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China Takes the Lead on Transfer Pricing Policy: Combating BEPS Through a Value Chain Analysis

The authors cite support for a ''value chain analysis'' in OECD draft and final BEPS guidance and describe how local Chinese tax authorities are applying the analysis under the recent documentation guidance in Bulletin 42.

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China's State Administration of Taxation on June 29, 2016 issued a new transfer pricing regulation—Bulletin 42,[1] which replaced specific sections stipulated in previous transfer pricing circulars[2] in relation to annual filing of related-party transactions and contemporaneous transfer pricing documentation. Bulletin 42 represents a new milestone in China's efforts to combat tax avoidance through transfer pricing. Since the project to combat tax base erosion and profit shifting (BEPS) initiated by the Organization for Economic Cooperation and Development and the Group of 20 countries in 2013, China has been one of most active countries in Asia to support the BEPS project's development and implementation. Throughout the country, various levels of the local tax authorities have been working to adapt the OECD guidance and recommendations into tax measures in order to equip themselves to face the tax avoidance challenges in their local tax administrations.

Bulletin 42 mainly reflects the Chinese tax authority's position in responding to the international standard set out in BEPS Action 13 in relation to transfer pricing documentation and country-by-country reporting.[3] In particular, Bulletin 42 introduced a value chain analysis (VCA) to be included in the local file documentation as of Jan. 1, 2016. This analysis requires company to disclose critical information such as financial statements of each related party, descriptions of all related parties involved in value creation and the corresponding profit allocation policy.

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[1] Bulletin [2016] No. 42 from China's State Administration of Taxation, Final Rules on Transfer Pricing Documentation released July 12, 2016; see 25 Transfer Pricing Report 407, 7/28/16.

[2] Guoshuifa [2008] Circular 114 and Guoshuifa [2009] No. 2.

[3] Final OECD recommendations under Action 13, the item in the BEPS plan that covers transfer pricing documentation, are at http://src.bna.com/tA.

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OECD References

The OECD's recommendations under Actions 8, 9 and 10—the three BEPS action items that focus on the transfer pricing analysis—contain various references to the global value chain. The main objective of Actions 8-10 is to ensure that transfer pricing outcomes are in line with economic value creation. Specifically, the final report issued under those actions stated that ''the splitting of profits should be based on a functional analysis of the parties' contributions.''[4]

While discussing highly integrated business operations may lead to use of the profit split method, the Action 8-10 report, in discussing the scope of revisions to the guidance on the transactional profit split method, stated at page 60:

> [I]t may be helpful to distinguish between sequential integration of a global value chain (which may involve the parties performing different activities linked through transactions between them in a coherent value chain, and which may not warrant the use of a profit split without taking into account further features of the arrangements) and parallel integration, which may involve the parties performing similar activities relating to the same revenues, costs, assets, or risks, within the value chain or at a stage in the value chain.

Purpose of Conducting a VCA

In the revised guidance on profit splits, the OECD gave the following guidance about the purpose of a VCA: ''A value chain analysis, undertaken as part of the broad-based analysis of the taxpayer's circumstances (see 1.34), may be useful in helping to identify when the transactional profit split method may be appropriate. Such an analysis may also assist in determining how the method, if indeed it is the most appropriate method, should be applied, including the profits to be split and the relevant splitting factors.''[5]

Intangibles

Research and development can be an important element of business strategy because intangibles such as patents, trademarks and know-how have become one of the key value drivers of many business models. In terms of analyzing value creation contributed by intangible assets, Action 8-10 emphasizes at paragraph 6.133: ''The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business.''

Tool to Identify Features

It should be noted that performing a VCA does not automatically lead to application of a profit split method. Rather, it is a tool to identify the features of relations between parties, as noted by the OECD: ''All business operations can be expressed through a value chain and many MNE groups operate through a global value chain,'' the latest profit splits draft states at paragraph 25. ''This alone does not imply that the transactional profit split should be applied. If that were the case, then a profit split would apply in almost every case and risk producing results contrary to the arm's length principle. Instead, the purpose of the VCA is to identify the features of the commercial or financial relations between the parties.''

The VCA as a tool would contribute to the following aspects in a transfer pricing analysis or documentation:

- delineating transactions (e.g., key value drivers, unique and valuable intangibles and significant risks);
- determining the level of integration between group companies;
- identifying parties relating to development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles; and
- evaluating whether the profit split method is the most appropriate method and subsequently determining the weighting of applicable profit split factors.

Content of the VCA

The OECD draft on profit splits said the VCA also may include the following information:

- economically significant functions, assets and risks;
- how the economic circumstances may create opportunities to capture profits in excess of what the market would otherwise allow; and
- sustainability of value creation.

SAT Requirements

Under Bulletin 42, multinationals must perform a VCA and include it in the local file documentation for China as of Jan. 1, 2016. The SAT provided no further instruction on how detailed information should be disclosed in relation to the VCA. The information to be included in the analysis includes:

- the flow of intercompany transactions, goods and capital, as well as a description of all related parties involved in ''value creation'';
- annual financial statements of each related party involved;
- measurement and attribution of ''value creation'' contributed by location-specific factors; and
- information on the variables used for profit allocation in the global value chain.

The SAT is aiming to use the VCA to gain better insight into the business activities and profit positions of the Chinese entities versus other related parties involved in the multinational's global value chain, as well as to determine profit attribution in relation to intangible assets. Through using a VCA, the Chinese tax authorities may be able to identify any misalignment between tax, economic or financial realities within a multinational group the Chinese entities are part of.

General Role Played by China

Before Restructuring

It used to be common that the Chinese operation was a full-fledged manufacturer in a multinational group, as illustrated below.

[4] See final OECD recommendations under Actions 8-10, online at 24 Transfer Pricing Report, 3/31/16 or http://src.bna.com/tx.

[5] See OECD July 4 revised discussion draft on profit splits, http://src.bna.com/gud.

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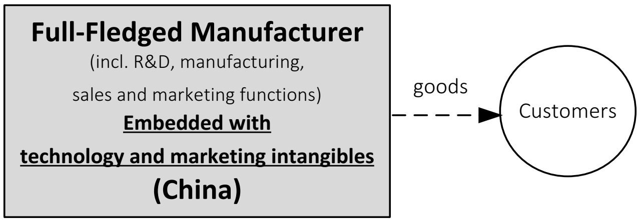
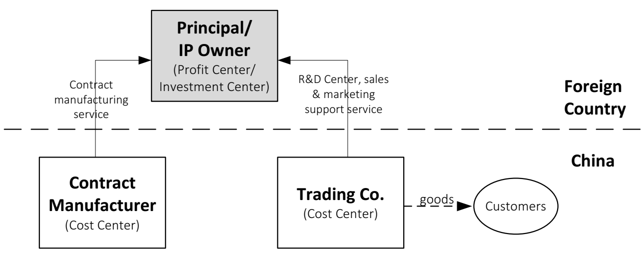


The next graphic illustrates the Chinese entity's position in the global value chain before the restructuring.

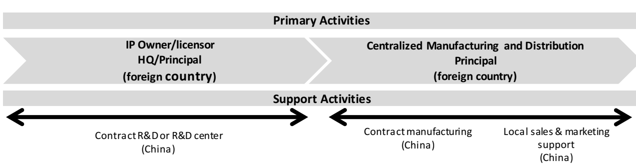
As the Chinese entity undertakes primary functions and risks in the global value chain, it is entitled to a portion of residual profit.

After Restructuring

Activities such as R&D and sales and marketing would mostly be reorganized into a new investment company (or a trading company) and located in economically developed cities such as Beijing or Shanghai. The Chinese operations after restructuring are as illustrated below.



The next graphic illustrates the Chinese entity's position in the global value chain after the restructuring.



After the restructuring, the manufacturing, R&D and sales and marketing activities undertaken by the full-fledged manufacturer would be split and classified as routine functions or support activities without any valuable intangibles. Subsequently, the Chinese entities would be remunerated on a cost-plus basis and wouldn't be able to claim any residual profit. All risks, entrepreneurial functions and unique intangibles would be allocated to the multinational company's global headquarters, or the so-called principal company, and remunerated based on a profit center or an investment center responsibility profile.

In light of the VCA requirement stipulated in Bulletin 42, the following questions would arise:

- Would the split of functions and allocation of risks in terms of the Chinese entities still apply?
- Were any preexisting intangibles created by the Chinese full-fledged manufacturer?
- If there were, have the intangibles been evaluated and remunerated in line with the arm's-length principle?
- Would the Chinese entities still be entitled to a portion of the residual profit after the restructuring?
- After the restructuring, is the R&D function performed by the Chinese entity in relation to DEMPE of intangibles in line with the display of value creation in the global value chain?

Example on R&D Activities

In many cases, valuable intangibles are buried in the contract R&D function after splitting of functions within multinational entities. Two or three decades ago, most of the full-fledged manufacturers in China had their own R&D departments undertaking local R&D or centralized R&D functions in multinational groups. Nowadays, the R&D functions that used to be part of the full-fledged manufacturer are split into:

- the contract R&D function undertaken by a separate company in China, and
- a risk-taking function undertaken by the so-called principal company located in foreign countries.

For example, before the business restructuring, the Chinese full-fledged manufacturer had its own R&D and technical department, testing center, laboratory, senior R&D professionals and R&D results. It also had its own localized technical manual, data specifications, standards, blueprints and engineering drawings that would complement and improve the multinational entity's technology. These intangible assets belonged to the Chinese full-fledged manufacturer.

However, after the restructuring, the R&D team of the full-fledged manufacturer would be split into a separate contract R&D company or R&D center, which would undertake routine functions and risks. All R&D results (intangible assets) would belong to the principal company located in foreign country.

As a result, the value of the significant R&D functions and results, being the important intangible assets of the multinational group and already created before restructuring by the Chinese full-fledged manufacturer in the global value chain, would suddenly disappear.

Preexisting intangibles such as well-assembled workforce, government license, customer relationships and previous experience are often not recognized during business restructuring. These intangibles could be significantly valuable to the multinational group and make a unique contribution to the global value chain.

However, as these preexisting intangibles wouldn't be reflected as assets in balance sheet, they wouldn't always be identified during restructuring. In addition, the cost of the R&D function in relation to developing intangibles may be expensed rather than capitalized in the balance sheet of the Chinese full-fledged manufacturer, and therefore the preexisting intangibles wouldn't be identified in the balance sheet. Often the R&D function after the restructuring would be classified as a contract R&D function undertaking routine functions and risks, and subsequently would be remunerated on a cost-plus basis without taking into account the preexisting intangibles.

These preexisting assets could represent significant value in a multinational group and should be assessed and remunerated in accordance with arm's-length principle in the global value chain.

Location-Specific Factors

As stipulated in Bulletin 42, location-specific factors (such as location savings and market premium) need to be taken into account in the VCA, which forms part of the local file documentation. Location-specific factors are defined as a type of benefit related to geographic location.

Generally, assets employed by multinationals in their business operations can be broadly classified into three categories:

- Category A—fixed or tangible assets;
- Category B—intangible assets; and
- Category C—so-called non-intangible premium assets such as location savings, local market features, assembled workforce, group synergies and market premium.

Appropriate remuneration for Category A can be determined through a cost-plus, return on sales or return on assets, while Category B can be measured through a return on investment (in the form of a royalty or lump-sum payment). Location-specific factors as part of Category C would often be addressed through bargaining power in the absence of reliable third-party comparables to determine an appropriate premium for allocation between group companies.

In China, the most critical difficulty is to find reliable domestic comparables, as there are limited publicly listed Chinese companies in financial databases. Therefore, the value created through location-specific factors in the global value chain is generally allocated through bargaining power between Chinese entities and the foreign parent or principal company. If the Chinese entity is the only company within the industry of the multinationals group that is capable of manufacturing the products under required international standards, the foreign parent or the principal company would have no option but to grant certain residual profit relating to the location-specific factors to the Chinese company.

However, if manufacturing of these kinds of products is considerably competitive and there are more companies located in different part of the world that are capable of manufacturing the products under the same quality standard, then the principal company or the foreign parent would have more options. In this case, the bargaining power of the Chinese entity would be reduced and consequently the Chinese company would be allocated less of a premium for location savings.

Approach in Analyzing Value Chain

The Chinese local tax authorities suggest that, for those contract manufacturing entities without unique intangibles having significant full-time equivalents (FTEs), salary and fixed assets, the corresponding profit allocation should reflect those circumstances.

The authors suggest the five approaches described below for analyzing value created by Chinese entities within a multinational's global value chain.

1. Assess alignment of three ratios. A practical approach is to assess whether the following three ratios are aligned in terms of the Chinese entity:

- operating margin (OM) to total group OM (OM ratio);
- gross margin (GM) to total group GM; and
- FTE to total group FTEs (FTE ratio).

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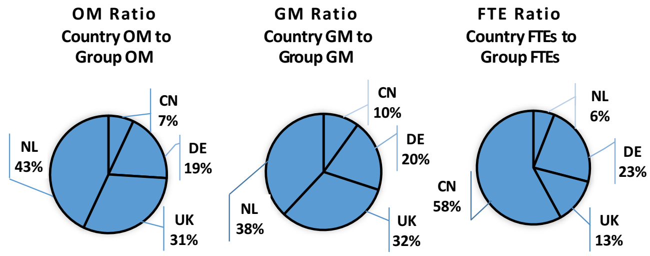
The graphic below represents a misalignment scenario between the three ratios. By looking at China entity's OM-to-GM ratio versus its FTE ratio, the greater the misalignment, the more explanation the tax authority would require.



2. Use audit trail information. LinkedIn profiles, job advertisements, digital agendas and other social media information can help identify the relevant functional profile of an employee or a company. Audit trails may provide detailed and up-to-date information about a multinational's operation in China and in foreign countries—information that could be useful during tax or transfer pricing audits.

3. Use transfer pricing files and forms. The transfer pricing master file, local file and related-party transaction reporting forms (including the form for reporting country-by-country data) can be used to further analyze the alignment of economic, financial and legal reality of a multinational's operations and its transfer pricing system in China.

4. Consider using the profit split method. Consider using the profit split method instead of the transactional net margin method to assess the value created by the Chinese entities.

5. Use the German exit charge approach. Introduce the exit charge approach applied by the German tax authority in dealing with business restructuring cases in China and to ensure splitting of functions is in line with the arm's-length principle.

Recent Audit in Shenyang

There is growing interest in audits conducted using a value chain perspective in China. Recently, the Shenyang city tax authority conducted an audit of a local company (Company A) and its related foreign parent (Company B) through analyzing the global value chain of the multinational group.

The tax authority noticed that Company B is a global leader in the electronics industry in which the multinational group operates. Company A's profit is continuously increasing and has an average operating margin around 10 percent. However, the tax authority found that 90 percent of the products manufactured by Company A are sold to Company B for resale to distributors. Company A's gross margin achieved from selling 90 percent of its products to Company B is three times lower than for the same products sold in the domestic market.

The tax authority conducted a further investigation of Company A's selling price in both the foreign and domestic market, as well as the gross margin achieved by Company A. Through analyzing the global value chain of the multinational group, it is clear that:

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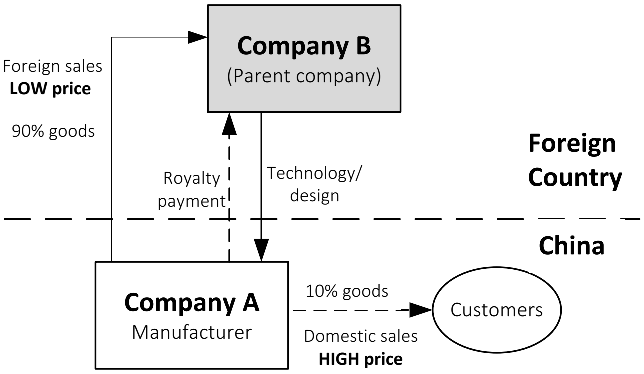


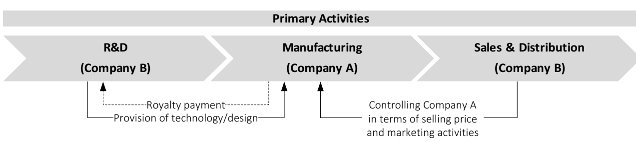
■ Company A manufactures products based on the product specifications, quality standard and manufacturing technology provided by Company B and pays a royalty to Company B for using the technology and design;

■ Company A also manages the quality control process and performs after-sales services;

■ Company B performs marketing and R&D functions; and

■ all product selling prices are decided by Company B; Company A doesn't have the right to agree on product sales prices (for either domestic or foreign sales).

The commercial relations of Company A and Company B in the global value chain can be visualized as follows:



Based on the above VCA, the tax authority concluded that:

■ the product manufacturing and sales process of Company A is controlled by Company B;

■ Company A has no right to decide on its product selling price;

■ Company A pays a royalty to Company B for using its technology and design;

■ the price used by Company A to sell products to Company B is significantly lower than selling price used by independent parties;

■ Company A, as the company's major manufacturing company, earns 10 percent of the global value chain, an amount that isn't in line with the arm's-length principle; and

■ Company B is artificially moving away the residual profit that Company A, as a profit center, should earn.

Through comprehensive data collection and analyzing the global value chain where Companies A and B, as well as other relevant group companies, operate, the tax authority made a tax adjustment to Company A of 16.5 million yuan ($2.4 million).

This case is a good example of how tax authorities are using a VCA in a tax and transfer pricing audit of a company with high profitability in China.

Conclusion

The Chinese tax authorities have recognized that the BEPS guidance gives them a good reason to look at value creation and profit attribution within multinationals. Taxpayers should expect that the authorities will assess the value created by Chinese entities from a global perspective, and that they are likely to:

■ ensure the splitting of functions is in line with the arm's-length principle in a restructuring case;

■ ensure all intangible assets created before and after a restructuring are appropriately remunerated;

■ evaluate, under the new business model, whether the functions undertaken and risk assumed by the Chinese entities are aligned with the profit attributed to them and whether the Chinese entities can claim part of the residual profit generated from the multinational's global value chain;

■ identify the commercial and financial relations between the parties;

■ determine whether any type of DEMPE activities creating valuable intangibles made by the Chinese entities are appropriately remunerated;

■ identify whether any localized intangibles are being created through contract R&D functions and ensure that they are separately paid for upon transfer;

■ evaluate the existence of location savings and perform qualification and quantification analyses to ensure an arm's-length allocation of these non-intangible premiums between group companies; and

■ ensure that the taxpayer's transfer pricing policy aligns with its execution of the policy.

In light of the OECD's BEPS actions and the efforts made by the Chinese tax authorities in combating BEPS—especially through Bulletin 42—a VCA has become an important tool to help the Chinese tax authorities obtain critical information from multinationals about the commercial and financial relations between various parties in the global value chain.