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China Alert

China rolled out a notice sparking anti-tax-avoidance investigations on substantial outbound payments for service fees and royalties

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The State Administration of Taxation (“SAT”) in China released the “Notice of Anti-tax-avoidance Investigations on Substantial Outbound Payments” (“Notice 146”) on 29 July 2014 to request the local tax bureaus to investigate the substantial outbound payments for service fees and royalties made by enterprises in China to their overseas related parties.

This alert briefly summarizes background information, contents of Notice 146 and our comments.

Background

In recent years, China tax authority has strengthened its enforcement on anti-tax-avoidance with an aim at preventing resident companies in China from eroding the China tax bases and improperly shifting their profits to overseas related parties. The SAT has noted that some of multinational companies’ subsidiaries in China have made substantial outbound payments to their overseas holding or related companies by adopting various arrangements without or with very weak economic substance. In order to rectify the issues and respond to the rapid change of global tax environment, the SAT issued Notice 146 to roll out a national tax investigation action plan on the above-mentioned payments.

Summary of Notice 146

According to Notice 146, the investigation was focused on service fees and royalties paid by China entities to their overseas related parties for years from 2004 to 2013, in particular to those in tax haven jurisdictions. All local tax bureaus at the city level or above have been required to conduct an analysis to assess the reasonableness of payments based on whether the relevant transactions were justified by reasonable commercial purposes and economic substance.

The following service fee payments may be suspected in carrying out for tax avoidance motive:

- Payments for services provided by shareholder(s) (including planning, management and supervision activities in respect with China entity's operation, finance and human resources, etc.);
- Group management service fees paid for the purpose of complying with the group united management requirements;
- Payments for the service which can be performed by the China entity itself, or duplicated services which have already been provided by a collaborating third party.
- Payments for the services which are unrelated to the functions and risks undertaken by the China entity, or if related, but not matched with the business operation of the China entity in operation scale or stage;
- Payments for the services which are provided simultaneously with occurrence of other transactions, where the service fees have been included in the consideration of other transactions, shall not be duplicated.

The following royalty payments may be suspected in carrying out for tax avoidance motive:

- Payments to recipients located in tax haven jurisdictions;
- Payments to overseas related parties undertaking no or limited functions;
- Significant payments made to the overseas recipients where the value of the intellectual property has been impaired or notable contribution has been made to the intellectual property by the China entity.





Our comments

1. As can be seen from Notice 146, the SAT has tightened the anti-tax-avoidance investigations on outbound related party payments to overseas jurisdictions. Multinational companies with such payment arrangements for their related companies in China should revisit the existing cross-border investment structures and profit repatriation arrangements so as to timely and properly manage their potential tax risks.
2. Notice 146 provides a list of suspicious outbound service fees and royalty payments and requests local tax officers to initiate an examination and analysis in order to determine the reasonableness of such payments and whether the fee arrangements under review have tax-driven motives. It is very important for the companies which have such related-party transactions to keep sufficient documentation in place to substantiate the commercial purposes and economic substance of such related-party transactions.
3. The investigation exercise is targeted at “substantial” related-party payments. The quantum of related-party transactions is one of the critical indicators for the tax authority in selecting the investigation target. In addition to substantiating the commercial reason and economic substance of the related-party transactions, companies are recommended to maintain a transfer pricing benchmarking analysis report to justify reasonableness of pricing policy of their related-party transactions.
4. Under current rules, if related party transactions do not comply with the arm’s length principle, or an enterprise makes other arrangements without reasonable commercial purpose, the tax authority in China has the right to make transfer pricing adjustments within 10 years after the transactions occurred. Notice 146 sets out a 10-year review period along the statute of limitation. Different with a tradition tax investigation to begin with 3 years back first, taxpayers which fall into the suspicious payments categories as stated in Notice 146 should prepare to open up their relevant payment accounts, records and supporting documents for an immediate review for 10 years. A higher demand is expected on the efficient provision of both relevant documentation and accounting / tax records for review.
5. In view of the rapid change of global tax environment, it is advisable that multinational companies with investments in China should keep abreast of the latest changes in Chinese tax regulations and plan ahead properly for transactions with their China affiliates.

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