



Difficulties in Pressing Forward

Advance Pricing Agreement (APA) in China

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Abstract

With the promulgation of the new Corporation Income Tax (CIT), the APA concept has been enacted into the tax laws. The detailed implementation rules to the CIT supports this APA framework and the proposed transfer pricing requirements to be released soon likely will exempt taxpayers with APAS from certain transfer pricing documentation requirements. But there are still some difficulties which hold back APA from pressing forward in China. This paper analyzes the difficulties and brings forward some measures to solve the difficulties.

Keywords: Advance Pricing Agreement, Critical Assumption, Tracing Management

Background

Transfer pricing has been a significant concern for multinational companies in China. In recent years, the Chinese tax authorities have increasingly strengthened their transfer pricing enforcement efforts, as evidenced by more frequent transfer pricing audits and enquiries, and larger amounts of transfer pricing adjustments. A number of alternatives are potentially available for multinational companies to manage their transfer pricing risks and to deal with transfer pricing disputes with the Chinese tax authorities. These include the preparation and maintenance of transfer pricing documentation and defense files, defense or negotiation with the in-charge tax bureaus to settle transfer pricing audits, domestic appeals, competent authority assistance, and unilateral or bilateral / multilateral advance pricing agreements (APAS).

An APA provides the taxpayer with an opportunity to achieve certainty on its transfer pricing before controversies arise with one (in a unilateral APA) or more (in a bilateral or multilateral APA) tax authorities. An APA is also an alternative to the traditional dispute resolution process involving transfer pricing audits and tax audit defense. An APA may take the form of unilateral, bilateral or multilateral. A unilateral APA involves only agreement between the taxpayer and the Chinese tax authority. A bilateral or multilateral APA involves an APA between the taxpayer and the Chinese tax authorities that is concurred by a mutual agreement between China and one or more relevant foreign competent authorities. Managed properly, the APA can be an invaluable tool for taxpayers to manage their transfer pricing issues in China.

1. Implementation of advance pricing agreement in China

In China, an APA is an arrangement that determines in advance, an appropriate set of criteria to ascertain the transfer prices of specified related parties transactions over a fixed period of time. The concept of an APA was first introduced into the Chinese transfer pricing regulations in 1998. In 2004, the State Administration of taxation (SAT) issued detailed rules on the application, evaluation, examination, negotiation and conclusion of APAS. Under the Chinese APA rules, a taxpayer must first apply for and obtain approval from the tax authorities before it can submit an APA application. The term of an APA may range from two to four years starting from the year in which the application is submitted, and may be extended backward to cover the application year. Rollback to years prior to the application year, however, is not permitted under the current APA rules. So far, there have been more than 180 APAS concluded in China, most of which are unilateral. In addition to the new bilateral APA with Korea in November, 2007, China has concluded two other bilateral APAS with Japan and the US respectively. (Spencer Chong, 2008) Many APA applications are currently being processed, including a number of bilateral APA ones.

The implementation of the new Corporate Income Tax ("CIT") in 2008 Law is expected to result in wider use of the APA by taxpayers. The CIT Law contains a provision on APAS which enhances the legal status of APA. Therefore, the taxpayer may find it more attractive to use an APA due to the increased certainty resulting from this. (Mike Godfrey, 2007) On the other hand, under the CIT Law and its proposed detailed implementation rules, where a taxpayer intends to implement a cost sharing arrangement ("CSA") in China, the SAT may require the taxpayer to apply for an APA to cover the CSA, or to go through an APA type of application procedure in order for the CSA to be recognized by the

Chinese tax authorities. However, the wider use of the APA in China is restricted by some factors.

2. Difficulties in pressing forward the APA in China

SAT has asked all levels of state and local tax authorities to press forward APA, but the effect is not very obvious on account of some difficulties. They can be illustrated as follows.

2.1 High cost of obtaining an APA leads to a narrow application

2.1.1 The process of APA negotiation is very complicated and springy

The six major phases in the APA process are: profiling conference; formal application; evaluation; negotiating and drafting; signing of the APA; and execution. Firstly, the taxpayer must evaluate their own situations and weigh the pros and cons before applying for the APA. To substantiate the APA case, taxpayers must adequately build up their business case, background, and commercial and economic analysis of the APA. Secondly, they submit the memorandum of pre-application including all methods of transfer pricing to the involved tax authority. Thirdly, checked and approved by the tax authority, taxpayers submit the application. The following procedures needs taxpayers and tax authorities to sit together to evaluate and negotiate; (During the course of negotiating the APA, taxpayers must ensure good communication with all levels of state and local tax authorities, taking a collaborative approach to quickly and accurately respond to and clarify any queries raised); then comes the signing. It needs huge manpower and material resources and financial resources.

The length of the process creates inefficiencies and substantially increases the cost of obtaining an APA. It presently takes approximately three to four years to resolve an APA case, so APA can not be applied in all cases. What's more, the APA can't be achieved sometimes. We can take America as an example. According to American APA procedure, every taxpayer signing an APA costs 20 thousand dollars. If the cap of operational fee is 4%, then the transaction amount between connected enterprises must be at least 5 billion dollars. Otherwise, the taxpayer will sustain losses from cost -efficiency perspective. For this reason, the American APA is mainly applied to the connected enterprises whose annual trading volumes are over 500 billion dollars. As for china, only large-sized multinational corporations have the desire and the ability to sign an APA.

2.1.2 Short period of validity

Both the taxpayer and tax authority sign the APA in accordance with the economic environment at that moment and mutually acceptable critical assumptions. But the economic environment may change greatly within a short period (three years or so) or the assumptions will not be tenable any longer. Then it's difficult for APA to carry out. That means the APA is not available for the new economic environment. The both sides of the taxpayer and tax collectors need to renegotiate and APA needs to renewal. Renewal APA will take the same amount of time to complete as a new APA takes.

2.2 Only bilateral or multilateral APA can really achieve the goal of signing an APA

The goal of signing an APA is to resolve the potential double taxation disputes and solve the problems that occur during the investigation of transfer pricing. But only bilateral or multilateral APA can really achieve the goal. To minimize taxpayer and governmental uncertainty and administrative cost, bilateral or multilateral APAS generally are preferable to unilateral APAS when competent authority procedures are available with respect to the foreign country or countries involved. (Donald L. Korb, 2005)Because an unilateral APA can provide only a partial resolution of cross-border transfer pricing issues because, although it confirms the tax treatment in China, it does not determine how the issues are to be resolved in the other country involved. Consequently, it does not eliminate the risk of double taxation in relation to the transfer pricing issues it addresses.

As introduced above, most of the APAS in China are unilateral ones. Up to now, there are only three bilateral APAS. Only a few countries adopt APA in their transfer pricing tax systems, and bilateral APAS take a substantially longer time to process than unilateral APAS, so it is difficult to sign more bilateral APAS. The unilateral APA remains a valuable, important component of Chinese APA system.

2.3 Limitations in implementing and administering APA

2.3.1 Great difficulties in figuring out critical assumptions and normal transaction price to get the ultimate profit ratio

In order to get the ultimate profit ratio of the taxpayer, critical assumptions which are accepted by both taxpayers and tax authorities must be figured out. These critical assumptions must be expressed in forms of objective business and economic standards. They can be expressed as a situation or results of taxpayers or an industry. In OECD's transfer pricing rules, there are seven critical assumptions which must be taken into consideration when signing an APA. They are: internal tax law and treaty clauses; custom duty, import limitation and rules made by government; taxpayers' economic situation, market share, market condition, ultimate sales price and sales amount; transaction risks for enterprises; exchange rate, interest rate and capital structure; categories of income and expenditure; enterprises'

organization form. It's difficult to decide which ones can be chosen to sign an APA among these factors.

On the other hand, during the evaluation period, it's difficult to figure out a uniform standard for methods of transfer pricing. The standard for the department in charge to evaluate the APA is also not easy to figure out, especially the transaction price in practice. If the principle of arm's length is still adopted in judging the connected enterprises' transactions, the APA will still have the fundamental defect of the traditional methodology which is used to adjust transfer pricing. What's more, because the quality of the goods, the produce and business time, the place and condition, environment of the normal transactions are different, the prices are different too; it is very hard to figure out a normal transaction price accepted by both taxpayers and different tax authorities.

All of these increase the difficulties for the APA to press forward in China, and make the pace of promoting APA very slowly.

2.3.2 Limitation in administering the APA

It is of great difficulty in administering APA system that APA is not sure to be effective. The efficiency of any system depends on its implementation and administration. As for the APA, tax authority must supervise and inspect the taxpayer in order to know if taxpayer obey the rules and keep the agreement after the sign of APA. Thus, it needs high levels of administrative methods and standards of the tax authority. Most of the countries in the world –especially those developing countries--can't meet these needs. In China, the administrative standards also need to improve greatly.

As to the establishment of organization and structure, the structure and the staff and their functions which administer the transfer pricing must be classified very clearly according to the international convention. (Yi Zhou, 2005) The tax officials who deal with transfer pricing and those who go in for APA fulfill their function separately. That means full-time tax officials are engaged in APA. Compared with the developed countries, there's no effective organization for tax administering on transfer pricing in China. Whatever in SAT, or in tax bureaus at basic level, fewer tax officials are engaged in tax administering on transfer pricing than those in developed countries. Let alone to disposing a rational separate distribution of tax staffs who deal with transfer pricing and APA. With the development of economy, mutual consulting and the bilateral APA negotiation will be on the rise. The limited structure and professional tax official will greatly hamper the promotion of APA in China. This problem will be more protruding in those developed regions where many foreign-funded enterprises lay their administrative organs.

On the other hand, a great number of professionals are needed to be competent at working on APA on account of the complexity and unknown risk during the whole process of APA. For example, in America, a coordinative group consisting of professionals from different fields is responsible for examining and approving the APA. The members of the groups include: (1) A leader who is in charge of negotiating with the enterprises, coordinating the different governments, and make draft of APA; (2) Full-time legal adviser who resolves the legal issues during the negotiation;(3) Acting manager and program manager who check up the issues of transfer pricing; (4) Experts on economics who foresee the economic development and analyze the financial situation; (5) A specialist who is proficient in analyzing the clauses of common tax treaties. This shows that in order to ensure the science and authority of the analysis and expectation, the countries which press forward the APA earlier attach great importance to sharing out the work and help one another among the experts from different fields. But we Chinese do research on APA later than other countries. And the qualified professionals on taxation, accounting and negotiation are so rare in China now. So the dispose of involved structure and staff which deal with APA plays a vital role in pressing APA forward smoothly.

2.4 Information disclosure

As part of the APA process, the taxpayer must apply prior year's data and future year's projections, including projected tax impact, and economic analyses of the transactions to be covered by the APA. Taxpayers are, in effect, laying their cards on the table. That's to say, they have voluntarily disclosed extensive (and sensitive) information about their operations and methods, to educate the SAT about their businesses. Once those data are given away, the taxpayers will suffer an irreparable loss. Although the tax authority has the responsibility to keep the information from giving away, the expansion of sphere of information disclosure increases the probability of being revealed especially when the APA isn't signed. In addition, the court also asks the taxpayers to disclose their sensitive information if there is a conflict between taxpayers and tax authorities. Thus, the risk that confidential and sensitive information might be given away will hamper taxpayers from signing a APA.

3. Countermoves and suggestions to overcome the difficulties

3.1 Simplify the procedure of APA.

First shorten the time period of signing an APA. By doing so, the flexibility and the successful rate of APA can be improved and the taxpayer's predictive revenue can be increased as well. At the same time, we can reduce the cost of obtaining an APA. Secondly, we should make up different procedure in accordance with different situations of different enterprises so that the labor and material resources can be deposited reasonably and then the working efficiency can be promoted.

3.2 Perfect the critical assumption

When the economic environment and the taxpayers' business activity changes greatly and the critical assumption doesn't change with that, the APA will be modified or even be concealed. Thus we must attach much importance to set up flexible critical assumption. Four aspects should be paid more attention to

3.2.1 Make the assumptions objective as possible as we can

Condition permitting, we must make the assumptions objective as possible as we can in case dispute between the two parties happens in the future. In practice, we can adopt the approach of deducing progressively. First make a lap presume on the factors which exert great influences on profit rate, then deduce the profit rate progressively. If there are some important factors or not successive factors, multi-scheme assumptions can be adopted. For example, when we presume the profit rate of an enterprise, first we can forecast its sale income by the status of its products in the international markets, the market share of its products, and its purchase orders. On account of the changes of the assumption conditions, the sale income may be high, medium and low. Then we can forecast its fixed cost and variable cost of product. Put the forecast results together, we can deduce the lap of gross profit rate of the given year. (He Jun) An APA with this kind of critical assumptions is very flexible so as to avoid accidents when it is carried out

3.2.2 The assumption must be distinguished from the applicable scope

The type of new products which the enterprise will produce must not be included in the applicable scope of APA, but belongs to the assumptions. In other words, when the professionals design the assumptions, they must take account of the new products.

3.2.3 The assumption must be distinguished from the taxpayer's obligation

The obligations that taxpayers must fulfill should be prescribed in APA. If a taxpayer doesn't execute according to the requirement, he violates the regulations of the APA, then the involved tax authority can ask him to fulfill his obligations in accordance with APA or conceal the APA. But they are only the obligations which the taxpayer must fulfill according to the clause of APA. They are not the assumptions, so they mustn't be prescribed in assumptions. Generally speaking, the assumptions can be designed in two sides. One is macro side, including economic environment, legal environment, etc; the other is micro side, including enterprises' business situation, accounting methods and so on. When we design the assumption, we must take a comprehensive account of taxpayers' specific circumstances, given operating environment, operating strategy and the concerned transactions.

3.3 Tighten up the administration on APA

3.3.1 Establish a simple and easy method of APA

In order to improve the management efficiency and successful rate of APA, we can adopt simple and easy method of APA at present and then transit to formal and normal APA. What matters is that this suit of simple and easy APA method must be scientific and reasonable determined by the nature of anti-tax avoidance. To establish a simple and easy method of APA, we should press forward the method of "tracing management" at first. Tracing management means that tax authorities should report the pricing strategies and business situations of those enterprises in the following years whose transfer pricing have been investigated and adjusted and supervise their behaviors. In order to let the enterprises keep the profit level, tax authorities should also present an interrogation over the enterprises' transfer pricing and the changes of enterprises' business situation regularly and on time. The local tax authorities in Shen Zhen city are the earliest tax authorities who have explored actively and carried out tracing management boldly. And then they attempted to adopt the advanced profit rate in tracing management which resulted in good efficiency. So now we should press forward it. But there is one thing we should pay attention to. Use the APA and the existed method for adjustment together. After adjusting the enterprises' transfer pricings which happened in the previous years, tax authorities must ask the enterprises to present their future development trend and market expectation and then decide the gross lap of profit rate for the following three years. On the basis of that, tax authorities and taxpayer can agree to sign a simplified APA. During the following three years, tax authorities must tighten up the tracing management in order to supervise the implement the APA.

3.3.2 Establish a concentration management mode of APA

Under the concentration management mode, SAT organize a special group to manage the affairs of advance pricing agreement in all overall manners, and set up structures which are posted in a number of chosen cities. The main task of the special group includes negotiating and signing APA, coordinating, supervising and releasing reports. Negotiating and signing means checking the date of APA, negotiating with the tax payers and other tax authorities from different countries and then signing APAS. Coordination includes transmitting the tax information which is exchange mutually between the concerned countries, transmitting the domestic information of APA and connecting concerned information with the aid of tax collection bureaus on the local level as well. Supervising includes inspecting the implementation of APAS and traced managing the taxpayers' implementation of APAS together with the local authorities. Releasing

reports includes explaining the development of that year's APA and transmitting the new trend of APA abroad. SAT makes a unified management on all-China APA on the basis of grass rooted tax authorities' territorial management.

This mode has some advantages. First, it helps to carry out the APA policy throughout the country and avoid the tax loss when local governments pursue their local interest. Thus, the efficiency of APA administration can be improved. Secondly, at present, not many tax officials are competent at managing affairs of APA in China. Under such circumstances, we can make full and concentration use of professional labor source to ensure the successive of APA by establishing a concentration management mode of APA. Thirdly, it helps to push forward the bilateral or multilateral APA. Bilateral or multilateral APAS involve the tax interest of concerned countries where the connected transactions take place, so they are the agreements between nations in the first place. They involve international harmonization inevitably. Such kinds of issues can only be solved by consulting between the general tax authorities of different countries.

3.3.2 Add the responsibility of taxpayers' producing evidence

When tax authorities and taxpayers have different opinions on the foundation of transfer pricing adjustment and the adjustment amount, which will have the responsibility to produce evidence? In practice, our tax authorities gain little resources about the international corporations' business situation. What makes the things worse is that there is no regulation to force the taxpayers to present the concerned data. Thus, tax authorities have no sufficient accordance to negotiate and adjust. The signed APA is only the result of testing the psychologies and negotiating technique of both sides. Under such kind of APA tax authorities' resources can be saved, but the government's tax revenue can't be protected from being eroded. Neither can the tax authorities in china get the data of the taxpayer' business activities abroad nor can go abroad to make an on-the-spot investigation. What's more, there are some obstacles in information exchange between countries. Now it's necessary to let the taxpayer take the responsibility to produce evidence which helps tax authorities supervise taxpayer's trend. A clear regulation should be made in the implementation rules that taxpayers have the obligation to present their management information abroad. If they can't produce reverse evidence to tax authorities' handling opinion, they must carry out the tax authorities' resolution; if they don't present the relevant management information in accordance with the law, they will be punished legally. By doing this, we can strengthen the tax control on international corporations.

3.3.3 Add a procedure of resolving controversy

It is inevitable that the controversy happens between tax authorities and taxpayer when tax authorities carry out the APA. Now there is no regulation on the ways of resolving the controversy in implementation rule. Some enterprises are afraid that their own rights and benefits may not be protected when the controversy happens, and then have misgivings on applying APA. We must dispel their misgivings and make them apply APA actively. Then a procedure of resolving controversy must be added in implementation rules. When the two sides have different opinions on the regulations in the agreement, they must discuss with each other first; if they can't agree with each other, then they can resolve the problem by administrative and judicial pronounce. This additional regulation can not only be favorable to tax connection and administration normally and defend the tax law from being violated, but also be favorable to protect the taxpayers' benefits.

3.4 Respect the taxpayers' desire and protect their business secrets

APA must be gained on a voluntary basis of taxpayers. If a taxpayer doesn't apply for an APA, the tax authority mustn't force the enterprise to sign APA. And when an enterprise quit during the course of negotiation of the APA for some reasons, the tax authority must respect the enterprise's desire. Only by doing this can we guarantee an APA 'S reasonable rule and simplified procedure to sign.

On the other hand, tax authorities have the obligation to protect taxpayer's business secrets. In the *implementation rules*, both the tax authorities and taxpayers are required to protect all the information which is collected during the whole course of the APA. But what kind of legal responsibilities should the tax authorities hold when they violate the obligation and make loss to the taxpayers? It is not clearly regulated in *implementation rules*. Then it is necessary to specifically regulate the tax authorities' obligations to protect the taxpayers' business secrets which are explored to them in the five phases of the APA and regulate the legal responsibilities of tax authorities when they violate this obligation.

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