Administrative Measures on Special Tax Adjustments (Trial) of the PRC

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Chapter I — General Provisions

Article 1 — These Measures are formulated in accordance with the Enterprise Income Tax Law of the People's Republic of China (hereinafter referred to as the "EIT Law"), the Regulations for the Implementation of the Enterprise Income Tax Law (hereinafter referred to as the "Implementation Regulations"), and the Law on the Administration of Tax Collection of the People's Republic of China (hereinafter referred to as the "Tax Collection Law") and its Implementation Rules, for the purpose of strengthening the administration of special tax adjustments.

Article 2 — These Measures shall apply to the special tax adjustment matters administered by the tax authorities in respect of enterprise income tax of enterprises, including but not limited to transfer pricing administration, advance pricing arrangements, cost sharing agreement administration, controlled foreign corporation administration, thin capitalization administration, and general anti-avoidance administration.

Article 3 — For the purposes of these Measures, related parties refer to enterprises, other organizations or individuals that have any of the following relationships with an enterprise:

(1) Direct or indirect control in respect of capital, operation, procurement, sales or other aspects;

(2) Direct or indirect control by the same third party;

(3) Other relationships with an associated interest.

Article 4 — Related party transactions referred to in these Measures mainly include:

(1) Transfer, sale, lease, or license of tangible assets;

(2) Transfer, sale, lease, or license of intangible assets;

(3) Provision or receipt of services;

(4) Financing transactions including loans, guarantees and other credit arrangements;

(5) Other transactions of a related party nature.

Article 5 — Tax authorities shall, when conducting special tax adjustments, apply the arm's length principle. Where related party transactions are not conducted on arm's length terms, resulting in a reduction of the taxable income of the enterprise or its related parties, the tax authority shall have the power to make adjustments using reasonable methods.

Chapter II — Related Party Reporting

Article 6 — An enterprise subject to audit and settlement of enterprise income tax on an actual basis shall, when filing its annual enterprise income tax return, submit the Annual Related Party Transactions Report (hereinafter referred to as the "Related Party Report") to the tax authority. The Related Party Report shall include information on related party relationships and related party transactions.

Article 7 — For the purposes of related party reporting, an enterprise shall determine whether a related party relationship exists based on the relevant provisions of the EIT Law, the Implementation Regulations, and these Measures.

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Article 8 — Related party transactions shall be classified by type as provided in Article 4 of these Measures. The enterprise shall report the total amount of each type of related party transaction during the tax year, disaggregated by related party.

Article 9 — An enterprise that implements a cost sharing agreement during the tax year shall separately identify such agreement in the Related Party Report.

Chapter III — Contemporaneous Documentation

Article 10 — An enterprise shall prepare contemporaneous transfer pricing documentation in accordance with the requirements of the tax authority. Contemporaneous documentation mainly includes the organizational structure, an overview of production and operations, analysis of related party transactions, analysis of the selection and application of transfer pricing methods, and functional and risk analysis.

Article 11 — An enterprise that falls under any of the following circumstances may be exempted from preparing contemporaneous documentation:

(1) The total amount of related party transactions in the tax year is less than the threshold prescribed by the tax authority;

(2) The related party transactions are subject to an advance pricing arrangement;

(3) A majority of the equity interests of the enterprise is held by foreign investors, and the enterprise submits contemporaneous documentation to the tax authority through the foreign investor.

Article 12 — An enterprise shall complete the contemporaneous documentation within six months following the end of the tax year. The contemporaneous documentation shall be kept for a period of ten years from the date of preparation.

Article 13 — An enterprise shall, when requested by the tax authority during a transfer pricing investigation, provide its contemporaneous documentation within the prescribed time limit.

Article 14 — Where an enterprise fails to prepare, provide, or keep contemporaneous documentation as required, the tax authority may determine the taxable income by estimation or through other reasonable methods.

Chapter IV — Transfer Pricing Methods

Article 15 — The tax authority shall use reasonable methods to assess and adjust related party transactions. Transfer pricing methods include the comparable uncontrolled price method, the resale price method, the cost plus method, the transactional net margin method, the profit split method, and other methods consistent with the arm's length principle.

Article 16 — The comparable uncontrolled price method compares the price charged in a related party transaction with the price charged in a comparable uncontrolled transaction under comparable circumstances. This method is generally applicable to all types of related party transactions.

Article 17 — The resale price method determines the arm's length purchase price by deducting an appropriate gross margin from the resale price at which a product purchased from a related party is resold to an independent party. This method is generally applicable to transactions where the reseller does not make substantial value-added contributions to the product.

Article 18 — The cost plus method determines the arm's length price by adding an appropriate mark-up to the costs incurred. This method is generally applicable to the provision of services or the sale of semi-finished products between related parties.

Article 19 — The transactional net margin method compares the net profit margin realized by an enterprise from a related party transaction with the net profit margin realized in comparable uncontrolled transactions.

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This method is generally applicable where the comparable uncontrolled price method, resale price method, or cost plus method cannot be reliably applied.

Article 20 — The profit split method allocates the combined profit from related party transactions among the related parties based on each party's contribution. This method is generally applicable to highly integrated related party transactions where each party makes unique and valuable contributions.

Article 21 — When selecting a transfer pricing method, the enterprise or the tax authority shall conduct a comparability analysis, considering factors such as the characteristics of the assets or services, the functions performed, the risks assumed, contractual terms, economic circumstances, and business strategies.

Chapter V — Transfer Pricing Audits and Adjustments

Article 22 — Tax authorities shall select enterprises for transfer pricing audits based on risk indicators including, but not limited to, the scale and nature of related party transactions, the profitability level of the enterprise relative to its industry, and the existence of loss-making or low-profit situations.

Article 23 — When conducting a transfer pricing audit, the tax authority may request the enterprise and its related parties to provide relevant information and documentation, and may conduct on-site investigations and inspections.

Article 24 — Where, through a transfer pricing audit, the tax authority determines that the pricing of related party transactions is not at arm's length, it may make a transfer pricing adjustment. The adjustment shall be made in accordance with the methods prescribed in Chapter IV of these Measures.

Article 25 — Where the tax authority makes a transfer pricing adjustment, it shall issue a written notice of adjustment to the enterprise. The enterprise shall pay the additional tax assessed, together with any applicable late payment surcharges, within the prescribed period.

Article 26 — Where an enterprise is subject to a transfer pricing adjustment, the tax authority may, in addition to the tax adjustment, impose an additional levy of 5% of the adjusted amount where the contemporaneous documentation requirement is met or the enterprise has actively cooperated with the audit.

Chapter VI — Advance Pricing Arrangements

Article 27 — An enterprise may apply to the tax authority for an advance pricing arrangement (hereinafter referred to as "APA") with respect to its future related party transactions. An APA is an agreement between the tax authority and the enterprise on the transfer pricing method and the arm's length pricing range for the enterprise's related party transactions for future years.

Article 28 — APAs are classified into unilateral, bilateral, and multilateral APAs. A unilateral APA is an arrangement between the enterprise and the Chinese tax authority. A bilateral or multilateral APA is an arrangement reached between the competent tax authorities of two or more jurisdictions based on a mutual agreement procedure under the applicable tax treaty, in which the Chinese tax authority participates.

Article 29 — An enterprise applying for an APA shall satisfy the following conditions:

(1) It has a reasonable business purpose and good-faith intent to comply with tax laws;

(2) It can provide complete and accurate information and documentation for the APA application;

(3) It has maintained contemporaneous documentation in accordance with the relevant provisions for the year(s) preceding the application period.

Article 30 — An APA shall generally cover three to five consecutive tax years. The enterprise and the tax authority may agree to apply the APA retroactively for a period not exceeding ten years prior to the year in which the formal application is filed.

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Article 31 — During the term of an APA, the enterprise shall submit an annual compliance report to the tax authority demonstrating that the terms of the APA have been satisfied. Where any material change affecting the APA occurs, the enterprise shall promptly notify the tax authority.

Article 32 — Where the tax authority discovers that the enterprise has concealed material facts or provided false information during the APA process, or fails to comply with the APA conditions, the tax authority may revoke or revise the APA.

Chapter VII — Cost Sharing Agreements

Article 33 — An enterprise entering into a cost sharing agreement with its related parties for the joint development or acquisition of intangible assets, or for the joint provision or receipt of services, shall comply with the arm's length principle.

Article 34 — For a cost sharing agreement to be recognized for tax purposes, the following conditions shall be satisfied:

(1) The agreement has a genuine commercial purpose and economic substance;

(2) The allocation of costs under the agreement is consistent with the benefits expected to be derived by each participant;

(3) The participants have the capability to independently exploit or use the results of the cost sharing arrangement;

(4) Contemporaneous documentation supporting the cost allocation is maintained.

Article 35 — Where a cost sharing agreement does not comply with the arm's length principle, the tax authority may make an adjustment to the enterprise's taxable income to reflect the arm's length allocation.

Article 36 — An enterprise participating in a cost sharing agreement shall report the agreement in the Related Party Report and provide the relevant documentation when requested by the tax authority.

Chapter VIII — Controlled Foreign Corporation Rules

Article 37 — Where a Chinese resident enterprise, or a Chinese resident enterprise together with Chinese resident individuals, controls a foreign enterprise that is established in a jurisdiction where the effective tax rate is significantly lower than the statutory tax rate in China (generally set at 50% or less of the Chinese statutory EIT rate), and such foreign enterprise does not distribute or reduces the distribution of its profits without reasonable business needs, the undistributed profits of the foreign enterprise shall be included in the taxable income of the Chinese resident enterprise for the current period.

Article 38 — Control for the purposes of this chapter means a shareholding (either direct or indirect) of 10% or more of the voting shares of the foreign enterprise, with a combined shareholding of 50% or more by all Chinese resident shareholders.

Article 39 — The controlled foreign corporation rules shall not apply where:

(1) The CFC is established in a jurisdiction designated by the SAT as not being a low-tax jurisdiction;

(2) The CFC's main business is active trading, production, or business operations;

(3) The CFC's annual profits are below the threshold prescribed by the SAT.

Chapter IX — Thin Capitalization Rules

Article 40 — Where the ratio of debt investments received by an enterprise from its related parties to equity investments exceeds the standard ratio prescribed by the tax authority, the interest expense attributable to the excess debt portion shall not be deductible in computing taxable income for the current period and for

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any carry-forward periods, unless the enterprise can demonstrate that the related party debt transactions comply with the arm's length principle.

Article 41 — The standard debt-to-equity ratio for enterprises in the financial sector is 5:1. For all other enterprises, the standard ratio is 2:1.

Article 42 — Related party debt investments include, but are not limited to, loans from related parties, guarantees provided by related parties, and other forms of financing from related parties.

Article 43 — The enterprise may present evidence to demonstrate that the terms and conditions of its related party debt transactions are consistent with the arm's length principle, including evidence of comparable arm's length financing arrangements.

Chapter X — General Anti-Avoidance Rule

Article 44 — The tax authority may apply the general anti-avoidance rule to deny a tax benefit or make an adjustment to the taxable income of an enterprise where the enterprise enters into an arrangement the main purpose or one of the main purposes of which is to obtain a tax benefit, and the arrangement lacks a reasonable commercial purpose.

Article 45 — When determining whether an arrangement lacks a reasonable commercial purpose, the tax authority shall consider all relevant facts and circumstances, including but not limited to:

(1) The form and substance of the arrangement;

(2) The timing and manner of the arrangement;

(3) The effect of the arrangement on the enterprise's financial position;

(4) The tax consequences of the arrangement;

(5) Whether there is a non-tax business purpose for the arrangement;

(6) Whether the enterprise would have entered into the arrangement on the same terms if there were no tax benefit.

Article 46 — Where the tax authority applies the general anti-avoidance rule, it shall follow the prescribed procedures and issue a written notice to the enterprise explaining the reasons for and the legal basis of the adjustment.

Article 47 — The general anti-avoidance rule may be applied to, but is not limited to, the following situations:

(1) Abusive use of tax incentives;

(2) Abusive use of tax treaty benefits;

(3) Abusive use of corporate organizational forms;

(4) Arrangements designed to avoid being classified as a tax resident enterprise of China;

(5) Other arrangements lacking commercial substance.

Chapter XI — Corresponding Adjustments and Mutual Agreement Procedures

Article 48 — Where a related party taxpayer in another jurisdiction has been subject to a transfer pricing adjustment by the tax authority of that jurisdiction, resulting in double taxation, the Chinese enterprise may apply to the Chinese tax authority for a corresponding adjustment.

Article 49 — The Chinese tax authority, upon receiving an application for a corresponding adjustment, shall review the application and make a decision based on the relevant provisions of the applicable tax treaty or arrangement.

Article 50 — An enterprise may apply to the Chinese competent tax authority to initiate a mutual agreement procedure under the applicable tax treaty to resolve taxation not in accordance with the treaty arising from a transfer pricing adjustment or other special tax adjustment.

Article 51 — An application for a mutual agreement procedure shall be filed within the time limit prescribed by the applicable tax treaty. The application shall include a detailed description of the facts and circumstances, the applicant's analysis, and relevant supporting documentation.

Chapter XII — Supplementary Provisions

Article 52 — For the purposes of these Measures, the term "tax year" refers to the period from January 1 to December 31 of a calendar year.

Article 53 — Where an enterprise disagrees with a special tax adjustment made by the tax authority, it may apply for administrative reconsideration or file an administrative lawsuit in accordance with the relevant laws. Prior to the conclusion of such proceedings, the enterprise shall first pay the tax assessed or provide a corresponding guarantee.

Article 54 — The State Administration of Taxation shall be responsible for the interpretation of these Measures.

Article 55 — These Measures shall be effective as of January 1, 2008. Where any previously issued tax regulations conflict with these Measures, these Measures shall prevail.

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