Observations on Q&As issued by China's STA on "Anti-Tax Avoidance During Pandemic Prevention and Control"

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In brief

The COVID-19 pandemic has created unprecedented challenges and uncertainties for the operations of multinational enterprises (MNEs). One core concern is dealing effectively with transfer pricing risks.

On December 18, 2020, the Organisation for Economic Co-operation and Development (OECD) issued its "Guidance on transfer pricing implications of COVID-19 pandemic" (the OECD Guidance), which represents the consensus of the member states or regions, including China, in the OECD's Base Erosion and Profit Shifting (BEPS) Inclusive Framework. Since then, various jurisdictions and regions, including Australia, Singapore, New Zealand, and Hong Kong SAR, have issued local interpretation and guidance on the transfer pricing arrangements of MNEs during times of economic uncertainty in the Asia-Pacific region.

In this context, on September 30, 2021, the International Taxation Department of China's State Taxation Administration (STA) released its "Questions and Answers on Anti-Tax Avoidance During Pandemic Prevention and Control" (the "Q&A") on its portal. This is the first time that the STA has provided, in written form, prescriptive instructions for tax authorities and MNEs when analyzing the impact of the COVID pandemic from a transfer pricing perspective. Observations on the Q&A related to transfer pricing are provided below.

Action item: In practice, the Q&A provides high-level guidance, and there will be uncertainties on how the Q&A should be interpreted and implemented in different provinces and major cities across China. Therefore, MNEs should revisit their transfer pricing arrangements during and after the pandemic on their actual circumstances, and collect the relevant data of the market environment. MNEs also should conduct reasonable transfer pricing analyses according to the Q&A to analyze whether corresponding measures should be made on their current transfer pricing arrangements in China.

In detail

Interpretation of the Q&A

The International Taxation Department of the STA addresses transfer pricing issues through five questions in the Q&A relating to transfer pricing investigations, transfer pricing administration, and transfer pricing services.

Transfer pricing investigations

Question 1: The pandemic has a material impact on the operations of enterprises and related-party transactions. Under such a circumstance, how would the tax authority conduct transfer pricing investigations?

STA answer: The impact of the pandemic on enterprises in different industries can vary significantly. For some industries, the pandemic has had a relatively large impact on enterprises, while for other industries the pandemic brought new development opportunities. In conducting transfer pricing investigations, tax authorities will follow the arm's-length principle (ALP), and consider the impact of the pandemic on related-party transactions of enterprises based on their specific circumstances.

Observations: The OECD Guidance defined the COVID-19 pandemic as a “hazard risk.” Tax authorities and MNEs should decide how this risk is reasonably distributed among related parties through controlled transactions based on the ALP. In the Q&A, the emphasis from the STA that the ALP should be applied when analyzing the impact of the COVID pandemic on related-party transactions is in line with the views of OECD. For more information on the OECD Guidance, please refer to PwC’s Tax Policy Alert titled “OECD released guidance on transfer pricing implications of COVID-19."

Question 2: During transfer pricing investigations, how would the tax authority view losses due to the impact of the pandemic?

STA answer: China’s tax authorities will consider the impact of the pandemic on enterprises in the transfer pricing investigations, in terms of the enterprises’ functions performed and risks assumed, the characteristics of related-party transactions, industry characteristics, comparable enterprises, and other factors. For additional expenses incurred by enterprises due to pandemic prevention and control, or increased operating expenses caused by the outbreak, tax authorities will carry out adjustments on the comparability analysis as appropriate, considering how the related costs and expenses would be allocated between independent third parties. It is recommended that enterprises should segregate and quantify the related costs and retain relevant evidence as reference material during investigations.

Observations: When analyzing the issue of "operating losses for multinational enterprises caused by the COVID-19 pandemic and how to allocate pandemic-related expenses," the OECD Guidance also pointed out that, in response to the COVID pandemic, when determining how special expenses and costs are allocated among related parties, it is necessary to consider the type of commercial arrangement an independent third party will reach.

For enterprises with large fluctuations in their income and profit levels during the pandemic, especially enterprises that have been negatively affected, horizontal comparisons with independent third parties and vertical comparisons with historical annual data can be considered to confirm and explain whether the fluctuations are caused by the pandemic. A further quantitative analysis then should be carried out to validate the appropriate allocation of additional costs and expenses with overseas related parties. For example, if the pandemic has resulted in a decline in sales revenue due to the suspension of production and operations, increase in logistics and transportation costs, drop in inventory prices, increase in labor costs, and pandemic prevention expenditures, a comparative analysis on the function, risk, and asset (FAR) profiles is recommended in seeking to arrive at a fair quantification and allocation of the impact.

The transfer pricing analysis on the impact of the COVID-19 pandemic is particularly important for enterprises that assumed simple functions and suffered losses during the pandemic. In accordance with the principle of matching an arm’s-length compensation to functions and risks, STA Public Notice [2017] No. 6 stipulates that “the enterprise engaged in a single production business such as toll processing or import processing, or engaged in distribution and contract R&D business, should maintain, in principle, a reasonable level of profit." Therefore, under the current transfer pricing regulations, if the above-mentioned enterprises incur losses during the pandemic or deviate from the group's transfer pricing policy, they still may face questioning from tax authorities and potential transfer pricing investigations.

Based on a detailed and reasonable analysis prepared by enterprises, the Q&A put forward the guidance that the competent tax authority can "make differential adjustments as appropriate" in transfer pricing investigations. This demonstrates an understanding of the challenges and an attitude from tax authorities, that supports enterprises actively managing their transfer pricing risks. However, it is worth emphasizing that the pandemic is not a "catch-all" reason for significant profitability fluctuations in enterprises. Different from the broad qualitative description, the Q&A clearly states that quantitative analyses such as cost analysis and comparability analysis are required. The Q&A also puts forward a higher requirement on the management of the enterprise's risk transfer. Therefore, enterprises that are more severely impacted by the pandemic should actively prepare detailed analyses as early as possible, take into account the 10-year statute of limitations for China's transfer pricing investigations, and retain the relevant supporting documents.

Transfer pricing administration

Question 3: Affected by the pandemic, if an enterprise's profit level in 2020 changes significantly, what aspects should be paid attention to when preparing contemporaneous transfer pricing documentation?

STA answer: According to the relevant provisions of Article 14(4) of STA Public Notice [2016] No. 42 (Public Notice 42), when preparing the transfer pricing documentation local file, enterprises should explain in detail the specific impact of the pandemic on its related-party transactions and on the value chain, etc. When conducting a comparability analysis, taxpayers should focus on the comparables in the same year, region, industry, product, function, and risk in order to reflect the impact of the pandemic on the profitability of the industry.

Observations: The COVID-19 pandemic may bring major challenges to the comparables analysis. The Q&A puts forward more detailed and targeted analysis guidelines for the same data period, which specifies higher requirements for enterprises in transfer pricing compliance, and also brings greater challenges to the effective implementation of comparability analyses. For example, according to Public Notice 42, the local file should be prepared before June 30 of the following year if related-party transactions are carried out, and contemporaneous documents should be provided within 30 days from the date required by the tax authority. Therefore, when preparing contemporaneous documents for the same period, most of the comparable data for the same year (i.e., 2020) are not publicly available due to the timing lag of information. Therefore, using public market data from 2019 and earlier may distort the comparability results in 2020, if no reliable adjustments can be performed.

In line with the guidance in the Q&A, enterprises severely impacted by the pandemic that have completed their local file for 2020, or have submitted contemporaneous transfer pricing documentation in response to a request from the in-charge tax authorities, can review the local file for 2020 as appropriate and consider supplementing or improving the relevant analysis based on sufficient communication with the in-charge tax authority.

Against the background of the national tax system gradually promoting the profit-level monitoring system for MNEs, such "big data" system will monitor enterprises that have undergone major changes in related-party transactions through risk indicators and may identify them as having higher transfer pricing risk, triggering follow-up risk management by tax authorities. Therefore, if there are significant deviations between the actual implementation of the pricing or profit level of related-party transactions and the results of the comparability analysis, there should be a supplementary analysis based on the background characteristics of the industry, region, and the group itself. For example, in contrast to the impact of unpredictable major events in history (such as the 2009 financial crisis) on the tested party and comparable enterprises, it may be possible to reconstruct the objective reasons for the major changes in the business operations during the special period, or to justify that the decline in business operations is not caused by the profit shifting due to unreasonable transfer pricing policies, in order to reduce the potential risks of transfer pricing tax supervision.

Transfer pricing services

Question 4: Does the government's relief policy responding to the pandemic affect the price adjustment of related-party transactions?

STA answer: During the pandemic, the Chinese government introduced a series of relief policies in terms of rent, taxes, and financing. The impact of government relief policies on transfer pricing arrangements would mainly be reflected in comparability analyses. If the enterprise believes that government assistance has had an impact on its transfer pricing arrangements, it should provide the relevant information in its transfer pricing documentation to support the transfer pricing analysis. The tax authority will follow the ALP, identify comparable factors, and ensure the fairness and consistency of the results of the comparability analysis.

Observations: The Q&A basically follows the OECD Guidance related to the views on "government subsidies and support projects." In this regard, enterprises should analyze the accounting treatment of the government's pandemic assistance policies. The relevant analyses include, for example, whether the pandemic relief has affected the current financial statements, and which accounting items will be affected. For instance, if pandemic-related subsidies are included in “non-operating income,” they generally will not affect the transfer pricing results of the current year. However, in contrast, if the pandemic subsidy affects related-party transaction arrangements — e.g., the subsidy is used to offset the payments due to related parties — it is recommended that enterprises conduct more detailed transfer pricing analysis based on an evaluation of economic factors related to the pandemic subsidies.

Some tax authorities may think that excellent pandemic prevention and control capabilities, and special government aid to the pandemic, are part of the location-specific advantages, and such benefit or advantages should be reflected in the margin earned by the local enterprises. PwC has observed that tax authorities in certain countries and regions (for example, Inland Revenue Authority of Singapore) advocate that independent third parties usually retain the relevant income of government pandemic subsidies for commercial reasons. Therefore, unless government pandemic subsidies provide otherwise, the benefits related to subsidies should not be exclusively enjoyed by or shared with its overseas related parties.

Question 5: How are previously signed advance pricing arrangements (APAs) influenced by the pandemic with regards to implementation?

STA answer: If the enterprise does make a material change in the implementation of the APAs due to the pandemic, it may report to the competent tax authority in written form to explain in detail the impact of the pandemic on the implementation of the APAs, with the relevant information included.

The in-charge tax authority shall analyze and assess the extent to which the material changes brought about by the pandemic have affected the APA. For unilateral APAs, tax authorities will negotiate with enterprises to revise or terminate the APAs; for bilateral or multilateral APAs, after the changes are reported to the STA, the STA and the corresponding competent authority will negotiate a settlement.

Observations: The STA Public Notice [2016] No. 64 provides the following guidance to the response mechanism that enterprises need to master during the implementation of APAs: “[d]uring the execution of the APAs, enterprises shall report the impact of changes on the implementation of APAs in written form to the competent tax authorities within 30 days from the date of the change in detail and attach the relevant information." The APA Implementation

Agreement usually makes "key assumptions" about matters that lead to significant changes in the fundamentals of the business.

The Q&A further clarifies that if the impact of the pandemic leads to a substantial change in the operating environment of the enterprise under the APA, where the key assumptions are affected, the enterprise may communicate with tax authorities in a timely manner during the covered period, provide supplementary analysis information, and continue to implement the APA, in order to seek understanding and cooperation between the tax administration and enterprises to reduce the impact of the COVID-19 pandemic. This view is in line with the relevant provisions of the OECD Guidance. Based on past tax practice in China, during business as usual, suspension or re-signing APAs during the covered period rarely has occurred. As a result, it seems unlikely that China's tax authorities would make large-scale revisions or suspend APAs during the covered period as a result of the pandemic. Once a consensus is reached, it is more likely that both tax administrations and enterprises would reasonably reflect the impact of the pandemic on the economic environment and related-party transactions during the renewal phase.

The takeaway

From 2020 to the present, the pandemic has posed significant challenges to the transfer pricing arrangements of MNEs, as well as to operations and supply chain management. The Q&A issued by the International Tax Department of the STA responds to the most common questions in day-to-day transfer pricing management and provides principled guidance. The Q&A encourages enterprises to strengthen their transfer pricing compliance, actively manage their transfer pricing risks, and actively communicate with tax authorities to strengthen and sustain transfer pricing services during periods of economic uncertainty caused by the COVID-19 pandemic.

The Q&A also provides guidance to China’s tax authorities to consider the impact of the pandemic as appropriate, based on compliance with the ALP, which is in line with the related content in the OECD Guidance.

Let’s talk

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

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