

The First Chinese Customs-Tax Authorities Collaborative Transfer Pricing Administration Pilot scheme launched in Shenzhen, China

June 2022

Background

Given the uncertainties to the global economic integration brought by the pandemic and the Chinese government's new focus on accelerating the development of 'domestic-international dual circulation, various Chinese government agencies have been focused on improving services provided to taxpayers. The objectives for the various departments are to optimize the business environment, clear up bureaucratic roadblocks, reduce compliance cost, and enhance management efficiency. On 18 May 2022, the Shenzhen Customs and the Shenzhen Tax Service, State Taxation Administration (hereinafter referred to as "Shenzhen STA") jointly issued a notice on "Implementation of the collaborative transfer pricing administration of related party importation" (hereinafter referred to as "the Notice"). The Notice introduces a pilot scheme on cross department collaboration between the Customs and the Tax Authorities in transfer pricing administration and services.

This collaborative administration will take into account both the Customs' existing advance rulings and the Tax Authorities' advance pricing arrangements ("APA") for corporate income tax to resolve differences in administration measures caused by the different regulatory bases and differences in assessment methodologies for dealing with transfer pricing of taxpayers' related party imports. The aim of the Notice is to enhance certainty and predictability of transfer pricing and Customs declarations for taxpayers that carry out related party imports in Shenzhen¹.

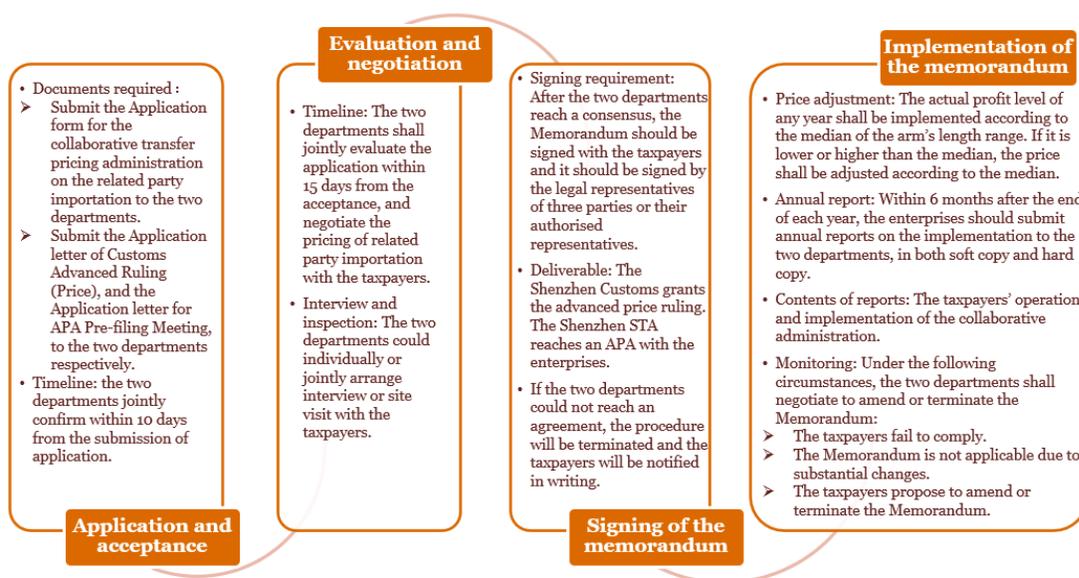
In detail

Brief description of the transfer pricing collaborative administration

- **Approach:** Shenzhen Customs and Shenzhen STA will jointly evaluate the pricing of taxpayers' related party imports. After a consensus is reached, the departments will co-sign a memorandum on collaborative transfer pricing administration of related party importation (hereinafter referred to as "Memorandum") with taxpayers, and arrange for a Customs advance ruling and an APA respectively.
- **Applicable taxpayers:** Taxpayers in Shenzhen with strong transfer pricing compliance awareness, and compliant with Article 4 in Order 236 of the General Administration of Customs (Interim Measures of the Customs of the People's Republic of China for the Administration of Pre-ruling, "Order 236") and Article 4 in Public Notice No. 64 of State Taxation Administration (Public Notice Issued by the STA on the Matters Regarding Enhancing the Administration of APA, "PN 64"):

¹ Shenzhen is a major sub-provincial city and one of the special economic zones of China. The city is located on the east bank of the Pearl River estuary on the central coast of southern province of Guangdong, bordering Hong Kong to the south. Shenzhen is one of the most populous cities in China and it becomes a global center in technology, research, manufacturing and transportation.

- ✓ Taxpayers registered as overseas business companies with Customs for carrying out actual import and export activities.
 - ✓ The amount of annual related party transactions has exceeded RMB 40 million for the previous consecutive three years.
- **Applicable period:** Three years. The collaborative arrangement will automatically expire after the expiration date. Taxpayers may apply to the Customs and the Tax Authorities for renewal within 90 days of the expiration date.
 - **Department:** The Shenzhen Customs department responsible is the Comprehensive Business Department of Customs (Customs in the taxpayers territory). The Shenzhen STA department responsible is the Comprehensive Business Department of the Fourth Branch, Shenzhen STA (hereinafter referred to as “the two departments”)
 - **Process:** The work mainly includes four stages: application and acceptance; evaluation and negotiation; memorandum signing; and memorandum execution. The main procedures and documents required at each stage are shown in the figure below:



In addition, the Notice also provides the “Application Form of Collaborative Administration (template)” and “Collaborative Administration Memorandum (template)”, which provide further guidance on implementation measures for the scope of application, period of application, requirements for price adjustment, enforcement of supervision, and dispute resolution.

Application form of collaborative administration (template)	Collaborative Administration Memorandum (template)	
<ul style="list-style-type: none"> • Basic information of the applicant, including name, address, contact person, business scope, etc • Overview of the reasons for applying for collaborative administration, including the fact description, the applicant's aim, the applicant's point of view and regulatory basis • Applicant's declaration • List of appendices 	<ul style="list-style-type: none"> • General definition • Scope of application • Period of application • Key assumptions • Transfer pricing methods and Customs valuation methods • Price adjustments • Annual report 	<ul style="list-style-type: none"> • Validity of the memorandum • Dispute resolution • Confidentiality obligations and responsibilities • Commencement, amendment and termination • Supplementary articles • Appendices <ul style="list-style-type: none"> (1) Details of advanced pricing arrangement (2) Details of custom advanced ruling on price

Our observations

➤ **Solutions to reconcile gaps in price determination between the Customs and the Tax Authorities and the corresponding double taxation issues**

In the past, when dealing with transfer pricing of related party imports, it was difficult for taxpayers to obtain approval from the Customs and the Tax Authorities at the same time. Customs normally focus on whether the import price is lower than the fair market level, which could result in under-payment of customs duties, value-added taxes etc. On the other hand, the Tax Authorities would focus on whether the import price is higher than the arm's length standard, which would lead to erosion of the corporate income tax base. The divergent viewpoints may cause potential issues of double price recognition and double taxation. The Notice, for the first time, introduces a collaborative administration between the Customs and the Tax Authorities, and provides solutions to the aforementioned issues to applicable taxpayers via the cross departmental collaboration.



➤ **Deepening the Customs’ advanced ruling practice and enhancing the efficiency of APA**

Order 236, effective since February 2018, provides taxpayers with the possibility of simplifying the process, improving efficiency for Customs clearance, and facilitating understanding of the Customs policy and other tax related matters in advance. However, in the past it has been uncommon to see “quantitative” reviews of related party import prices and the relevant advance ruling being reached. This Shenzhen collaborative transfer pricing administration pilot scheme provides quantitative and enforceable advance ruling measures, through discussion between the Tax Authorities and Customs, on the basis of Customs’ existing advanced ruling practice. The collaborative administration facilitates resolution of customs-related issues that taxpayers may face when dealing with related party transactions.

The Public Notice on “Matters Regarding the Application of the Simplified Procedures of Unilateral APA”, issued by the STA in July 2021 simplifies the application procedures (from 6 stages to 3 stages) and shortens the processing time (the Notice of Tax Related Issues will be delivered within 90 days, the analysis and evaluation will be completed within 6 months) based on the existing standard APA procedures, providing more efficient tax services to taxpayers. With the collaborative transfer pricing administration delivered by both the Customs and the Tax Authorities, the Notice will provide broader transfer pricing certainty to boost and improve the application efficiency of an APA (especially simplified procedures of unilateral APAs).

➤ **Promotion of mutual understanding between the Customs and Tax Authorities on transfer pricing methodologies**

In recent years, following increasingly frequent communication between the Customs and the Tax Authorities, both parties have developed a better understanding of the price evaluation methods used by their counterparts. Based on the recent dialogue between taxpayers and the Customs, we also observed that Customs have developed a deeper understanding of transfer pricing principles and methodologies. Customs have become increasingly flexible when applying Customs’ evaluation methods in reviewing taxpayers’ transfer pricing policies, acknowledging that the taxpayers may adopt other reasonable transfer pricing methods (such as TNMM, PSM, etc.) according to the nature of their related party transactions. We hope that the collaborative transfer pricing administration pilot scheme will further promote a mutual understanding of the evaluation methods between the Customs and Tax Authorities, narrow the gaps in rules, and reduce the transfer pricing compliance risk of taxpayers in these two areas.

➤ **Fulfilment of foreign exchange compliance requirement during transfer pricing adjustment**

Whenever taxpayers make a transfer pricing adjustment, there are practical issues related to the foreign exchange compliance. On 19 January 2021, the State Administration of Foreign Exchange (“SAFE”) issued the “Question & Answers regarding Foreign Exchange Administration for Service Trade (II)” (hereinafter referred to as “SAFE Q&A”), is the first to clarify the foreign exchange cash in-flows and out-flows in the transfer pricing adjustment from a policy perspective. For actual and legitimate transfer pricing adjustments (e.g. backed by written notice issued by the Tax Authorities or Customs for transfer pricing adjustment), the foreign exchange cash in-flows and out-flows can be handled under the terms of the original trades. The collaborative transfer pricing administration in the Notice will provide written documents to the applicable taxpayers issued by the Tax Authorities and the Customs (e.g. memorandum of collaborative administration, advanced ruling on price by the Shenzhen Customs, APA signed between the Shenzhen STA and taxpayers). This will make it easier for taxpayers to meet the foreign exchange compliance requirement when making the necessary transfer pricing adjustments (e.g. the profit level needs to be adjusted according to the median of arm’s length range, as implemented in the Memorandum).

➤ **Radiation effect of the Shenzhen pilot scheme**

For now, the Notice is only applicable to taxpayers in jurisdictions covered by Shenzhen Customs and Shenzhen STA. In the meantime, for detailed considerations on how the customs valuation practice can be fully integrated to the transfer pricing methods from technical perspectives (e.g. applicability of the transfer pricing methods other than TNMM, flexibility on adopting arm’s length range for taxpayers with multi-product categories), the two

departments and taxpayers will still need to further discuss and explore based on actual situations faced by taxpayers.

As the Notice is first launched in Shenzhen, we look forward to seeing how this will set a precedent and how it may be launched in other regions of China in the future.

Our recommendations

As the first collaborative administration between the Customs and the Tax Authorities, the Notice improves compliance certainty and management efficiency for taxpayers. The Notice opens a precedent for the coordinated governance of the Customs and Tax Authorities on transfer pricing of related party imports, and puts forward higher compliance requirements for taxpayers. We suggest that taxpayers actively evaluate the impact of the Notice, and respond effectively according to their own situations and business plans in the future.

- Shenzhen taxpayers: Take advantage of the policy and evaluate the application of collaborative administration

The collaborative administration in the Notice provides tools to improve transfer pricing certainty. We suggest Shenzhen taxpayers (especially those that have imports as their main related party transactions, those who were requested by the Customs or the Tax Authorities to make transfer pricing adjustments, and those who plan to apply for APA or advanced ruling on prices) to:

- ✓ Consider the applicability and feasibility for applying for the collaborative administration, and evaluating the advantages in application and potential impact from a Customs and tax perspective.
- ✓ Take advantage of the policy and formulate practical application plans and strategies for future negotiation with the Customs and Tax Authorities.
- ✓ Seek assistance from external experts, if necessary, to effectively promote the application, negotiation, and subsequent implementation.

We anticipate the following taxpayers in Shenzhen would benefit from the Notice:

- ✓ Those wholesale or retail distributors in the retail and consumer industry who import products from overseas related parties; and
- ✓ Those manufactures who import raw materials and components from overseas related parties and sell finished products in the domestic market.

- Other taxpayers: Review the compliance status and plan for certainty improvement in cross-border related party transactions

The collaborative administration pilot scheme in Shenzhen will potentially impact cooperation between the Customs and Tax Authorities in other regions and similar policies may be enacted in the future. We suggest other taxpayers to consider:

- ✓ Reviewing their related party transaction arrangements, mitigating transfer pricing risks from both the Customs and tax perspective.
- ✓ Paying attention to the future development of the collaborative administration scheme, and maintaining positive communication with local Customs and Tax Authorities.
- ✓ Planning in advance for the improvement of certainty in cross-border related party transactions.

Summary

Taxpayers have long faced practical issues in managing their transfer pricing risks for related party imports from a customs and tax perspective. The collaborative administration, piloted by Shenzhen Customs and Shenzhen STA, is an important innovation which will help Shenzhen taxpayers to achieve comprehensive tax certainty. In the meantime, we also noted that there are still some issues that have not been clarified and will need to be further explored in the future, such as:

- If taxpayers strictly follow the provisions of the Memorandum and make the transfer pricing adjustments according to the median of the arm's length range, how should they resolve the tax rebates for corporate income tax and turnover tax?
- Whether Customs will accept taxpayers using other transfer pricing methods (such as CUP/identical or similar price method, PSM, or other reasonable methods) in the advanced ruling on import price?
- Whether Customs will accept a transfer pricing method which selects an overseas related party as the tested party?
- Whether Customs will accept the value chain analysis and location-specific factors as required in the transfer pricing regulation?

PwC has in-depth experience in interacting with both the Customs and Tax Authorities. We have assisted a client in completing the bilateral APA and reaching an agreement with the Customs related to the evaluation of the price of imported products. The following experts would maintain close and frequent communications with the relevant departments to offer the latest insights and professional solutions to our client in real-life case planning and implementation.

- PwC Transfer Pricing Service Team
- PwC Worldtrade Management Services
- PwC Foreign Exchange & Business Advisory and Corporate Tax Services

Let's talk

If you would like further advice in relation to the topic outlined above or a deeper discussion of how this issue might affect your business, please contact:

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