



State Administration of Taxation issues inaugural Annual Advanced Pricing Arrangement Report on Chinese APA program

The State Administration of Taxation (SAT) of the People's Republic of China recently issued its inaugural China Advanced Pricing Arrangement Annual Report (2009) (APA Report). The APA Report also highlights the statistical survey on the development of China's APA program during 2005 to 2009.

Overview

The SAT recently issued its inaugural annual APA Report, which includes an introduction to China's APA program, the implementation procedures and related forms, and the recent development of the APA practice in China, together with a statistical survey of China's APA program for the period from 1 January 2005 to 31 December 2009. The document titled *China Advanced Pricing Arrangement Annual Report*, published in December 2010, puts China in line with some national tax authorities, including the United States, Japan, Korea, Australia, Canada and Italy, to publicise comprehensive reports on their APA programs. By issuing a periodical disclosure of the developments of its APA program, the SAT hopes to achieve strengthened cooperation with the taxpayers, as well as a higher degree of transparency for the regulations within the PRC and guidelines for their application. It underscores the SAT's interest in further developing and enhancing its APA program.

China's tax authorities signed 53 APAs during the five year period between 1 January 2005 and 31 December 2009. Forty one agreements were unilateral APAs and the remaining 12 agreements were bilateral APAs. Interestingly, the figures show an increasing trend toward bilateral APAs being successfully negotiated, while the number of successful unilateral APAs per annum decreases. In 2009, the number of bilateral APAs signed was seven, exceeding the five unilateral APAs signed in the same year.

The SAT's APA Report can be found at: www.kpmg.com.cn/gtps.

APA Process

A. Pre-requisites

To apply for an APA, taxpayers generally should have annual related-party transactions exceeding RMB 40 million, have fulfilled their related party filing responsibilities in compliance with the laws, and prepared, preserved, and submitted contemporaneous documentation as requested. APAs are valid for transactions conducted in a period of three to five consecutive years, starting from the year after the year during which formal written application is submitted. To apply for an APA, no application fee will be required.

B. Procedure

The APA process generally involves six phases, as discussed in our China alert issues [1](#) and [8](#) in 2009 as well as [Circular 2](#) and which are illustrated in the flow chart below:

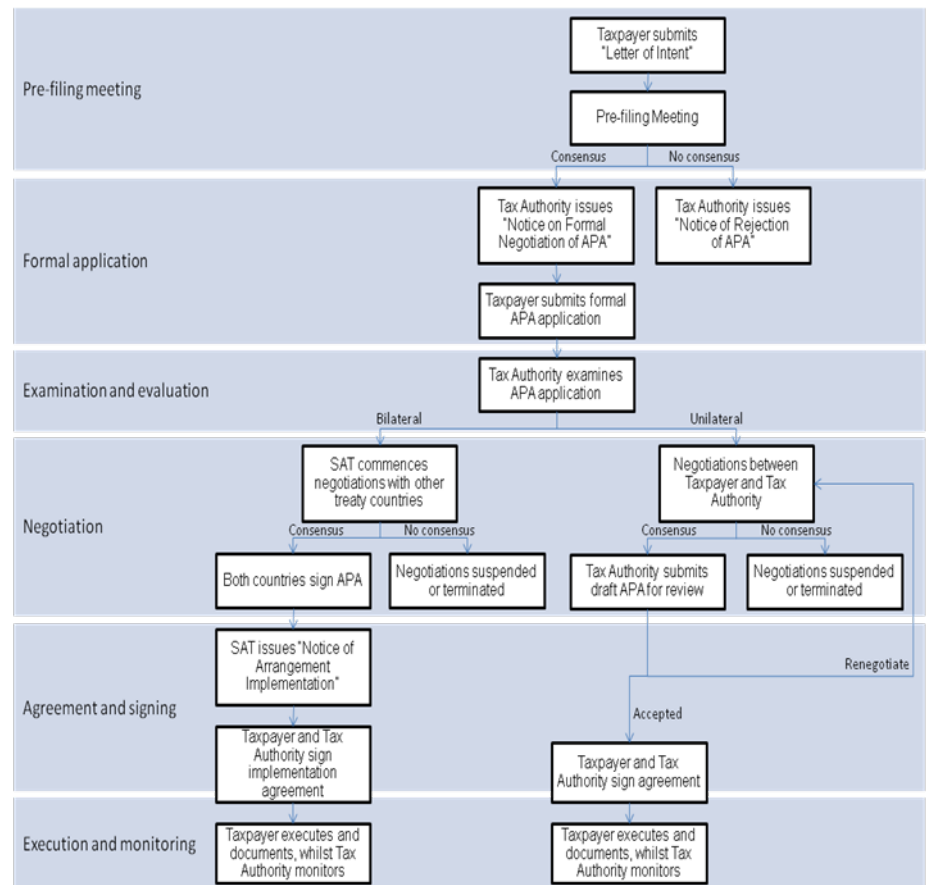


Chart 1: Flow chart of the APA application and administration process

For bilateral or multilateral APA applications, the taxpayer is requested to provide consistent reports to both competent authorities, which means any application report originally prepared in a foreign language is to be fully translated into Chinese without deletions or abridgements.

C. Rollback

The terms and conditions agreed upon in an APA are applicable starting from the year after the year during which the formal written application is submitted. Therefore, any agreement on pricing made within an APA is not automatically legally binding for any tax audits in the year during which the enterprise submits its formal written application or any prior year. However, APAs can be retroactively applied to identical or similar transactions to those covered in the APA upon request and the tax authorities' approval. The relevant regulations for transfer pricing investigations are applicable to the rollback period, as far back as 10 years.

D. Renewal

If the taxpayer would like an APA to be renewed when it expires, an application for renewal may be submitted 90 days prior to expiration. The application must be accompanied by sufficient evidence that there have been no material alterations to the existing circumstances.

E. Cancellation

An existing APA may become invalid or terminated under any of the following conditions:

- Upon expiration
- In case of irreconcilable dispute between taxpayer and tax authorities
- Breach in critical assumptions or fundamental change in circumstances.

Statistical Survey

Acceptances

According to the APA Report, the tax authorities have, as of 31 December 2009, been involved with 120 APAs at various stages. The number of cases pending in the pre-acceptance phase has risen to 51 applications (26 for unilateral and five for bilateral APAs), amongst which 20 were at the informal discussion stage. During 2005 to 2009, 54 cases were agreed, whereby one had not yet been signed. Of the 53 concluded APAs, 41 were on a unilateral basis and 12 bilateral. The bilateral APAs included nine APAs, which were negotiated with other Asian countries, two APAs, which were negotiated with European countries and one APA, which was negotiated with the United States.

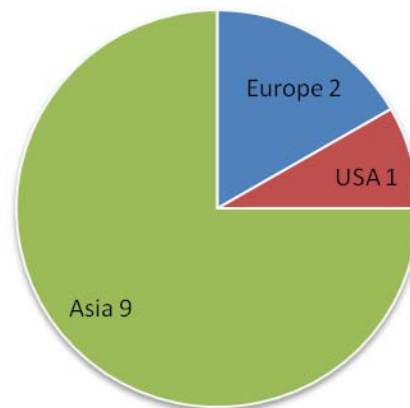


Chart 2: Countries / Region that have signed bilateral APAs with China during 2005 to 2009

Processing Times

The Report states that of the 53 APAs signed during the five year period from 2005 to 2009, only two (both bilateral) took longer than two years to be processed. For both unilateral and bilateral APA applications, more than half were processed within one year. The time required depends on many factors, such as the type of APA, the complexity of the issues involved, the quality of the information provided, the extent of the cooperation, as well as the workload of the tax officers.

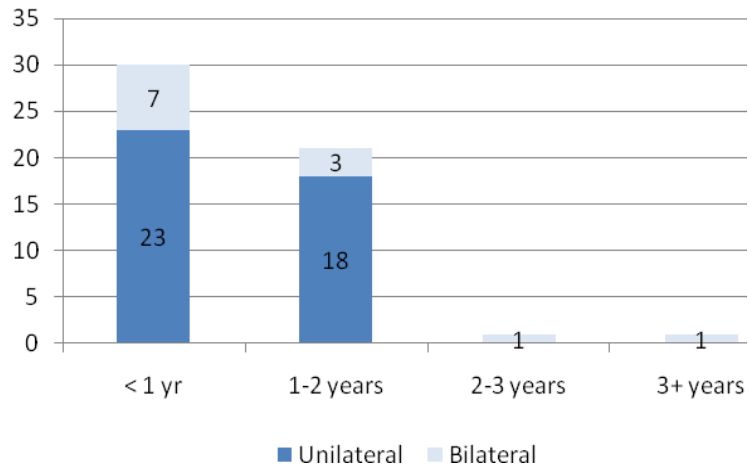


Chart 3: Processing times of the concluded unilateral and bilateral APAs

Transaction Types

The APA Report also describes the different types of transactions covered by the APA concluded cases. The largest category of transaction covered was the “purchase and sale of tangible assets” that appeared in 42 concluded APAs and 11 APAs at the formal acceptance stage. Predominantly, taxpayers requesting APAs were manufacturing entities with these types of intercompany transaction flows. The second largest grouping was the “transfer of intangible assets” that appeared in 13 concluded cases and eight APAs at the formal acceptance stage, which was followed closely by the type “provision of services” covered in 13 concluded APAs and five APAs in formal applications. The transaction type “financing” had neither APA applications accepted nor APAs concluded. The APA Report states that the SAT expects the share of the tangible asset transaction type to decrease relative to the other transaction types, in light of China’s tertiary industry development.

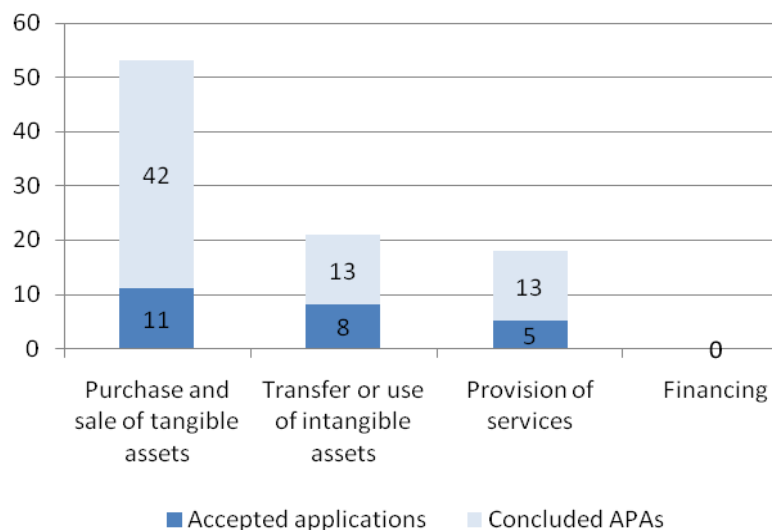
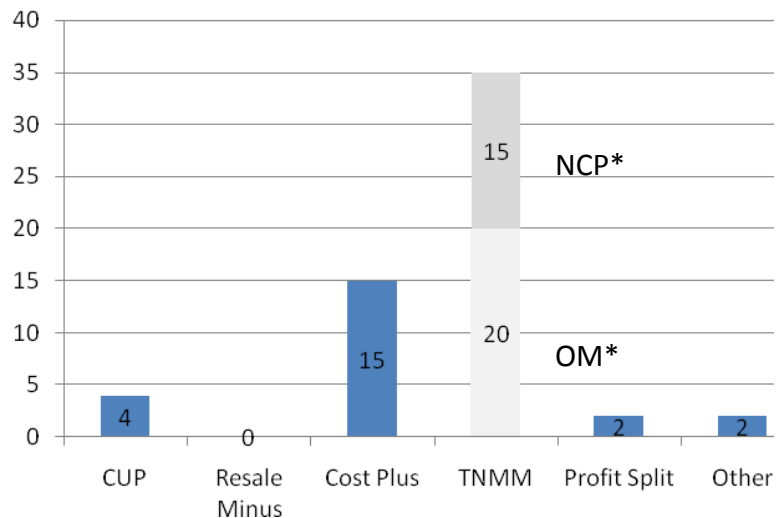


Chart 4: Type of related party transactions covered

Transfer Pricing Methods

The APA Report describes that during 2005 and 2009, the most common transfer pricing method applied in both the unilateral and bilateral APAs was the Transactional Net Margin Method (TNMM), which was agreed upon in 35 of the signed unilateral and bilateral APAs. Twenty of these stipulated that the return on sales ratio should be used as the profit level indicator, whereas the other 15 stipulated the full cost mark-up. The second most common transfer pricing method was the cost plus method, which was used in 15 of the signed APAs. The remaining eight¹ instances had different methods employed in the APAs - the CUP method applied in four instances, the Profit Split method in two and the remaining two were defined as other.

Notably, the SAT anticipates that the resale price method and the profit split method will be more frequently applied in the APA program the future.



*NCP refers to net cost plus which is calculated as operating margin divided by total operating costs. OM refers to operating margin which is calculated as operating profits divided by turnover.

Chart 5: Transfer pricing methods adopted

KPMG Observations

This APA Report is viewed as another important milestone for the development of China's APA program, and sends a clear and positive signal that APAs are increasingly attractive to multinational companies operating in China and that Chinese tax authorities more willing to accept them. The continuing standardisation of procedures and the development of stronger transfer pricing laws have laid down the foundation for the program. The publication of this inaugural APA Report reflects the desire and continuing efforts of the SAT to work together with the taxpayers, deliver higher quality and technically advanced work, as well as building a transparent system.

There is an observable trend toward bilateral APAs and using APAs to deal with more complex issues that are driven by both the taxpayer and the tax

¹ Please note that some of the APAs agreed, set forth the application of more than one transfer pricing method.

authorities. The SAT is of the view that APAs can set precedents for transfer pricing for the same industry nationwide. They are putting a lot more effort in examining APA applications, involving conducting on-site fact finding interviews and performing industry-wide studies and organising nationwide trainings. As implied in the APA Report, the SAT is expecting more cooperation from the taxpayers, particularly in providing information and data requested to further the APA negotiation process and to allow more technically-advanced approaches being adopted.

In future, the Chinese tax authorities will have recruited and trained a larger pool of tax officers with transfer pricing expertise to support the APA program, thereby alleviating the current bottleneck between application and conclusion.

The APA program should be seen as a way for taxpayers to increase the assurance in their transfer pricing and also a way to mitigate potential double taxation risk. For risk management purposes, multinational enterprises should assess their transfer pricing risks and determine whether an APA may be beneficial, especially since a cooperative and proactive attitude by a taxpayer is usually viewed positively by the SAT and evidenced by the publication of this APA Report.

By Cheng Chi, Partner in Charge, China and Hong Kong SAR, Global Transfer Pricing Services and Ho-Yin Leung, Senior Manager, Global Transfer Pricing Services



Contact us

Beijing/Shenyang

Khoonming Ho

+86 (10) 8508 7082

khoonming.ho@kpmg.com

Qingdao

Vincent Pang

+86 (532) 8907 1728

vincent.pang2@kpmg.com

Shanghai/Nanjing

Chris Ho

+86 (21) 2212 3406

chris.ho@kpmg.com

Hangzhou

Martin Ng

+86 (571) 2803 8081

martin.ng@kpmg.com

Chengdu

Anthony Chau

+86 (28) 8673 3916

anthony.chau@kpmg.com

Guangzhou

Lilly Li

+86 (20) 3813 8999

lilly.li@kpmg.com

Fuzhou/Xiamen

Jean Li

+86 (591) 8833 1118

jean.j.li@kpmg.com

Shenzhen

Eileen Sun

+ 86 (755) 2547 1188

eileen.gh.sun@kpmg.com

Hong Kong

Karmen Yeung

+852 2826 8080

karmen.yeung@kpmg.com

kpmg.com/cn



Our National Transfer Pricing Specialists

Cheng Chi

Partner in Charge
China & HK
Global Transfer Pricing Services
+86 (21) 2212 3433
cheng.chi@kpmg.com

Beijing

Irene Yan

Partner
+86 (10) 8508 7508
irene.yan@kpmg.com

Leonard Zhang

Director
+86 (10) 8508 7511
leonard.zhang@kpmg.com

Tony Feng

Senior Manager
+86 (10) 8508 7531
tony.feng@kpmg.com

Maria Mei

Senior Manager
+86 (10) 8508 7562
maria.mei@kpmg.com

Carter Li

Senior Manager
+86 (10) 8508 7564
carter.li@kpmg.com

Guangzhou

Kelly Liao

Partner
+86 (20) 3813 8668
kelly.liao@kpmg.com

Michelle Sun

Senior Manager
+86 (20) 3813 8615
michelle.sun@kpmg.com

Grace Luo

Senior Manager
+86 (20) 3813 8609
grace.luo@kpmg.com

Kari Pahlman

Partner
Asia Pacific Leader
Global Transfer Pricing Services
+852 2143 8777
kari.pahlman@kpmg.com

Hong Kong

Kari Pahlman

Partner
+852 2143 8777
kari.pahlman@kpmg.com

Karmen Yeung

Partner
+852 2143 8753
karmen.yeung@kpmg.com

John Kondos

Partner
+852 2685 7457
john.kondos@kpmg.com

Adam Zhong

Senior Manager
+852 2685 7559
adam.zhong@kpmg.com

Thomas Cheung

Senior Manager
+852 2685 8945
thomas.cheung@kpmg.com

Japanese Business

Yasuhiko Otani

Partner
+86 (21) 2212 3360
yasuhiko.otani@kpmg.com

Hiroyuki Takahashi

Director
+86 (10) 8508 7078
hiroyuki.takahashi@kpmg.com

Shanghai

Cheng Chi

Partner
+86 (21) 2212 3433
cheng.chi@kpmg.com

Amy Rao

Director
+86 (21) 2212 3208
amy.rao@kpmg.com

Ho-Yin Leung

Senior Manager
+86 (21) 2212 3358
hoyin.leung@kpmg.com

Lu Chen

Senior Manager
+86 (21) 2212 3407
lu.chen@kpmg.com

Josephine Yanagi

Senior Manager
+86 (21) 2212 3097
josephine.yanagi@kpmg.com

Shenzhen

Eileen Sun

Partner
+86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Angie Ho

Director
+86 (755) 2547 1276
angie.ho@kpmg.com

Jack Pan

Senior Manager
+86 (755) 2547 1138
jack.pan@kpmg.com

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2011 KPMG, a Hong Kong partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. © 2011 KPMG Advisory (China) Limited, a wholly foreign owned enterprise in China and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International Cooperative ("KPMG International").