

China tightens control on outbound payments

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In Brief

- » On 18 March, 2015, China issued the “Announcement for Corporate Income Tax (“CIT”) on Payment to Overseas Related Parties” (“Announcement 16”).
- » Announcement 16 reiterates that payments to overseas related parties must be authentic, and the pricing shall be in line with the arm’s length principle.
- » Announcement 16 provides guidance to Chinese tax authorities on how to review the tax issues for outbound payment to overseas related parties.

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In detail

State Administration of Taxation (“SAT”) has been paying special attention to intra-group outbound payment of service fee and royalty since 2012. After several measures issued in 2014, SAT has recently taken a significant step to formalize the tax position regarding certain types of outbound payments from transfer pricing perspectives.

Announcement 16 reiterates the arm’s length principle when enterprises make payments to overseas related parties. The Chinese tax authorities can ask the Chinese enterprises to provide relevant evidences, including the agreement, details on the substance, and pricing arrangements of the transactions. If the Chinese tax authorities identify that the payment is not in accordance with the arm’s length principle, it may, within 10 years from the transaction, make a special tax adjustment.

Announcement 16 illustrates four types of intra-group payments that are not deductible for China CIT purposes.

1. Payment without substance

Enterprises cannot deduct the payments made to overseas related parties, which do not perform functions, assume risks, or have no substantial business activities.

2. Service fee payment violating “benefit matching” principle

Services provided by overseas related parties are expected to bring direct or indirect economic benefits to the Chinese enterprises. Therefore, service fees paid to overseas related parties in the following six circumstances cannot be deducted by the Chinese enterprises:-

- 1) Services irrelevant to the functions and risks borne by the Chinese enterprises, or irrelevant to the operation of the Chinese enterprises
- 2) Controlling, management and supervisory services carried out by overseas related parties for protecting the direct or indirect investors’ interests in the Chinese enterprises
- 3) Services already purchased from third parties or provided in-house by the Chinese enterprises
- 4) No specific services provided by overseas related parties, although the Chinese enterprises may benefit incidentally from being part of the group
- 5) Services already compensated through other related party transactions
- 6) Services without bringing direct or indirect economic interest to the Chinese enterprises

3. Royalty payment to parties having no value contribution to the intangible assets

Royalty paid to overseas related parties which only possess the legal ownership but do not contribute to the value creation of the intangibles is not deductible by Chinese enterprises.

SAT further requires that in a royalty payment for intangibles, the economic benefits that each party is entitled to should be determined based on the contributions made by each party to the value of the intangible assets (i.e. based on each party’s functions performed, assets employed and risks assumed in the intangible assets development, enhancement, maintenance, protection, application and promotion).

4. Royalty payment to overseas holding / financing companies

If an overseas holding or financing company is established for the main purpose of financing and listing, the royalty paid to such overseas related party as a compensation for incidental benefits arising from financing or listing activities is not deductible for CIT purposes by Chinese enterprises.

WTS observation

SAT has already organized two audits regarding overseas payments in recent years:-

- In early 2009, SAT asked local tax authorities to probe into cases of non-trade payments from China to non-residents which could potentially trigger withholding tax obligations; and
- In late 2014, SAT initiated the investigation against the substantiality and deductibility of payments from a transfer pricing perspective.

Chinese tax authorities are intensifying their anti-tax-avoidance measures from the tax base erosion and profit shifting ("BEPS") perspectives. Companies practicing non-trade payments to overseas related parties are advised to consider the following actions in order to monitor the tax risks:-

- Assess the authenticity and reasonableness of the payments
- Review the sufficiency in transfer pricing documentation
- Establish a sound and sustainable internal charge mechanism

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