permanent establishment (PE) rules preventing avoidance of PE status, and measures improving mutual agreement procedure (MAP).

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[4] https://www.oecd.org/tax/beps/china-deposits-an-instrument-for-the-approval-of-the-multilateral-beps-convention.htm

[5] Article 34 of the MLI.

The MLI contains a matching mechanism. Signatory jurisdictions nominate DTAs within their treaty network as covered tax agreements (CTAs) for updates and select updates from a range of options under the MLI. Where two signatory jurisdictions both nominate the DTA they have with each other and the jurisdictions select the same or compatible updates option, the MLI updates may take effect. To make such matching mechanism work, the signatory jurisdictions deposit their instrument of approval with the OECD, which discloses their choice of updates or reservations not to update certain articles.

China's DTAs to be covered by the MLI

China listed 100 out of its existing 112 DTAs as CTAs for the MLI.[6] As of 30 June 2022, among the 100 CTAs, 47 counterparty jurisdictions have selected their DTAs with China to be covered by the MLI and have deposited their instrument of approval with the OECD,[7] meaning the MLI will enter into force for the DTAs pursuant to Article 35 of the MLI.[8]

China's MLI positions

China's MLI positions in its instrument of approval are largely consistent with its positions at the time it signed the MLI in 2016.

- **Principal purpose test (PPT) to prevent treaty shopping activities:** Article 7 of the MLI proposes the PPT and limitation on benefits (LOB) rules to prevent treaty abuse activities. China has chosen to adopt the PPT, which denies treaty benefits if one of the principal purposes of an arrangement or transaction is to obtain treaty benefits.

  Compared to China's domestic general anti-avoidance rules, which target arrangements or transactions with the sole or main purpose of obtaining tax benefits, the PPT appears to have a broader scope and may potentially impact arrangements or transactions that have reasonable commercial purposes.
- **Holding period for dividend:** China has chosen to adopt the 365-day look-back period rule for the purpose of determining the minimum holding period for reduced withholding tax rate on dividend.[9] Since China already has a one-year look-back period rule under its domestic tax law, the change should not impact MNCs' current treaty positions.
- **Capital gain from alienation of shares or interests of entities deriving value primarily from immovable properties:** China has chosen to update the treaty article relating to disposal of shares or interests in land-rich entities by expanding the scope of the article to cover disposal of interests in partnerships and trusts with immovable properties. Notably, China reserved on the 365-day look-back period rule for the purpose of determining whether an entity was land-rich at any point. This is because China already has a three-year look-back period rule under its domestic tax law.[10]
- **Hybrid mismatch (tax transparent entities):** China reserved on the article relating to tax-transparent entities.[11] One reason for the reservation is that China has not finalized domestic tax rules for tax-transparent entities and would prefer to negotiate such rules on a bilateral basis.
- **Dual resident entities:** China has chosen to adopt article 4 of the MLI, which provides that the tax residency of a dual resident entity should be determined by MAP rather than by defaulting to the place of effective management. In the absence of a mutual agreement between the competent tax authorities, the entity may not be entitled to treaty benefits unless the competent authorities agree otherwise.

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[6] The excluded DTAs include the treaties with Chile, India, New Zealand, Spain, Congo, Angola, Rwanda, Kenya (yet to be effective) and Argentina (yet to be effective) and the double taxation arrangements with Macau, Hong Kong and Taiwan, PRC.

[7] http://www.chinatax.gov.cn/chinatax/n810341/n810825/c101434/c5178626/content.html

[8] Article 35 of the MLI provides a different effective date for taxes withheld at source and other taxes levied by a contracting jurisdiction.

[9] Article 8(1) of the MLI.

[10] STA Bulletin [2012] No. 59.

[11] Article 3 of the MLI.

- **Avoidance of PE status:** China has chosen not to update the PE articles and not to adopt the proposals to address commissionaire arrangement, specific activity exemption and contract-splitting scheme. However, China has been pushing out the OECD on the PE issue. Even before the BEPS project, China has developed its own interpretation of PE that aligns with the new principles under the MLI.[12]
- **MAP and arbitration:** China reserved on article 16 of the MLI that a taxpayer can present a MAP request to either contracting state. China maintains its position that a taxpayer can only initiate a MAP request with the competent tax authority of the taxpayer's resident jurisdiction or state of nationality (for non-discrimination cases) and that the competent authority will implement a bilateral notification or consultation process. Meanwhile, China has opted out of the article on mandatory arbitration.

- Our observation

As anticipated, China has chosen not to adopt many of the MLI articles that are not required under the minimum standard. However, this is not to say that MNCs can underestimate the implication of the MLI's implementation in China. MNCs with cross-border transactions should keep the MLI in mind when evaluating their treaty positions. As discussed above, one significant modification to China's DTAs is the PPT. Although the ultimate impact of the PPT remains unclear, MNCs that wish to claim treaty benefits should expect China tax authorities' treaty administration to be enhanced to accommodate the change brought by the MLI, thus creating additional burden and risk for MNCs. Another trend we observed in recent years is that China tax authorities exchange information with their foreign counterparts more frequently. Therefore, MNCs should be mindful that information historically not available to China tax authorities may become more visible to China tax authorities in the context of MLI when assessing their treaty positions.

Although China has opted out of the relevant MLI articles, it has unilaterally developed its own interpretation of PE that aligns with the new principles under the MLI. Therefore, MNCs with cross-border transactions in China should continue to monitor their PE position in China.

3. Implementation guidance on certain stamp duty policies

- In brief

In June 2021, the Standing Committee of the 13th National People's Congress (NPC) officially announced the Stamp Duty Law of China ("**SD Law**"), which became effective from 1 July 2022. The SD Law replaced the prior SD Provisional Regulations.[13] To clarify certain policies under the SD Law and questions in practice, on 12 June 2022, the Ministry of Finance (MOF) and STA jointly issued Bulletin [2022] No. 22 ("**Bulletin 22**"),[14] which provides implementation guidance for certain SD issues.

- In more detail

Notably, Bulletin 22 clarifies the following:

- **SD taxpayers:** The SD Law provides that entities and individuals who conclude taxable documents within PRC or conclude taxable documents outside PRC but for use within PRC should be liable for SD. Bulletin 22 further clarified that SD taxpayers should be entities or individuals who are legally responsible or liable for taxable documents.

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[12] See Circular [2010] No. 75.

[13] Our prior coverage is available at https://insightplus.bakermckenzie.com/bm/tax/asia-pacific-2021-china-tax-update.

[14] Bulletin of MOF and STA on Implementation Guidance for Certain Stamp Duty Policies, Bulletin [2022] No. 22, issued on 12 June 2022.

- **Taxable documents concluded outside PRC but for use within PRC:** The SD Law generally provides that taxable documents concluded outside PRC but for use within PRC should be subject to SD. In clarifying the meaning of "use within PRC," Bulletin 22 provides the following scenarios where SD should be levied.

Subject matter of the taxable document	Use within PRC
Real property	Real property is physically in PRC
Equity interest	Equity interest of a PRC resident company
Moveable asset or trademark, copyright, patent and knowhow	Either the seller or buyer is within PRC (except if the subject matter is completely used outside PRC)
Service	Either the service provider or service recipient is within PRC (except if the service is completely provided outside PRC)

- **SD administration:** Bulletin 22 provides the following scenarios where SD taxpayers can re-determine the SD: (1) the original amount in the taxable document is different from the actual settlement amount and the original amount on the taxable document is adjusted; and (2) the SD is overpaid or underpaid due to the miscalculation of value-added tax (VAT).

- Our observation

Bulletin 22 addresses a number of practical questions that are particularly relevant to cross-border transactions. MNCs should consider the SD implications in structuring the transactions.

- **Equity transfer:** Bulletin 22 confirms that provided the subject matter is the equity interest of a PRC resident company, the transferor and transferee (domestic or foreign) should be subject to SD. Foreign transferors or transferees can report and pay SD by themselves or appoint a domestic agent for the reporting and payment of SD. Technically speaking, an indirect transfer agreement that is concluded outside PRC should not be subject to SD as the subject matter is not the equity interest of a PRC resident company.

- **Sale of tangible asset, license of intangible asset and service:** Bulletin 22 leverages the principles under VAT regulations in determining whether a taxable document is used within PRC by reference to the location of the seller/service provider and buyer/service recipient. Under Bulletin 22, if the seller/service provider or buyer/service recipient is within PRC, the document for the sale of tangible asset, license of intangible asset and service could be subject to SD. For example, a foreign company that sells goods or provides a license to a company within PRC could be subject to SD. We have seen some cases in practice that the foreign companies are required by the PRC companies to fulfil their SD obligation. MNCs are advised to monitor the local practice and check whether their existing agreements specify which party should bear SD.

  Similar to the treatment under VAT regulations, Bulletin 22 includes these exceptions to the general rule: (1) complete foreign use of asset and (2) complete foreign performance of service. Bulletin 22 does not provide detailed guidance on how to determine the foreign use of asset and performance of service. The application of the exceptions should be analyzed for each case.

- **Administrative burden:** Under the SD Law, MNCs can either report and pay SD by themselves or appoint a domestic agent in China to fulfil their SD obligation. However, in practice, the self-reporting method may not be always straightforward and MNCs may need to work with tax authorities and other parties (e.g., banks) to figure out a practical solution. For MNCs with a large number of taxable documents, the administration burden should not be underestimated.

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