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

Attachments D.3. and D.4. (China Country Practices and Kenya Country Practices)

Summary

The paper supplements CRP.40 and encloses for the information of the Subcommittee the most recently available components, composed by countries, of Part D of the Transfer Pricing Manual. These comprise an updated contribution from China (Attachment D.3) and a new contribution from Kenya (Attachment D.4). As noted in CRP.40, we are advised that the contribution from Brazil will not be altered at this stage. An updated contribution from India is expected and it will be made available when provided.

The nature of Part D as indicated in the Foreword to the First Edition Manual (when it was Chapter 10) is that it does not purport to represent agreed Committee decisions:

> Chapter 10 is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. Chapter 10 should be read with that difference in mind.

This fundamental characteristic of the Country Practices part of the Manual (Part D) is why the texts are only provided, as for past editions of the Manual, for Committee information, rather than approval. They are therefore provided for information only.

CHINA: COUNTRY PRACTICE[1]
Transfer Pricing Opportunities and Challenges for Developing Countries in the Post-BEPS Era

1. Introduction

1.1. On 5 October 2015, the Organization of Economic Cooperation and Development (OECD) published 15 final reports and an explanatory statement on the Base Erosion and Profit Shifting (BEPS) project. After an intensive two-year process, the international tax reform mandated by the G20 leaders and coordinated by the OECD has finally come to fruition. The post-BEPS era focusing on the implementation of the BEPS outcomes was ushered in. One thing that made this reform different from the previous ones is the involvement of many developing countries in both the early stage when the various measures were developed and the later implementation phase. Voice of the developing countries has started to be heard by the global community when international tax policies were made. This unprecedented event has provided the developing countries with an opportunity to begin at the same starting line as their developed counterparts. However, the opportunity comes with challenges. Having the right to speak does not necessarily mean being ready to speak. Getting involved is far from being able to lead. After all, it is imperative that the developing countries continue to build capacity in tax administration to get more ready to speak and lead.

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

[1] Contributed by the State Taxation Administration of People's Republic of China.

for international tax cooperation to achieve a globally fair and modern international tax system and to foster growth".

1.3. Transfer pricing is a weighty component of the international tax reform as 10 of the 15 action plans relate to it. The BEPS project was set to tackle the epidemic situation where profits had been left untaxed because multinational enterprises ("MNEs") had managed to shift the income to no-tax or low-tax jurisdictions. Historically, transfer pricing administration had been focusing on dealing with how to allocate taxing rights between jurisdictions and preventing/eliminating double taxation under mutual agreement procedures ("MAP"). The priority of the ongoing international tax reform, however, was to address double non-taxation where MNEs paid no taxes or less than their fair share of taxes in jurisdictions with well-established corporate income tax regimes. The support shown by more than 100 countries and regions for the BEPS project suggests that this common goal was able to rally interested tax jurisdictions including both developed and developing countries to work together. Yet some important questions remain unanswered. For example, has the project resolved all the differences developed and developing countries have in transfer pricing? Or, have the international tax rules become fairer and less biased as the result of the reform? Thanks to the concerted efforts by developed and developing countries in combating tax avoidance, the reform now needs to reconsider the classic transfer pricing question of how to allocate profits retrieved from the tax havens. The rules need to be fair and clear on who creates value and how the profits should be allocated between countries. The overarching principle of the BEPS project that the profits should be taxed where economic activities occur and value is created has guided jurisdictions to develop measures to counter tax avoidance in tax havens. That being said, developing countries need more specific rules and practical guidance on important issues such as how to determine the places of economic activities and value creation, how to allocate the profits retrieved from the tax havens between countries with corporate income tax system, how to divide the pie between countries both of which are the places of economic activities and value creation, and above all, how to apply arm's length principle in transfer pricing legislation and practice. This is where the United Nations Practical Manuel on Transfer Pricing for Developing Countries (hereafter referred to as "UN Practical Manuel on Transfer Pricing") comes in handy.

Amongst the 15 Action Items of the BEPS Project, Action 1 drew a lot of attention. However, the 2015 Final Report failed to deliver a solution to the broader tax challenges raised by the digitalization of economy. Since then, member states of the Inclusive Framework, including China, have been working together towards reaching a consensus-based solution. As the solution is still under development, how it will interact with the existing international tax rules, and how it will affect the post-BEPS international tax landscape shaped by the other 14 Action Items is remained to be seen. Nonetheless, developing countries need to be prepared for the new challenges and opportunities that this change will bring about, including in the area of transfer pricing.

2. 1 Part One: Recent Developments in China Transfer Pricing Practice

2.1.1 The transfer pricing tax regime was first introduced in China in 1991. Over the past 3decades, the Chinese tax administration has been exploring ways to improve the transfer pricing administration and have made significant improvements over the last 10 years. Drawing from practical experience and international best practices, the Chinese tax administration was able to establish a well-rounded transfer pricing tax regime that includes legal framework, practical guidance, administrative process and operational mechanism. Dedicated transfer pricing teams were also trained and deployed at various levels of tax offices. With the view to stopping profit shifting and protecting China's taxing right, the Chinese tax administration also recognizes that it is important to respect facts and data in any transfer pricing analysis.

2.1.2 Transfer pricing administration has been put at the center of STA's anti-avoidance work agenda in the recent years. Recognizing that preventative measures are as important as transfer pricing audits, the STA has built a three-pronged tax avoidance prevention and control system with consistent and standardized approach for administration, service and investigation. It is important that tax avoidance prevention should run parallel to transfer pricing investigations. Ways to prevent taxpayers from evading tax obligation include strengthened tax administration and improved taxpayer service. Investigations are only used as deterrence to foster taxpayer voluntary compliance. Moreover, different measures were taken to build a three-pronged tax avoidance prevention and control system. The first aspect of the three-pronged system is administration. A tracking system was put in place to monitor the profits of foreign MNEs operating in China. Chinese tax administration has put extra emphasis on routine review of related party filings and contemporaneous transfer pricing documentation. Follow-up monitoring subsequent to transfer pricing audits was implemented to encourage taxpayers to ensure their profitability is in line with the arm's length principle. As to the second prong, service, seminars and trainings were provided to inform taxpayers of the latest tax regulations and policies. Double taxation was prevented (eliminated) through unilateral/bilateral APAs and resolution of MAP cases. With regard to the last aspect, investigation, both isolated and coordinated anti-avoidance audits were carried out to act as deterrence to regulate the profitability of individual companies or particular industries. Above all, the tax offices across the country have coordinated their actions to ensure that both domestic laws and international policies were followed in a consistent and standardized manner. As a result, inconsistency due to different work procedures was reduced to the minimal. The developments in China's transfer pricing administration can be therefore summarized in the following 8 aspects.

2.2. Domestic Legislation and Practical Guidance

2.2.1. Legislation always comes first in transfer pricing. The Tax Collection and Administration Law and its Implementation Regulations and the Enterprise Income Tax Law and its Implementation Regulations and Individual Income Tax Law all contain clauses on transfer pricing. The first time that China introduced a comprehensive anti-avoidance regime into the legislation was through the "Special Tax Adjustment" provision in Chapter 6 of the Enterprise Income Tax Law and its Implementation Regulations in 2008. Not only did this chapter include provisions on transfer pricing and APA with which China had more experience but also clauses on cost sharing agreement, thin capitalization, control foreign companies, general anti-avoidance rule and the levy of interest as a result of transfer pricing adjustments for which China had to draw on international experience. In January 2009, the STA released the Implementation Measures of Special Tax Adjustments (Trial Version) (more commonly known as the "Circular 2"). It had since served as the practical guidance for China's transfer pricing, and in broader scope, the anti-avoidance administration. and provided the legal basis for tax administration's assessments and taxpayer compliance. In August 2018, transfer pricing rules, controlled foreign corporations rules, and general anti-avoidance rules were introduced into the newly revised Individual Income Tax law. Starting from 2016, STA has released a series of regulations to revise and update the Circular 2. Firstly, the Public Notice on Matters Regarding Refining the Filing of Related Party Transactions and Administration of Contemporaneous Transfer Pricing Documentation (Public Notice of the STA [2016] 42, hereafter referred to as the "Public Notice No. 42") was put into effect in June 2016. As set out in the BEPS Action 13, Public Notice No. 42 has adopted clauses to require qualified taxpayers to file Country-by-Country reports in China. Public Notice on Matters Regarding Enhancing the Administration of Advance Pricing Arrangements (Public Notice of the State Administration of Taxation [2016] 64, hereafter referred to as "Public Notice No. 64") was then released to provide more detailed guidance on the APA process. The release of Public Notice of the State Administration of Taxation on Issuing the "Administrative Measures of Special Tax Investigation and Adjustment and Mutual Agreement Procedure" (Public Notice of the State Administration of Taxation [2017] 6, hereafter referred to as the "Public Notice No. 6") replaced the procedural guidance relating to transfer pricing as set out in the Circular 2.

2.3. Centralized Approval System to Assure Consistency and Standardization

2.3.1. There are more than 720,000 tax officials and 36 provincial level tax offices in China. It is paramount for a big country like China to be consistent and standardized in law enforcement especially when it comes to transfer pricing administration. An MNE might set up 30 subsidiaries across China. Without a consistent standard, tax administrations from different areas may find disparate comparable sets and derive various profit levels for transfer pricing cases of similar nature. To prevent this from happening, the STA has put in place a national anti-avoidance system under which tax administrations are to report and obtain approval from the STA headquarters when they need to initiate or close an anti-avoidance (including transfer pricing) case since 2015. The reporting chain put in place to standardize the audit procedures, improve the quality of closed cases, strengthen audit efforts, and organize national coordinated investigation . In 2012, the STA released the "Internal Approval Procedures for Substantial Special Tax Adjustment Cases (Trial Version) (Guoshuifa [2012]16) (hereafter referred to as the "Internal Approval Procedures") to streamline procedures including related party filing review, contemporaneous transfer pricing documentation analysis, high-risk taxpayer identification, case initiation, audit and analysis, case closing, and follow-up taxpayer monitoring and tracking subsequent to an audit. As required by the "Internal Approval Procedures, a three-level transfer pricing audit system was established. The system features collective decision and penal approval. First, for every audit case, the in-charge tax administration needs to set up special task team to conduct the investigation. Second, the task team needs to formulate the preliminary assessment and report it to the tax administration at provincial level whose specialist panel is responsible for approving the case. In addition, for a case qualified as a substantial case especially a case that requires national coordination, the STA headquarters needs to call upon a nation-wide expert panel to make the final decision on the case. In September 2016, the STA has released the Internal Procedures for Special Tax Adjustment (Shuizongfa [2016]137), in which the roles and responsibilities of tax administrations at different levels and the collective review and approval system were further clarified. This system has enabled the tax administrations of different areas to work in a manner that would ensure the consistency in the selection of transfer pricing method and the determination of appropriate profit levels. A unified work standard across the country was formed accordingly. The consistency has made tax assessments more effective as deterrence measures. Tax officials are better protected from risks in enforcing the law thanks to the internal control system built according to the "Internal Procedures for Special Tax Adjustment".

2.4. Monitor Profits of MNEs in China

2.4.1. Transfer pricing administration needs to move up the line of defense. Prevention can be very effective in fostering taxpayer voluntary compliance with the arm's length principle and fulfilling tax obligation. Only when the taxpayers fail to be compliant the audits should be initiated. To better leverage the preventive effect, the STA has installed a monitoring system to track the profits of MNEs in China. The primary data sources are the annual corporate income tax returns and the accompanying related party filings. The information is compiled, compared and analyzed by year, industry, and geographical area. A monitoring system was designed to combine industry analysis with individual taxpayer screening. Tax administrations would receive alerts when the risks are identified. The history record and performance evaluation that the tax authorities have with a particular taxpayer can also be accessed in the system. In addition, by requiring taxpayers to prepare contemporaneous transfer pricing documentation and monitoring taxpayers in the follow-up years subsequent to the audits, taxpayers can better understand tax administrations' approach to transfer pricing administration.

2.5. Intensify Audit Efforts

2.5.1. Audit efforts for nationally coordinated cases that involve several companies in a same industry or multiple subsidiaries of a same MNE group was intensified to improve the quality of closed cases. Investigations should be carried out in a consistent and standardized manner so that inconsistent assessment simply because tax administrations have different ways to go about cases that involve companies in the same industry or subsidiaries of a same group can be avoided. The transfer pricing audits can therefore be more effective as a tax avoidance deterrence measure. In the past years, China has initiated several nationally coordinated audits targeting industries including shoe manufacturing, computer manufacturing, high speed road construction, retail stores and hotels and fast-moving consumer goods. Apart from being subject to the nationally coordinated audits, automobile sector, luxury goods industry and pharmaceutical companies were also being analyzed at the industry level. The "income approach" was developed and applied to multiple cases to address the challenges posed by transfer of equity and intangibles between related parties. The Chinese tax administration has attached great importance to several key industry sectors and been paying attention to possible base erosion transactions including outbound payments and transfer of equity. In the meantime, the use and transfer of intangibles, intra-group services, and financial transactions have gradually come to the fore of Chinese tax administration's work, which has contributed to the quantitative analysis of location specific advantage

The tax revenue contributed by the anti-avoidance work was RMB 679,000,000 in 2006 and RMB 64,634,000,000 in 2019. The number was more than 94 times higher with an annual increase rate of 41.97%. The revenue contribution from the administration measures was 56,872,000,000, whereas the revenue collected through the service measures was 2,719,000,000. And the rest was contributed by the audit adjustments.

2.6. APA Program and MAP Process

2.6.1. China has in place a MAP mechanism to eliminate double taxation resulted from transfer pricing audits and a bilateral APA program to provide early certainty for cross-border taxpayers. Unilateral APAs can also be reached between the Chinese tax administration and the taxpayers. By the end of 2019, China has signed 76 bilateral APAs and 113 MAP agreements with 15 countries. During the negotiations, where appropriate, concepts such as value chain analysis and factors contributing to value creation long held by the Chinese tax administration were discussed with and recognized by some treaty partners. In order to better inform the public of China's APA program, the STA started to release "China APA Annual Report" in 2010. So far 10 reports have been published on the OECD official website and met with well reception from the international community.

2.7. Expand Data Sources for Comparability Analysis

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

2.8. Enhance International Communication and Cooperation

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

2.9. Build a Professional Transfer Pricing Team

2.9.1. Building a dedicated transfer pricing team has always been the priority of the STA. Trainings on anti-avoidance has been conducted in various forms such as discussions on domestic legislation, peer-to-peer case sharing, seminars delivered by experts from the OECD as well as from other countries, special training sessions on difficult topics such as transfer pricing involving intangibles, financial service sector, and pharmaceutical industry. The combination of in-class training and on-job learning has yielded good results as evidenced by significant improvement in tax officials' professional capabilities. On the other hand, resources have been devoted to transfer pricing administration as well. Tax bureaus specialized in anti-avoidance work were set up in Beijing, Jiangsu province and Shenzhen. The purpose was to pool the local talents and let them focus on transfer pricing and other anti-avoidance work. In addition, in response to the increased workload related to transfer pricing audits and bilateral negotiation in the post-BEPS era, the STA has enhanced efforts in the training and development of talents for transfer pricing to ensure that sufficient resources and manpower is allocated to the work.

3. Part Two: China's Transfer Pricing Regime

3.1. As provided by the Tax Collection and Administration Law, Enterprise Income Tax Law and the Individual Income Tax Law, the core of China's transfer pricing regime is the arm's length principle. Just like many countries in the world, China has made great efforts to uphold the arm's length principle despite many challenges encountered in the process. That being said, China's transfer pricing regime has drawn on some other internationally recognized norms besides the arm's length principle. Transfer pricing is essentially an issue of allocation of taxing rights among countries which could lead to audit adjustment that could result in double taxation for an MNE group. Both the country that initiates the audit and the country in which the related party is resident should ensure that the treaty obligations to prevent and eliminate double taxation are implemented. In order to resolve double taxation, the two countries need to negotiate with each other. The agreement can only be reached if both the negotiating parties are looking at the same principles, rules and methods. Therefore, it is necessary to have a set of international rules on transfer pricing that are respected by all countries. However, the inherent disparity between countries cannot be overlooked. Countries may be subject to different domestic conditions or have unique tax regimes. Different stages of economic and social development might pose distinct challenges too. All these factors need to be taken into account when designing international rules. Both developed and developing countries can find the general rules to be fair and easier to accept if they reflect different needs and conditions of the countries. By the time this chapter is drafted, China has signed double taxation treaties with 108 countries and the number is only dwarfed by that of UK and France. In addition, China is the top destination for foreign investment in the meantime has the volume of outbound investment that is only second to the US. The extensive treaty network and ever-growing need for cross-border investment has prompted China to engage in bilateral treaty negotiation with many countries. The situation dictates China to follow international standards in dealing with transfer pricing or other international taxation issues. The fast economic and social development for the past 40 years has also made China one of a kind. The uniqueness shows in China's transfer pricing area as well. This is why China needs to strike a balance between conforming to international conventions while being able to deal with some unique issues for transfer pricing purposes.

3.2. Related Party Filing

3.2.1. Article 43 of the "Enterprise Income Tax Law" stipulates that taxpayers need to attach related party transaction report to their annual corporate income tax returns. Both resident and non-resident taxpayers required to file annual corporate income tax returns shall submit related-party filings. Public Notice No. 42 added some forms, including the forms for country-by-country (CbC) reporting, to the original "Annual Reporting Forms for Related Party Transactions" and making them 19 altogether. Aside from filling the 6 forms for CbC reporting (3 in Chinese and 3 in English), companies should report related party transactions incurred by type (i.e., tangibles, intangibles, financial assets, intra-group financing, service provision, etc.). According to the Public Notice No. 42, Chinese Tax resident enterprises that fall into any of the following two categories shall file the CbC report: (1) The resident enterprise is the ultimate holding company of a MNE group having total consolidated group revenue of more than 5.5 billion RMB during the fiscal year immediately preceding the reporting fiscal year as reflected in its consolidated financial statements for such preceding fiscal year. (2) The resident enterprise has been appointed by the MNE group to file the CbC report. The introduction of CbC report filing obligation set out by Public Notice No. 42 was one of the measures taken by China to implement the 4 minimum standards of the BEPS project.

3.3. Related Party Relationships

3.3.1. The existence of related party relationships is the prerequisite for related party filing and the basis for tax administration's transfer pricing adjustments. Article 109 of the Implementation

Regulations for the Enterprise Income Tax Law provides that the related party relationship refers to direct or indirect control relationship with respect to capital, business operation, purchases and sales. The definition was exemplified in Public Notice No. 42 which provides for 7 types of related party relationships. For example, 25% shareholding is the ownership threshold to constitute the related party relationship.

3.4. Contemporaneous Transfer Pricing Documentation Requirements

3.4.1. Chinese corporate taxpayers are required by the law to prepare contemporaneous transfer pricing documentation by tax year and submit it when requested by the tax administration. Contemporaneous transfer pricing documentation may include master file, local file and special issue file. Any enterprise that meets one of the following criteria shall prepare a master file : (1) The enterprise that has incurred cross-border related party transactions during the tax year concerned, and the MNE group to which the ultimate holding company which consolidates the enterprise belongs has prepared a master file. (2) The annual total amount of the enterprise's related party transactions exceeds RMB 1 billion. The master file is to provide an overview of the global business operations of the MNE group to which the ultimate holding company belongs. Different from the recommended legislation template set out in the BEPS Action 13 report, the master file submitted to Chinese tax administration also needs to include (1) A description of business restructurings, industrial restructurings, transfers of functions, risks or assets occurred within the group during the fiscal year; (2) functions, risks, assets and personnel of principle research and development facilities; (3) Name and location of the constituent entity that files the CbC report for the MNE group; and (4) a list of the MNE group's existing unilateral advance pricing agreements, bilateral APAs. Any enterprise that meets one of the following criteria during the fiscal year shall prepare a local file: (1) The annual related party transfer of tangible asset exceeds RMB 200 million (for toll manufacturing transaction, the amount is calculated using the import/export customs declaration prices); (2) the annual related party transfer of financial assets exceeds RMB 100 million; (3) The annual related party transfer of intangibles exceeds RMB 100 million; (4) the annual total amount of other related party transactions exceeds RMB 40 million. In addition to what is required in the Action 13 report, taxpayers need to provide (1) value chain analysis that notes the measurement and attribution of value creation contributed by location specific factors; (2) information on outbound investment; (3) information on related party equity transfer; and (4) information on provision/receipt of related party service. Also, Public Notice No. 42 has set out detailed filing requirements for the description of business, related party, and related party transactions of local entities. Furthermore, taxpayers need to describe local entities' contribution to the group's overall profit or residual profit regardless of the transfer pricing method selected. Aside from the master file and local file, Chinese taxpayers need to prepare special issue file as part of their contemporaneous transfer pricing documentation if certain criteria are met. Special issue files include report on cost sharing agreements and thin capitalization. An enterprise that is a party toa cost sharing agreement shall prepare a special issue file. Similarly, an enterprise with a related party debt-to-equity ratio exceeding the prescribed threshold shall prepare a special issue file.

3.5. Transfer Pricing Audits

3.5.1. Chinese taxpayers whose transfer pricing of the related party transaction are inconsistent with the arm's length principle could be subject to audits conducted by the tax administration. The transfer pricing audit procedures are made very clear in the Public Notice No.6. It embodies the essence of the minimum standards required by the BEPS Action 14 (Making Dispute Resolution Mechanisms More Effective) and is the culmination of China's efforts to revise and update the Circular 2. Public Notice No.6 also reflects the outcomes of the BEPS Action 8-10 Final Report (Aligning Transfer Pricing Outcomes with Value Creation).

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

3.5.3. Taxpayers fall into the following categories would be more likely to be identified as the potential transfer pricing audit targets during the screening process. (1) Enterprises with large amount of related party transaction or multiple types of related party transactions; (2) Enterprises with long-term losses, thin profit margin or fluctuating profit; (3) Enterprises with profit lower than the industry average level; (4) Enterprises with profit level that does not align with its functional and risk profile or with returns that do not correspond to cost allocated; (5) Enterprises that enter into transactions with related parties located in low-tax countries (regions); (6) Enterprises that fail to report the related party transaction or prepare contemporaneous documentation as required; (7) Enterprises with a related party debt-to-equity ratio exceeding the prescribed threshold; (8) Enterprises owned or controlled by Chinese resident enterprises or jointly controlled by Chinese resident enterprises and Chinese resident individuals, established in a country (region) with effective tax rate lower than 12.5% and do not distribute or under-distribute profits without reasonable business needs; and (9) Enterprises that implement other tax planning schemes or arrangements without proper commercial purposes.

3.6. Transfer Pricing Methods

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

3.7. APA Program

3.7.1. In accordance with the Implementation Regulation of the Tax Collection and Administration Law, the Enterprise Income Tax Law and its Implementation Regulations, Chinese taxpayers can enter into APAs with tax administration on the pricing principles and calculation methods for related party transactions for future years. The APA process involves the following 6 stages: pre-filing meeting, intent submission, analysis and evaluation, formal application, negotiation and signing, implementation and monitoring. There are 3 types of APAs that are available: unilateral APAs, bilateral APAs and multilateral APAs. An APA generally covers related party transactions for 3 to 5 consecutive years in the future. Per taxpayer's application, the APA can be retrospectively applied to the prior years not exceeding 10 years. The general threshold which a

taxpayer needs to meet in order to apply for an APA is that the amount of annual related party transactions should be more than RMB 40 million for the past 3 years prior to the application year.
3.7.2. Chinese tax administration can prioritize the acceptance of an APA application from a taxpayer if it falls into one of the following categories. (1) The taxpayer's annual reporting of related party dealings and contemporaneous transfer pricing documentation are well completed with adequate disclosures. (2) The taxpayer has a level A tax credit rating. (3) Special tax investigation on the taxpayer was conducted and closed. (4) Renewal application was submitted by the taxpayer upon expiration of the existing APA with no substantial change to the facts and circumstances specified in the existing APA. (5) Information and documents submitted by the taxpayer are complete and adequate; value chain analysis and supply chain analysis are clear and thorough; location specific factors including location savings and market premium, etc. have been given adequate consideration; and the proposed transfer pricing method and the calculation method are appropriate. (6) The taxpayer can actively cooperate with the tax authorities during the APA process. (7) For a taxpayer applying for a bilateral APA, the competent authority of the relevant treaty partner has displayed strong intention to move forward with the APA negotiation and attach importance to the case. (8) There are any other factors present that could benefit the negotiation and signing of the APA requested by the taxpayer.

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

3.8. MAP Process

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

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

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

4. Part Three Challenges Facing China and Other Developing Countries

4.1. China shares many things with other developing countries in terms of transfer pricing administration. As a relatively late starter in the area, China has drawn on OECD Transfer Pricing Guidelines and experience of developed countries. In the meantime, China has encountered many challenges including lack of appropriate comparables, quantification and allocation of location specific advantages, identification and valuation of intangibles to which solutions were not readily available in the OECD Transfer Pricing Guidelines. Now, developing countries are looking to UN Practical Manual on Transfer Pricing to provide solutions to these challenges that are more common to them.

4.2. Major Challenges

4.2.1. Arm's Length Principle

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

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

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

4.2.1.4. The biggest shortfall of applying the arm's length principle is that it may leave taxpayers uncertain about whether the pricing of related party transactions or the profit of the related companies is reasonable. In fact, no one has a definite answer. Most audits or MAP cases are the result of compromises between tax administrations and taxpayers or competent authorities of two/more countries.

4.2.2. Lack of Reliable Comparables

4.2.2.1. One of the key challenges for developing countries is the lack of reliable, public information on comparables. For a developing country, there are usually only a small number of public companies, while information on domestic private companies is lacking or inadequate. This limits the amount of publicly available information on domestic companies that can be used for transfer pricing analysis. Take China as an example. Up till the end of 2019 , there are about 4000 listed companies in China whereas the private companies are not bound by law to disclose financial information to the public. It is unrealistic to expect that reliable comparables to the tested companies can be found in 4000 listed companies. In particular, there would be a lack of comparables for companies who are first movers in an industry not yet fully exploited. In practice, foreign companies are often used as an alternative to domestic comparables. As a result, comparables sets are often dominated by companies in developed countries, simply because there are usually a much larger number of public companies in these countries.

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

4.2.2.3. One of the most common adjustments in China is accounting for differences in geographic comparability when applying profit-based transfer pricing methods, such as the transactional net margin method ("TNMM"), to determine an arm's length price. For example, when an Asia Pacific set of companies is used to benchmark the transfer prices of a Chinese taxpayer, it often includes companies from both developed countries (such as Japan and Korea), as well as developing countries (such as Indonesia and Vietnam). Generally speaking, the Asia Pacific set is more likely to contain companies from developed countries due to a greater number of listed companies in those countries and hence there is a greater volume of publicly available financial information.

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

4.2.3. Location Specific Advantages

4.2.3.1. The globalisation of trade and economies has given rise to concepts such as "location savings", "market premium," and more generally, location specific advantages ("LSAs"). The LSAs are advantages for production arising from assets, resource endowments, government industry policies and incentives, etc., which exist in specific localities. For example, household electronics manufacturers invest in China to take advantage of a large pool of well-educated low-cost labour and a well-developed network of suppliers, or global automotive companies set up joint ventures ("JVs") in China to assemble automobiles locally to be close to the market and the customers and to take advantage of lower costs. Limited guidance is available on these concepts in the OECD guidelines. It has been seen that certain issues such as location savings and market premium arise more frequently in China and other developing economies, rather than in established and developed economies (which comprise the bulk of the membership of the OECD).
4.2.3.2. Location savings are the net cost savings derived by an MNE when it sets up its operations in a low-cost jurisdiction. Net cost savings are commonly realised through lower expenditure on items such as raw materials, labour, rent, transportation and infrastructure even though additional expenses ("dis-savings") may be incurred due to the relocation, such as increased training costs in return for hiring less skilled labour.

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

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

i. Identify if an LSA exists.

ii. Determine whether the LSA generates additional profit.

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

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

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

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

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

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

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

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

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

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

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

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

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

Steps and Calculations

	Steps	Calculations
i.	Calculate the arm's length range of FCMUs based on foreign comparables, mostly in developed countries	Assume the median FCMU is 8%
ii	Calculate the difference between the cost base of the Chinese taxpayer (e.g. 100) and the average cost base of the foreign companies (e.g. 150)	150 – 100 = 50
iii	Multiply the arm's length FCMU (e.g. 8%) with the difference in the cost bases (50)	8% x 50 = 4
iv	The resulting profit is the additional profit (i.e. 4) attributable to China for location	4

	savings	
v	Determine the total arm's length profit for the Chinese taxpayer	4 + 8% x 100 = 12
vi	Determine the adjusted arm's length FCMU for the Chinese taxpayer	12 / 100 = 12%

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

4.2.4. Intangibles

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

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

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

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

4.3. Practical Issues and Solutions

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

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

4.3.3. While China generally respects the limited risk characterization of sole function entities[2]; determining an adequate return for such entities is a challenge, as explained below. Further, China's legislation has a specific article in its transfer pricing rules to require that such entities should not bear risks or suffer from losses arising from strategic failures, capacity under-utilisation, or holdup in the sales of products, etc., if they do not perform business strategy decision making, product R&D, or sales functions. Simply put, if their upside is limited, their downside should be limited too. Contract R&D is an area where the contribution of developing countries is often underestimated. The transfer pricing method commonly used to reward R&D activities performed by a subsidiary of an MNE in China is cost plus. Sometimes, it has been found that the principal

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

entity that is claimed to be responsible for the R&D has neither the technical expertise nor the financial capacity to be responsible. In other instances, the Chinese entity has obtained “high and new technology status” in Chinese law and therefore enjoys tax incentives on the basis of ownership of valuable core technology. However, it also claims to be a contract R&D service provider with no valuable intangibles. These are but a few examples where a cost-plus approach would not be adequate. It is expected that companies claiming high tech status should be performing activities that result in the creation of intellectual property of which they can claim economic or legal ownership. It is not sufficient by itself that the contract R&D entity has shifted the majority of its risks (e.g. unsuccessful research) to its entrepreneurial related party. A proper analysis of the value provided by the contract R&D entity to the overall group operations should be conducted to determine the appropriate arm’s length return for the R&D entity.

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

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

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

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

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

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

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

4.4. Alternative Methods to the Traditional Transactional Net Margin Method

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

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

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

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

4.5. Other Experience and Recommendations

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

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

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

4.5.4. As an emerging market economy, China's has established a three-pronged tax avoidance prevention and control system with consistent and standardized approach for administration, service and investigation. As the second part of this paper states, China does not always have the same technical expertise and resources that developed countries possess. Nevertheless, experience on transfer pricing in China is accumulating quickly. The underlying objective in conducting audits is to show China's resolve to enforce tax compliance and to remind the MNEs to take into account Chinese companies' contribution to the global profit when determining the transfer pricing policies.

5. Conclusion

5.1. The BEPS project has reshaped the international tax landscape in an unprecedented manner, and the ongoing work on addressing the tax challenges arising from the digitalisation of economy will further change the status quo. In the time when the globalisation is at the crossroads, combined with the trade frictions among countries and severe impact of Covid-19 pandemic, the MNEs are likely to be pressured to rethink their global operation and value chain distribution. This will in turn bring in new challenges, especially in the area of transfer pricing that the tax administrations of developing countries will need to deal with.

5.2 The Chinese tax administration appreciates the opportunity to share with fellow developing countries the experience and insight on transfer pricing administration, and welcomes inputs that could provide useful perspectives.

TRANSFER PRICING – KENYA'S EXPERIENCE

Introduction

Transfer pricing refers to the setting of prices for transactions occurring between associated entities. It is a common practice with globalization and growth in international trade. Transfer pricing manipulation increases the risk of capital flight and shifting of profits by multinational enterprises. Kenya has put up measures to protect her tax base from transfer pricing risks posed by cross-border transactions between related entities, through enactment and enhancement of tax legislation and administration.

Transfer Pricing legislation in Kenya

Section 18(3) of Income Tax Act, Chapter 470, Laws of Kenya, is the basic legislation governing transfer pricing in Kenya. The Section requires that the business income from dealings between a resident person or a permanent establishment with a related non-resident person, be determined as if the parties are independent persons dealing at arm's length. The Income Tax (Transfer Pricing) Rules, 2006, provide guidelines to be applied by related enterprises in determining the arm's length prices of goods and service in transactions involving them. The Income Tax (Transfer Pricing Rules) 2006 heavily borrows from the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines.

Transfer Pricing developments

Kenya's transfer pricing legislation has been enhanced over the years. Section 18(3) of the Income Tax Act has been in the Act since its enactment in 1973, but remained largely untested for several years until the hallmark transfer pricing case of Unilever (Kenya) Limited that was ruled in 2005. The audit conducted on Unilever (Kenya) Limited in 1998, revealed that Unilever (Kenya) charged lower prices to Unilever (Uganda) than those charged both to customers in Kenya and to unrelated parties in the export market both in Uganda and elsewhere. This led to a dispute that went to the courts of law. The case was ruled in favor of Unilever, based on two main reasons: that there were no regulations to guide the application of Section 18(3) at the time; and Section 18(3) was itself unclear, placing burden of proof on the Commissioner and not on the taxpayer. Following the judgment in the case of *Unilever Kenya Ltd v Commissioner of Domestic Taxes* in 2005, Kenya issued the Income Tax (Transfer Pricing Rules) 2006.

There have been subsequent legislation amendments on section 18(3) and other related sections:

- In 2010, the section was amended to get rid of the statement that required the Commissioner to prove that the transactions were arranged in such a way to reduce taxable profit.
- To minimize tax leakage through transfer pricing, section 18(6) was also amended in 2010 to include transactions between individuals who are related by consanguinity or affinity.

- Through Legal Notice No. 54 of 2012, the Commissioner may issue guidelines on application of the transfer pricing methods set out in the Transfer Pricing Rules.
- The Finance Act 2014 expanded the scope to include the dealings between a non-resident and its permanent establishment (PE).
- The Finance Act 2017, introduced section 18A, that brought transactions with taxpayers in preferential regimes within the scope of Transfer pricing (in line with BEPS action 5 on Harmful Tax practices).

These amendments have eased the practical application of the transfer pricing legislation in Kenya. The transfer pricing legislation is now widely applied by both Kenya Revenue Authority (KRA) and the taxpayers in the determination of arm's length price. Several transfer pricing audits have since been conducted and disputes resolved, raising substantial revenues. Many companies with related party cross-border transactions have now registered their transfer pricing policies with the Commissioner.

Embracing the G20/ OECD BEPS Project outcomes

Kenya has embraced internationally recognized guidelines namely United Nations (UN) and OECD Transfer pricing guidelines and the OECD Base Erosion and Profit Shifting (BEPS) project outcomes.

Kenya has embraced the BEPS outcomes and has gone ahead to implement some of the recommendations contained in the BEPS reports. Kenya is in the process of reviewing the Income Tax Act and KRA has proposed several amendments to be included in the revised Act to address BEPS issues. Some of the developments include:

a) *Transactions with companies in low tax jurisdictions*
   The widening the definition of related parties within the meaning of international transactions to include companies in low tax jurisdictions, or tax havens to give lee way to transfer pricing review of transactions entered into with a company in a tax heaven even in situations where no relationship between the two companies is seen.

b) *Preferential tax regimes*
   Kenya has expanded the scope of transfer pricing legislation to include transactions with related resident entities operating in preferential tax regimes, in line with BEPS action 5 on Harmful Tax practices.

c) *Transfer pricing documentation*
   Kenya is in the process of enacting rules regarding transfer pricing documentation to enhance transparency. It has already developed a tax return that is meant to ensure that all the required information is disclosed. This is proposed to cover:

   - Country by country reporting
   - Disclosure of beneficial ownership

- Domestic operations disclosures
- Imposition of penalties on failure to maintain and or avail transfer pricing documentation

d) *Widening the scope of Permanent Establishment (PE)*
Kenya is in the process of widening the scope of PEs to include activities that were omitted previously, for instance dependent agents, commissionaire agents among others. This is in line with BEPS Action 6.

e) *Pricing of commodities*
Proposal to have an additional method for benchmarking commodities using data from international or domestic commodities markets. This is in addition to the conventional methods.

f) *Enhancement of Dispute Resolution under Mutual Agreement Procedure (MAP).*
Kenya is open to resolving tax disputes with countries which it has tax treaties with in line with BEPS Action 14.

g) *Development of a multilateral instrument*
Kenya is already in the process of reviewing existing Double Tax Treaties (DTAs), identifying gaps within the DTAs to propose measures to address the gaps identified in the DTAs, In line with the outcome of BEPS Action 15.

Other developments and proposals

Other enhancements in tax legislation and administration to protect against base erosion and profit shifting from cross-border transactions include:

a) *Mutual Administrative Assistance in Tax Matters (MAC)*
Kenya has ratified the Mutual Administrative Assistance in Tax Matters (MAC) agreement which is to be deposited with the OECD, promoting the ability to exchange tax information with other jurisdictions globally; upon request and later to enter into process of exchange of information automatically and spontaneously

b) *Management of Treaties*
Kenya is in the process of preparing a treaty policy and a treaty negotiation strategy which is meant to secure and safeguard taxing rights.

c) *Proposal to anchor Advance Pricing arrangements (APA) in the legislation*
Kenya has already developed a framework for APA and it has also made proposals to have APA anchored in law

d) *Kenya has already joined the Global Forum on Exchange of Information and Transparency*.

Tax administration for transfer pricing - Capacity development

The Unilever (Kenya) Limited case was among the first transfer pricing audit cases conducted by KRA. Kenya Revenue Authority's (KRA) instituted the transfer pricing audit unit in 2009. This unit specialised in transfer pricing audits and has grown to what is now the International Tax Office (ITO) with trained and dedicated staff, from less than 10 officers to the current level of about 40 officers. The unit has ensured adequate training of its staff through in-house training and collaboration with international organizations like the World Bank funded training programs, among others.

KRA has committed resources to support transfer pricing audits through procurement of transfer pricing database for benchmarking studies and providing office equipment and facilities.

International engagements

KRA has been engaged in many international platforms on transfer pricing and international tax matters, including active participation in regional bodies like the Africa Tax Administrators Forum (ATAF) and the East Africa Revenue Authorities Technical Committee (EARTC); participation in international transfer pricing seminars; having her staff take part in supporting transfer pricing audits in other countries under the OECD's Tax Inspectors Without Borders initiative; and having membership and participating in the OECD Working Parties under the OECD BEPS Inclusive Framework. Kenya has membership to OECD working parties such as:

- Action 1 Address the tax challenges of the digital economy
- Action 5 Counter harmful tax practices more effectively, taking into account transparency and substance
- Actions 8, 9, 10 Assure that transfer pricing outcomes are in line with value creation

Conclusion

Kenya has enhanced its tax legislation and worked towards aligning it with international practices to safeguard its revenue by sealing avenues that have caused revenue leakages. KRA's ITO is dedicated to keeping pace with the changing landscape in the taxation of cross border transactions.