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Update of the United Nations Practical Manual on Transfer Pricing for Developing Countries

China Country Practice[1]

Transfer Pricing Opportunities and Challenges for Developing Countries in Post-BEPS Era

1. Introduction

1.1. On 5 October 2015, the Organization of Economic Cooperation and Development (OECD) published 15 final reports and an explanatory statement on the Base Erosion and Profit Shifting (BEPS) project. After an intensive two-year process, the international tax reform mandated by the G20 leaders and coordinated by the OECD has finally come to fruition. The post-BEPS era focusing on the implementation of the BEPS outcomes was ushered in. One thing that made this reform different from the previous ones is the involvement of many developing countries in both the early stage when the various measures were developed and the later implementation phase. Voice of the developing countries has started to be heard by the global community when

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international tax policies were made. This unprecedented event has provided the developing countries with an opportunity to begin at the same starting line as their developed counterparts. However, the opportunity comes with challenges. Having the right to speak does not necessarily mean being ready to speak. Getting involved is far from being able to lead. After all, it is imperative that the developing countries continue to build capacity in tax administration to get more ready to speak and lead.

1.2. As a G20 member, the world's major economy and the largest developing country, China has been actively involved with the BEPS project since 2013. The State Administration of Taxation ("SAT") has endeavored to attend every relevant BEPS meeting, trace the progress of the project, research on many topics such as intangibles for transfer pricing purposes and comparability analysis. In the process, the SAT has provided China's position on various issues like location specific advantages ("LSAs"), exploitation of intangibles, and application of profit split method. During the post-BEPS phase, China values the outcomes of BEPS project and has adopted some of them into domestic legislations. China welcomes OECD's effort to build an inclusive framework by inviting more jurisdictions especially the developing countries to commit to the follow-up work including further research on specific areas as well as implementation accompanied by review and monitoring. This will lead to enhanced coordination and cooperation across the globe. On the other hand, China calls for more respect to jurisdictions' sovereignty during the review and monitoring process. Given the nature of developing countries, more flexibility is also essential for them to play on the level field with developed countries. A fair and equitable international tax system that benefits all the participants can only be built if the jurisdictions remain autonomous and informed even though they are subject to review. As the G20 leaders' communiqué at Hangzhou summit points out, all the members "will continue the support for international tax cooperation to achieve a globally fair and modern international tax system and to foster growth".

1.3. Transfer pricing is a weighty component of the international tax reform as 10 of the 15 action plans relate to it. The BEPS project was set to tackle the epidemic situation where profits had been left untaxed because multinational enterprises ("MNEs") had managed to shift the income to no-tax or low-tax jurisdictions.

Historically, transfer pricing administration had been focusing on dealing with how to allocate taxing rights between jurisdictions and preventing/eliminating double taxation under mutual agreement procedures ("MAP"). The priority of the ongoing international tax reform, however, was to address double non-taxation where MNEs paid no taxes or less than their fair share of taxes in jurisdictions with well-established corporate income tax regimes. The support shown by more than 100 countries and regions for the BEPS project suggests that this common goal was able to rally interested tax jurisdictions including both developed and developing countries to work together. Yet some important questions remain unanswered. For example, has the project resolved all the differences developed and developing countries have in transfer pricing? Or, have the international tax rules become fairer and less biased as the result of the reform? Thanks to the concerted efforts by the developed and developing countries in combating tax avoidance, the reform now needs to reconsider the classic transfer pricing question of how to allocate profits retrieved from the tax havens. The rules need to be fair and clear on who creates value and how the profits should be allocated between countries. The general principle of the BEPS project that the profits should be taxed where economic activities occur and value is created has guided jurisdictions to develop measures to counter tax avoidance in tax havens. That being said, developing countries need more specific rules and practical guidance on important issues such as how to determine the places of economic activities and value creation, how to allocate the profits retrieved from the tax havens between countries with well-established corporate income tax regimes, how to divide the pie between countries both are the places of economic activities and value creation, and above all, how to apply arm's length principle in transfer pricing legislation and practice. This is where the United Nations Practical Manuel on Transfer Pricing for Developing Countries (hereafter referred to as "UN Practical Manuel on Transfer Pricing") comes in handy.

1.4. Chinese tax administration has been exploring ways to improve transfer pricing administration ever since China introduced transfer pricing tax regime in 1991. Significant developments have been seen in the past two decades. First, China has established a relatively sound legal framework composed of transfer pricing legislation and specific rules. Second, China has intensified efforts in transfer pricing audits. Third, China has built a centralized review system under which transfer pricing audit cases can only be approved by the national expert panel. Fourth, China has continued to develop the MAP mechanism and advance pricing arrangement ("APA") program. Fifth, China has installed a monitoring system that tracks the profits of all the MNEs in China. Lastly, China has been committed to developing a transfer pricing professional team.

1.5. This paper intends to share China's practical experience in transfer pricing legislation and administration and to highlight some of the challenges facing developing countries.

2. Part One: Recent Developments in China Transfer Pricing Practice

2.1. Transfer pricing administration has been put at the center of SAT's anti-avoidance work agenda in the recent years. Bearing in mind that tax avoidance preventative measures are as important as transfer pricing audits, the SAT was determined to forge a three-pronged tax avoidance prevention and control system with consistent and standardized approach for administration, service and investigation. To start with, transfer pricing investigations should run parallel to tax avoidance prevention. Ways to preventing taxpayers from evading tax obligation include strengthened tax administration and improved taxpayer service. Investigations are using as deterrence to foster taxpayer voluntary compliance. Moreover, different measures were taken to build a three-pronged tax avoidance prevention and control system. The first aspect of the three-pronged system is administration. A tracking system was put in place to monitor the profits of MNEs in China. Chinese tax administration has put extra emphasis on routine review of related party filings and contemporaneous transfer pricing documentation. Follow-up monitoring subsequent to transfer pricing audits was implemented to encourage taxpayers to bring their profitability to be more in line with ARM'S LENGTH PRINCIPLE. As to the second prong, service, seminars and trainings were given to inform taxpayers of the latest tax regulations and policies. Double taxation was prevented or eliminated through unilateral/bilateral APAs and resolution from MAP. With regard to the last aspect, investigation, both isolated and coordinated anti-avoidance audits were carried out to act as deterrence to regulate the profitability of the audited companies and industries. Above all, the tax authorities across the country have coordinated their actions to ensure that both domestic laws and international policies were followed in a consistent and standardized manner. In other words, inconsistency due to different work procedures was kept to minimal. The recent developments in China's transfer pricing administration can be therefore summarized in the following 8 aspects.

2.2. Domestic Legislation and Practical Guidance

2.2.1. Legislation always comes first in transfer pricing. The Tax Collection and Administration Law and its Implementation Regulations and the Enterprise Income Tax Law and its Implementation Regulations all contain clauses on transfer pricing. The first time that China introduced a comprehensive anti-avoidance regime into the legislation was through the "Special Tax Adjustment" provision in Chapter 6 of the Enterprise Income Tax Law and its Implementation Regulations in 2008. Not only did this chapter include provisions on transfer pricing and APA with which China had had years of experience but also clauses on cost sharing agreement, thin capitalization, control foreign companies, general anti-avoidance rule and interests on additional tax payments for which China had to draw on international experience. In January 2009, the SAT released the Implementation Measures of Special Tax Adjustments (Trial Version) (more commonly known as the "Circular 2"). It has since served as the practical guidance for China's transfer pricing, and in broader scope, the anti-avoidance administration. It has provided the legal basis for tax administration's assessments and taxpayer compliance. Furthermore, China will add an anti-avoidance provision to the soon-to-be revised Tax Administration and Collection Law and Individual Income Tax Law. As a part of the effort to update the Circular 2, the SAT has released the Public Notice on Matters Regarding Refining the Filing of Related Party Transactions and Administration of Contemporaneous Transfer Pricing Documentation (Public Notice of the SAT [2016] 42, hereafter referred to as "Public Notice 42") in June 2016. As set out in BEPS Action 13, Public Notice 42 has adopted clauses to require qualified taxpayers to file Country-by-Country reports in China. The other measures related to transfer pricing documentation were also incorporated into the Public Notice. In addition, the SAT is planning to update the regulations to clarify how taxpayers can access to China's APA program and MAP mechanism as well as the procedures of special tax adjustment investigation.

2.3. Centralized Approval System to Assure Consistency and Standardization

2.3.1. There are more than 800,000 tax officials in China who work either in the state tax bureaus or local tax bureaus which can be set up at provincial level (67 in total), municipal level (666 in total) and county level (88996 in total) and below. It is paramount for a big country like China to be consistent and standardized in law enforcement especially when it comes to transfer pricing administration. A MNE might set up 30 subsidiaries across China. Without a consistent standard, tax authorities from different areas might find disparate comparable sets and derive various profit levels for transfer pricing cases of similar nature. To prevent this from happening, the SAT has put in place a national anti-avoidance system under which tax authorities are to report and obtain approval from the SAT headquarters when they need to build or close a transfer pricing or other anti-avoidance case since 2015. The chain of command was able to standardize the audit procedures, improve the quality of closed cases, intensify audit effort, organize national coordinated investigation, keep out interference from local governments and enhance cooperation between state tax bureaus and local tax bureaus. In 2012, the SAT released the "Internal Approval Procedures for Substantial Special Tax Adjustment Cases (Trial Version)(Guoshuifa [2012]16) (hereafter referred to as "Internal Approval Procedures") to streamline procedures including related party filing review, contemporaneous transfer pricing documentation analysis, high-risk taxpayers identification, case building, audit and analysis, case closing, and follow-up taxpayer monitoring and tracking subsequent to an audit. As required by the "Internal Approval Procedures, a three-level transfer pricing audit system was built. The system features collective decision and penal approval. First, for every audit case, the in-charge tax administration needs to set up special task team to conduct the investigation. Second, the task team needs to formulate the preliminary assessment and report it to the tax administration at provincial level whose specialist panel is responsible for approving the case. In addition, for a case qualified as a substantial case especially a case that requires national coordination, the SAT headquarters needs to call upon a nation-wide expert panel to make the final decision on the case. In September 2016, the SAT has released the Internal Procedures for Special Tax Adjustment (Shuizongfa [2016]137), in which the roles and responsibilities of tax authorities at different levels were further clarified and so as the collective review and approval system. This system will enable tax authorities of different areas to work towards consistency in terms of transfer pricing method and profit level determined thereof It is expected a unified work standard across the country can be established. The consistency will make tax assessments more effective as deterrence measures. Tax officials can be better protected from risks in enforcing the law thanks to the internal control system built according to the "Internal Procedures for Special Tax Adjustment".

2.4. Monitor Profits of MNEs in China

2.4.1. Transfer pricing administration needs to move up the line of defense. Prevention can be very effective in fostering taxpayer voluntary compliance with ARM'S LENGTH PRINCIPLE and fulfilling tax obligation. Only when the taxpayers fail to be compliant the audits should be initiated. To better leverage the preventive effect, the SAT has installed a monitoring system to track the profits of MNEs in China. The primary data sources are the annual corporate income tax returns and the accompanying related party filings. The information is compiled, compared and analyzed by year, industry, and geographical area. Relying on the China Taxation Administration Information System (CTAIS), the monitoring system was designed to combine industry analysis with individual taxpayer screening. Tax authorities would receive alerts when the risks are identified. The history record and performance evaluation that the tax authorities have with a particular taxpayer can also be accessed in the system. Along with monitoring the tax compliance, the system will also generate effect analysis that reflects the contributions made by tax administrations of different areas to the tax revenue collected from the transfer pricing administration, investigation and service. This will in turn help build tax administration's capacity in managing taxation of cross-border transactions. In addition, by requiring taxpayers to prepare contemporaneous transfer pricing documentation and monitoring taxpayers in the follow-up years subsequent to the audits, it is expected that taxpayers will better identify with tax administration’s approach to transfer pricing administration.

2.5. Intensify Audit Effort

2.5.1. Audit effort for nationally coordinated cases that involve several companies in a same industry or multiple subsidiaries of in a same MNE group was intensified to improve the quality of closed cases. Investigations should be carried out in a consistent and standardized manner so that disparate assessment simply because tax authorities have different ways to go about cases that involve companies in the same industry or subsidiaries belonging to the same group can be avoided. The transfer pricing audits can therefore be more effective as a tax avoidance deterrence measure. In the recent years, China has initiated a series of nationally coordinated audits targeting industries including shoe manufacturing, computer manufacturing, high speed road construction, retail stores and hotels. Apart from being subject to the nationally coordinated audits, automobile sector, luxury goods industry and pharmaceutical companies were also the subjects of industry analyses. The “income approach” was developed and applied to multiple cases to address the challenges posed by transfer of equity and intangibles between related parties. The Chinese tax administration has also continued to explore unchartered areas. The audits were extended from foreign invested companies to Chinese companies with outbound investments, from manufacturing sector to the tertiary sector, from sale and purchase of tangible goods to transactions like equity or intangibles transfer and corporate financing. The tax revenue contributed by the anti-avoidance work was RMB 679,000,000 in 2006 and RMB 61,000,000,000 in 2010. The number was more than octogintupled with an annual increase rate of 64.84%. In addition, the average tax assessment from a single case has risen from RMB 3,836,200 in 2006 to RMB 58,450,000 in 2015. The amount is more than 14 times higher. The number of substantial cases has grown exponentially too. In 2006, there were 10 cases with levy over RMB 10,000,000 among which only 1 case collected over RMB 100,000,000 in tax revenue. In 2015, the number of cases with assessment over RMB 10,000,000 was increased to 77 with 20 cases that collected over RMB 100,000,000.

2.6. APA Program and MAP Process

2.6.1. China has put in place a MAP mechanism to eliminate double taxation resulted from transfer pricing audits and a bilateral APA program to provide certainty for cross-border taxpayers. Unilateral APAs can also be reached between the Chinese tax administration and the taxpayers. China's first bilateral APA was signed with Japan in 2005. So far the SAT has received 195 applications for bilateral APA and 106 applications for MAP assistance in transfer pricing cases. 19 countries and regions were involved. By the end of 2015, China has signed or reached 51 bilateral APAs and 44 MAP agreements with 7 countries. As a developing country and emerging market economy, China has comparative advantages due to big market size, cheap land and labor, and effective market demand. The SAT has put great emphasis on concepts such as location savings and market premiums and presented them during numerous bilateral negotiations. Some of China's treaty partners were able to respect and acknowledge the value contributed by these specific economic factors. In order to better inform the public of China's APA program, the SAT started to release "China APA Annual Report" in 2010. So far 6 reports have been published on the OECD official website and met with well reception from the international community.

2.7. Expand Data Sources for Comparability Analysis

2.7.1. Internal data extracted from corporate income tax returns and VAT refund database has played a primary role in identifying high-risk taxpayers. Meanwhile, external data obtained from National Bureau of Statistics, General Administration of Customs, State Administration of Foreign Exchange along with business information compiled in the National Database of Companies in Secondary Sector, Bureau van Dijk, Standard & Poor's NetAdvantage was also put to good use in comparability analysis.

2.8. Enhance international communication and cooperation

2.8.1. The SAT has been actively participating in meetings organized by the UN and the OECD especially when the BEPS project was involved. The SAT has also presented China's position on important issues including intangibles, transfer pricing documentation and comparability analysis and brought in concepts like exploitation of intangibles, quantification of LSAs, value contribution by decision execution that were later incorporated into the updated OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter referred to as "OECD Transfer Pricing Guidelines"). By taking opportunities to talk to tax officials from other countries as well as representatives from MNEs, the SAT has been able to foster mutual understanding with them. On top of that, the SAT has always been willing to share China's experience in transfer pricing legislation and practice with other developing countries. Productive discussions on application of location savings and market premium in transfer pricing was generated in the process.

2.9. Build a Professional Transfer Pricing Team

2.9.1. Building a dedicated transfer pricing team has always been the priority of the SAT. Anti-avoidance training has been conducted in various forms such as discussions on domestic legislation, peer-to-peer case sharing, seminars delivered by experts from the OECD as well as from other countries, special training sessions on difficult topics such as transfer pricing involving intangibles, financial service sector, and pharmaceutical industry. The combination of in-class training and on-job learning has yielded good results as evidenced by significant improvement in tax officials' professional capabilities. On the other hand, resources have been devoted to transfer pricing administration as well. Several special tax bureaus tasked with anti-avoidance work were set up in Beijing, Shanghai and Jiangsu province. The purpose was to pool the local talents and let them focus on transfer pricing and other anti-avoidance work. In addition, in response to the increased workload related to transfer pricing audits and bilateral negotiation in the post-BEPS era, the SAT has set up 3 anti-avoidance divisions in the headquarters. 16 extra people were recruited this year and 26 more people are expected to join the team in the next 2 years. Eventually a 50-people team dedicated to transfer pricing will be working in the SAT headquarters. Altogether there will be around 500 people working in anti-avoidance across the country. Aside from that, the SAT plans to add quantitative analysts to the mix as some countries already did. The economist teams will be formed not only in the SAT headquarters but also in the provinces with export-oriented economy. The first item on the teams' work agenda will be the quantification of technological intangibles, marketing intangibles, equity transferred, market premiums and location savings, etc..

3. Part Two: China's Transfer Pricing Regime

3.1. As provided by the "Tax Collection and Administration Law" and "Enterprise Income Tax Law", the core of China's transfer pricing regime is arm's length principle. Just like many countries in the world, China has made great efforts to uphold arm's length principle despite many challenges encountered in the process. That being said, China's transfer pricing regime has drawn on some other internationally recognized rules besides the arm's length principle. The transfer pricing issue can always be boiled down to the issue of international taxation as transfer pricing adjustment made to a company belonging to a MNE group will most likely lead to double taxation of the group. Both the country that initiates the audit and the country in which the related party is resident should ensure that the treaty obligations to prevent and eliminate double taxation are implemented. In order to resolve double taxation, the two countries need to negotiate with each other. The agreement can only be reached if both the negotiating parties are looking at the same principles, rules and methods. Therefore, it is not to be argued the necessity of having a set of international rules that are respected by all the countries for transfer pricing issues. However, the inherent disparity between countries cannot be overlooked. Countries might have special domestic situations or unique tax regimes. Different stages of economic and social development might pose distinct challenges too. All these factors need to be taken into account when designing international rules. Both developed and developing countries can find the general rules to be fair and easier to accept if the rules reflect special features of each group. So far China has signed double taxation treaties (agreements) with 105 countries or regions and the number is only dwarfed by that of UK and France. In addition, China is the top destination for foreign investment with its outbound investment jumped to the second place in the world. The extensive treaty network and ever-growing need for cross-border investment has prompted China to get into bilateral negotiation with many countries. The situation dictates China to follow international standards in dealing with transfer pricing or other international taxation issues. At the same time, the fast economic and social development for the past 30 years has made China one of a kind. The uniqueness also presents in China's transfer pricing area. This is why China needs to strike a balance between conforming to international conventions and acknowledging its unique situation in transfer pricing legislation and practice.

3.2. Related Party Filing

3.2.1. Article 43 of the "Enterprise Income Tax Law" stipulates that taxpayers need to attach related party transaction report to their annual corporate income tax returns. In other words, both resident and non-resident taxpayers required to file annual corporate income tax returns shall submit related-party filings. Public Notice 42 added some forms, including the forms for country-by-country (CbC) reporting, to the original "Annual Reporting Forms for Related Party Transactions" and making them 19 altogether. Aside from filling the 6 forms for CbC reporting (3 in Chinese and 3 in English), companies should report related party transactions in different categories (i.e., intangibles, intangibles, financial assets, financing, service, etc.) if applicable. According to the Public Notice 42, Chinese Tax resident enterprises that fall into any of the following two categories shall file the CbC report: (1) The resident enterprise is the ultimate holding company of a multinational enterprise's (hereafter referred to as the "MNE") group having total consolidated group revenue of more than 5.5 billion RMB during the fiscal year immediately preceding the reporting fiscal year as reflected in its consolidated financial statements for such preceding fiscal year. (2) The resident enterprise has been appointed by the MNE group to file the CbC report. The introduction of CbC report filing obligation into Public Notice 42 was one of the measures taken by China to implement the 4 minimum standards of the BEPS project.

3.3. Related Party Relationships

3.3.1. The existence of related party relationships is the prerequisite for related party filing and the basis for tax administration's transfer pricing adjustments. Article 109 of Implementation Regulations for the Enterprise Income Tax Law provides that the related party relationship refers to direct or indirect control relationship with respect to capital, business operation, purchases and sales. The definition was exemplified in Public Notice 42 which provides for 7 types of related party relationships. For example, 25% shareholding is the ownership threshold to constitute the related party relationship.

3.4. Contemporaneous Transfer Pricing Documentation Requirements

3.4.1. Chinese corporate taxpayers are required by the law to prepare contemporaneous transfer pricing documentation by tax year and submit it when requested by the tax administration. Contemporaneous transfer pricing documentation may include master file, local file and special issue file. Any enterprise that meets one of the following criteria shall prepare a master file : (1) The enterprise that has conducted cross-border related party transactions during the tax year concerned, and the MNE group to which the ultimate holding company that consolidates the enterprise belongs, has prepared a master file. (2) The annual total amount of the enterprise's related party transactions exceeds RMB 1 billion. The master file is to provide an overview of the global business operations of the MNE group to which the ultimate holding company belongs. Different from the recommended legislation template set out in the BEPS Action 13 report, the master file submitted to Chinese tax administration will also need to include (1) A description of business restructurings, industrial restructurings, transfers of functions, risks or assets occurring within the group during the fiscal year; (2) functions, risks, assets and personnel of principle research and development facilities; (3) Name and location of the constituent entity that files the CbC report for the MNE group; and (4) a list of the MNE group's existing unilateral advance pricing agreements, bilateral APAs. Any enterprise that meets one of the following criteria during the fiscal year shall prepare a local file: (1) The annual related party transfer of ownership of tangible assets exceeds RMB 200 million (for toll manufacturing transaction, the amount is calculated using the import/export customs declaration prices); (2) the annual related party transfer of financial assets exceeds RMB 100 million; (3) The annual related party transfer of ownership of intangibles exceeds RMB 100 million; (4) the annual total amount of other related party transactions exceeds RMB 40 million. In addition to what is required in the Action 13 report, taxpayers will need to provide (1) value chain analysis including Measurement and attribution of value creation contributed by location specific factors; (2) information on outbound investment; (3) information on related party equity transfer; and (4) information on related party services. Also, PN 42 has more stringent and detailed filing requirement for description of business, related party, and related party transactions of local entities. Furthermore, taxpayers will need to describe contribution to the group's overall profit or residual profit by the local entities regardless of the transfer pricing method selected. Aside from the master file and local file, Chinese taxpayers will need to prepare special issue file as part of their contemporaneous transfer pricing documentation if certain criteria are met. Special issue files include special issue file on cost sharing agreements and special issue file on thin capitalization. An enterprise that enters into or implements a cost sharing agreement (hereafter referred to as "CSA") shall prepare a special issue file for the CSA. An enterprise with a related party debt-to-equity ratio exceeding the threshold shall prepare a special issue file on thin capitalization.

3.5. Transfer Pricing Audits

3.5.1. Chinese taxpayers with related party transaction not in line with arm's length principle are subject to transfer pricing audits conducted by the tax administration. The transfer pricing audit procedures are made very clear in the Circular 2. As suggested by the OECD Transfer Pricing Guidelines Comparability analysis is also provided for in the Circular 2. However, the investigation is only as important as other means including risk management and taxpayer service listed in Part One of this paper to foster taxpayer compliance.

3.5.2. Through reviewing taxpayers' related party filings and contemporaneous transfer pricing documentation as well as tracking profitability of MNEs in China, the Chinese tax administration has been able to identify taxpayers with transfer pricing risks and alert the taxpayers to the risks. The taxpayers are allowed to make self-adjustment after they realize the existence of the risks either as the result of the tax administration's alerts or an effective internal control system. To the extent that the adjusted results do not conform to the APL, the tax administration may initiate transfer pricing audits on the taxpayers.

3.5.3. During the screening process for transfer pricing audit targets, taxpayers fall into the following categories will likely to jump out. (1) enterprises with significant amount of or different categories of related party transactions; (2) enterprises with consecutive losses, low profitability, or fluctuating profitability for a long time; (3) enterprise with profit levels that are lower than the industry average; (4) enterprises with mismatch between profitability and functional profit or mismatch between benefits shared and costs allocated; (5) enterprises that have transactions with related parties in tax havens; (6) enterprises that have not submitted the related party filings or prepare contemporaneous transfer pricing documentation in accordance to the relevant regulations; (7) enterprises with related party debt-to-equity ratios exceeding the designated threshold.

3.6. Transfer Pricing Methods

3.6.1. Like most countries, Chinese tax administration and taxpayers are allowed to choose from the following 6 transfer pricing methods: comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method, profit split method and other appropriate methods. Neither does one method have priority over other methods nor does the method applied needs to be proved as the best method. Other appropriate methods include asset valuation methods through cost approach, market approach and income approach or other methods that can reflect that the profits are taxed where economic activities take places and value is created.

3.7. APA Program

3.7.1. In accordance with the Implementation Regulation of the Tax Collection and Administration Law, the Enterprise Income Tax Law and its Implementation Regulations, Chinese taxpayers can enter into APAs with tax administration on the pricing principles and calculation methods for related party transactions for future years. The APA process involves the following 6 stages: pre-filing meeting, intent submission, analysis and evaluation, formal application, negotiation and signing, implementation and monitoring. There are 3 types of APAs that are available: unilateral APAs, bilateral APAs and multilateral APAs. An APA generally covers related party transactions for 3 to 5 consecutive years in the future. Per taxpayer’s application, the APA can be retrospectively applied to the prior years as long as 10 years. The general threshold which a taxpayer needs to meet in order to apply for an

APA is that the amount of annual related party transactions should be no less than RMB 40 million for the past 3 years prior to the application year.

3.7.2. Chinese tax administration can prioritize the acceptance of the application from a taxpayer if it falls into one of the following categories. (1) The taxpayer's annual reporting forms for related party dealings and contemporaneous transfer pricing documentation are well completed with adequate disclosures. (2) The taxpayer has a level A tax credit rating. (3) Special tax investigation on the taxpayer was conducted and closed. (4) Renewal application was submitted by the taxpayer upon expiration of the existing APA with no substantial change to the facts and circumstances specified in the existing APA. (5) Information and documents submitted by the taxpayer are complete and adequate; value chain analysis and supply chain analysis are clear and through; location specific factors including location savings and market premium, etc. have been given adequate consideration; and the proposed transfer pricing method and the calculation method are appropriate. (6) The taxpayer can actively cooperate with the tax authorities during the APA process. (7) For a taxpayer applying for a bilateral APA, the competent authority of the relevant treaty partner has displayed strong intention to move forward with the APA negotiation and attach importance to the case. (8) There are any other factors present that benefit the negotiation and signing of the APA requested by the taxpayer.

3.7.3. Chinese tax administration attaches great importance to APA implementation. Upon expiration of the advance pricing arrangement, if the weighted average operating result of the enterprise during the term of the advance pricing arrangement falls below the median of the interquartile range and are not adjusted to the median, tax authorities will decline the renewal application.

3.8. MAP Process

3.8.1. In accordance with the relevant provisions in the relevant tax treaties, the SAT will provide MAP assistance to both requests submitted by the taxpayers and requests initiated by the competent authorities of the treaty partners. Aimed to prevent or eliminate double taxation resulted from transfer pricing adjustments, the SAT would consult with the competent authorities of the treaty partners to resolve the disputes. One area which MAP can be applied to is taxation resulted from transfer pricing adjustments that might require corresponding adjustments from the other contracting state. MAP can also be used to negotiate bilateral/multilateral APAs.

3.8.2. Taxpayers who wish to request MAP assistance should complete the Application Form for Mutual Agreement Procedures and submit it with necessary documentation to the SAT headquarters within the timeframe specified in the relevant tax treaties. The SAT can initiate the MAP process after receiving the aforementioned documents if the submitted documentation is in accordance with provisions in the relevant tax treaties. The SAT can require the taxpayers to provide additional information if the submitted documentation is found insufficient. In a case where the competent authority of the other contracting state requests to initiate the MAP process, the SAT will start the MAP process upon the receipt of the formal notification if the request is in accordance with provisions in the relevant tax treaties. The SAT needs to give written notification to the relevant local tax administration and inform the competent authority of the other contracting state if it decides to initiate MAP process.

3.8.3. If an agreement is reached between the SAT and the competent authority under MAP, it will then be forwarded to the relevant local tax administrations. The local tax administrations need to deliver the agreement to the taxpayer within 15 days from the day it receives the written notification from the SAT headquarters. If there is additional tax payment (refund) involved, the local tax administration will also need to deliver the "Notification of Additional Tax Payment (Refund) Resulted from Mutual Agreement with Respect to Special Tax Adjustments" or "Notification of Additional Tax Payment (Refund) Resulted from Advance Pricing Arrangement" to the taxpayers. Moreover, the local tax administrations are responsible for ensuring the implementation of the agreements.

4. Part Three Challenges Facing China and Other Developing Countries

4.1. China shares many things with other developing countries in terms of transfer pricing administration. As a relatively late starter in the area, China has drawn on OECD Transfer Pricing Guidelines and experiences of developed countries. In the meantime, China has met with many challenges including lack of appropriate comparables, quantification and allocation of location specific advantages, identification and valuation of intangibles to which solutions were not readily available in the OECD Transfer Pricing Guidelines. The ongoing international tax reform has provided a great opportunity for developing countries to be involved in the international rule making process. During the process, developing countries were able to raise these unique issues and present their positions for everyone to discuss. The reform also prompted the developing countries to strengthen capacity building. It is encouraging that some of the issues facing the developing countries are addressed in the BEPS action reports. Even though there is still a long way to go, it is the right way to go. Now, developing countries are looking to UN Practical Manual on Transfer Pricing to provide solutions to these challenges that are common to all of them.

4.2. Major Challenges

4.2.1. Arm's Length Principle

4.2.1.1. The arm's length principle is at the core of OECD Transfer Pricing Guidelines. Most Countries including China see it as the fundamental principle in transfer pricing. The arm's length principle requires that transactions occurred between associated companies in a same MEN group to be referenced to uncontrolled transactions on comparable conditions. Uncontrolled comparable transactions are often hard to find in real life. In practice, companies that perform similar functions, assume similar risks, own similar assets, and operate under comparable circumstances to the tested companies are used instead. Yet most times it is still a stretch to say the comparable companies found are real reliable comparables to the tested companies.

4.2.1.2. The arm's length principle dates back to as early as the 1920s when there were very few MNEs and hence very few transactions between related parties. It was much easier to find independent comparables back then. The invention of arm's length principle had pointed out the direction for tax practitioners to resolve the thorny issue of transfer pricing. However, after almost a century, the application of arm's length principle has started to be challenged by the prevalence of MNEs. The statistics show that over 2/3 of world trade involves MNEs. Well over 50% of world trade compromises related party transactions. With more and more companies poised to conduct business as groups, economic activities are more and more likely to take place in the inner circle of MNE groups. It is nearly impossible to take out one piece of a value chain of a MNE group and try to match it to comparable transactions/companies. Take a pharmaceutical group as an example. Suppose the parent company developed a new formulation and has contracted a subsidiary to use the formulation to manufacture the drug. The question is how much royalty should the subsidiary pay for the right to manufacture. The arm's length principle can hardly be applied here as there are no comparable transactions on the market to be found because the parent company would not give the formulation to a third party company to manufacture.

4.2.1.3 The challenges to the arm's length principle are not something unique to developing countries. Developed countries are facing it as well since the trend for companies to work as MNE groups to conduct cross-border transactions does not discriminate between developed and developing countries. It is just that the developing countries are dealing with the challenges with more difficulty as this chapter will explain later in more detail.

4.2.1.4. The biggest shortfall of applying arm's length principle is that it might distort the inflexibility of law enforcement and leave taxpayers uncertain about whether the pricing of related party transactions or the profits of the related companies are appropriate. No one has a definite answer. Most audits or MAP cases are the result of compromises between tax administrations and taxpayers or competent authorities of two/more countries.

4.2.1.5. The BEPS project still holds arm's length principle as the principal standard in transfer pricing issues. No country has decided to forgo the ARM'S LENGTH PRINCIPLE either since there is no better alternative as well-acknowledged available yet. But at the very least it should be recognized that the arm's length principle has its limitations and they are accentuating in today's world economy. Researches to explore better alternatives to the arm's length principle should be encouraged. Academia and research facilities should also get involved in the process.

4.2.2. Lack of Reliable Comparables

4.2.2.1. One of the key challenges for developing countries is the lack of reliable, public information on comparables. For a developing country, there are usually only a small number of public companies, while information on domestic private companies is lacking or inadequate. This limits the amount of publically available information on domestic companies that can be used for transfer pricing analysis. Take China as an example. As of the September 2016, there are 2952 listed companies in China whereas the private companies are not bound by law to disclose financial information to the public. It is unrealistic to expect that reliable comparables to the tested companies can be found in less than 3000 listed companies. In particular, there would be a lack of comparables for companies who are first movers in an industry not yet fully exploited. In practice, foreign companies are often used as an alternative to domestic comparables. As a result, comparables sets are often dominated by companies in developed countries, simply because there are usually a much larger number of public companies in these countries.

4.2.2.2. While globalisation and free capital mobility are the basis for the use of foreign comparables, the existence of foreign exchange controls in many developing countries violates this precondition. Accordingly, significant comparability adjustments may be necessary for companies in developed countries to be used as comparables for companies in developing countries. In some cases, it may require a different methodology such as profit split as no sufficiently reliable comparability adjustment may be feasible.

4.2.2.3. One of the most common adjustments in China is accounting for differences in geographic comparability when applying profit based transfer pricing methods, such as the transactional net margin method ("TNMM"), to determine an arm's length price. For example, when an Asia Pacific set of companies is used to benchmark the transfer prices of a Chinese taxpayer, as often being the case, it often includes companies from both developed countries (such as Japan and Korea), as well as developing countries (such as Indonesia and Vietnam). Generally speaking, the Asia

Pacific set is more likely to contain companies from developed countries due to a greater amount of listed companies in those countries and hence there is a greater volume of publicly available financial information.

4.2.2.4. China takes the view that there may be instances where the differences in geographical markets are so material that it warrants comparability adjustments to bridge the differences. By making such comparability adjustments, taxpayers in developing countries can overcome the practical difficulties in applying the arm's length principle to their transfer pricing analysis.

4.2.3. Location Specific Advantages

4.2.3.1. The globalisation of trade and economies has given rise to concepts such as "location savings", "market premium," and more generally, LSAs. The LSAs are advantages for production arising from assets, resource endowments, government industry policies and incentives, etc., which exist in specific localities. For example, household electronics manufacturers invest in China to take advantage of a large pool of well-educated low-cost labour and a well-developed network of suppliers, or global automotive companies set up joint ventures ("JVs") in China to assemble automobiles locally to be close to the market and the customers and to take advantage of lower costs. Limited guidance is available on these concepts in the OECD guidelines. It has been seen that certain issues such as location savings and market premium arise more frequently in China and other developing economies, rather than in established and developed economies (which comprise the bulk of the membership of the OECD).

4.2.3.2. Location savings are the net cost savings derived by a MNE when it sets up its operations in a low cost jurisdiction. Net cost savings are commonly realised through lower expenditure on items such as raw materials, labour, rent, transportation and infrastructure even though additional expenses ("dis-savings") may be incurred due to the relocation, such as increased training costs in return for hiring less skilled labour.

4.2.3.3. Market premium relates to the additional profit derived by a MNE by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product.

4.2.3.4. In dealings with Chinese taxpayers, the Chinese tax administration has adopted a four-step approach on the issue of LSAs:

i. Identify if an LSA exists.

ii. Determine whether the LSA generates additional profit.

iii. Quantify and measure the additional profits arising from the LSA.

iv. Determine the transfer pricing method to allocate the profits arising from the LSA.

4.2.3.5. In determining LSAs and their impact on transfer pricing, both industry analysis and quantitative analysis are critical.

4.2.3.6. The automotive industry is a good example where there are many LSAs that have led to extraordinarily high profits that are rightly earned by Chinese taxpayers. The LSAs include:

i. The "market-for-technology" industry policy, which requires foreign automotive manufacturers to form JVs in order to assemble automobiles in China, forcing foreign automotive manufacturers to compete for limited market access opportunities by offering favourable terms including provision of technologies at below market price;

ii. Chinese consumers' general preference to foreign brands and imported products – this general preference, as opposed to loyalty to a specific brand, creates opportunities for MNEs to charge higher prices and earn additional profits on automotive products sold in China;

iii. Huge, inelastic demand for automotive vehicles in China due to the large population and growing wealth of the population;

iv. Capacity constraints on the supply of domestically assembled automotive vehicles;

v. Duty savings from the lower duty rates on automotive parts (e.g. 10%) compared to imported vehicles (e.g. 25%) – when MNEs manufacture products in China as opposed to importing the products from outside of China, they are able to generate overall savings from the lower duty rates, even if the MNEs incur manufacturing costs and sell their domestically-manufactured products at a lower sales price compared to a foreign-manufactured vehicle; and

vi. A large supply of high quality, low costs parts manufactured by suppliers in China.

4.2.3.7. For a 50/50 JV with partners having conflicting interest in the Chinese automotive industry, the Chinese JV partner generally contributes local distribution network, intimate knowledge about the local market, and the right market access. However, it does not typically have control of the JV operation, which is usually controlled by the foreign JV partner. The foreign JV partner also controls the supply chain of the parts. To the extent there could still be potential transfer pricing issues, the primary issue involves the JV being overcharged for the parts and services that are provided by related parties. In the absence of such overcharges, the JV's results mainly reflect an arm's length outcome, which in turn reflect the contribution of LSAs to the JVs.

4.2.3.8. A further example can be that of a Chinese taxpayer performing contract research and development ("R&D") services for an offshore affiliate, and the full cost mark up ("FCMU") as the profit level indicator for a comparable set comprising of foreign companies located in developed countries (and hence, incurring higher costs). The following example outlines the steps to calculate the adjusted FCMU taking into consideration of the location savings.

4.2.3.9. It is assumed that the Chinese taxpayer's cost base was 100, the average cost base for the company's R&D centres in developed countries was 150, and the median FCMU of the comparables was 8%. The comparison of the cost base between the Chinese taxpayer and that of the foreign companies is measured on an equal platform, such as the total costs (labour, raw materials, land and rent, etc) per unit of output.

Steps Calculations

	Steps	Calculations
i.	Calculate the arm's length range of FCMUs based on foreign comparables, mostly in	Assume the median FCMU

	developed countries	is 8%
ii	Calculate the difference between the cost base of the Chinese taxpayer (e.g. 100) and the average cost base of the foreign companies (e.g. 150)	150 – 100 = 50
iii	Multiply the arm's length FCMU (e.g. 8%) with the difference in the cost bases (50)	8% x 50 = 4
iv	The resulting profit is the additional profit (i.e. 4) attributable to China for location savings	4
v	Determine the total arm's length profit for the Chinese taxpayer	4 + 8% x 100 = 12
vi	Determine the adjusted arm's length FCMU for the Chinese taxpayer	12 / 100 = 12%

4.2.3.10. The Chinese tax administration has come across many other cases of market premiums for Chinese taxpayers, particularly in the luxury goods, pharmaceutical and automotive industries. These three industries have gained significant momentum over the past decade with booming demand from the market. Many MNEs have set up sales subsidiaries which have been involved in heavy marketing and sales activities to build the brand image among Chinese customers and cultivate their appetite for the MNEs' products. The exponential growth in sales revenue has brought in additional profits for the MENs. Given that the taxation should follow value creation, the Chinese tax administration takes the view that the additional profits should be taxed in China if they are derived from the unique characteristics of Chinese market. For example, the Chinese subsidiaries of some luxury brands have undertaken significant promotion activities to educate Chinese customers who had known nothing about the brands before. With more and more Chinese customers now are familiar with the brands and products, sales revenue has experienced great increase for the Chinese subsidiaries. On the other hand, deterred by the high prices set by the MNE groups in the Chinese stores, some Chinese customers who would have went to luxury stores in China instead chose to go abroad. The money spent by Chinese shoppers in overseas luxury stores has been growing at the fast and steady rate of more than 50% in the recent years and constituted a sizeable portion of sales revenue of overseas affiliates. Take one brand as an example. The products sold to Chinese nationals in stores located in countries other than China accounted for 12% of the total sales generated in these areas for the brand. This portion of the sales revenue and the profits realised thereof should be attributed to the marketing contribution made by Chinese subsidiaries and taxed in China.

4.2.4. Intangibles

4.2.4.1. Intangibles are as major an issue for developing countries as they are for developed countries. While MNEs in developed countries often have superior technology intangibles, they need the fast growing market in the developing countries and contribution of the subsidiaries in these countries to develop the market in order to monetize the value in such intangibles. For developing countries, marketing intangibles and LSAs are often closely integrated, and due consideration is necessary to properly compensate the contribution of the subsidiaries in developing countries.

MNEs often provide intangibles to their Chinese affiliates in the initial stages of the local operation to help establish the business in China. These intangibles may take various forms, such as global brand name, technical know-how or business processes. Over time, the local Chinese subsidiaries acquire the skill and experience from operations in China, and may even contribute to the improvement of the MNE’s original intangibles. The issue in this scenario is whether the local Chinese affiliates should be entitled to additional profit, and if so, what is the appropriate method to calculate the additional profit?

4.2.4.2. For example, if a Chinese affiliate was charged a 3% royalty for the use of a manufacturing process when the Chinese operations were established 10 years ago in 2002, then it may not be reasonable for the Chinese affiliate to continue paying the same royalty in 2012 without revisiting whether the intangible has continued to provide the same value over time. This is particularly the case if the Chinese affiliate has improved a manufacturing process provided by its parent company, through a process of trial and error and conducting manufacturing operations over a 10-year period. The Chinese tax administration would question whether the Chinese affiliate should continue to pay a royalty to the parent company for the manufacturing process, or whether the Chinese affiliates should be entitled to a return on the intangibles that they have developed and shared with the group companies.

4.2.4.3. The Chinese tax administration is glad to see that the updated OECD Transfer Pricing Guidelines on intangibles has made it clear that entities involved with the development enhancement, maintenance, protection and exploitation of intangibles should be compensated for their contributions. The value of an intangible developed by the parent company might be enhanced, maintained, protected and exploited by the local subsidiaries. Developing countries need to give special consideration to the value creation to intangibles contributed by these economic activities undertaken by the local subsidiaries.

4.3. Practical Issues and Solutions

4.3.1. In a globalising economy, MNEs usually set up operations in developing countries to take advantage of comparative advantages that these countries offer. For example, they set up manufacturing operations to take advantage of the abundant cheap labour or natural resources to supply products for overseas markets, R&D to take advantage of local talent for overseas principals, and distribution of imported products to the local market. These operations often take the form of contract or toll manufacturing, contract R&D, and limited risk distribution to leave little profit to the local country, despite the fact that many such comparative advantages contribute significant profits to the MNE group. The following paragraphs share some of the

Chinese experience in dealing with these transfer pricing issues.

4.3.2. A holistic view of functions and risks may need to be taken. Many MNEs have set up multiple companies in China with each company performing only a single function, such as manufacturing, distribution, R&D, and services, and claim that each of these entities is entitled to a limited return. Others have some or all of manufacturing, distribution, R&D, and services functions in one entity, and still claim that each of these functions is entitled to only a routine return. The Chinese tax administration takes the view that when a group has multiple single function entities, they may have to be taken into consideration as a whole in order to properly determine the return the group of companies should earn in China. Similarly, an entity with multiple functions may have to be reviewed in its entirety in order to properly determine its returns.

4.3.3. While China generally respects the limited risk characterization of sole function entities[2]; determining an adequate return for such entities is a challenge, as explained below. Further, China's legislation has a specific article in its transfer pricing rules to require that such entities should not bear risks or suffer from losses arising from strategic failures, capacity under-utilisation, or holdup in the sales of products, etc., if they do not perform business strategy decision making, product R&D, or sales functions. Simply put, if their upside is limited, their downside should be limited too. Contract R&D is an area where the contribution of developing countries is often underestimated. The transfer pricing method commonly used to reward R&D activities performed by a subsidiary of a MNE in China is cost plus. Sometimes, it has been found that the principal entity that is claimed to be responsible for the R&D has neither the technical expertise nor the financial capacity to be responsible. In other instances, the Chinese entity has obtained "high and new technology status" in Chinese law and therefore enjoys tax incentives on the basis of ownership of valuable core technology. However, it also claims to be a contract R&D service provider with

[2] For example, toll or contract manufacturing, limited risk distribution, or limited risk service provider.

no valuable intangibles on the other hand. These are but a few examples where a cost plus approach would not be adequate, and a different method such as profit split would be more appropriate. It is expected that companies claiming high tech status should be performing activities that result in the creation of intellectual property of which they can claim economic or legal ownership. It is not sufficient by itself that the contract R&D entity has shifted the majority of its risks (e.g. unsuccessful research) to its entrepreneurial related party. A proper analysis of the value provided by the contract R&D entity to the overall group operations should be conducted to determine the appropriate arm's length return for the R&D entity.

4.3.4. Contract manufacturing is one of the most common forms of manufacturing used by MNEs in China, particularly dealing with manufacturing products for export. In evaluating a contract manufacturer's return, the TNMM is often used as the transfer pricing method with the FCMU being the most commonly used profit level indicator.

The arm's length principle involves testing controlled transactions with uncontrolled transactions to determine how independent parties would have acted in broadly comparable situations. This principle becomes challenging to apply where a company relies on its related parties for both input purchase and output sales. If such a company is to be evaluated on a cost plus basis, a low intercompany purchase price results in an undervalued cost base that will ultimately under-compensate the contract manufacturer. However, the reasonableness of the purchase price is often difficult to assess. A further issue therefore arises on how the reasonableness of a taxpayer's intercompany arrangements in this situation should be evaluated.

4.3.5. The Chinese approach to evaluating such companies is to start with the general presumption that the related party purchase price of materials is at arm's length, and evaluate the reasonableness of the mark up earned by the contract manufacturer on its cost base. The rationale for accepting the related party purchase price is that Customs can act as a check on the reasonableness of the import price of materials and safeguard against unreasonably low intercompany purchase prices. The next step is to proceed with the transfer pricing analysis by adopting a cost plus methodology and using the FCMU as the profit level indicator. The challenge that follows lies in the search for suitable comparable companies, as discussed earlier in this paper.

4.3.6. Toll manufacturing is a common form used by MNEs in developing countries, but its proper return is difficult to determine since there are only a few independent listed companies that perform such activities. Some taxpayers simply use the FCMU for contract manufacturers as the mark-up for toll manufacturers. This grossly underestimates the return to toll manufacturers. Others use return on assets as a profit level indicator based using contract manufacturers as comparables, and this may also underestimate the return, particularly for labour intensive toll manufacturers as often being the case in developing countries.

4.3.7. In practice, the Chinese tax administration has sought to first estimate the total cost of the toll manufacturing operation as if it were a contract manufacturer, usually by adding back costs of raw materials which may be obtained from Customs. It then estimates the appropriate returns (say, FCMU) for contract manufacturing based on contract manufacturing comparables, and apply this to the estimated total cost to arrive at the total contract manufacturing profit, from which it then adjusts for factors such as inventory carrying costs, to arrive at the total profit for the toll manufacturer. This approach works well when reliable customs information on raw materials is available. If customs information on raw materials is not available or not reliable, then there are unresolved issues as to what should be an appropriate profit level indicator and how it could be derived.

4.3.8. Sales, marketing and distribution are another set of functions where it has been seen that MNEs often underestimate the contribution of developing countries. Chinese experience shows that many MNEs treat its Chinese distribution entities as a limited risk distributor, and use a set of simple distributors performing limited functions in a mature market such as Japan as the comparables. There are a couple of obvious deficiencies in such an approach. First, there often is a mismatch in terms of functional profile, as the Chinese entity may perform significantly more functions than these so-called comparables, which is evident as it incurs significantly more operating expenses relative to sales. Second, it does not account for differences in market differences, with China being a fast growing economy and having strong demand which requires relatively less selling effort and therefore can achieve higher efficiency and profitability. Other LSAs such as country premium and any marketing intangibles that are created by the Chinese entity are also commonly ignored.

4.3.9. In practice, the Chinese tax administration has attempted to correct such deficiencies by using a more appropriate transfer pricing method, such as profit split in the cases where we identify significant local marketing intangibles or LSAs, or performing comparability adjustments when TNMM is used. For example, if the median operating expense to sales ratio for the comparable set is only 7%, and the same ratio for the taxpayer was 40%, to the extent there is location savings, the Chinese tax administration would adjust the cost base first. The Chinese tax administration would then calculate the additional return required for the extra efforts made by the Chinese taxpayer to derive the total return for the Chinese taxpayer.

4.4. Alternative Methods to the Traditional Transactional Net Margin Method

4.4.1. While the TNMM may still be used when there is a lack of adequate local comparables, such as using foreign comparables with proper adjustments, as in the contract R&D example, sometimes a different method such as the profit split may be more appropriate. An example is the electronic manufacturing services ("EMS") sector, where the entire, or nearly the whole manufacturing and assembly activities of a foreign EMS MNE group, have been outsourced to its Chinese affiliates.

4.4.2. The typical set up for these manufacturing and assembly operations is such that the majority of the work force and tangible assets of these foreign EMS multinational groups are located in China, including many high level operational staff. The headquarters of these EMS companies are located outside of China, with the EMS group's revenues supported by significant manufacturing contracts with third party global consumer electronics companies. Often, in such instances, the MNE group's transfer pricing policies have little regard for properly compensating the Chinese manufacturer. The profits of the Chinese manufacturer are stripped away as much as possible on the basis that the manufacturer is a contract manufacturer or a toll manufacturer with a very low risk profile.

4.4.3. Under this scenario, China takes the view that a risk based approach may place insufficient regard for the fact that there are sizeable assets located in China (i.e. the work force and factory plants). In many cases, the majority of the headcount of the EMS group are based in China, with only a few management personnel residing outside of China. Rather than a transactional or profits based approach, a contribution analysis approach may be more suitable. This means that remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group. In this case, the assets and the people should largely dictate where the group's profits should stay, and a global formulary approach should be a realistic and appropriate option.

4.4.4. Alternatively, the Chinese tax administration may determine the property return for the headquarters, with the Chinese manufacturer earning the residual profits. Another potential alternative may be to evaluate the Chinese manufacturer on the return on its assets or capital employed, using the group's results as a comparable for the Chinese manufacturer.

4.5. Other Experience and Recommendations

4.5.1. One of the key issues faced by developing countries is the lack of experience and knowledge on how MNEs operate and on a particular industry. Transfer pricing is commonly acknowledged as one of the most difficult international tax issues, and MNEs as well as tax administrations in developed countries have developed and dedicated substantial resources including talents to this area. The Chinese experience has been that a dedicated team, with accounting, economics, and industry background would be very critical, in order for tax administrations in developing countries to effectively administer their transfer pricing rules.

4.5.2. Issues such as LSAs further raise the stakes. To effectively deal with such issues, solid economic and quantitative analyses are necessary. Compared with MNEs, which have vast resources at their disposal to hire the best professionals, and with tax administrations in developed countries which also have developed a large team of economists and quantitative analysts, developing countries such as China have a clear disadvantage, which has to be fixed urgently. As explained earlier in this paper, the SAT has committed to putting in place a dedicated team by adding more facilities and manpower. In order to assure the consistency in transfer pricing administration, substantial cases are centrally approved by specialist panel either at provincial level or national level depending on the significance of the cases.

4.5.3. One way to address the disadvantages faced by developing countries in transfer pricing administration is to expand the statute of limitations. For example, the statute of limitations for corporate income tax is normally five years in China. However, the statute of limitation for transfer pricing has been extended to ten years, allowing more time for tax administration to check on taxpayers' transfer pricing issues. Another way is to set clear compliance and penalty rules, putting the burden of proof on taxpayers and encouraging taxpayers to be in compliance and make self-adjustments when needed. It has been found that contemporaneous transfer pricing documentation requirements coupled with penalty rules have been very effective to encourage taxpayer compliance. An industry wide or a MNE group wide audit has also been a very effective and efficient way for the tax administration to make use of its limited resources to maximise its benefits.

4.5.4. As an emerging market economy, China's priority is to establish a three-pronged tax avoidance prevention and control system with consistent and standardized approach for administration, service and investigation. As the second part of this paper states, China does not always have the same technical expertise and resources that developed countries possess. Nevertheless, transfer pricing work in

China is developing quickly. The real objective in conducting audits is to show Chine’s resolve to enforce tax compliance. The industry-wide investigation was one of the means to accomplish the objective. As a testament to its success, the average profit margin in one of the industries focused on has increased from less than 1% to 5.6% between 2004 and 2008.

5. Conclusion

5.1. Application of the arm’s length principle to the companies in developing countries poses a practical challenge. Once developing countries overcome the issues of a sound legal framework for transfer pricing, they often encounter the issue of a lack of sufficient transfer pricing specialists to carry out the analysis, and a lack of reliable comparables for the analysis itself.

5.2. China, as a developing country, has unique economic and geographic factors which contribute to the profitability of Chinese taxpayers and their foreign parent companies. These factors include but are not limited to readily available migrant labour, low labour and infrastructure costs, first mover advantages in certain industries, foreign exchange controls, growing population and consumer demand for foreign and luxury products. Other developing countries have their own unique features that similarly require special attention from a transfer pricing perspective. In China’s experience, MNEs have often implemented group transfer pricing policies that are sensitive to the developed countries’ transfer pricing regulations and nuances, but neglect to consider whether the arm’s length principle has been applied properly for the company in the developing country.

5.3. China has overcome this challenge by using some practical solutions that are sensitive to unique economic and geographic factors for companies operating in China. These solutions include concepts such as location savings, market premium and alternative methods of analysis besides the traditional transactional and profit based methods.

5.4. The Chinese tax administration has shared its insights on applying the arm’s length principle for developing countries, and welcomes other perspectives on these issues.