

# China launches first collaborative TP administration pilot program between Customs, Tax Authorities in Shenzhen

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## In brief

Responding to the uncertainties to global economic integration brought by the Covid-19 pandemic and the Chinese government's recent focus on accelerating the development of 'domestic-international dual circulation,' various Chinese government agencies have been focused on improving services provided to taxpayers. The objectives of the various departments are to optimize the business environment, clear bureaucratic roadblocks, reduce compliance cost, and enhance management efficiency.

To facilitate these objectives, on May 18, the Shenzhen Customs and the Shenzhen Tax Service, State Taxation Administration (Shenzhen STA) jointly issued a notice on "Implementation of the Collaborative Transfer Pricing Administration of Related Party Importation" (the Notice). The Notice introduces a pilot program on cross-department collaboration between the Customs and the Tax Authorities in transfer pricing administration and services.

This collaborative administration will take into account both the Customs existing advance ruling procedures and the Tax Authorities advance pricing arrangements (APA) for corporate income tax in order to resolve differences in administration measures caused by the different regulatory bases and differences in assessment methodologies for dealing with transfer pricing of taxpayers' related-party imports. The aim of the Notice is to enhance certainty and predictability of transfer pricing and Customs declarations for taxpayers that carry out related-party imports in Shenzhen, one of the most populous cities in China and a global center in technology, research, manufacturing, and transportation.

**Action item:** Taxpayers should evaluate the impact of the Notice, and respond according to their respective situation and business plans in the future.

## In detail

### Transfer pricing collaborative administration

#### Approach

The Shenzhen Customs and the Shenzhen STA will jointly evaluate the pricing of taxpayers' related-party imports. After a consensus is reached, the departments will co-sign a memorandum on collaborative transfer pricing administration of related-party importation (Memorandum) with taxpayers, and arrange for a Customs advance ruling and an APA, respectively.

#### Applicable taxpayers

Taxpayers in Shenzhen that have strong transfer pricing compliance awareness — and that are compliant with Article 4 in Order 236 of the General Administration of Customs (Interim Measures of the Customs of the People's Republic of China for the Administration of Pre-ruling, "Order 236") and Article 4 in Public Notice No. 64 of State Taxation Administration (Public Notice Issued by the STA on the Matters Regarding Enhancing the Administration of APA, "PN 64") — include:

- Taxpayers registered as overseas business companies with Customs for carrying out actual import and export activities.
- The amount of annual related-party transactions has exceeded RMB 40 million for each of the previous consecutive three years.

#### Applicable period

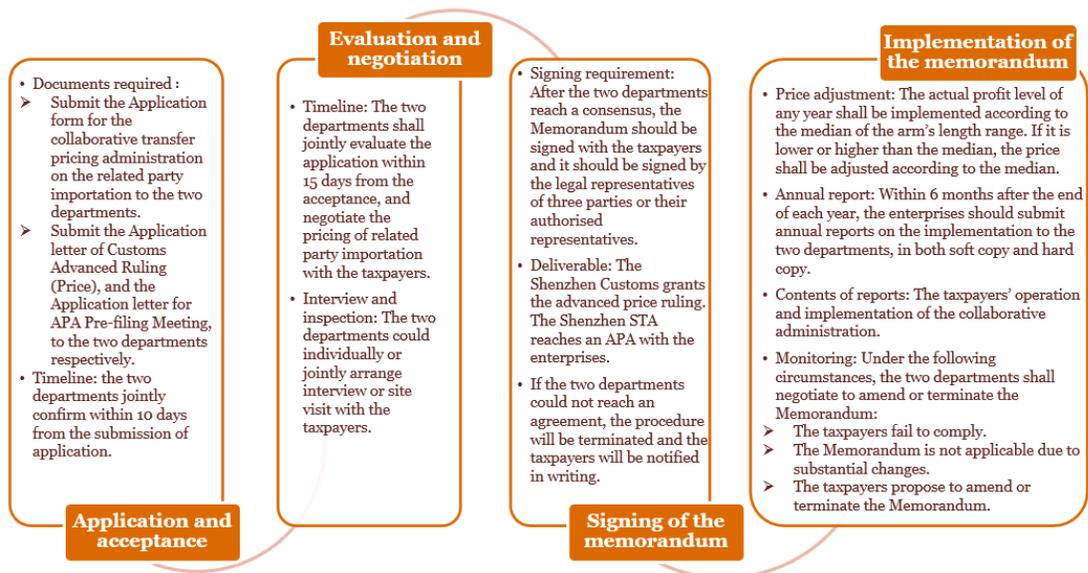
The applicable period for the collaborative arrangements is three years, and will automatically expire after the expiration date. Taxpayers may apply to the Customs and the Tax Authorities for renewal within 90 days in advance of the expiration date.

#### Responsible customs and tax departments

The responsible Shenzhen Customs and Shenzhen STA departments for the pilot program are the Comprehensive Business Department of Customs (the Customs in the taxpayer's territory) and the Comprehensive Business Department of the Fourth Branch, Shenzhen STA (the two departments).

#### Process

The work mainly includes four stages (1) application and acceptance, (2) evaluation and negotiation, (3) memorandum signing, and (4) memorandum execution. The main procedures and documents required at each stage are shown in the figure below:



In addition, the Notice also sets forth the ‘Application Form of Collaborative Administration (template)’ and ‘Collaborative Administration Memorandum (template),’ which provide further guidance on implementation measures for the scope of application, period of application, requirements for price adjustment, enforcement of supervision, and dispute resolution.

Application form of collaborative administration (template)
<ul style="list-style-type: none"> <li>Basic information of the applicant, including name, address, contact person, business scope, etc</li> <li>Overview of the reasons for applying for collaborative administration, including the fact description, the applicant's aim, the applicant's point of view and regulatory basis</li> <li>Applicant's declaration</li> <li>List of appendices</li> </ul>

Collaborative Administration Memorandum (template)
<ul style="list-style-type: none"> <li>General definition</li> <li>Scope of application</li> <li>Period of application</li> <li>Key assumptions</li> <li>Transfer pricing methods and Customs valuation methods</li> <li>Price adjustments</li> <li>Annual report</li> </ul>
<ul style="list-style-type: none"> <li>Validity of the memorandum</li> <li>Dispute resolution</li> <li>Confidentiality obligations and responsibilities</li> <li>Commencement, amendment and termination</li> <li>Supplementary articles</li> <li>Appendices                     <ul style="list-style-type: none"> <li>(1) Details of advanced pricing arrangement</li> <li>(2) Details of custom advanced ruling on price</li> </ul> </li> </ul>

**Observations**

Reconciling gaps in price determination and corresponding double taxation issues

In the past, when dealing with transfer pricing of related-party imports, it may have been difficult for taxpayers to obtain approval from Customs and the Tax Authorities at the same time. The Customs Authorities normally would focus on whether the import price is lower than the fair market level, which would result in under-reporting of custom duties and value-added taxes. On the other hand, the Tax Authorities would focus on whether the import price is higher than the arm's-length standard, which would lead to erosion of the corporate income tax base. The divergent viewpoints may cause potential issues of double price recognition and double taxation. The Notice, for

the first time, introduces the collaborative administration between the Customs and the Tax Authorities, and seeks to resolve these issues to applicable taxpayers via the cross-departmental collaboration.



### Deepening the Customs’ advance ruling practice and enhancing the efficiency of APA

Order 236, effective since February 2018, provides taxpayers with the possibility of simplifying the process, improving efficiency for Customs clearance, and facilitating understanding of the Customs policy and other tax-related matters in advance. However, in the past it has been uncommon to see ‘quantitative’ reviews of related-party import prices and the relevant advance ruling being reached. This Shenzhen collaborative transfer pricing administration pilot program provides quantitative and enforceable advance ruling measures, through discussion between the Tax and Customs Authorities, on the basis of Custom’s existing advance ruling practice. The collaborative administration seeks to facilitate resolution of Customs-related issues that taxpayers may face when dealing with related-party transactions.

The Public Notice on “Matters Regarding the Application of the Simplified Procedures of Unilateral APA,” issued by the STA in July 2021, simplifies the application procedures (from six stages to three stages) and shortens the processing time — the Notice of Tax Related Issues will be delivered within 90 days, the analysis and evaluation will be completed within six months — based on the existing standard APA procedures, providing more efficient tax services to taxpayers. With the collaborative transfer pricing administration delivered by both the Customs and the Tax Authorities, the Notice is designed to provide broader transfer pricing certainty to boost and improve the application efficiency of APAs (especially simplified procedures of unilateral APAs). For the introduction and practical experience sharing of simplified procedures, please refer to our Tax Insights [China STA publishes Public Notice on the application of simplified procedures for unilateral APAs](#) (published August 30, 2021), and [China’s first unilateral APAs under the simplified procedures have been signed](#) (published March 22, 2022).

### Promotion of mutual understanding on transfer pricing methodologies

Due to different regulatory bases and requirements, the Customs and the Tax Authorities traditionally have applied different methods in evaluating related-party import prices. Generally, Customs focuses on the price (or gross profit) of related-party transactions, while the Tax Authorities focus on the operating profit of the taxpayers. The following table provides an example of a comparison of transfer pricing methods with Customs evaluation methods when looking at related-party imported goods for sales to the domestic market.

Transfer pricing methods	Customs valuation methods
	Transaction value method
<b>Comparable uncontrolled price method (CUP)</b>	Identical price method Similar price method
<b>Cost plus method</b>	Computed price method
<b>Resale price method</b>	Deductive price method
<b>Transactional net margin method (TNMM)</b>	Fallback price method
<b>Profit split method (PSM)</b>	
<b>Other method consistent with the arm's-length principle</b>	

### Observations

In recent years, following frequent communication between Customs and the Tax Authorities, both parties have developed more knowledge of the price evaluation methods used by their counterparts. Based on recent dialogue between taxpayers and Customs, Customs has reached a deeper understanding of transfer pricing principles and methodologies, and has become increasingly flexible when applying evaluation methods in reviewing taxpayers' transfer pricing policies, acknowledging that the taxpayers may adopt other reasonable transfer pricing methods (e.g., TNMM, PSM) according to the nature of their related-party transactions. The rationale for introducing this policy is that the collaborative transfer pricing administration pilot program will further promote a mutual understanding of the evaluation methods between the Customs and the Tax Authorities, narrow the gaps in rules, and reduce the transfer pricing compliance risk of taxpayers in these two areas.

### Foreign exchange compliance requirement during transfer pricing adjustment

When taxpayers make a transfer pricing adjustment, practical issues exist related to the foreign exchange compliance. On January 19, 2021, the State Administration of Foreign Exchange (SAFE) issued the "Question & Answers regarding Foreign Exchange Administration for Service Trade (II)" (SAFE Q&A), which clarifies the foreign exchange cash in-flows and out-flows in the transfer pricing adjustment from a policy perspective. For actual and legitimate transfer pricing adjustments (e.g., backed by written notice issued by the Tax Authorities or Customs for transfer pricing adjustment), the foreign exchange cash in-flows and out-flows can be handled under the terms of the original trades.

The collaborative transfer pricing administration in the Notice will provide written documents to the applicable taxpayers issued by the Tax Authorities and Customs (e.g., memorandum of collaborative administration, advance ruling on price by the Shenzhen Customs, and APA signed between the Shenzhen STA and taxpayers). This should make it easier for taxpayers to meet the foreign exchange compliance requirement when making the necessary transfer pricing adjustments (e.g., the profit level needs to be adjusted according to the median of arm's-length range, as implemented in the Memorandum). For details, please refer to our Tax Insight, [China issues Q&A regarding the Administration on forex cash in-flows and out-flows of TP adjustments](#) (dated 30 March 2021).

### Initial applicability of the Shenzhen pilot program

At the moment, the Notice is only applicable to taxpayers in jurisdictions covered by the Shenzhen Customs and Shenzhen STA. In the meantime, for detailed considerations on how the Customs valuation practice can be fully integrated into the transfer pricing methods from a technical perspective — e.g., applicability of the transfer pricing methods other than TNMM, and flexibility on adopting arm's-length range for taxpayers with multi-product categories — the two departments and taxpayers still will need to discuss and explore solutions based on actual taxpayer circumstances.

Given that the Notice is for Shenzhen, it remains to be seen whether the pilot program will set a precedent and how it may be launched in other regions of China.

## **Observations**

As the first collaborative administration between the Customs and the Tax Authorities, the Notice seeks to improve compliance certainty and management efficiency for taxpayers. The Notice opens a precedent for the coordinated governance of the Customs and the Tax Authorities on transfer pricing of related-party imports, and puts forward higher compliance requirements for taxpayers.

Shenzhen taxpayers should take advantage of the pilot program and evaluate the application of collaborative administration. Shenzhen taxpayers — especially taxpayers that have imports as their main related-party transactions, taxpayers who were requested by the Customs or the Tax Authorities to make transfer pricing adjustments, and taxpayers that plan to apply for an APA or advanced ruling on prices — should:

- Consider the applicability and feasibility for applying for the collaborative administration, and evaluate the advantages in application and potential impact from Customs and Tax perspectives.
- Take advantage of the program and formulate practical application plans and strategies for future negotiation with the Customs and Tax Authorities.
- Seek assistance from external specialists, if necessary, to effectively promote the application, negotiation, and subsequent implementation.

The following taxpayers in Shenzhen may benefit from the Notice:

- Wholesale or retail distributors in the retail and consumer industry that import products from overseas related parties; and
- Manufacturers that import raw materials and components from overseas related parties and sell finished products in the domestic market.

The collaborative administration pilot program in Shenzhen potentially will impact cooperation between the Customs and Tax Authorities in other regions, and similar policies may be enacted in the future. Taxpayers outside Shenzhen should consider:

- Reviewing their related-party transaction arrangements, mitigating transfer pricing risks from both the customs and tax perspectives.
- Monitoring future developments of the collaborative administration program, and maintaining positive communication with local Customs and Tax Authorities.
- Planning in advance for the improvement of certainty in cross-border related-party transactions.

## **The takeaway**

Taxpayers have long faced practical issues in managing their transfer pricing risks for related-party imports from Customs and Tax perspectives. The collaborative administration, piloted by Shenzhen Customs and Shenzhen STA, offers an important innovation designed to help Shenzhen taxpayers to achieve comprehensive tax certainty. At the same time, some issues have not been clarified and need to be further explored in the future, such as:

- If taxpayers strictly follow the provisions of the Memorandum and make the transfer pricing adjustments according to the median of the arm's-length range, how should they resolve the tax rebates for corporate income tax and turnover tax?
- Will Customs accept taxpayers using other transfer pricing methods (e.g., CUP/identical or similar price method, PSM, or other reasonable methods) in the advance ruling on import price?

- Will Customs accept the transfer pricing method which selects an overseas related party as the tested party?
- Will Customs accept the value chain analysis and location-specific factors as required in the transfer pricing regulation?

## Let's talk

For a deeper discussion of how this development might affect your business, please contact:

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