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UPCOMING NATIONWIDE TRANSFER PRICING INVESTIGATION AGAINST OUTBOUND SERVICE FEE AND ROYALTY PAYMENTS

On 29 July 2014, the China State Administration of Taxation (**SAT**) released an internal notice to the China tax authorities at the provincial levels, in the name of "Notice on Anti-avoidance Investigation against Large Amount Outbound Payments" (Circular Shui Zong Ban Fa [2014] No. 146, **Notice 146**), urging a nationwide investigation against transactions involving "large amounts of inter-company service fee and royalty payments". Provincial tax authorities are required to immediately start an investigation and report upwards the relevant initial investigation results by the mid of September 2014. There is no doubt that a new wave of transfer pricing audits will be launched based on the investigation results.

Investigation Scope and Target Taxpayers

According to Notice 146, the scope of the investigation covers inter-company service fee and royalty payments made to overseas affiliates occurred during the 10-year period from 2004 to 2013. Although Notice 146 does not specify the group of taxpayers to be investigated, Foreign Invested Enterprises (**FIEs**) apparently are the main investigation targets. In the past decade, it is believed that quite a number of FIEs would have inter-company transactions involving large amounts with overseas affiliates and thus the accumulated transaction values could be significant.

Target Transactions

As a guideline for the local tax authorities, Notice 146 suggests a special attention to be placed on service fee and royalty payments with the following features.

Service fee payment made:

- to overseas for shareholder services, such as provision of operation, finance and HR consultancy services;
- for provision of group management service;
- for services that can be conducted by the chinese payer itself, or have been provided by third parties;
- for services that are irrelevant to the chinese payer's functions and risks, or incompatible to the chinese payee's business operation;
- for services that have been covered in other transaction prices.

Royalty payment made:

- to entities incorporated in tax heavens;
- to an overseas affiliate with no substantial or fairly limited functions;
- for depreciated licenses, or for ips to which the chinese payer has special contribution.

Next Steps

In the next few weeks, many FIEs may receive requests from their in-charge tax authorities for providing summary/detailed information on their outbound payments made for inter-company service fees and royalties. Such information, together with local tax authorities' analysis, will then be submitted to the SAT for further review. As a result, it is possible that the SAT and local tax authorities will come up with a list of taxpayers for formal transfer pricing audits in the fourth quarter of 2014.

For FIEs with substantial amounts of historical outbound inter-company service fee and royalty payments, we note that presentation and justification of the underlining transactions would be critical if the entities are asked by the local tax authorities for submission of relevant information. As a formal transfer pricing audit could be imminent, it is advisable that the FIEs should start prepare or review the FIE's transfer pricing defense/management files.

On the other hand, it should be noted that Notice 146 also indicates another new trend for China transfer pricing audits. FIEs may consider review and refurbish their existing transfer pricing arrangements and policies to mitigate their transfer pricing risks.

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