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FOCUS

NEW ORDERS AND ROUTINES OF INTERNATIONAL ECONOMIC GOVERNANCE: PROGRESS AND PROSPECTS

TRANSFER PRICING IN BEPS PROJECT AND CHINA'S RESPONSE

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Abstract A major concern on base erosion and profit shifting (BEPS) is transfer pricing, which is discussed in BEPS Action Items 8–10 and 13. Actions 8–10 contain revised guidance, which ensures that transfer pricing rules secure outcomes that better align operational profits with the economic activities that generate them, as well as guidance on transactions involving cross-border commodity transactions and on low value-adding intra-group services. Action 13 contains a three-tiered standardized approach to transfer pricing documentation, including a minimum standard on country-by-country reports (CbCRs). However, the approach of Actions 8–10 still focuses on the restoration of the dysfunctional rules built on the arm's length principle, which is rooted in the principle of separate independent entity. The threshold of Action 13 excludes many large multinational enterprises (MNEs) from the CbCR requirement and deprives developing countries access to the information of MNEs below the threshold. Chapter 6 of the Chinese Corporate Income Tax Law, under the title "Special Tax Adjustments," provided the legal foundations of transfer pricing and transfer pricing documentation in China. To effectively implement the BEPS package in China and to comprehensively update the existing Circular 2, the State Taxation Administration (STA) released a Discussion Draft of a Circular on Implementation Measures for Special Tax Adjustments in September 2015, ranging from Action 3 (controlled foreign company rules), Action 8–10 (aligning transfer pricing outcomes with value creation) to Action 13 (transfer pricing documentation and country-by-country reporting) in details. Right now, a series of patches, such as the STA Bulletins 45, 42, 64, and 6, have been made to replace a substantial part of Circular 2.

Keywords base erosion and profit shifting (BEPS), transfer pricing, corporate income tax law, Actions 8–10, Action 13

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INTRODUCTION

Base erosion and profit shifting (BEPS) is not only a topic covered by global mainstream media, but also a top priority on the agenda of international organizations. In St. Petersburg, Russia in September 2013, the G20 leaders endorsed an action plan to address BEPS. On October 5, 2015, the OECD and G20 released the final BEPS package of 13 reports in conjunction with the 2015 Final Report of Explanatory Statement. The BEPS package represents the first substantial — and overdue — renovation of the international tax standards in almost one hundred years, and also marks an unprecedented turning point in the history of international tax law.[1] Its mission is to align the location of taxable profits with the location of economic activities and value creation. Some generally accepted principles of international tax law — including the single tax principle, the benefit principle, the non-discrimination principle, and the transparency principle — are incorporated in the reports. Although the real effect of the BEPS project remains to be evaluated, the BEPS project will help to tackle BEPS issues. In doing so, the project will

[1] Reuven S. Avi-Yonah & XU Haiyan, *Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight*, 6(2) Harvard Business Law Review, 207 (2016).

empower governments in the tax collection from multinational enterprises (MNEs) in a coordinate manner, level the playing field for the business community and governments, and restore the public confidence on tax law. Despite considerable progress, there are many shortcomings with the BEPS project due to the short two-year framework. Hence, the project is not the culmination of international tax law reform; rather, it is the first step toward the modernization of global tax governance in the long run.

A major BEPS concern is transfer pricing. Transfer pricing is the price charged by one member of a multinational organization to another member of the same organization for the provision of goods or services or the use of a property, including intangible property. In other words, transfer pricing relates to the price applied to inter-company transactions. Transfer pricing rules, which are set out in Article 9 of tax treaties based on the OECD and UN Model Tax Conventions and the Transfer Pricing Guidelines (TPG), are used to determine the conditions on the basis of the arm's length principle (ALP), including the price, for transactions within an MNE group. Transfer pricing rules serve to allocate income earned by a MNE among those countries in which the company does business.

In general, this paper is divided into three parts. Part One will analyze the achievements of Actions 8–10 and Action 13 of BEPS regarding the transfer pricing, as well as limits of Actions 8–10 and Action 13. Since China has actively participated in both developing and implementing the BEPS project, Part Two will give a brief overview of China's involvement in the BEPS project. Part Three will summarize China's responses to transfer pricing measures (Actions 8–10 and 13).

I. ACHIEVEMENTS OF ACTIONS 8–10 AND ACTION 13

A. General Requirements of BEPS Actions 8–10 and 13

Transfer pricing legislation requires that transactions among international affiliated enterprises should comply with the ALP. This valuation principle is commonly applied to commercial and financial transactions between related companies. It says that transactions should be valued as if they had been carried out between unrelated parties, each acting in his or her own best interest. There are several methods regulating transfer pricing, namely comparable uncontrolled price (CUP) method, resale price method, cost plus method, transactional net margin method (TNMM), and transactional profit split method.

BEPS Actions 8–10 and 13 focus on areas of concern involving transfer pricing, and aim at bringing about rule changes involving the treatment of intangibles, risks and capital, and other high-risk transactions, as well as improving new "country-by-country" reporting requirements. It is a minimum standard for countries to adopt country-by-country reporting procedures for a three-tiered reporting system of master file, local

file, and country-by-country reports (CbCRs), and to adopt international agreements and procedures to automatically exchange CbCRs.[2]

Additional prescriptions include undergoing periodic OECD monitoring of CbCR implementation,[3] revising allocation rules to attribute risks to related parties on the basis of control and financial capacity,[4] revising allocation rules to prevent legal ownership as sole determinant of source of income attributed to intangibles,[5] revising allocation rules to attribute value to companies that perform important functions,[6] limiting non-controlling companies to risk-free return or less on financial transactions,[7] and limiting values attributed to group synergy to companies contributing to synergistic benefits.[8]

1. Achievements of Actions 8–10: Assure Transfer Pricing Outcomes Are in Line with Value Creation. — The existing transfer pricing rules fail in prices and efficient allocation of the income of MNEs among taxing jurisdictions. Some MNEs have been able to use and/or misapply those rules to separate income from the economic activities that produce that income and to shift it into low-tax environments. This most often results from transfers of intangibles and other mobile assets for less than full value, the over-capitalization of lowly taxed group companies, and from contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties.

As special measures, either within or beyond the ALP, may be required with respect to intangible assets, risk, and over-capitalization to address these flaws, the mission of Actions 8, 9, and 10 is to assure that transfer pricing outcomes are in line with value creation. The existing standards in this area have been clarified and strengthened, including guidance on the ALP and an approach to ensure the appropriate pricing of hard-to-value intangibles has been agreed upon within the ALP. Action 8, Action 9, and Action 10 are closely connected to each other in this area.

As misallocation of the profits generated by valuable intangibles has heavily contributed to BEPS concerns, Action 8 aims to develop rules to prevent BEPS by moving intangibles among group members. This involves: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation; (iii) developing transfer pricing rules or special measures for transfers of

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[2] BEPS Action 13 Report, at 9–10.

[3] BEPS Action 13 Report, at 10, 23.

[4] BEPS Actions 8–10 Reports, at 10.

[5] Id.

[6] Id.

[7] BEPS Actions 8–10 Reports, at 11.

[8] Id.

hard-to-value intangibles; and (iv) updating guidance on cost contribution arrangements. Action 8 looked at transfer pricing issues relating to controlled transactions involving intangibles, since intangibles are by definition mobile and they are often hard-to-value. To assure the appropriate pricing of hard-to-value intangibles, Action 8 has devised an additional tool for countries to address the use of information asymmetry between taxpayers and tax authorities to undervalue intra-group transfers of intangibles.

Action 9 aims to develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This involves adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules need to require alignment of returns with value creation. Under Action 9, contractual allocations of risk are respected only when they are supported by actual decision-making and thus exercising control over these risks.

Action 10 focuses on other high-risk transactions and aims to develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This Action adopted transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be re-characterized; (ii) clarify the application of transfer pricing methods, in particular, profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses. Action 10 deals with the scope for addressing profit allocations resulting from controlled transactions which are not commercially rational, the scope for targeting the use of transfer pricing methods in a way that results in diverting profits from the most economically important activities of the MNE group, and the use of certain types of payments (such as management fees and head office expenses) between members of the MNE group to erode the tax base in the absence of alignment with the value-creation.

The combined report contains revised guidance which ensures that transfer pricing rules secure outcomes that better align operational profits with the economic activities which generate them. The report also contains guidance on transactions involving cross-border commodity transactions and on low value-adding intra-group services. As those two areas were identified as having critical importance by developing countries, the guidance will be supplemented with further work mandated by the G20 Development Working Group, which will provide knowledge, best practices, and tools for developing countries to price commodity transactions for transfer pricing purposes and to prevent the erosion of their tax bases through common types of base-eroding payments.

2. Achievements of Action 13: Re-Examine Transfer Pricing Documentation. — A key issue in the administration of transfer pricing rules is the asymmetry of information

between taxpayers and tax administrations, which could undermine the administration of the ALP and enhance opportunities for BEPS.

In many countries, tax administrations do not have a whole picture of a taxpayer's global value chain. Divergences between approaches to transfer pricing documentation requirements could also increase the compliance costs for businesses. In this respect, it is important that adequate information about relevant functions performed by other members of the MNE group in regard to intra-group services and other transactions is made available to the tax administration.

Although MNEs demand transparency of tax law administration from the tax authorities, they are reluctant to be transparent to the tax authorities. BEPS is difficult to survive in the transparent international tax environment. Improved and better-coordinated transfer pricing documentation is vital to the reliable quality of information provided to tax administrations and affordable compliance burden on MNEs.

Therefore, it is urgent to develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The MNEs should provide all relevant governments with needed information on their global allocation of the income, economic activity, and taxes paid among countries according to a common template.

The Action 13 report contains a three-tiered standardized approach to transfer pricing documentation, including a minimum standard on CbCR. First, the guidance on transfer pricing documentation requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a "master file" that is to be available to all relevant tax administrations.

Second, it requires that detailed transactional transfer pricing documentation be provided in a "local file" specific to each country, identifying material related-party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.

Third, large MNEs are required to file a CbCR that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid, and accrued and other indicators of economic activities. The large MNEs refer to those with annual consolidated group revenue equal to or exceeding 750 million EUR. CbCRs should be filed in the ultimate parent entity's jurisdiction and shared automatically through government-to-government exchange of information. In limited circumstances, secondary mechanisms (including local filing) can be used as a backup. An agreed implementation plan will ensure that information is provided to the tax administration in a timely manner, that confidentiality of the reported information is preserved and that the CbCRs are used appropriately.

It is recommended that the first CbCRs be required to be filed for MNEs' fiscal years starting from January 1, 2016. Of course, some jurisdictions may need time to transform the reporting system into their domestic legislation.

For the first time, the three documentation tiers will require taxpayers to disclose consistent transfer pricing positions, will provide tax administrations with useful information of the entire picture of MNE operation, and enable them to assess transfer pricing risks to make determinations about whether, where, when, and how audit resources can most effectively be deployed. By ensuring a consistent approach to transfer pricing documentation across countries and by limiting the need for multiple filings of CbCRs through the use of information exchange among tax administrations, MNEs will also see the benefits in terms of a more limited compliance burden. In fact, anticipation of this reporting system has already begun to discourage aggressive tax planning.

B. The Limits of Actions 8–10 and Action 13

1. The Limits of Actions 8–10. — Actions 8–10 are the most important part of the BEPS project in addressing related-party transactions of MNEs. Of course, the transfer pricing documentation requirements in Action 13 are also closely relevant to these three actions. The purpose of Actions 8–10 is to assure that transfer pricing outcomes are in line with value creation. The proposals on transfer pricing have made extensive revisions to the OECD's TPG, which in fact will further strengthen the discretionary power for tax authorities to adjust them. Many proposals take the form of international standards, which could have some direct effects as international "soft law."

Although the goal is totally correct, the approach of Actions 8–10 is very problematic. The solutions still focus on restoration of the dysfunctional rules built on the ALP, which is rooted in the principle of a separate independent entity. According to the ALP, all intra-group transactions are supposed to be rational and reasonable as commercial transactions between unrelated parties in comparable economic circumstances.

To implement the ALP, Actions 8–10 made transfer pricing rules more sophisticated and complex, so as to authorize tax authorities to re-characterize the related-party transactions within the MNE group. To find the available comparables, the tax authorities are required to make careful and informed judgments in good faith based on subjective analysis of detailed facts and circumstances relevant to the functions, assets, and risks undertaken by different group members located in different jurisdictions.

As the approach of Actions 8–10 is inevitably subjective and discretionary, the real effect of attribution of the tax base of MNEs will rely on the interactive bargaining and negotiation between MNEs and tax authorities. If the game is not fair enough, either under-taxation or over-taxation will arise. To avoid under-taxation, tax authorities will tend to maximize their discretionary power of re-characterizing, which might lead to the

strong opposition from the MNE taxpayers. For the similar reasoning, to avoid over-taxation, MNEs might upgrade their aggressive BEPS schemes. As a result, both enforcement and compliance costs will be increased, and more disputes will be created. Moreover, as a subjective judgment will be made independently and separately by different national authorities, different jurisdictions might make conflicting re-characterization conclusions on the same intra-group transaction.

The complicated and uncertain approach of re-characterizing intra-group transactions is most challenging for developing countries, as they do not have the necessary resources and expertise to administer the revised version of TPG. Of course, it is also very costly or even impossible for developed countries to search for precise and genuine comparables. Although the G20 Development Working Group promise to help developing countries deal with the problem of lack of comparables, it is not clear whether a simple, effective win-win solution on pricing method will be made available in the near future. We do not wish to see any form of one-sided solutions, including purely subjective discretion favored by tax authorities, and a purely notational transfer pricing method favored by MNEs.

As indicated earlier, the principle of separate independent entity and the principle of arm's length are at most legal fictions, which do not actually exist in commercial reality. In fact, even the terms of transactions between independent and unrelated parties are not necessarily fair and reasonable, if the two parties do not have equivalent negotiation powers at a level playing field. As the comparability analysis is not practical and feasible as anticipated, we propose the formulary apportionment system based on the single unitary entity principle. In other words, the MNE group will be treated as a single and unitary entity, and all intra-group transactions will be disregarded. Compared with the approach of separate entity, this route will be more simple, direct, and effective in addressing the BEPS concerns arising from intra-group related-party transactions.

In fact, OECD has already noticed the proposed alternative income allocation systems, including formula-based systems. Unfortunately, OECD finally refused to replace the current transfer pricing system. The reason is not flawed proposed alternatives but the familiarity with the current approach and the reluctance to switch to a new approach by launching ambitious reform.

Although the US and other states stubbornly defended and insisted on the dysfunctional ALP for transfer pricing adjustments and resisted alternatives, there is no credible evidence to indicate that 34 OECD members have reached clear and concrete agreement on unanimously opposing the system of formulary apportionment of profits based on the single entity principle. Moreover, there are no scientific research findings to indicate that the single entity approach has more weakness and less strength than the separate entity approach.

To offer easy, certain, clear, and predictable solutions to the BEPS concerns arising from transfer pricing, formulary apportionment methodology should be adopted, and the allocation of assets, payroll, sales, and other factors need to be restructured and weighted. This will better allocate the tax base of MNEs according to the location where economic activities and value creation take place. Needless to say, to make the formulary apportionment approach successful and sustainable, the principle of separate independent entity needs to be replaced by the principle of single unitary entity.

2. The Limits of Action 13. — The annual CbCR is the most important measure in Action 13 to ensure minimum transparency of transfer pricing. However, there are some limitations to it.

First, the threshold of 750 million EUR of annual consolidated group revenue is unreasonably high for major MNEs in developing countries, although this threshold is tailor made for the needs of developed countries. Such a threshold will exclude many large MNEs from the CbCR requirement and deprive developing countries access to the information of MNEs below the threshold. In fact, many large MNEs have annual consolidated group revenue of less than 750 million EUR. Needless to say, some large MNEs will be motivated enough to manipulate their group revenue to a level of less than 750 million EUR. In our opinion, all MNEs should be subject to CbCR requirement.

Second, all the transfer pricing documents are only required to submit to the tax authorities, but not to the public and civil society organizations. It seems that the philosophy of this institutional arrangement is to preserve the confidentiality of the information and to ensure the appropriate use by the government. However, the commercial confidentiality is not strong enough to defeat the public's right to information of BEPS. The relevant stakeholders and the public need to have access to the MNEs' transfer pricing documentation. The reason is very simple; BEPS could hurt other taxpayers and stakeholders in relevant jurisdictions. We believe that BEPS concerns will be more effectively addressed with the active and informed participation of stakeholders and the public based on disclosed transfer pricing. Under the public pressure and support, the domestic legislatures and tax authorities will be more diligent and competent in tackling the BEPS issues. Of course, a high level of transparency will also benefit the MNEs, as it will significantly reduce compliance burden and will improve their public image of credibility in terms of BEPS concerns.

Third, the CbCRs are only required to file with the tax authority of the MNE's ultimate parent entity's jurisdiction, instead of all the tax authorities of the jurisdictions where the MNEs have taxable business presences. To ensure rapid availability of CbCRs, we urge the CbCRs to be shared automatically and simultaneously among all the interested jurisdictions, which have good reason to believe the existence of taxable presences by MNEs. Of course, if the MNEs' transfer pricing documentation is made available to the public, the double standards will be completely rooted out.

Fourth, although the content of CbCRs covers the major issues of transfer pricing, it is difficult to exhaust all the data needed by tax authorities to assess the BEPS concerns arising from transfer pricing. Therefore, necessary data should be added into the CbCRs on a regular basis.

II. OVERVIEW OF CHINA'S INVOLVEMENT IN THE BEPS PROJECT

China has actively participated in both developing and implementing the BEPS project. China's tax base has been seriously eroded by aggressive international tax planning that has the effect of artificially shifting profits to locations where they are subject to non-taxation or substantially reduced taxation.

In the three earlier decades since the late 1970s, China had received more inbound foreign direct investments including advanced technologies and intangibles than the outbound investments of Chinese investors. However, as China started to implement the "going global" strategy in the 21st century, in particular the Belt and Road Initiative, more and more China-based corporations became increasingly active in outbound investment and intangibles export oversea. In response to the new scenario of increasingly accelerated globalization of China-based MNE groups, China has to take a very holistic approach to deal with the BEPS challenges from different perspectives, including domestic action (Actions 2–5), treaty-based action (Actions 6–7) and transfer pricing measures (Actions 8–10 and 13).

In the post-BEPS era, China is expected to implement the BEPS project in a more consistent and coherent way, and will take whatever measures necessary to guarantee the successful implementation of the BEPS package in collaboration with the global community. That is why China's State Taxation Administration (STA) has quickly translated many minimum standards and recommendations of the BEPS project into domestic regulations.

A. China as a Victim of BEPS

Although China is the second largest economy, the largest trader of goods, the top third country of both outbound and inbound direct investment in the world,[9] China is one of the major victims of BEPS. In the past four decades of market-oriented reform since the late 1970s, China's tax base has been seriously eroded by aggressive international tax planning that has the effect of artificially shifting profits to locations where they are subject to non-taxation or reduced taxation.

In response to the Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries of the UN Committee of Experts on International Cooperation in

[9] Reuven S. Avi-Yonah & XU Haiyan, *China and BEPS*, MDPI, 4, 7 (2018)/G20beoction Action 13, g, corporate income tax lawLaw.

Tax Matters (hereinafter referred to as the "UN Tax Committee"), China clearly indicated, "China currently does not have a system which quantitatively analyzes the base erosion in our country." Yet, we do find, and it is obvious, that the major threat China faces is that many MNE groups have shifted their profits by means of tax planning and transfer pricing.

Without any exaggeration, almost all the highly speculative tax evasion and avoidance strategies and tactics have been widely used by MNEs doing business in China, including but not confined to hybrid mismatch arrangements, controlled-foreign-company (CFC), interest deductions, harmful tax practices, treaty shopping, artificial avoidance of permanent establishment status, manipulative transfer pricing, etc.

In particular, China has identified some most common BEPS practices and structures including the following. First, MNE groups tend to adopt transfer pricing principles and methodologies in such intra-group dealings as purchase and sale transactions, financing transactions, equity transfer transactions, and service provision transactions, in order to lower the profits of their subsidiaries in China. Second, MNE groups establish shell companies with no genuine economic substances in the low-tax jurisdictions and tax heavens to shift profits.

Chinese tax authorities make their judgment by auditing MNE groups' annual filing and reviewing their contemporaneous documentation, considering the profit levels of the industry and comparable companies, and performing functional analysis. They then make adjustments as necessary when their judgment is made. However, China has encountered two primary obstacles in assessing whether the appropriate amount of profit is reported in China and in ensuring that tax is paid on such profit. First, China is in lack of comparable companies. China's domestic legislation requires that the listed companies must make mandatory disclosures, but the unlisted companies are not required to make such disclosures. Therefore, it is unrealistic to find comparables from the over 2,000 listed companies in China. Second, some corporate taxpayers are often unwilling to provide the tax authorities with necessary information, such as resale prices, especially the business operation and profits throughout the supply chain. Their reluctance to cooperate increases the difficulties for the tax authorities to have a big picture in mind in their audits.

As far as the most important BEPS action is concerned, China believes that transfer pricing-related actions are most important to it. China also considers BEPS Action 11 increasingly important, as China is dedicated to establish methodologies to collect and analyze data on BEPS, which is something developing countries should work hard on.

To warrant sustainable growth and development, China has good reasons to share the priorities identified by the OECD/G20 BEPS package and to take a stronger and more coordinated stance in fighting the excessive BEPS opportunist behaviors of MNEs that seek to avoid paying their fair share of taxes. Generally speaking, China has prioritized its efforts on the implementation of BEPS project in various aspects in the past years.

B. Active Participation in the Development of BEPS Project

China has been active in shaping the process of developing the BEPS package not only by and through the OCED/G20 platform, but also by and through the UN Tax Committee. As a subsidiary body of the Economic and Social Council, the UN Tax Committee is responsible for keeping under review and updating, as necessary, the UN Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries; further, it provides a framework for dialogue with a view to enhance and promote international tax cooperation among national tax authorities and assesses how new and emerging issues could affect this cooperation. The Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries was established at the ninth session of the UN Tax Committee in October 2013, aiming to communicate with officials in developing countries and ensure their views are incorporated into the OECD/G20 BEPS project as well as the on-going United Nations tax cooperation work. China has been closely working with other countries in advancing the progress of the BEPS project, including but not confined to making submissions to the subcommittee questionnaire on how developing countries view and prioritize BEPS project issues in 2014.

As a key partner of the OECD plus a member of the G20, China has contributed actively to the development of the BEPS package. As Angel Gurría, Secretary-General of the OECD, indicated, China's unique perspectives and policy experience have enriched the work of the OECD, increased the relevance of our analyses, and supported a more inclusive global policy debate in today's challenging global economic environment. Looking ahead, even stronger engagement of China with the OECD would help increase recognition of the country's reform progress and strengthen its role in global economic governance.

To be well prepared for the involvement at the level of OECD discussion on BEPS, the STA set up both a leadership group and working group on the G20 tax reform project, and clarified the duties and working plans of these two groups. More than 50 officials have participated in the conferences, research activities, and advice feedback on all relevant topics of the BEPS project. The STA also appointed its representative to the steering committee of the BEPS, working with other committee members on designing, supervising, and reviewing the proposed BEPS actions. From 2013 to 2015, the STA has participated in 86 meetings relevant to the BEPS project, and submitted over 1,000 pieces of position statements and proposals to the OECD. Many of the proposals have been adopted and reflected in the final BEPS package. China has made significant contributions to the recognition of core principles of the BEPS package and the successful completion of the BEPS project, and also effectively advocated for developing countries and emerging economies.

To reflect and accommodate reasonable claims and suggestions from the local tax authorities, business community, and the civil society, the STA communicates with the

interested organizations and individuals on a regular basis. In addition to promoting the mutual understanding between the BEPS Working Group and the local tax authorities responsible for international tax law enforcement, the STA has paid great attention to the opinions of the MNEs, domestic firms, accounting firms, tax consulting firms, and universities.

The dialogues and interactions between the government and the private sector has enabled the STA to have a clear picture of the different concerns and expectations of taxpayers, consulting firms, and independent third parties for the purpose of making informed and feasible decisions on shaping and implementing the BEPS project. Needless to say, the technical details of the BEPS package and the domestic rules and mechanism are also easy to be understood by taxpayers and professionals. The informed academia is also able to advise the government in choosing better policy alternatives in case of controversy.

China's active participation in the formulation of the BEPS package naturally leads to its efficient translation of BEPS package into domestic rules. In addition to successfully introducing some of its best practices into the BEPS package, China has opportunities to understand the positions and rationales of other jurisdictions. Thus, potential misunderstandings could be minimized in the process of bilateral or multilateral collaboration on implementation of the BEPS package.

C. Chinese Legal Framework of Corporate Income Tax as It Relates to BEPS Implementation

The China's Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (hereinafter referred to as the "ITLEFIFE") of April 9, 1991[10] created many measures providing tax relief for the purpose of boosting foreign investment. For example, under Article 8(1) of the ITLEFIFE, any manufacturing enterprise with foreign investment scheduled to operate for a period of no less than ten years shall, from the year beginning to be profitable, be exempted from income tax in the first and second years and allowed a fifty percent reduction in the third through fifth years. However, the income tax exemption or reduction for enterprises with foreign investment engaged in the exploitation of resources such as petroleum, natural gas, rare metals, and precious metals shall be regulated separately by the State Council. Enterprises with foreign investment which actually operate for a period less than ten years, shall repay the amount of income tax exempted or reduced.

Although there are no exact statistics on the use of these provisions and their

[10] See 中华人民共和国外商投资企业和外国企业所得税法 (*Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises of the People's Republic of China*), issued by the National People's Congress.

effectiveness, many foreign-funded enterprises and foreign enterprises benefited mainly from the tax holidays offered by the ITLEFIFE. However, most of the tax reliefs offered to the enterprises with foreign investment and foreign enterprises were not available to Chinese domestic firms governed by the Interim Regulation on Corporate Income Tax promulgated by the State Council on December 13, 1993. The dual tax incentives standards and the tax reliefs only available to foreign firms were criticized by many domestic firms, especially private firms, as discrimination against domestic firms. Theoretically speaking, the dual tax incentives standards were incompatible with the national treatments and fair competition requirements of globalized market economy. Therefore, it is necessary to terminate the dual tax incentives relief standards for domestic firms and foreign firms after China joined World Trade Organization in 2001.

The China's Corporate Income Tax Law (hereinafter referred to as the "CITL"), applicable to both domestic and foreign firms, was promulgated on March 16, 2007, and came into force as of January 1, 2008.[11] The ITLEFIFE was repealed simultaneously as of January 1, 2008. To ensure a smooth transitional period, Article 57 of the CITL declares, for enterprises that were established prior to the promulgation of the CITL and enjoyed lower tax rates according to the provisions of the previous tax laws and administrative regulations, their income tax rates shall, according to the provisions of the State Council, be gradually transferred to the tax rate provided in the CITL within five years after the CITL is promulgated. The enterprises that have enjoyed the preferential treatment of tax exemption for a fixed term may, according to the provisions of the State Council, continue to enjoy such treatment after the promulgation of the CITL until the fixed term expires. However, for those that have failed to enjoy the preferential treatment due to failure to make profits, the term of preferential treatment may be counted as of the year when the CITL is promulgated. The high- and new-tech enterprises that need the key support of the state newly established in the particular areas established by law for developing foreign economic cooperation and technological exchanges or in the areas where the State Council has provided for the implementation of the above-mentioned special policies may continue to enjoy transitional preferential tax treatments, according to the specific measures to be formulated by the State Council. Other enterprises falling in the encouraged category as already determined by the State Council may enjoy the preferential treatment of tax reduction or exemption according to the provisions of the State Council.

Therefore, the implementation of the BEPS package in China has to be conducted in the context of the Chinese tax legal system based on the CITL and its subordinated regulations and guidance.

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[11] See 中华人民共和国企业所得税法 (*Corporate Income Tax Law of the People's Republic of China*), issued by the National People's Congress.

III. RESPONSES TO TRANSFER PRICING MEASURES (ACTIONS 8–10 AND 13)

A. The Legal Framework of Transfer Pricing and Transfer Pricing Documentation in China before the Release of the BEPS Package in 2015

Chapter 6 of the CITL, under the title "Special Tax Adjustments," provided the legal foundations of transfer pricing and transfer pricing documentation in China, including the authorization of tax authorities to adjust the tax, the ALP, cost contribution agreements (Article 41), advance pricing arrangements (APA, Article 42), annual report on the related transactions, adjustment methodology, CFCs (Article 45), thin capitalization (Article 46), general anti-tax avoidance (GATA, Article 47), etc. Chapter 6 of the Implementation Regulations of Corporate Income Tax Law (hereinafter referred to as the "CITLIR") further defined the terms used by Chapter 6 of the CITL in detail.

For example, Article 43 of the CITL imposed the transfer pricing documentation requirements in China. When an enterprise files its annual corporate income tax returns with the tax authority, it shall enclose an annual report on the related-party transactions. When the tax authority investigates into the related-party transactions, the enterprise and its affiliates as well as other enterprises relevant to the affiliated transactions under investigation, shall provide the pertinent documents.

Article 36 of the Law on the Administration of Tax Collection (hereinafter referred to as the "LATC") authorized Chinese tax authorities to make reasonable adjustments in case of the receipt or payment of charges or fees which are not priced at arm's length prices and results in a reduction of the taxable income.

Pursuant to the CITL, the CITLIR and the bilateral tax treaties on the avoidance of double taxation, the STA released the Measures for the Implementation of Special Tax Adjustments (for Trial Implementation) of 2009 (Circular 2)[12], which represents the most comprehensive and significant regulation in addressing the transferring pricing and transfer pricing documentation in China before the release of the BEPS package in 2015.

B. Overview of the Transfer Pricing and CbCR Changes in China

To effectively implement the BEPS package in China and to comprehensively update the existing Circular 2, the STA released a Discussion Draft of a Circular on Implementation Measures for Special Tax Adjustments (hereinafter referred to as the "Discussion Draft") in September 2015, ranging from Action 3 (CFC rules), Actions 8–10 (aligning transfer pricing outcomes with value creation) to Action 13 (transfer pricing documentation and country-by-country reporting) in detail. Compared with 13

[12] See 特别纳税调整实施办法(试行) (*Implementation of Special Tax Adjustments (for Trial Implementation)*), issued by the STA.

chapters and 118 articles in the Circular 2, there are 16 chapters and 168 articles in the Discussion Draft of 2015.

Although the long-expected new single version of Circular 2 has not been finalized yet, a series of patches have been made to replace the substantial part of Circular 2. For example, Article 69 of the Circular 2 was replaced by the STA Bulletin 45 of June 16, 2015. Chapters 2–3, Articles 74 and 89 of the Circular 2 were replaced by the STA Bulletin 42 on Matters concerning Improving the Administration of Affiliation Reporting and Contemporaneous Documentation of June 29, 2016. Chapter VI of the Circular 2 was replaced by the STA Bulletin 64 on the Issues concerning Improving the Administration of Advance Pricing Arrangements of October 11, 2016. Chapters 4–5, 10–11 of the Circular 2 were repealed by the STA Bulletin 6 on Measures for the Administration of Special Tax Investigation and Adjustments and Mutual Agreement Procedures of March 17, 2017.[13]

Following the release of the aforementioned Bulletins, the majority of innovative institutional arrangements proposed in the 2015 Discussion Draft have been produced as a series of separate items. It is likely that the remaining parts of the Discussion Draft will also be released as piecemeal documents, rather than as a single comprehensive regulation. As a result, the existing valid parts left in the Circular 2 are only Chapter 7 (cost sharing agreements) except Articles 69 and 74 annulled by the Bulletin 42, Chapter 8 (CFC), Chapter 9 (thin capitalization) except Articles 89 annulled by the Bulletin 42, and Chapter 10 (general anti-avoidance).

Bulletin 45 of 2015, Bulletins 42 and 64 of 2016, and Bulletin 6 of 2017 have not only substantially updated the transfer pricing specific clauses of Circular 2, but also basically reflected the final results of the BEPS package, especially Actions 8–10, and Action 13. As China has fully endorsed the underlying standards on transfer pricing, the BEPS project has substantially promoted the convergence of transfer pricing standards between China and other countries.

C. Transfer Pricing Documentation Requirements of Bulletin 42 of 2016

The CbCR and contemporaneous documentation are one of the four minimum standards of the BEPS package. To implement the BEPS Action 13, the STA released Bulletin 42 of 2016, which fundamentally updated the previous requirement for contemporaneous documentation under Chapter 2, Chapter 3, Article 74 and Article 89 of the Circular 2, and the requirement for annual reporting of related-party transactions under the Circular 114.

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[13] SAT, 关于发布《特别纳税调查调整及相互协商程序管理办法》的公告 (*Announcement on Issuing the Measures for the Administration of Special Tax Investigation and Adjustments and Mutual Agreement Procedures*), available at http://www.chinatax.gov.cn/n810341/n810755/c2538695/content.html (last visited Jan. 26, 2020).

As the first step of the STA to localize OECD/G20 BEPS project recommendations into domestic legislation, Bulletin 42 introduced the three-tiered framework of comprehensive related-party transactions reporting and improved the existing contemporaneous documentation, based on Circular 2. Bulletin 42 established ambitious transfer pricing compliance requirements at two levels: (i) annual report forms on related-party transactions (RPT Forms), including three forms/tables of CbCR; and (ii) three-tiered contemporaneous documentation, including master file, local file, and special file. As the CbCR is incorporated in the RPT Forms of 2016, China has developed four-tiered standardized approach (master file, local file, special file, and CbCR).

Any resident enterprise subject to tax levied on auditing accounting books and non-resident enterprises with establishments or offices in China subject to corporate income tax levied on an actual basis, should report its related-party transactions in a fiscal year by filling the RPT Forms, along with the annual corporate income tax return, by May 31 of every fiscal year.[14]

Bulletin 42 recognizes five types of related-party transactions: (i) transfer of the right to use or ownership of tangible assets, including commodities, products, buildings and structures, means of transportation, machinery equipment, and tools and instruments; (ii) transfer of financial assets, including accounts receivables, notes receivables, other receivables, equity investment, debt investment, and the assets formed by derivative financial instruments; (iii) transfer of the right to use or ownership of intangible assets, including patent right, know-how, trade secrets, trademark right, brands, list of clients, sales channels, franchised rights, government licensing, and copyright; (iv) accommodation of funds, including all types of long- and short-term loans (including capital pool of the group), guarantee expenses, all types of prepayments with accrued interest, delayed receipts and payments; and (v) trading of services, including market investigation, marketing planning, agency, design, consulting, administration, technical services, contract research and development, maintenance, legal services, financial management, auditing, recruitment, training, and centralized procurement.[15]

Under Article 11 of the Circular 2 and Circular 114, there were nine old RPT Forms. To enhance the global transparency of the BEPS picture of the MNE group, Bulletin 42 increased the lengths of RPT Forms to 22 items, including reporting entity information form; annual summary form on related-party transactions; related-party relationship form; transfers of ownership in tangible assets form; transfers of ownership in intangible assets form; transfers of rights to use tangible assets form; transfers of rights to use intangible assets form; financial assets transaction form; financing form; related-party services form; equity investment form; cost contribution agreement form; outbound payment form;

[14] Art. 1 of the Bulletin 42; Art. 54 of the CITL.

[15] Art. 4 of the Bulletin 42.

overseas related-party information form; financial analysis form of annual affiliated transactions between enterprises (unconsolidated); financial analysis form of annual affiliated transactions between enterprises (consolidated); form on the global allocation of income, taxes, and business activities; list of entities within the multinational group; and additional information. The last three forms on the CbCR should be prepared in both Chinese and English.

Given the fact that not every table/form in the 22 RPT Forms is mandatory for the taxpayer to file, and given the different thresholds for the taxpayers to prepare certain forms, this author speculates that, although some MNEs need to file all the RPT Forms, most taxpayers will be only required to file no more than 9 forms before the release of Bulletin 42. The STA also expressed the same idea.[16]

As envisaged by the BEPS Action 13 Report, the CbCR will provide annually the amount of revenue, profit before income tax, income tax paid and accrued, number of employees, stated capital, retained earnings, tangible assets, and business activities of each entity of the MNE group in each tax jurisdiction. Following the model legislation of the BEPS Action 13 Report, Bulletin 42 made it mandatory for large MNEs to file the CbCR in three forms/tables, as part of RPT Forms of 2016, for the purpose of disclosing the global allocation of the income, taxes paid, and economic activity among countries.

In the past decades, Chinese tax authorities have complained about the difficulties in acquiring the full global picture of MNEs' value-creating activities and profit allocations. With the help of the CbCR, tax authorities will obtain a preliminary understanding of the allocation of an MNE's profits around the globe, the distribution of the entities/jurisdictions engaging specific activities along an MNE's value chain, and the relevant tax positions for each of the tax jurisdictions. Of course, the authentic, accurate and complete CbCR will also help the MNEs demonstrate their compliance with the ALP on their transfer pricing activities. Therefore, the CbCR will benefit both the tax authorities and the taxpayers.

The primary reporting entity is the ultimate holding company of the MNE group with annual consolidated group revenue in the immediately preceding fiscal year of not less than 5.5 billion CNY — roughly equivalent to the threshold of 750 million EUR as specified under the BEPS Action 13 Report. The ultimate parent entity is able to consolidate the financial statements of all constituent entities under its umbrella, while its own financial statements cannot be consolidated by any other enterprises. The secondary reporting entity is the constituent entity nominated or designated by the MNE group to file the CbCR.[17]

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[16] STA, 关于完善关联申报和同期资料管理有关事项的公告 (*Announcement of the State Administration of Taxation on Matters concerning Improving the Administration of Affiliation Reporting and Contemporaneous Documentation*), available at http://www.chinatax.gov.cn/n810341/n810755/c2208516/content.html (last visited Jan. 30, 2020).

[17] Art. 5 of the Bulletin 42.

Chinese tax authorities may also request a taxpayer under special tax investigation to provide a CbCR in any of the following circumstances: (i) The MNE group has not provided a CbCR to any country; (ii) although the MNE group has provided a CbCR to another country, China has not established the information exchange mechanism on the CbCR with that country; or, (iii) despite the fact that the MNE group has provided the CbCR to another country with such a mechanism with China, China has not successfully obtained the CbCR.[18]

Bulletin 42 requires qualified taxpayers to prepare the CbCR by completing three specified forms/tables under the BEPS Action 13 Report, including: (i) overview of allocation of income, taxes, and business activities by tax jurisdiction; (ii) list of all the constituent entities of the MNE group included in each aggregation per tax jurisdiction; and (iii) additional information.

As recommended by the BEPS Action 13 Report, the first CbCRs would be filed by December 31, 2017. For MNEs with a fiscal year ending on a date other than December 31, the first CbCRs would be required to be filed later in 2018, twelve months after the close of the relevant MNE fiscal year, and would report on the MNE group's first fiscal year beginning after January 1, 2016. Thus, an inter-government exchange mechanism is expected to be ready for the exchange of the first CbCRs.

In response to the three-tier structure for transfer pricing documentation as set out in BEPS Action 13, Bulletin 42 restructured the contemporaneous documentation into a three-tier structure, including master file, local file, and special file. The qualified taxpayers should prepare and file contemporary documentation on related-party transactions in the fiscal year at the request of the tax authority.[19] As each file has its own filing thresholds, it is possible for one taxpayer to file two or three of the contemporaneous documents.

D. Bulletin 6 of 2017 on the Special Tax Investigation and Adjustments

To further streamline and improve the transparency and predictability of transfer pricing investigation undertaken by Chinese tax authorities, the STA released its long-awaited Bulletin on Measures for the Administration of Special Tax Investigation and Adjustments and Mutual Agreement Procedures (Bulletin 6) on March 17, 2017, as another step in converting the BEPS Actions 8–10 Reports into domestic regulations on transfer pricing. Bulletin 6 was effective from May 1, 2017, and replaced Chapters 4, 5, 11, and 12 of the Circular 2, Circular 188, Circular 363, Bulletin 54, and Bulletin 16.

Bulletin 6 not only reflects the outcome of the BEPS Actions 8–10 Reports, but also consolidates previous regulations and existing practices on transfer pricing. It is expected

[18] Art. 8 of the Bulletin 42.

[19] Art. 10 of the Bulletin 42.

that the introduction of Bulletin 6 will greatly improve the predictability, reliability, and transparency of transfer pricing investigation by clarifying the focus points and the rationale of Chinese tax authorities, standardize the transfer pricing investigation practices, and indirectly force the corporations to take initiatives on voluntary and honest self-adjustments.

Embedded in treaties and appearing as Article 9(1) of the OECD and UN Model Tax Conventions, interpreted by OECD's TPG, ALP is re-emphasized by the BEPS package. To help tax authorities and taxpayers evaluate transfer prices between associated enterprises, and to prevent double taxation, China also uses the ALP as the cornerstone of transfer pricing rules. Article 37 of the Bulletin 6 authorized tax authorities to "make adjustments to the full amount of payments made to overseas related parties that have performed no function, assumed no risk, or carried out no substantive activities, which are not in compliance with the arm's length principle."

Article 4 of the Bulletin 6 listed 9 categories of target corporations with the risk features to be investigated by tax authorities: (i) enterprises with significant amount or substantially multiple types of related-party transactions; (ii) enterprises with longtime losses, low profitability or fluctuating profitability; (iii) enterprises with profit levels lower than average levels of the same industry; (iv) enterprises whose profit levels do not match their functions performed and risks assumed, or whose shared benefits do not match their allocated costs (CCA); (v) enterprises that transact with related parties in low-tax jurisdictions (tax havens); (vi) enterprises that fail to file their related-party transaction reporting forms or to prepare contemporaneous documentation; (vii) enterprises whose related-party debt-to-equity ratio exceeds the standard ratio (thin capitalization); (viii) enterprises incorporated in a jurisdiction where the effective tax rate is lower than 12.5%, controlled by Chinese tax resident companies, or by Chinese tax resident companies and Chinese nationals, having either failed to distribute profits or reduced the distribution of profits without reasonable business needs (CFC); and (ix) enterprises who engage in tax planning schemes or tax arrangements that lack reasonable business purposes (general anti-avoidance, GAA).

Under Article 4 of the Bulletin 6, both residents and non-residents shall be subject to investigation. This is likely to happen in the cases involving CFC or GAA issues. Tax authorities may deal with non-residents either directly or through a resident related party. According to the interpretation of the STA, the legal basis for the investigation of the foreign tax residents is the CITL.[20] Such a legal basis should be Article 43 of the CITL, which said, "When the tax organ investigates into the affiliated transactions, the

[20] STA, 关于发布《特别纳税调查调整及相互协商程序管理办法》有关问题的解答 (*Questions and Answers on Issuing the Measures for the Administration of Adjustments under Special Tax Investigation and Mutual Consultation Procedures*), available at http://www.chinatax.gov.cn/n810341/n810760/c2538658/content.html (last visited Feb. 5, 2020).

enterprise and its affiliates, as well as other enterprises relating to the affiliated transactions under investigation, shall provide the pertinent materials according to the relevant provisions." Article 114(2) of the CITLR further referred the term "other enterprises relating to the related transaction under investigation" to those enterprises that are similar to the enterprise under investigation in the contents and pattern of production and business management.

The special tax adjustment is generally not applicable to wholly domestic related-party transactions. Based on the approach of Article 30 of the Circular 2, Article 38 of the Bulletin 6 provides that, "as a general principle, no special tax adjustment shall be made with respect to the transaction between domestic affiliates whose actual tax burdens are the same, provided the transaction has not directly or indirectly decreased the overall tax revenue of China."

The process of special tax investigation would be generally launched in the case of the failure of appropriate self-adjustment of the taxpayers. Therefore, Bulletin 6 encourages taxpayers to take initiative to adjust its transfer pricing on its own. Tax authorities may also remind taxpayers of any taxation risk in question, based on verification of the related-party transactions reporting, administration of the contemporaneous documentation, and monitoring of corporate profit level. When taxpayers choose to self-adjust, they should file the newly introduced "Special Tax Adjustments Self-Payment Form."[21]

Tax authorities shall initiate special tax investigation in cases where taxpayers request tax authorities to confirm the principles and methods of the transfer pricing. Despite any self-adjustment by taxpayers, tax authorities may use their discretion to initiate a special tax audit process if they deem the self-adjustment is insufficient.

Consistent with the OECD's TPG, Article 111 of the CITLIR recognized the CUP method, the resale price method (RPM), the cost-plus method (CPM), the TNMM, the profit split method (PSM), and other methods in compliance with the ALP. Article 16 of Bulletin 6 continues to authorize the tax authorities to choose one of the above-mentioned reasonable transfer pricing methods, based on the comparable analysis, to analyze the related-party transactions. The detailed guidance of Bulletin 6 on the methods generally reflected the positions of the OECD's TPG.

Article 22 of the Bulletin 6 introduced three frequently used asset valuation methods, including cost, market, and income, to support transfer pricing analysis of the transactions of either individual pieces of corporate assets, including intangible assets, or entire corporate assets as a whole.

This Article also introduced a broad language "other methods in compliance with the

[21] Art. 3 of the Bulletin 6.

arm's length principle" as to include any other reasonable methods that comply with the ALP and can appropriately reflect the principle that profits should be taxed where economic activity takes place and where value is created. The broad wording of "other methods" will offer necessary discretion and flexibility for tax authorities to employ any reasonable methods available to reflect the principle that profits should be taxed where economic activity takes place and where value is created, for the purpose of fair and reasonable special tax adjustment.

E. Transfer Pricing of Intangible Property Transactions

Different from the traditional unilateral approach to the payment of royalties paid by Chinese enterprises to the oversea affiliates, Bulletin 6 introduced the bilateral approach to the payment of royalties between Chinese enterprises and their affiliates, including the payment received by Chinese corporations from their oversea affiliates. As the new rules on transfer pricing of intangible property transactions covers both transferors and transferees of intangibles, Chinese tax authorities will give enough attention to the BEPS risks associated with intangibles transactions between the members of China-based MNE groups. Therefore, it is essential for China-based MNE groups to ensure the arm's length nature of the royalties received by Chinese taxpayers from their oversea affiliates as licensees of intangibles. It is expected that there will be serious discussions on the BEPS risk associated with the royalties received by Chinese taxpayers from their offshore affiliates. Of course, Chinese tax authorities will not weaken their priority focus on the traditional BEPS risks arising from the payment of the royalties from Chinese corporations to their oversea affiliates.

In addition to duplicating the five functions (development, enhancement, maintenance, protection and exploitation, DEMPE) outlined by the BEPS Actions 8–10 Reports and the OECD's TPG, Bulletin 6 identifies "promotion" of intangibles as another key function for the purpose of DEMPEP (including development, enhancement, maintenance, protection, exploitation and promotion) analysis. As Chinese tax authorities will conduct six-function (DEMPEP) analysis of the intangibles transactions under the new rules, the value contribution by and through marketing and promoting activities undertaken by Chinese companies will be appropriately rewarded. This innovation further reinforced Chinese traditional emphasis on the huge value of marketing and promotion efforts in attracting Chinese consumers to buy international brands at the price of generous premiums.

The DEMPEP analysis depends on different facts and circumstances, including business models of the MNE group and intangibles natures of the related-party transactions. However, Bulletin 6 is silent on further quantification and weighting of the performance of various contribution in considering the arm's length adjustment of income related to intangible property between and among various members of the MNE group.

The necessary discretion should be controlled by rule of law, especially the due process of law, so as to strike a good balance between sophisticated taxpayers and tax authorities in the process of arm's length analysis of transfer pricing of intangibles transactions.

To warrant the predictability of tax audit and adjustment, the STA would be well advised to develop detailed guidance based on Chinese specific circumstances and the BEPS Actions 8–10 Reports in the future. Neither ignorance of the significant functions of design and control, nor ignorance of the significant functions of exploitation and promotion is rationale and convincing without due regard to the facts and circumstances in specific individual cases in question.

Under Bulletin 6, an entity that merely possesses the legal ownership of intangible assets, but has not contributed toward the value creation of the intangible assets, should not be entitled to any benefit arising from the exploitation of such intangible assets.[22] Such position reflected the recommendations of the BEPS Actions 8–10 Reports, which indicates that, "For intangibles, the guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible"; "Legal ownership of intangibles by an associated enterprise alone does not determine entitlement to returns from the exploitation of intangibles."[23]

Under Bulletin 6, an entity that has merely funded intangible development activities but has not performed any DEMPEP functions or assumed any risks in the creation and exploitation of intangible assets, should only be entitled to a reasonable financing return.[24]

Under Bulletin 6, tax authorities may conduct special tax adjustment on the royalties received or paid as a result of intangibles licensing transactions, in case of the failure of timely adjustment by the taxpayer on one of the following situations: (i) The value of intangible assets have changed fundamentally; (ii) an adjustment mechanism on royalty for comparable transactions between unrelated parties would have been in place, pursuant to usual and normal business practices; (iii) the functions performed, risks assumed and assets used by the enterprise and its related parties have changed during the course of the exploitation of intangible assets; and (iv) the enterprise and its affiliates have not been appropriately compensated for the ongoing DEMPEP of intangibles.[25] These rules are generally consistent with recommendations under the BEPS Actions 8–10 Reports, although discussions there are much more detailed.

Tax authorities are expected to pay particular attention to whether the value of the licensed intangibles has declined since the royalty was initially established, whether price

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[22] Para. 1, Art. 30 of the Bulletin 6.

[23] BEPS Actions 8–10 Reports, at 10, 64.

[24] Para. 2, Art. 30 of the Bulletin 6.

[25] Art. 31 of the Bulletin 6.

adjustment clauses are commonly found in uncontrolled comparable transactions, whether the related parties have changed their functions as well as if assets and risks have changed, and whether the transferee or the licensee has performed further additional DEMPEP functions for which it has not been reasonably and fairly compensated.

The core spotlight of Bulletin 6 is the recognition of the principle of benefit commensurate with the royalty rate. Bulletin 6 declares that the royalty paid or received for the transaction of intangibles should match the economic benefits generated by the intangibles for the enterprise or its affiliates. If the royalty does not match the economic benefit derived to the enterprise or its affiliates, and thus result in a reduction in the taxable gross income or taxable income of the enterprise or its related party, tax authorities may initiate special tax adjustment on such royalty. Assuming the licensed intangibles have generated no economic benefit, and assuming the transactions are not arm's length, tax authorities may make adjustments up to the full amount of the royalties paid. Assuming an enterprise pays a royalty to a related party that merely has the ownership of the intangibles, and assuming the royalties are not arm's length, tax authorities may make special adjustments up to the full amount of the royalty.[26]

These rules have reinforced the substance principle reflected in the BEPS package and the recommendations of the BEPS Actions 8–10 Reports, including "legal ownership of intangibles by an associated enterprise alone does not determine entitlement to returns from the exploitation of intangibles, and associated enterprises performing important value-creating functions related to the development, maintenance, enhancement, protection and exploitation of the intangibles can expect appropriate remuneration."[27] The substance principle requires the magnitude of royalty specified in the contracts to be commensurate with the economic benefit in substance, and thus ensures arm's length pricing.

F. Transfer Pricing of Intra-Group Service Transactions

Articles 34–36 of the Bulletin 6 are designed to determine the nature and level of the arm's length in related-party service transactions, based on Article 4 of the Bulletin 16 and existing enforcement practice, and inspired by the internationally accepted and OECD sanctioned "benefits test."

As indicated by the BEPS Actions 8–10 Reports, there are two issues in the analysis of transfer pricing for intra-group services. One issue is whether intra-group services have in fact been provided. The other issue is what the intra-group charge for such services for tax purposes should be in accordance with the ALP.[28]

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[26] Art. 32 of the Bulletin 6.

[27] BEPS Actions 8–10 Reports, at 64.

[28] BEPS Actions 8–10 Reports, at 144.

Following the same line of thinking, Article 34 of the Bulletin 6 introduces two interrelated principles for the transfer pricing of intra-group service transactions to follow: the benefit principle and the ALP. First, the related-party services should be beneficial to the service recipient. Second, the service fee paid or received should be arm's length. In case of the failure to satisfy the two interrelated requirements, a special tax adjustment shall be made.

To determine whether intra-group services have been rendered, the second paragraph of Article 34 of the Bulletin 6 introduces benefits test recommended by the BEPS Actions 8–10 Reports. The arm's length related-party service transactions should be beneficial service transactions that are priced according to business practices and fair prices for transactions conducted between unrelated parties in the same or comparable circumstances. The term "beneficial service" is defined as the service activity, which is able to deliver direct or indirect economic benefit to the recipient, and which an independent enterprise would have been willing to pay for or would have performed the activity in-house for itself, in the same or comparable circumstances.

The first paragraph of Article 34 of the Bulletin 6 authorizes tax authorities to make a special tax adjustment by disallowing the deduction of the service fee, where an enterprise pays the service fee to its related parties for services that are not beneficial.

Although Bulletin 6 has not provided any detailed documentation requirements on the intra-group service transactions, it will be very helpful for the recipient and the provider of services to prepare and maintain genuine and reliable documents, including the books and records, to support the existence of beneficial services and the compliance of the ALP. It is irresponsible for the taxpayers and the tax consultants to wait for the STA guidance before preparing the documents. The rationale is that the burden of proof on the compliance of the ALP is on the shoulder of the parties to intra-group service transactions, instead of the tax authorities.

Article 35 of the Bulletin 6 listed 6 categories of non-beneficial intra-group service: (i) duplicative services (services that have already been procured or carried out by the enterprise itself); (ii) shareholder activities (services that are carried out to exercise control, management, and supervision of the enterprise with a view to protect the investment interests of a direct or indirect investor); (iii) services that benefit solely from being part of the group (services not specifically carried out for the recipients, although the enterprise has obtained an incidental benefit by belonging to a particular group); (iv) services that have already been compensated in another related-party transaction; (v) services that are irrelevant to the functions performed or risks assumed by service recipients, or do not meet the business needs of the service recipients; and (vi) any other services that cannot bring direct or indirect economic benefit to the service recipient, or that an independent enterprise would have been unwilling to pay for or would not have performed the activity in-house for itself.

Based on the BEPS Actions 8–10 Reports, Article 36 of the Bulletin 6 introduced the direct and indirect charging methods for related-party services, except for the elective, simplified approach introduced by the BEPS Actions 8–10 Reports for low value-adding intra-group services of Chapter VII of the TPG. The elective, simplified approach specifies a wide category of common intra-group services which commands a very limited profit mark-up on costs, applies a consistent allocation key for all recipients for those intra-group services, and provides greater transparency through specific reporting requirements including documentation showing the determination of the specific cost pool.[29] The reason is that the STA has long considered all intra-group service transactions highly risky.

Article 36 of the Bulletin 6 requires the reasonable pricing methods to be selected based on the consideration of the concrete content and features, the functions, risks, costs, and expenses undertaken by the service provider, the benefits and market circumstances of the recipient, the financial situation of the transactions parties, and the pricing level of comparable transactions. Where the direct "reasonable cost" is unavailable, the indirect "apportioned cost" shall be identified based on the match between the benefit enjoyed by the recipient and the outcome of the apportionment. Compared with the Discussion Draft, Article 36 of the Bulletin 6 deleted the language "plus an arm's length mark-up" on calculating a service fee.

The impact of Article 36 of the Bulletin 6 is that the ALP will be actively applied to the intra-group service transactions, and the MNE groups have to reflect and re-adjust their existing unreasonable transfer pricing policies correspondingly. For example, where an overseas affiliate has outsourced all of the service that it used to provide to a corporate taxpayer in China, the outsourcing affiliate may not charge the Chinese taxpayer for the serve provided by external unrelated parties any more.

CONCLUSION

China has actively participated in both developing and implementing the BEPS project. One of the key reasons is that China's tax base has been seriously eroded by aggressive international tax planning that has the effect of artificially shifting profits to locations where they are subject to non-taxation or substantially reduced taxation. Generally speaking, the current institutional arrangements on transfer pricing have satisfied the requirements of the BEPS package. As China has been endeavoring to improve stable, transparent, fair, and predictable legal environment of doing business in China, it passed the Foreign Investment Law on March 15, 2019 and regulations on environment of doing business. To attract multinational corporations to do business in

[29] BEPS Actions 8–10 Reports, at 14.

China, it is expected that transfer pricing regulation in China will be more transparent, inclusive, and investor-friendly in the future. To improve the transparency and fairness of transfer pricing regulation, the STA has published a series called the China Advance Pricing Arrangement Annual Report. The latest Annual Report of 2018 was released in April, 2019.[30] The most compelling challenge from the global economy recession triggered by COVID-19 will further require and empower China to strike a good balance between implementation of BEPS transfer pricing requirements and protection of sustainable growth of multinational corporations. Indeed, there is still a long way to go for China to closely collaborate with OECD members and other stakeholders including the developing countries in terms of exchange of the best practices of transfer pricing regulation and addressing new challenges to international tax justice in the age of globalization and digitalization.

[30] STA, *China Advance Pricing Arrangement Annual Report (2018)*, available at http://www.chinatax.gov.cn/chinatax/n810214/n810606/c4244610/5080963/files/e27ec0785264482aa1ee50ec3e9c755c.pdf (last visited Apr. 6, 2020).