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State Administration of Taxation ("SAT")

People's Republic of China

Views on Service Fees and Management Fees

I. Legislations and regulations governing service fees and management fees of the People's Republic of China

(I) Service fees

The Corporate Income Tax Law ("CIT") of the People's Republic of China ("PRC") stipulates in Article 41 that "*if a business transaction between an enterprise and a related party does not comply with the arm's-length principle, thus reducing the taxable income or revenue of the enterprise or the related party, the tax authorities are empowered to make adjustments using reasonable methods.*" That is, in China, service fees received and paid between related parties must be in compliance with the arm's-length principle.

(II) Management fees

The Implementation Rules for the CIT Law of the People's Republic of China stipulates in Article 49 that "*management fees paid between*

enterprises, rental and royalties paid between business establishments within enterprises and interest paid between business establishments within non-bank enterprises shall not be deductible". Management fees specified in the above article, in general, relate to shareholder activities, which are charged on the basis of an associated relationship between investors and investees, therefore not deductible in calculating taxable income for CIT purposes.

Since the PRC tax law provides different taxation treatments for management fees and service fees, in practice, enterprises often take tax deductions under the category of service fees for various types of intra-group services fees, including management fees.

II. SAT's views on the application of the arm's-length principle for intra-group services

According to Chapter VII Special Consideration for Intra-group Services of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD TP Guidelines"), whether intra-group services comply with the arm's length principle should mainly be analyzed from the following two aspects: firstly, to determine whether intra-group services have been rendered; and secondly, to determine an arm's length price that an independent third party would have been willing to pay for the services rendered under the same circumstances. In determining whether services have been rendered, the OECD TP

Guidelines mainly employ the *benefit test*. That is, an activity provides a "benefit" if it directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position or that may be reasonably anticipated to do so.

The PRC generally agrees with the framework on intra-group services provided by the OECD TP Guidelines, however in addition to the analyses outlined in the OCED TP Guidelines, we believe that the following issues should also be taken into account:

1. When applying the benefit test, it should not only be considered from the service recipient's perspective. Instead, the analysis should be performed from the perspective of both the service provider and the service recipient. One example is services provided by a parent company that are associated with its own strategic management, but not classified as "shareholder activities". Although the subsidiary may benefit from such services, the parent company will benefit more. Therefore, the parent company should not charge service fees to the subsidiary merely because the subsidiary may benefit from such services.

2. When performing the benefit test, analyses should also be made with regard to whether the services are necessarily needed by the subsidiary. For example, various advisory and legal services provided by a parent company may indeed confer some benefit to a manufacturing subsidiary in China. However, these high-end services may not be needed

from the perspective of the subsidiary given its functions and a cost-benefit analysis.

3. When analysing intra-group services, considerations should be made with regard to whether the provision of various services from a parent company to subsidiaries have already been remunerated through the transfer pricing policies of other related party transactions. For instance, when the parent company provides intangible assets to the subsidiary and shares the associated residual profit（i.e. receiving royalty from its subsidiary）, then the parent company should not separately charge the subsidiary additional management fees regarding management or control activities. Another example is when the parent company charges the subsidiary service fees related to purchasing raw materials on behalf of the group, allowing the subsidiaries to benefit from reduced raw materials costs, yet at the same time, the subsidiary sells finished goods to the parent, and the transfer prices of the finished goods are determined on a full cost plus mark-up basis (assuming the mark-up complies with the arm's-length principle). In this example, the final beneficiary of the reduced cost of raw materials is the parent company. Therefore, the subsidiary should not pay service fees to the parent for the provision of intra-group purchasing services.

4. The definition of shareholder services in the OECD TP Guidelines is too narrow. In the revised OECD TP Guidelines published in 2010,

shareholder activities no longer include management or stewardship activities, which means that the parent company can charge its subsidiaries service fees relating to managing and controlling the subsidiaries and the subsidiaries can deduct these expenses in calculating their taxable incomes. In fact, most of the subsidiaries in developing countries have their own management teams, and they only need management decision approvals from the parent companies due to authorisation requirements. In this situation, we believe that these types of management services are likely to be duplicative activities or shareholder activities and, therefore, should not be charged.

III. Practical difficulties regarding intra-group services in China

Based on our practical experience in transfer pricing investigations relating to intra-group services in China in recent years, there are mainly two areas of difficulties:

(I) Validating the authenticity of the services rendered and the reasonableness of the associated allocation mechanisms

In comparison with related party buy/sale transactions, intra-group services have a wider variety of arrangements and are undertaken in many different forms. Therefore, the breadth of potential information regarding service fees could be very large (from thousands to tens of thousands pieces of information). In this regard, the tax administrations of developing countries find it difficult to verify the authenticity of these

fees. Furthermore, determining whether the allocation method applied is in accordance with the arm's length principle is another practical difficulty since intra-group services are mostly charged applying an indirect charge method utilising various allocation keys. Due to the fact that most of the parent companies or service centres of multinational enterprises are located overseas, the local taxpayers can often only provide information regarding their own operations instead of an overall understanding of the entire intra-group services structure. Potential issues could comprise whether the subsidiaries in other countries that similarly benefit from the services follow the same methodology to pay the service fees and the actual amount of service fees charged to the various subsidiaries. We recommend that the United Nations Practical Manual on Transfer Pricing ("UN TP Manual") refers the relevant requirements in relation to transfer pricing documentation contained in the OECD Action Plan on Base Erosion and Profit Shifting ("BEPS"), and requires that the parent company discloses in the Master File the transfer pricing policies for global intra-group services, the method and the amount of service fees allocated to each subsidiary.

(II) Differentiation between royalties and technical service fees

There are circumstances where intra-group service arrangements may be connected with the transfer of tangible goods or intangible assets (or license of proprietary technologies). In certain situations, it is very

difficult to draw a line between the transfer of intangible assets or the license of proprietary technologies and the provision of services. For example, a proprietary technology licensing contract containing service terms may provide the rights to use the proprietary technology as well as the provision of technical assistance services. We recommend that the UN TP Manual provides additional guidance on how to differentiate royalties from technical service fees.

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