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China's Chapter of U.N. Manual Advocates Reimbursement For Location Savings, Added Profit for Local Intangibles

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Chinese related parties must be appropriately remunerated for their location-specific advantages and should be entitled to additional profit when they improve their foreign related party's original intangibles, including global brand names, technical know-how, and business processes, according to China's State Administration of Taxation.

The SAT, in a chapter of the United Nations' Transfer Pricing Practical Manual for Developing Countries, approved Oct. 15, said the added profit is appropriate to reflect China's unique economic and geographic factors that contribute to the profitability of Chinese taxpayers and their foreign parent companies.

In Chapter 10.2 of the manual, the SAT states that these unique factors include readily available migrant labor, low labor and infrastructure costs, first-mover advantages in certain industries, foreign exchange controls, and growing population and consumer demand for foreign and luxury products. Although much of the Organization for Economic Cooperation and Development transfer pricing guidelines still may apply to developing countries, the tax agency said it has had to fashion practical solutions to deal with unique issues that ''have not been addressed, or at least not sufficiently or practically addressed by the OECD Guidelines.''

On the question of local intangibles, the SAT said that while multinational enterprises set up contract research and development operations to take advantage of local talents, such enterprises ''leave little profit to China'' despite the R&D contributing significant profits to the multinational group.

Chapter 10.2 of the U.N. manual, *China Country Practices, Bridging The Gap—Applying the Arm's Length Principle in Developing Countries*, appears in the Text section of this issue.

China and the United States recently concluded a bilateral advance pricing arrangement with Microsoft Corp. that reimburses China for the country's location-specific advantages and recognizes local enhancements to foreign related-party intangibles. (See the related article in this issue.)

New Frontier

Glenn DeSouza of Baker & McKenzie in Shanghai told BNA Nov. 7 that generally speaking, the principles articulated by the SAT in the U.N. manual, including whether location savings should in part be captured in the Chinese taxpayers' cost base and reflected in the markup rate, should be regarded as aspirational as opposed to actual policies that have been put into effect.

DeSouza pointed to an example in the U.N. manual where the markup rate is 8 percent based on comparables, but the SAT argues that a 12 percent markup is appropriate given that the average cost base in China is significantly lower than the cost base for the companies' research and development centers in developed countries.

While some of China's innovations, such as location savings, already have manifested themselves in advance pricing arrangements, DeSouza said, they have not yet been enforced widely by the local tax bureaus, which are the organs implementing transfer pricing on the front line.

Sébastien Gonnet of NERA Economic Consulting in Beijing said Oct. 31 that location savings is the next transfer pricing frontier in China.

Gonnet, speaking at an IBC conference in Singapore, recounted that four years ago in a meeting with the head of the SAT in Beijing, the official complimented the thoroughness of his client's bilateral APA application but asked Gonnet to return six months later after addressing the issues of location savings, market premium, and local intangibles.

Location-Specific Advantages

According to Chapter 10.2 of the U.N. manual, ''location specific advantages'' are production advantages ''arising from assets, resource endowments, government industry policies and incentives, etc, which exist in specific localities.''

For example, the SAT in Chapter 10.2 said that household electronics manufacturers invest in China to take advantage of a large pool of well-educated, low-cost labor, and a well-developed network of suppliers.

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Global automotive companies set up joint ventures in China to assemble automobiles to be close to their customers and to take advantage of lower costs.

The SAT said limited guidance is available on location-specific advantages in the OECD transfer pricing guidelines. ''[L]ocation savings and market premium arise more frequently in China and other developing economies, rather than in established and developed economies.''

China Solution

In Chapter 10.2, the SAT outlines China's solution to reconcile the arm's-length principle with the lack of reliable comparables in developing countries.

According to the SAT, location savings are the net cost savings derived by a multinational company 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.''

Market premium, the SAT said, ''relates to the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product.''

In dealings with Chinese taxpayers, the SAT said it has adopted a four-step approach on the issue of location-specific advantages:

- identify whether such an advantage exists;
- determine whether it generates additional profit;
- quantify and measure the additional profit arising from the location-specific advantages; and
- determine the transfer pricing method to allocate the profits arising from those advantages.

In determining location-specific advantages and their impact on transfer pricing, ''both industry analysis and quantitative analysis are critical,'' the SAT said.

Automotive Industry

The SAT pointed to the automotive industry as an example of many location-specific advantages leading to ''extraordinarily high profits'' that are rightly earned by Chinese taxpayers. The SAT identified six such advantages in the automotive industry:

- China's ''market for technology'' industry policy, which requires foreign automotive manufacturers to form joint ventures in order to assemble automobiles in China, forcing foreign automotive manufacturers to compete for limited market access opportunities by offering favorable terms including provision of technologies at below-market prices.
- Chinese consumers' general preference for foreign brands and imported products. ''This general preference, as opposed to loyalty to a specific brand, creates opportunities for MNEs [multinational enterprises] to charge higher prices and earn additional profits on automotive products sold in China.''
- Huge, inelastic demand for automotive vehicles in China due to the large population and growing wealth of the population.
- Capacity constraints on the supply of domestically assembled automotive vehicles.
- Duty savings from the lower duty rate of 10 percent on imported automotive parts compared to a 25 percent rate on imported vehicles. ''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.''
- A large supply of high-quality, low-cost parts, manufactured by suppliers in China.

Joint Ventures

The SAT explained that for a 50/50 joint venture with partners having conflicting interests in the Chinese automotive industry, the Chinese joint venture partner generally contributes the local distribution network, intimate knowledge about the local market, and the right market access.

However, the Chinese partner does not typically control the joint venture operation. That operation usually is controlled by the foreign partner, which also controls the supply chain for the parts.

According to the SAT, the most important potential transfer pricing issue in the automotive industry ''involves the JV being overcharged for the parts and services that are provided by related parties.''

In the absence of such overcharges, the SAT said the joint venture's results will mainly reflect an arm's-length outcome, which in turn will reflect the contribution of location-specific advantages to the joint venture.

Contract R&D

The SAT gave an example of location-specific advantages involving a Chinese taxpayer performing contract research and development services for an offshore affiliate, with a ''full cost mark up (FCMU) as the profit level indicator'' for a comparable set of foreign companies located in developed countries that have higher costs.

In the example, the Chinese taxpayer's cost base is 100, the average cost base for the company's R&D centers in developed countries is 150, and the median FCMU of the comparables is 8 percent. 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.''

The SAT said the adjusted FCMU should be calculated to take into account China's location savings as follows:

- Calculate the arm's-length range of FCMUs based on foreign comparables, mostly in developed countries, resulting in a median FCMU of 8 percent.
- Calculate the difference between the cost base of the Chinese taxpayer (100) and the average cost base of the foreign companies (150), which is 50.
- Multiply that difference (50) by the arm's-length FCMU (8 percent), which equals 4.
- The additional profit of 4 is attributable to China for the location savings.
- The total arm's-length profit for the Chinese taxpayer is 4 percent + 8 percent × 100 = 12.
- Calculate the adjusted arm's-length FCMU for the Chinese taxpayer, which is 12/100 = 12 percent.

The SAT said it ''has come across many other cases of market premiums for Chinese taxpayers, particularly in the luxury goods sector.''

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Chinese Tax Authorities

DeSouza said the Chinese tax authorities ''move in a very deliberate and gradual way when implementing new policies.''

The cycle is as follows, DeSouza said. First, the regulation is passed; then, there are pilot applications in certain areas; and finally, after extensive training, the policy is rolled out across the nation. Therefore, it may be some time before the transfer pricing propositions outlined in the U.N. manual become the prevailing practice across the country.

DeSouza said there are no surprises in the U.N. manual. The SAT has for a number of years been raising these issues and debating them in various forums. While the manual does not comport with the actual practices taken to date, it certainly is reflective of the thinking at the Chinese tax authorities.

The positions taken by China are in line with those positions taken by other countries in a similar economic stage of development, he said.

U.N. Manual

Gonnet said many foreign companies are setting up R&D centers in China—not for the purposes of providing services to the U.S. or German parent, ''but to get closer to the market to develop products that will be more acceptable in the region.''

Previously, the concept of location savings related only to the issue of cost, Gonnett said, but taxpayers now must address the issue of location-specific advantages, because the SAT believes that taxpayers benefit not only from China's cost advantage but also from its large market.

Gonnet pointed out that Chapter 5 of the U.N. manual—in addition to the SAT's position set forth in Chapter 10.2—provides an analytical framework for location savings and location-specific advantages.

Chapter 5 explains that ''[t]aken together, location savings and each of the other types of benefit related to geographical location are called location-specific advantages.''

According to Chapter 5, the relocation of a business, in addition to location savings, may result in location-specific advantages, including:

- highly specialized skilled manpower and knowledge;
- proximity to growing local or regional market;
- large customer base with increased spending capacity;
- advanced infrastructure—for example, information and communication networks and distribution systems; and
- market premium.

OECD Guidelines

Gonnet said the OECD transfer pricing guidelines include only two examples on location-specific advantages and that this limited guidance does not constitute an analytical framework.

The first example, he said, involves a branded clothes manufacturer in a high-cost country, owning all of the intellectual property, including the brand and designs. The manufacturer then decides to relocate basic contract manufacturing operations to a low-cost country.

In this case, Gonnet said the OECD guidelines conclude that all or most of the location savings would be attributed to the parent because of the lesser bargaining power of the contract manufacturer. The relocated activity is highly competitive and does not employ valuable intangibles or assume significant risks, whereas the parent has the option realistically available to use either the affiliate or a third party.

Gonnet said in the second OECD example, a provider of highly specialized engineering services in high-cost country A opens a subsidiary in low-cost country B. The clients of the parent in A ignore the subcontracting arrangement and are charged country A hourly rates until competition forces the parent to pass some of the savings to the clients.

If the subsidiary in B is the only entity capable of providing the required standards, or has some locally developed intangibles, Gonnet said, the OECD recommends a profit split method to determine the split of location savings.

OECD Intangibles Draft

DeSouza said it would be tempting to see the OECD discussion draft on intangibles as counterpoint to the U.N. manual. ''But I think that although there are differences, there has been a significant attempt to really bridge the gap between the parties.'' He pointed out that India and China are not members of the OECD but have observer status.

Gonnet said the OECD discussion draft's position that location-specific advantages are not intangibles is correct. Such advantages are external factors, Gonnet said—for example, foreign companies do not control the wages in India and China, nor do they control the amount of traffic on a certain road adjacent to a retailer. ''So by definition, [location-specific advantages] are not intangibles.''

Paragraph 24 of the OECD discussion draft states that ''market specific characteristics'' are not intangibles and should be taken into account in a transfer pricing analysis through the required comparability analysis.

The paragraph states that specific characteristics of a given market may affect the arm's-length conditions of transactions in that market. For example, the high purchasing power of households in a particular market may affect the prices paid for certain luxury consumer goods. ''Similarly, low prevailing labor costs, proximity to markets, favourable weather conditions and the like may affect the prices paid for specific goods and services in a particular market.''

A New Tax Order

DeSouza said that in 2000, OECD nations controlled 60 percent of gross world product. Now it is at 50 percent and is expected to drop to about 40 percent in 2030.

With new players such as Brazil, Russia, India, China, and South Africa (BRICS), nongovernmental organizations, and the U.N. entering the fray, the transfer pricing dynamics are different, DeSouza said. ''Ultimately, it's about each country getting a fair deal.''

DeSouza said China is part of the global economic system but wants to safeguard its interests—and it now has the clout to do so. A high-ranking SAT official recently said "China has become a major source of global profits but it does not show up in China tax books."

As "an exceptional country," DeSouza said, China will want a say in writing the rules, whether it is greenhouse gases, transfer pricing, or intellectual property, "and that is the way it will be."

DeSouza said that with China now the second-largest economy, and accounting for 30 percent of the world's growth, the materiality of China in tax planning has become profound.

China is already the world's largest market for automobiles, steel, and smartphones, he said.

Defining Intangibles

Cindy Li, tax director of Microsoft (China) Co. Ltd., said Oct. 31 that the OECD's discussion draft on intangibles "may be a bit narrow from a developing country point of view" in defining intangibles for transfer pricing purposes.

Li, speaking at the same conference as Gonnet, said that if the OECD "can add more about location savings and market premium" in the draft, it would help companies operating in developing countries such as China. At the conference, Li also described a recently signed Microsoft Corp. advance pricing arrangement, which required a reimbursement to China for location-specific advantages.

Jean-Louis Barsac, regional tax director of Alcatel-Lucent Shanghai Bell Company Ltd., also speaking at the conference, said the definition of intangibles proposed by the OECD discussion draft "is going in the right direction" because multinational enterprises are creating new kinds of intangibles.

DeSouza told BNA Nov. 7 that going forward in China, "the most significant area of controversy facing multinationals will be intangibles."

Royalties

The SAT in Chapter 10.2 of the U.N. manual gave an example of a Chinese affiliate being charged a 3 percent royalty for the use of a manufacturing process by its foreign related party. The affiliate's operations in China were established 10 years ago in 2002.

According to the SAT, under this scenario, "it may not be reasonable for the Chinese affiliate to continue paying the same royalty in 2012 without revisiting whether the intangible has continued to provide the same value over time."

This is particularly the case, the SAT said, if the Chinese affiliate, while conducting the manufacturing operations over the 10-year period, has improved its foreign related party's manufacturing processes through a process of trial and error.

"We would question whether the Chinese affiliate should continue to pay a royalty to the parent company for the manufacturing process," the SAT said, suggesting that, instead, the Chinese affiliate should be entitled to a return on the intangibles that it has developed and shared with the multinational group.

DeSouza said "there is some merit to the U.N. China Chapter manual position that to a considerable extent the success of foreign multinationals in China is due to their activities in China."

For example, DeSouza said, in the automobile industry, the growing profit enjoyed by some multinationals cannot be solely attributed to their overseas technology but also reflects such factors as their customization of products for the local market, their establishment of a local dealer network, and their creation of a Chinese brand name.

DeSouza said multinationals who acknowledge these other drivers to profitability will find that their defense of their royalty will be more credible, persuasive, and sustainable in the long run.

Intangibles

The SAT said in Chapter 10.2 that while multinational enterprises in developed countries often have superior technology intangibles, they need the fast-growing market in the developing countries, and the contributions of the subsidiaries in these countries, to develop the market in order to monetize the value in such intangibles.

For developing countries, the SAT said, marketing intangibles and location-specific advantages often are closely integrated, "and due consideration is necessary to properly compensate the contribution of the subsidiaries in developing countries."

DeSouza said the issue of intangibles is so important—not just for tax planning purposes, but also to the fundamental value of a company—that it cannot be addressed exclusively by the tax director but also must have the involvement of legal counsel specializing in intellectual property.

The issue of local Chinese intangibles is becoming particularly complicated, DeSouza said, because the definition of intangibles has vastly expanded to include "a lot of very soft areas such as workforce in place and goodwill and it is clear that these are being created locally."

DeSouza said the positions taken by China in the U.N. transfer pricing manual will be a challenge to conventional transfer pricing models in some cases. For example, multinationals are used to setting in place a royalty and keeping it locked in—a practice the U.N. manual suggests will need to be defended.

Contract R&D

The SAT said in Chapter 10.2 of the U.N. manual that contract R&D is an area where the contribution of developing countries is often underestimated.

The tax agency pointed out that the transfer pricing method commonly used to reward R&D activities performed by toll and contract manufacturers, limited-risk distributors, and limited-risk service providers of a multinational enterprise in China is cost plus.

The SAT said that sometimes the principal entity that the taxpayer claims is 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 enterprise (HNTE) status" under 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, the SAT said, and a different transfer pricing method, such as profit split, would be more appropriate.

The SAT said that companies claiming HNTE status should perform activities that result in the creation of

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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, the SAT said.

HNTE Status

DeSouza said he estimates that the vast majority of multinationals operating in China traditionally have taken the position that all of their intangibles are held offshore.

The SAT clearly is challenging this position, DeSouza said, and asserting that those multinationals that have received HNTE status, and that are spending significantly to develop the local brand name and then taking those expense deductions in China, should be willing to acknowledge that IP is being created in China.

DeSouza said a multinational enterprise recently was challenged by the Chinese tax authorities as to why, if it has HNTE status, ''it is continuing to pay such high royalties,'' and another enterprise was challenged for high marketing expenses.

Intellectual property in China will reflect itself either in reduced royalties being paid to the overseas parent or in higher profit rates being reported in China, he said.

Profit Split

The SAT said that 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 case of significant local marketing intangibles or location-specific advantages, or by performing comparability adjustments when the transactional net margin method is used.

For example, the SAT said that if the median operating expense to sales ratio for the comparables set is only 7 percent, and the same ratio for the taxpayer was 40 percent, ''[t]o the extent there is location savings, we would adjust the cost base first.''

The Chinese tax administration then would calculate the additional return required for the extra efforts made by the Chinese taxpayer to derive the total return for the Chinese taxpayer, the SAT said.

R&D Life Cycle

Microsoft's Li said that if the SAT asserts that a profit method is appropriate to reflect location savings, ''this does not necessarily mean that we must go through the profit split method.''

Li suggested that taxpayers emphasize to the SAT the significance of their function and risk analysis. ''The legal concept is one thing, but we should focus more on the substance.''

The taxpayer should do ''a very deep, comprehensive, function and risk analysis,'' Li said. This will show the SAT that even though the taxpayer has many talented R&D people in China, who are cheaper, ''it does not mean that they will bring an additional profit to the whole company.'' They are not involved in high-end strategical planning or the whole management developing process.

Li said a taxpayer should explain its entire R&D life cycle to the Chinese tax authorities—from strategic thinking and planning to design, coding, testing, and shipping to market. The whole life cycle should tell the SAT ''what exactly we are doing here versus what the global team doing.''

Then, Li said, the SAT can compare the value provided to the Chinese market and address whether the profit split method should be used to reflect the location savings, or whether there is another way to ''adjust your comparables and then reach a different result.''

☐ **This article has been updated since it was first published online.**