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Review of the New Chinese Implementation Rules for Advance Pricing Arrangements for Transactions between Related Parties

The number of requests for Advance Pricing Arrangements (“APA”) in Japan has increased since the APA program was introduced in 1987. As exemplified by the release of the 1999ⁱ circular, the majority of such requests are for bilateral or multilateral APAs, and the number of Competent Authority proceedings that took place in connection with APAs in 2003 totalled 802003ⁱⁱ. In these circumstances, the establishment of guidelines for APAs in China had been a matter of great concern for companies investing in that country, which have faced heavy transfer pricing taxation imposed by the Chinese tax authorities.

The Chinese tax authorities, like tax authorities in other countries, have taken a positive stance toward the APA program. The program was first introduced in China with the enactment of Transfer Pricing Regulations effective April 23, 1998ⁱⁱⁱ. In fact, almost 130 unilateral APAs are reported to have been concluded to date in various regions and cities^{iv}. However, there exist regional differences in respect of the implementation procedures and contents of these APAs, depending on the region where the application was submitted; thus they are open to question as to whether there is reasonableness and fairness among them. Given this situation, the State Administration of Taxation (“SAT”) released Circular 118 (of 2004), Implementation Rules for Advance Pricing Arrangements for Transactions between Related Parties (“Implementation Rules”) on September 20, 2004; the Implementation Rules provide detailed implementation procedures for APAs in order to standardize the procedures at the national level, after years of deliberation.

With the release of the Implementation Rules, it is expected that the regional differences mentioned above will be reduced, and more APAs will be concluded. Although the Implementation Rules were designed for application to unilateral APAs, as China has a poor record of concluding bilateral and multilateral APAs, it is clearly stated that they are to be applied to bilateral/multilateral APAs as well. The term of an APA provided by the Implementation Rules may range from two to four years starting from the year after the formal application is made, but may be rolled back to cover the year of the formal application. The Implementation Rules are, however, silent as to whether the APAs can be rolled back to years prior to the year of formal application. Furthermore, the Implementation Rules are also silent as to the timescale for completing the APA application

process. As a the unilateral APA process has historically taken eight to twelve months to conclude, we anticipate a lengthier process in the future, given the more stringent requirements under the Implementation Rules.

The Implementation Rules contains 33 articles providing specific procedures for pre-filing meetings, execution of the APA, and subsequent monitoring for compliance. They are organized into eight chapters, namely General Principles, Pre-filing Meetings, Formal Application, Examination and Evaluation, Negotiation, Execution, Implementation and Monitoring, and Supplementary Provisions. The Implementation Rules also contain 15 related forms as attachments. We have summarized the specific procedures contained in the Implementation Rules below; the tax authorities at the city, autonomous prefecture level, or higher will enforce these procedures.

1. Pre-filing Meetings (Chapter 2, Articles 4 – 7)

During pre-filing meetings, the local tax authorities and the taxpayer will together explore the feasibility of the APA proposed by the taxpayer. The tax authorities will notify the taxpayer in writing of their comments on the APA, which includes details stipulated in Article 6. If both parties reach an agreement to proceed with the negotiation of the APA, the tax authorities will issue the taxpayer with written notice of the start of formal negotiations.

2. Formal Application (Chapter 3, Articles 8 – 9)

The taxpayer is required to file a written application to the tax authorities within three months after receipt of the notice that formal negotiations have commenced. The application should include the following items at least:

- (1) Organization structure of the group and related parties, relationship among the related parties, and details of related party transactions;
- (2) Financial statements for the past three fiscal years, and documents explaining the characteristics of products and assets;
- (3) Related party transactions and periods to be covered under the APA;
- (4) Comparison of functions and risks between the related parties;
- (5) Nature of the APA, i.e. bilateral or multilateral;
- (6) Analysis of the proposed transfer pricing methodology (“TPM”), functional and comparable analyses that support the TPM selected, and critical assumptions upon which the TPM depends;
- (7) Market and industrial analyses;

- (8) Financial forecasts and business plans for the APA period;
- (9) Whether or not the related parties will cooperate to provide information;
- (10) Consideration of double taxation issues; and
- (11) Consideration of relevant domestic and international laws, tax treaties, etc.

3. Examination and Evaluation (Chapter 4, Articles 10 – 12)

Upon receiving the formal application and its attachments from the taxpayer, the tax authorities must, in principle, examine and evaluate the application and attachments, and reach a conclusion about the application within the next five months. Article 11 provides a minimum of 6 items the tax authorities should consider during this examination and evaluation process.

4. Negotiation (Chapter 5, Articles 13 – 14)

Within 30 days from the date the tax authorities reach their conclusion following examination and evaluation, they must negotiate with the taxpayer and, upon mutual agreement, draft the APA. The draft should contain the 15 items stipulated in Article 14.

5. Execution of APA and Renewal (Chapter 6, Articles 15 – 17)

The tax authorities must formally sign the APA with the taxpayer within 30 days from the date on which drafting began. The APA is renewable. In order to renew the APA, the taxpayer must file a request for renewal no later than 90 days before the expiration date of the initial APA. The tax authorities are required to complete their examination and evaluation of the renewal request, and draft the renewed APA, within 60 days from receipt of that request.

6. Implementation and Monitoring (Chapter 7, Articles 18 – 22)

Once the APA has been mutually agreed, the Implementation Rules require the taxpayer to submit an annual APA compliance report to the tax authorities within four months after the end of each covered year, evidencing compliance with the terms of the APA. In addition, the taxpayer must provide the tax authorities with written notification of any substantial change in the contents of the APA within 15 days after that change has occurred.

7. Cooperation among Relevant Tax Authorities (Chapter 8, Articles 23 – 24)

As to the relationship^v among the tax authorities involved in the APA, the Implementation Rules specifically require cooperation among tax authorities that are located in the same province, autonomous prefecture, city under central authority, or government-designated city, as well as cooperation among those in different provinces (autonomous prefectures/cities) together with the SAT's responsibilities. The stipulation suggests that uniform APAs covering related party transactions between an umbrella company and its subsidiaries located in various places in China may now be feasible.

8. Confidentiality (Chapter 8, Articles 25 – 26)

Both the tax authorities and the taxpayer assume an obligation to maintain confidentiality obligation of all information submitted during the APA process, and receive confidentiality protection under the relevant provisions of the tax and national security laws. Furthermore, the Implementation Rules provide that, where an APA cannot be reached between the tax authorities and the taxpayer, any non-factual information obtained during the negotiation process (such as suggestions, assumptions, ideas, and judgements), cannot be used by the tax authorities to audit the related party transactions at a later date.

9. Attachments to the Implementation Rules

The following related forms are contained in the Implementation Rules. Attachments 8, 10, 13, and 15 are documents managed by the tax authorities internally.

- Attachment 1 : APA minutes (Supplementary Provisions)
- Attachment 2 : Notice of formal negotiation of APA (Pre-filing Meetings)
- Attachment 3 : Formal written application of APA (Formal Application)
- Attachment 4 : Request for extension of formal written application of APA (Formal Application)
- Attachment 5 : Response to request for extension of formal written application of APA (Formal Application)
- Attachment 6 : Initial conclusion on examination/evaluation (Examination and Evaluation)
- Attachment 7 : Notice of extension of examination/evaluation (Examination and Evaluation)
- Attachment 8 : Approval of initial conclusion on examination/evaluation (Examination and Evaluation)
- Attachment 9 : APA agreement (reference document, Negotiation)

- Attachment 10 : Approval of APA draft agreement (Negotiation)
- Attachment 11 : Application for APA renewal (Execution of APA)
- Attachment 12 : Response to application for APA renewal (Execution of APA)
- Attachment 13 : Approval of APA renewal (Execution of APA)
- Attachment 14 : Report of changes in APA agreement (Implementation and Monitoring)
- Attachment 15 : Memorandum regarding APA agreement (Supplementary Provisions)

Finally, the introduction of APA programs in foreign countries^{vi}, the increase in the number of applications for bilateral/multilateral APAs, and the promotion of APAs by the transfer pricing guidelines issued by the Organization for Economic Cooperation and Development (“OECD”)^{vii} also served as background to the introduction of the Implementation Rules. We assume that many companies from all over the world that enter the Chinese market will be extremely interested in the feasibility of bilateral/multilateral APAs through a relevant tax treaty,^{viii} in order to reduce the risk of double taxation. Even though detailed implementation procedures for APAs are now set forth, there still remain a number of problems when considering bilateral/multilateral APAs. These difficulties are the result of a combination of factors, including the poor Chinese record of settling transfer pricing issues through Competent Authority proceedings, the lack of rules for applying for Competent Authority proceedings, irregular handling of finalized unilateral APAs and audit assessments of transfer prices for past years, and limited public information about comparable Chinese companies. With the introduction of these Implementation Procedures however, the conclusion of bilateral/multilateral APAs is more likely, and active discussions between Competent Authorities to resolve double taxation issues relating to cross-border transactions with China are anticipated within the foreseeable future.

ⁱ “Commissioner’s Directive on procedure for confirmation of transfer pricing methodologies to determine the arm’s length price” issued October 25, 1999 (subsequently incorporated into “Commissioner’s Directive on the operation of transfer pricing” issued June 1, 2001).

ⁱⁱ Based on figures released by the National Tax Agency, September 21, 2004.

ⁱⁱⁱ Article 48 of Circular 59 (of 1998), “Transfer Pricing Regulations” issued by SAT.

^{iv} Unilateral APAs are primarily concluded in regions and cities such as Pearl River Delta, Shanghai, Tianjin, and Xiamen.

^v Cooperation among the relevant tax authorities includes cooperation from SAT, and regional tax offices (relating to issues such as a consistency between income and circulation taxes).

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- ^{vi} The APA program was first introduced in Japan in 1987, followed by the U.S. (1991), Canada and New Zealand (1994), Australia and Mexico (1995), South Korea (1996) and Brazil (1997). The program was introduced in China in 1998; and subsequently by the U.K., France and the Netherlands (1999) and Germany (2000).
- ^{vii} Chapter IV, F., Advance Pricing Arrangements (“APA”) of “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” (“OECD Guidelines”).
- ^{viii} See for example “Agreement between the Government of Japan and the Government of the People’s Republic of China for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (Treaty No. 5 of 1984)”.

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