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INSIGHT: Covid-19 Puts Limited Risk Structure at Risk—Analysis from the Chinese Angle




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The outbreak of the coronavirus (or COVID-19) in China in January was described by many as a black swan event, recognizing the highly unexpected and severe global impact. With the rapid global spread of the virus, consumers slowing down their buying, and workers failing to go back to their workplaces, an array of dysfunctional events are taking place, which put a lot of pressure on multinational enterprises' (MNCs) businesses. It also imposes tremendous challenges to the cross-border tax arrangements of MNCs, in particular, their transfer pricing systems.

For a long time, the classical limited risk model has been deployed by many MNCs in their global operations including China. In many instances, the Chinese subsidiaries are characterized as contract manufacturers if they produce for the group, or limited risk distributors if they sell group-made or sourced products in the Chinese market. Variations to these models exist, but fundamentally they tend to include profit guarantee mechanisms. In the current coronavirus situation, these companies are bound to see their profits decline significantly, and for many, even into negative territory.

For MNCs with these demand and/or supply shocks, in the short-term, they ought to decide whether and how to maintain their current transfer pricing systems, taking into account the tax consequences and the risks thereof. In the medium- to long-term, reconfiguring their supply chain to avoid over reliance on single country sourcing will likely be on the table. This will likely lead to the diversification of certain production operations away from China. These types of restructuring will undoubtedly bring a host of tax and transfer pricing issues.

In a series of articles, we will examine the associated transfer pricing issues and establish frameworks for analyzing the facts and circumstances as well as action plans for managing the transfer pricing and tax risks in this context. The first of the series will focus on the 2020 transfer pricing treatment for the limited risk operations in China.

AN OVERVIEW OF THE IMPACT OF CORONAVIRUS IN CHINA AND GLOBALLY

When the outbreak emerged in China, the Chinese government put in place stringent measures in order to contain the spread of the virus and to stem further spreading within the country and around the world. Wuhan and the Hubei province were put into strict lockdown to prevent movement of people. Other provinces and cities soon followed with various lockdown and social distancing measures. These unprecedented and extensive measures to contain the virus have led to a significant slowdown, if not a complete shutdown, for most industries. Since the beginning of the Chinese New Year in late January, many work sites were sealed, and people were discouraged or even prohibited from leaving their homes in areas where the virus spread was severe. These measures were gradually loosened in late February with the exception of those areas that were most impacted, in particular the Hubei province.

As a result, most production lines were stopped, and only recently have we seen a resumption. But they were still far from running at the country's full capacity at the time this article is written. On the consumption front, with the exception of shopping for grocery supplies and other essential items mostly through on-line platforms, with people staying at home, there are hardly any visits to retail outlets generally, resulting in a sharp slide in consumer spending until very recently.

The press release of the National Bureau of Statistics of China of March 2 showed that the Purchasing Managers' Index (PMI) of China in February 2020 (seasonally adjusted) dropped significantly. The PMI is an index of the prevailing direction of economic trends in the manufacturing and services sectors derived from monthly surveys of company purchasing managers. China's manufacturing PMI per the National Bureau of Statistics of China was at 35.7, down 14.3 from January 2020. The non-manufacturing PMI was at 29.6, a drop of 24.5 compared to January 2020. The figures mean that only 35.7% of manufacturing purchasing managers and 29.6% of non-manufacturing purchasing managers are reporting improvement in new orders. These figures suggest a substantial contraction in economic activities in the month and give a glimpse of what is to come in the near future (PMI below 50% suggests contraction or recession and vice-versa).

Against this backdrop and the increasing speed of the spread of the coronavirus globally impacting the global economy, the International Monetary Fund (IMF) has, subject to working on new assumptions and baseline scenarios, cut the 2020 growth outlook for China to below 5.6%, as announced in a joint press conference on the coronavirus outbreak by IMF Managing Director and the World Bank Group President on March 4. Further, the Organization for Economic Cooperation and Development (OECD) in its latest Economic Outlook Interim Report March 2020 has further warned that the coronavirus outbreak presents the global economy with its greatest danger since the financial crisis. China's economic and business prospects will certainly feel the impact of these expected global conditions.

On a positive note, the Chinese government has quickly put together ranges of monetary, fiscal, and economic policy measures in order to combat the impact to the Chinese economy and to provide impetus for a turnaround. The Chinese tax authorities have taken steps in rolling out certain tax relief measures and are expected to join other government authorities to further the efforts in this regard. It is important to note that the tax authorities also have an important task of collecting tax revenues amid the expected sharp decline in tax contributions by businesses.

Despite the gradual recovery of the Chinese market and the resumption of Chinese operations of the MNCs, businesses and communities around the world were dealt a further blow when the World Health Organization announced the coronavirus outbreak as a global pandemic on March 11. Further demand shocks are expected, which would likely have a further negative impact Chinese businesses.

LIMITED RISK STRUCTURES AT RISK

Limited risk manufacturing, distribution, and service company structures are common for many MNCs in their global operations where certain subsidiaries are organized with limited decision-making power, such that they are insulated from both the downside and upside impacts of most, if not all, business risks.

The updated 2017 OECD Guidelines, issued as a result of the release of final Base Erosion and Profit Shifting (BEPS) paper in 2015, places the importance of accurately delineating the actual transactions through functional analysis and identification of risks by the contracting parties. The assumption of increased risks is generally followed by an increase in expected return, and as such, it is essential to determine which functions are conducted in connection with the relevant risks and which parties assume these risks. In the context of the latter, the assumption of risks should be demonstrated by control in mitigating risks and the financial capacity to deal with the consequences of these risks materializing. Under limited risk structures where significant economic risks such as the market risk and/or operational risk are not assumed by the limited risk entities, the expected upside return naturally would been taken away. Consequently, the downside economic impact would be limited as well. Unless proven otherwise, such entities would, in general circumstances, earn routine profits.

The concept is accepted in China as well. The Chinese transfer pricing regulations, through the promulgation of the State Tax Administration Public Announcement on Administrative Measures of Special Tax Investigations, Adjustments and Mutual Agreement Procedures [2017] No. 6 (Announcement 6) provides that where an enterprise engages in single function activities, such as toll or contract manufacturing, distribution, and contract research and development, shall in principle maintain a reasonable profit level. Announcement 6 further provides that the tax authorities are empowered to make special tax adjustments if such entities assume risks and losses resulting from decisions made by related parties, under-utilization, sluggish sales, or R&D failure that should have been assumed by their related parties.

We have also observed real life audit cases where loss making companies characterized as single function entities or limited risk entities were assessed by the Chinese tax authorities and tax assessments were made based on deemed transactions with the overseas headquarters as a way to cover-up the shortfall and to return a profit to the Chinese subsidiary.

In some instances, by design, the Chinese subsidiaries are not limited risk operations. However, the Chinese tax authorities sometimes argue that activities performed by the head office—such as budgetary controls, approval of strategic and marketing plans, and reporting and performance management—form the basis to recharacterize such risk-bearing entities as limited risk entities resulting in additional tax assessments based on a deemed routine return basis. Under these circumstances, external shocks such as demand or supply disruptions are unlikely to be a key consideration of the Chinese tax authorities when performing assessments.

With the coronavirus outbreak, even in the best case scenario, most Chinese companies will likely lose one full month of sales, with the hope of some catching-up to happen for the rest of the year. Now with the virus spreading around the world, global demand may be suppressed further putting future sales at greater risk. These factors combined could very well eat up the profits of the multinational taxpayers in China for the whole year resulting in non-tax paying positions. It is, therefore, not surprising that the Chinese tax authorities could be expected, in the first instance, to dispute any tax positions attributing losses to those limited risk operations as they are regarded as ''risk-insulated.'' The tax authorities may further challenge some ''for risk'' operations as *de facto* limited risk operations and apply the same doctrine.

Companies need to decide how to manage their transfer pricing systems under the current economic conditions. It is possible that companies may choose to stick to the transfer pricing policy typical for a limited risk structure, i.e., a transactional net margin method (TNMM) to render a routine (often fixed) return to the Chinese subsidiary. To avoid double taxation, in absence of established true-up mechanisms in China, companies have to find ways to adjust their operating margins in China upwards, without triggering customs duty disputes (in the event the import price were to be lowered), and/or foreign exchange irregularities (if some form of compensation remitted into China is not tied to the cost of goods transacted). There are a host of practical issues that need to be managed in order to increase the margin of the Chinese entities, and often, solutions are not necessarily perfect.

However, given the economic shock, some companies could make decisions to amend the prevailing TNMM policies either by ignoring the target margin and leaving the result of its Chinese operations as is, or seeking for a reduced TNMM target margin for part of the tax year, if not the whole. Transfer pricing analyses are facts and circumstances based and are not typically black and white as even third-party negotiations regarding price relief and support payments, for instance can be expected to vary by company, industry, and market. In the ensuing sections, we will be examining specific circumstances that may support a departure from the prevailing TNMM policies, recognizing there are others that perhaps do not warrant a departure.

ADDRESS THE DISRUPTION AND THE NEED FOR ADJUSTING THE TRANSFER PRICING POLICIES

The general expectation is that limited risk entities (and entities that the Chinese tax authorities deem limited risk) should maintain a routine profit in line with their transfer pricing policies based on the periodic update of their TNMM benchmarking studies.

When the profit level of these entities does not meet the transfer pricing policy as a result of the disruptions brought about by the coronavirus, taxpayers have various options to manage their transfer pricing pursuant to their dealings with their Chinese subsidiaries, depending on the facts and circumstances, and to some extent, their appetite for Chinese tax and transfer pricing risks. The analyses of facts and circumstances may yield conclusions that are not perfectly unambiguous. In all cases, however, the standard should be tied to how unrelated parties would act under similar facts and circumstances—application of the arm's-length standard.

On one end of the spectrum, MNCs may determine that the offshore principal companies should compensate the Chinese entities for all the shortfall in the profits in strict accordance with the transfer pricing policy. On the other end of the spectrum, MNC groups may decide that it is reasonable to leave the profit level of the Chinese entities as is by advancing arguments that these are a result of risks for operating in local markets that are inherent and not foreseen. In between both ends of the spectrum, companies may opt to just compensate the variable costs, up to the break-even point, or choose to compensate to a lower margin than what was provided for by the original transfer pricing policies.

Whichever option is adopted by MNC groups to address the lack of profit in the Chinese entities, adequate analysis of arm's-length market behavior should be made to support and sufficiently document the position taken. It should be noted that implementation of extra compensation to the Chinese entities may also invite challenges in regulatory constraints and consequences imposed by Chinese government agencies such as Customs, State Administration of Foreign Exchange (SAFE), and State Administrations of Industry and Commerce. The analysis ought to focus on the following aspects, which are not mutually exclusive.

Contractual analysis

An apparent starting point of an analysis is to conduct a thorough review of the contracts governing the intercompany transactions—the terms, rights, and obligations. The contractual framework governs the arrangements, conduct, and risks of the parties, and ultimately how the parties are compensated under the arrangements. The contracts are generally drafted and confer certain limitations on the rights and risks of the Chinese entities to varying degrees resulting in entities from extremely limited risk (e.g. toll manufacturing, indent, or agency sales) to more fully functional (and risk bearing) companies (e.g. licensed manufacturers and full-fledged distributors). Economic compensation would differ among those different arrangements.

Many, if not all, contracts contain force majeure clauses. The pertinent question is whether the related parties will be able to rely on the clause to relieve offshore parties from compensating the Chinese entities' reduced profitability under the existing transfer pricing systems.

Force majeure is defined as an event that no human foresight could anticipate or which, if anticipated, is too strong to be controlled. The event then prevents either party from performing its obligations under a contract. A party's ability to claim relief for a force majeure event depends upon the terms of the contracts and the force majeure provision in particular. Many contractual provisions set out a specific list of force majeure events including diseases and pandemics.

For contracts without a list of events constituting force majeure, the catch-all meaning of the term ''outside the reasonable control'' may qualify the coronavirus outbreak as a force majeure event. The outbreak has a causal link and impairs the performance of the contract due to the quarantine measures and closure of factories and businesses. The reliance of force majeure would also be subject to the affected party(ies) having taken all reasonable measures to mitigate the event and the consequences that follow.

If the coronavirus outbreak is outside the reasonable control of parties, there can be arguments for the financial impact of the disruptions borne by the parties themselves. After all, limited risk entities, as separate going concerns, are not entirely risk-free and are subject to some form of risks. They should, in some circumstances, shoulder the economic consequences brought about by those risks. Under a third-party situation, the limited risk entity would typically have the power to take reasonable steps to mitigate the fallout and minimize financial losses. The offshore principal, on the other hand, could not have anticipated and/or controlled a force majeure event, and should not bear the financial consequences of the limited risk entity.

However, the above arguments could be thwarted if the conduct between the parties, upon further scrutiny, shows that many aspects of the daily operations (e.g. realigning production lines, deciding on cost cutting measures) are not within the control of the limited risk entity to the extent that mitigating actions would need the approvals of the offshore principal. The consequence of the parties' conduct as such would suggest that some form of compensation should be due the limited risk entities. As always, the determination as to what action is warranted depends upon a careful functional and contractual or legal analysis.

Analysis on the reduced profit or losses

Closely linked to the legal analysis is the economic analysis on the source(s) of losses or profits under target. A business case has to be established to justify the options considered by MNCs on the treatment of missed profits arising from a business downturn. It is unlikely that Chinese tax authorities would accept a wholesale explanation by taxpayers that the losses or reduced profits are due to the coronavirus outbreak and simply out of their control.

The analysis of each factor contributing to the losses will hopefully help identify which parts of the losses or the profit decline that are attributed to the outbreak and which parts are due to the impact of the transfer pricing systems itself. Even if the aforementioned contract analysis supports a departure from the transfer pricing policy, it may not be (fully) applicable to the whole of 2020. With resumption of operations underway in China, it is required to separate out the periods of (1) fully-virus-impacted, (2) transition, and (3) normal. Costs incurred and revenue generated during these periods likely warrant different treatments. Arguably, much of the analysis should focus on the fully-virus-impacted period, and to a lesser extent, the transition period.

By default, during normal periods, existing transfer pricing policies should be observed without the need of adjustments. It should be noted, however, that during the period when Chinese operations fully resume, there could be demand shock externally. hence the offshore principal cuts back on orders. This is a highly likely scenario given the worrying global spread of coronavirus at this juncture. This may still warrant an analysis to determine whether the transfer pricing policies should be adjusted.

There can be frequent instances where, without the impact of the coronavirus outbreak, the systemic issues within the transfer pricing systems undercompensate the Chinese limited risk entities. If it is determined that part of the losses or profit decline is a result of transfer pricing, it would be necessary to remedy the financial impact.

MNC groups should also be ready to determine the factors and subsequently quantify the impact of the coronavirus outbreak, supported by evidence where relevant.

Third-party comparables and business practices

An investigation into the latest comparables and the broader business practices would provide some understanding on the approach for companies to adopt when faced with whether and how to compensate the Chinese operations.

The comparables provide the level of profit to guide how much a tested party under the TNMM (i.e. the limited risk entity) should be earning. As commonly noted, the comparable analysis is generally less than perfect due to issues in the selection of comparables arising from the subjectivity of the screening process, and more fundamentally, no companies are perfectly the same in terms of functions, risks, and assets. Specifically, independent companies do not typically have risks limited by contracts to the extent seen in intercompany agreements. Furthermore, the data is usually not robust enough to provide insights into the circumstances that could contribute to or impact on the reported financial performance. Often, the reference to the range of profit level indicators (PLI) (e.g. full cost mark-up or operating margin) established by comparable companies is historical. Finally, information on, for example, what third-party distributors earned during the span of the coronavirus in 2020 will not be publicly available until sometime in 2021, too late for any real time analysis. Due to the lack of real-time data, it becomes impossible to make reference to comparable analysis with any degree of confidence. This is where comparability adjustments could come into play.

While targeting the median established by comparable companies is the transfer pricing policy of the Chinese operations, periods such as the outbreak of the coronavirus and the lack of the latest comparable data may necessitate an adjustment of the policy to a lower level within the interquartile range or even below the observation of the lower quartile of the range. After all, the OECD Guidance (para 3.62) has indicated that where the range comprises results of relatively equal and high reliability, it could be argued that any point in in the range satisfies the arm's-length principle. Such an approach, however, brings up issues such as subjectivity in determining to which point the transfer policy should be adjusted.

Further, relevant broader business practices should also come into play when making deliberations on the transfer pricing policies. Industry or specific economic indicators such as output data or sales trends could be leveraged for further economic analysis so that a more objective justification can be arrived at to support the options selected. An MNC group's dealing with third-party suppliers of goods or services, and buyers under similar but not necessarily identical circumstances, can provide good bases for the analyses. There are also known cases of third-party dealings in the public domain for which the terms and conditions can also serve as a reference for supporting the position taken by the company. For example, during economic downturn, there is evidence of strategic supplier relationships in automotive industry that allow for a reduced margin or no margin at all to be earned by the supplier.

Past contract execution

Taxpayers could also make reference to historical execution or implementation of contractual arrangements. Past implementation of transfer pricing policies, for various practical reasons, could result in variation in the Chinese operations' financial performance. If there was over-compensation of the Chinese operations in the past years, considerations could be made to leverage these high margins to cover the lower profits (or losses) of the current year affected by the outbreak, through a weighted average multi-year testing against the weighted average results of the comparable companies.

One must note that the Chinese tax authorities have frequently dismissed multi-year analysis approach. They would cite the Chinese regulations (e.g. Article 25 of Announcement 6), which provide that in an audit, tax adjustments are made on the audit years individually. In practice those yearly adjustments are done against the comparable companies' yearly results of the same period or multiple year results. However, one can argue that the concept of yearly adjustment is only provided in the regulations that administer transfer pricing audits by the tax authorities which implies the applicability of this concept should be limited to the situation of an audit by the tax authorities, not a contemporaneous adjustment of transfer pricing mechanisms by the taxpayer. This is similar to the concept of adjustment to the median which is provided in the same regulations as noted above but day-to-day implementation is not necessarily observed by taxpayers. Further, in Advance Pricing Arrangements (APAs) concluded by the Chinese tax authorities, it is typical to allow for individual year deviation from the median within the range.

One can argue implicitly such measures, individual year separate adjustment and adjustment to medians, have some bearings of punitive nature for companies to be chosen for audit and subsequently adjusted. The Chinese tax authorities encourage self-adjustments by taxpayers rather than bearing the tax risks until an audit is conducted. In any event, under these unprecedented circumstances relating to the coronavirus, there can be room for discussions with the Chinese tax authorities for the best way to mitigate transfer pricing risks and arrive at a win-win situation for both parties.

Determine the alternative compensation mechanisms for (fully) impacted periods

With the analyses outlined above, one can first determine whether force majeure can excuse offshore principal companies from applying the existing transfer pricing policies during the (fully) impacted periods i.e., leave them unattended and report the results as it is. However, when full support cannot be rendered for a no-compensation position, one should examine the source of profit target deficiency, referencing third-party evidence including the comparables analyses, and assessing past year performance in order to determine:

(1) what costs should be included in the compensation formula; and

(2) whether and how much of a mark-up should be applied.

In addressing (1) two lines of arguments can be considered, namely the ''controllability'' doctrine and the ''survival'' test. For costs that are controllable by the limited risk entity yet no efforts were made in reducing them by that entity—such as overtime, performance bonus, certain redundancy related costs, and certain committed costs—one may argue those should be excluded from cost base in determining compensation. Conversely, if it is the offshore principal that has the authority on measures associated with these costs and yet decided not to take any actions, one may argue these costs should still be part of the cost base.

The ''survival'' test goes in a very different trajectory. The underlying principle is that no limited-risk contractual relationships, assuming consistency with the arm's-length principle, are enforced on a permanent basis in full, and that the survival of both the offshore principal entity and the limited risk entity are, in their mutual interest, based on a long lasting business relationship. In order not to overburden the principal, the limited risk entity may be willing to agree to compensation or financial support adequate for it to maintain the operational scale (even though without output or commensurate output), in order to fulfill its role in the future. This may lead to arguments of compensation up to the point the limited risk entity is breakeven from a financial stand point. It may even go further, support the position that compensation will only be based on the variable costs, leaving the entity bearing all of its fixed costs without additional compensation.

The mark-up is a less prevalent question in this context but nevertheless may impact the actual tax collection and so cannot be avoided. If the survival test argument is appropriate given the MNC's facts and circumstances, it also provides support for a policy that no mark-up should be rendered at all. Even without relying upon a survival test argument, one could assess whether, from an economic stand point, the costs incurred, be they fixed, committed or fully variable, cannot be avoided due to business circumstances, i.e. that these are idle costs during the impacted period that do not result in outputs. In that light, a mark-up might be argued away.

At last, if a mark-up needs to be rendered, the consideration should be connected with what was discussed previously on comparables and relevant adjustments, including whether a reduced margin or a margin averaged out on multiple year basis could be supported.

In a nutshell, there is no cookie-cutter approach that can be adopted here. Analysis of the facts and circumstances specific to the MNC in question, on the contracts, conduct and execution, on the third party evidence, and ultimately on an arm's-length test such as a survival test, are the critical processes in developing the tax positions in this unprecedented period of human history.

ADVANCE PRICING ARRANGEMENT

Some taxpayers have APAs in place with the tax authorities, be they unilateral or bilateral. Some taxpayers may also be in the midst of APA discussions with the tax authorities. It then comes into question whether the outbreak would result in the invalidation of the critical assumptions of the concluded APAs, or its impact on future profitability which necessitates the reconsideration of the setting of critical assumptions.

For concluded APAs, taxpayers would have to balance between the need to fulfill the terms of the APAs in which case the offshore party would have to compensate the Chinese entity based on the rates or range indicated in the APAs, and whether to invoke the invalidity of critical assumptions, such as a significant change in economic conditions, which triggers the need to bring the APA matters back into discussion with the tax authorities. Many would attest that APAs take a great deal of effort and time to conclude, thus, opening up the concluded APAs for further discussions with a risk of ceasing the agreements might largely be avoided by taxpayers. However, if stakes are high, active communications with the tax authorities would be encouraged to explain the impact of the coronavirus outbreak (including aspects discussed above and below) and how the outbreak impacts the implementation of the agreed APA. Among the things that can be brought to the table is the possibility of meeting a lower level compensation or the possibility of making special factor adjustments.

PRACTICAL TAX AND TRANSFER PRICING ISSUES FOR ADJUSTING TRANSFER PRICING

Making transfer pricing adjustments such as upward adjustments is not a walk in the park in China due to the strict controls on foreign exchange that do not provide for true up adjustments that are available in many other jurisdictions. Cash can only be moved in and out of the country under approved categories set by SAFE either through trade related items or a restricted list of non-trade related categories.

If the upward transfer pricing adjustments had no corresponding underlying transactions, which might be the case in most instances, it would then call into question which category such adjustments can fall under. In the past, the SAFE accept them as service transaction that would invariably attract a VAT charge (the prevailing rate is 6%) on the offshore entity making the compensation. This charge is a real tax cost leakage for the offshore entity as they are not recoverable. More recently, however, the SAFE and the tax authorities are open to having discussions with taxpayers needing to making transfer pricing compensation, where we observe the SAFE authorities introduced another category for the funds to be transferred in and not treated as services. Such measures are not automatic, requiring discussions with both of the authorities, and taxpayers must meet certain conditions from a practical perspective (including having the funds channeled through specific banking institutions).

Aside from one-off aggregated upward adjustments, one can consider prospective downward import price adjustments to increase the profit of the Chinese entities during the late part of 2020 for the ones that import significant amounts of goods from offshore related parties, in particular, import distributors. This will not complicate the foreign exchange issues outlined above, but fully exposes the company on the resulting reduction of applicable import duties, consumption taxes and import VAT administered by the Customs. Attention to the implementation, including the possibility of seeking advanced certainties with the Customs, is required.

Other less effective, sometimes laborious, approaches are also available. Companies should strategically evaluate all the options and chose the one that can work best based on their given facts and circumstances.

RECOMMENDATIONS

If the analyses carried out warrant a departure from the original transfer pricing policies, taxpayers would be wise to be prepared to defend the positions taken.

Immediate term

As noted above, the facts and analyses should be clearly documented as the first layer of defense. This is especially true for companies who meet the threshold of preparing China's contemporaneous transfer pricing documentation as required by the STA Public Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation [2016] No. 42 (Announcement 42). Companies have to weigh the narrative with supporting analyses that would go into the documentation if there is a departure from the transfer pricing policy, or a profit level outside the interquartile range of comparable companies under the TNMM. Strong and logical quantitative analyses would certainly go a long way in helping the tax authorities in understanding the reasons for the departure of the transfer pricing policies.

Taxpayers should also consider proactive communication with the tax authorities with the objective of avoiding future double taxation, particularly if the stake is significant. There are two aspects supporting this approach: (1) the tax authorities do not like surprises, and they need to continuously manage their revenue budgets and report any deviations; and (2) the communication will demonstrate the taxpayer's intention of being compliant and showing respect, as in the case of self-assessment, which is encouraged by the tax authorities. Of course, the communication with the tax authorities may lead to a situation where either no affirmative answers are given, or the tax authorities reject the proposed position outright. In the former case, a taxpayer should assess the robustness of its documentation and the rationale provided before deciding whether or not to go ahead with engaging the tax authorities. In the latter case, although outright rejection does not happen very often, one should still consider the options amongst further discussions before implementation, during implementation, and in the abortion of the proposed treatments.

The Chinese tax authorities have in the past few years been upgrading themselves to provide efficient services to taxpayers and support the general economy in line with the fundamental shift in the way the Chinese tax authorities carry their duties, i.e. from pre-approval controls to post-transaction monitoring. Although the Chinese tax authorities have various information and digital tools at their disposal to track tax receipts and identify risk factors of particular taxpayers, the general transfer pricing enforcement environment has been rather conducive. Taxpayers can take advantage of a friendlier tax authority to present facts and analyses so that some form of comfort can be achieved (although not absolute certainty as China does not have an advance ruling regime). A full assurance can only be attained through obtaining an APA, which is time consuming and resource intensive, and typically adopted by taxpayers when stakes are high and the issues are contentious.

Longer term

Nonetheless, in the long term, MNCs should revisit their transfer pricing systems and recalibrate the systems to take into consideration future economic shocks resulting from an act of God or an act of government to avoid future tax disputes on limited risk structures. Specific terms and conditions should be put forward in the intercompany contracts to allow for an adjustment to the ''normal'' transfer pricing system under specific circumstances.

The intercompany contractual provisions should also be supported by a robust documentation trail that evidences their alignment with the functional behavior of the parties, which ultimately decide how risks are allocated and borne. Henceforth, contractual provisions that align with the functional behavior are less likely to be challenged and subsequently recharacterized.

As seen above, we attempt to demonstrate the issues at stake are complex and solutions are not necessarily black and white. At the end of the day, the regulations in place need to be considered in tandem with the practice and the attitude of the tax authorities in arriving at the final position, taking into account the implementation challenges. Suffice to say, the practice and attitude of the tax authorities are constantly evolving and sometimes circumstantial and therefore should not be taken as preset and granted. In difficult times, constructive thinking and executions are key to business success and the same goes with transfer pricing and tax risk management.

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