



Issue 9 | 23 Dec 2014

China Alert

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

For more information, please contact

Charles Chan

Chairman and CEO

Tel: +852 2894 6818

Email: charles.chan@crowehorwath.hk

Wilson Tam

Executive Director

Tel: +852 2894 6679

Email: wilson.tam@crowehorwath.hk

Albert Cheung

Executive Director

Tel: +852 2894 6830

Email: albert.cheung@crowehorwath.hk

George Lam

Associate Director

Tel: +852 2894 6656

Email: george.lam@crowehorwath.hk

C Yuen

Senior Advisor

Tel: +852 2894 6812

Email: chung.yuen@crowehorwath.hk

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.

For more information,
please contact:

国富浩华税务(香港)有限公司
**Crowe Horwath Tax Services (HK)
Limited**
Member Crowe Horwath International

9/F Leighton Centre, 77 Leighton Road,
Causeway Bay, Hong Kong

E-mail : info@crowehorwath.hk
Telephone : +852 2894 6888
Facsimile : +852 2895 3752
Service Hotline : +852 2894 6611

About Crowe Horwath International

Crowe Horwath International is ranked among the top 10 global accounting networks with about 200 independent accounting and advisory services firms with nearly 700 offices in 120 countries around the world. Crowe Horwath International's member firms are committed to impeccable quality service, highly integrated service delivery processes and a common set of core values that guide our decisions daily. Each firm is well-established as a leader in its national business community and is staffed by nationals, thereby providing a knowledge of local laws and customs which is important to clients undertaking new ventures or expanding into other countries. Crowe Horwath International member firms are known for their personal service to privately and publicly held businesses in all sectors and have built an international reputation in the areas of audit, tax and advisory services.

Information can be obtained at: www.crowehorwath.net

www.crowehorwath.hk

Disclaimer: The information ("Information") contained in this article have been prepared in general terms only and should not be construed as any advice, opinion or recommendation. The application of the Information to specific situations will depend on the particular situations involved. Professional advice should be sought before the application of the Information to any particular circumstances.

Crowe Horwath Tax Services (HK) Limited is a member of Crowe Horwath International, a Swiss verein (Crowe Horwath). Each member firm of Crowe Horwath is a separate and independent legal entity. Crowe Horwath Tax Services (HK) Limited and its affiliates are not responsible or liable for any acts or omissions of Crowe Horwath or any other member of Crowe Horwath and specifically disclaim any and all responsibility or liability for acts or omissions of Crowe Horwath or any other Crowe Horwath member.