

Circular of the State Administration of Taxation on the Issuance of the Implementation Measures of Special Tax Adjustments (Provisional)

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State taxation bureaus and local taxation bureaus of all provinces, autonomous regions, municipalities directly under the Central Government and cities specifically designated in the state plan:

In order to implement the PRC Corporate Income Tax Law and its Implementation Rules, and to regulate and strengthen the administration of special tax adjustments, the State Administration of Taxation has formulated the Implementation Measures of Special Tax Adjustments (Provisional). These Measures are hereby issued to you for implementation.

Attachment: Implementation Measures for Special Tax Adjustments (Provisional)

January 8, 2009

Implementation Measures of Special Tax Adjustments (Provisional)

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Chapter 1 General Provisions

Article 1 This set of Measures¹ is formulated to administer special tax adjustments in accordance with the PRC Corporate Income Tax Law (the "CIT Law") and its implementation rules (the "Implementation Rules"), the PRC Tax Collection Administration Law (the "Tax Collection Law") and its implementation rules (the "Tax Collection Law Implementation Rules"), and relevant provisions of the avoidance of double taxation treaties (arrangements) between the Chinese government and governments of relevant countries (or regions) (the "tax treaties or arrangements").

Article 2 The Measures shall apply to the special tax adjustment administration by tax authorities, covering business enterprises' transfer pricing, advance pricing arrangements, cost sharing arrangements, controlled foreign corporations, thin capitalisation and general anti-tax avoidance.

Article 3 In respect of transfer pricing administration, tax authorities shall examine business transactions between enterprises and their related parties ("related-party transactions") and evaluate whether they are conducted on an arm's-length basis, in

¹ The "Implementation Measures of Special Tax Adjustment (Provisional)" are referred to as the "Measures" throughout the text.

addition to conducting investigations and making adjustments, as required under Chapter 6 of the CIT Law and Article 36 of the Tax Collection Law.

Article 4 In respect of advance pricing arrangement administration, tax authorities shall examine and evaluate enterprises' pricing principles and computation methods of related-party transactions for (a) future year(s), and negotiate with the enterprises to reach an advance pricing arrangement, in accordance with Article 42 of the CIT Law and Article 53 of the Tax Collection Law Implementation Rules.

Article 5 In respect of cost sharing arrangement administration, tax authorities shall examine and evaluate whether cost sharing arrangements among enterprises and their related parties are executed on an arm's-length basis, in addition to conducting investigations and making adjustments, in accordance with Paragraph 2 of Article 41 of the CIT Law.

Article 6 In respect of controlled foreign corporation administration, tax authorities shall examine, evaluate, and investigate the controlled foreign corporations' non-distribution or decreased distribution of profits, and adjust the income tax attributable to Chinese resident enterprises in accordance with Article 45 of the CIT Law.

Article 7 In respect of thin capitalisation administration, tax authorities shall examine, evaluate, and investigate (along with adjustments) whether proportions of related party debt investments to equity investments received in enterprises comply with the prescribed ratio or are set on an arm's-length basis, in accordance with Article 46 of the CIT Law.

Article 8 In respect of general anti-tax avoidance administration, tax authorities shall examine enterprises' taxable income and evaluate whether it has been reduced through transactions or actions for non-reasonable business purposes; they shall also conduct investigations and make adjustments, in accordance with Article 47 of the CIT Law.

Chapter 2 Related Party Filing

Article 9 The term "related-party relationships," as referred to in Article 109 of the Implementation Rules of the CIT Law and in Article 51 of the Tax Collection Law Implementation Rules, primarily refers to relationships between an enterprise and other parties, organisations or personnel under one of the following situations:

(i) One party directly or indirectly holds a total of 25 percent or more of the shares in the other party, or 25 percent or more of the shares of both parties are directly or indirectly held by a third party. When either party indirectly holds the shares of another party through an intermediate party, the indirect shareholding will be deemed as the same as the shareholding by that party in the other party if it holds more than 25 percent of the shares.

(ii) Loans between two parties (excluding independent financial institutions) account for 50 percent or more of either party's paid-in capital, or 10 percent or more of either party's total loans are guaranteed by the other party (excluding independent financial institutions).

(iii) More than half of one party's senior management (including board members or managers) or at least one senior board member who has the controlling power over the board is appointed by the other party, or more than half of both parties' senior management (including board members or managers) or at least one senior board member of each of both parties who has the controlling power over the board is appointed by a third party.

(iv) More than half of one party's senior management (including board members and managers) are also senior management of the other party (including board members and managers), or at least one senior board member of either party who has the controlling power over the board is also a senior board member of the other party.

(v) One party's production and business operations can only be carried out normally with rights to industrial property, proprietary technology, etc., provided by the other party.

(vi) One party's purchase and sales activities are largely controlled by the other party.

(vii) The services that either party receives or offers are largely controlled by the other party.

(viii) Other relationships, in addition to relationships of family members and relatives, such as those involving one party's actual control of the other party's

production, operations or transactions, or both parties' interests being connected, despite the shareholding percentage not reaching the level specified in the first paragraph of this article.

Article 10 Related-party transactions mainly include the following:

(i) The sale, purchase, transfer and use of tangible property, including selling, purchasing, assigning and leasing tangible property such as buildings, means of transport, machinery, tools, and products;

(ii) The transfer and use of intangible property, including assigning ownership of or providing the right to use licenses, such as land use rights, copyrights, patents, trademarks, client lists, marketing channels, brand names, business secrets, and proprietary technology as well as industrial property rights such as industrial product designs or utility models;

(iii) Financing, including all types of long-term and short-term loans and security, and all kinds of interest-bearing advances and deferred payments;

(iv) The provision of services, including market research, marketing, management, administration, technical services, maintenance, design, consultancy, agency, scientific research, legal services and accounting services.

Article 11 When filing annual tax returns, resident enterprises whose tax is levied according to accounting books as well as non-resident enterprises that have establishments in China and file and pay corporate income tax on an actual basis shall also submit the "Enterprise Annual Reporting Forms for Related Party Transactions of the Peoples' Republic of China" which includes the following forms:

- Related Party Transactions Annual Reporting Forms of the People's Republic of China – Related Parties
- Related Party Transactions Annual Reporting Forms of the People's Republic of China – Summary of Related-Party Transactions
- Related Party Transactions Annual Reporting Forms of the People's Republic of China – Sales and Purchase
- Related Party Transactions Annual Reporting Forms of the People's Republic of China – Services

- Related Party Transactions Annual Reporting Forms of the People’s Republic of China – Intangible Assets
- Related Party Transactions Annual Reporting Forms of the People’s Republic of China – Fixed Assets
- Related Party Transactions Annual Reporting Forms of the People’s Republic of China – Financing
- Related Party Transactions Annual Reporting Forms of the People’s Republic of China – Outbound Investment
- Related Party Transactions Annual Reporting Forms of the People’s Republic of China – Outbound Payment.

Article 12 If an enterprise is unable to submit the Reporting Forms in accordance with Article 11 before the relevant deadline and needs to defer the submission, this shall be dealt with in accordance with the Tax Collection Law and its Implementation Rules.

Chapter 3 Contemporaneous Documentation Administration

Article 13 Enterprises shall prepare, maintain, and submit, upon request of tax authorities, contemporaneous documentation regarding their related-party transactions for every tax year, in accordance with Article 114 of the Implementation Rules.

Article 14 The contemporaneous documentation shall chiefly include:

(i) Organisational structure

(a) The related organisation and ownership structure of the group that an enterprise is affiliated with;

(b) Change of relationships between the enterprise and its related parties during the year;

(c) Information on related parties transacting with the enterprise, including related parties’ names, legal representatives, senior management, such as board members or managers, registered address as well as actual business address, and related individuals’ names, nationality, inhabitancy, and family information. Related parties that directly influence the pricing of related party transactions shall be specified;

(d) Taxes of income tax nature, the rates and tax incentives applicable to the related parties;

(ii) Overview of Business Operations

(a) Business overview of the enterprise, including any changes of business and the enterprise's development; overview of the industry and its development; business strategy; main economic and legal issues such as industry policies and industry restrictions that will influence enterprises and their industry; group industry chains; and the enterprise's position;

(b) Composition of core businesses, and the proportions of their revenue to the total revenue, as well as the proportions of their profit to the total profit;

(c) Analysis of the enterprises' industry position and related market competition;

(d) The enterprises' internal organisational structure and the respective functions performed, risks assumed, and assets employed by the enterprises and their related parties in the related-party transactions (including completing the "Function and Risk Analysis Form");

(e) Consolidated financial statements of the group, the preparation of which can be extended according to its accounting year, but no later than 31 December of the year after the year the related-party transactions occurred.

(iii) Information on Related-Party Transactions

(a) Types, participants, timing, value amount, currency, and contractual terms of the related-party transactions;

(b) Trade terms of related-party transactions, and any changes during the year, together with explanations;

(c) Comparison of business processes between related-party transactions and third-party transactions, including information flows, logistics flows and cash flows;

(d) Intangible assets involved in related-party transactions, and their influence on the pricing;

(e) Copies of all contracts or agreements in connection with related-party transactions, with explanations of their execution;

(f) Analysis of major economic and legal factors that affect pricing of related-party transactions;

(g) Allocation of revenues, cost, expenses and profits between related-party transactions and unrelated party transactions. When direct allocation is not available, the allocation shall be made by using reasonable ratios, and the determination of the ratios shall be justified (including completion of the "Financial Analysis on Annual Related Party Transactions Form").

(iv) Comparability Analysis

(a) The factors to be considered in a comparability analysis include characteristics of properties or services in the transaction, functions and risks of the parties involved in the transaction, as well as contractual terms, economic environments and operating strategies;

(b) Information on the functions performed, risks assumed and assets employed by comparables;

(c) A description of the comparable transactions, such as physical features, quality, and utility of tangible assets; for financing business, normal interest rates, amounts, currency, duration, and guarantees, borrowers' credit standing, repayment terms, and methods used to calculate interest for financing business; the services' nature and extent; intangible asset types and transaction modes, the right to use intangible assets through the transaction, and benefits from using intangible assets;

(d) Sources of, as well as the conditions and reasons for selecting, the comparable information;

(e) Adjustments made to the comparable data for the differences, together with reasons for making such adjustments;

(v) Transfer Pricing Method Selection and Application

(a) Transfer pricing methods applied and reasons for application. When a profit-based method is chosen, the enterprises' contributions to the overall profit or residual profit level of the group shall be explained;

(b) How the comparable information supports selected transfer pricing methods;

(c) Assumptions and judgments made in the process of determining price or profit in comparable unrelated-party transactions;

(d) Determination of the arm's-length price or profit using an appropriate transfer pricing method and relevant comparable analysis.

(e) Other information that supports the transfer pricing methods selected.

Article 15 Any enterprise that meets one of the following conditions is exempt from preparing contemporaneous documentation:

(i) Per annum related-party purchases and sales totalling less than RMB 200 million (the amount of processing activities is calculated based on declared value of imports and exports during the year) and other related-party transactions totalling less than RMB 40 million (the amount of related-party financing is

calculated based on the interest paid or received). These amounts shall not include related-party transactions under cost sharing arrangements or advance pricing arrangements within the year;

(ii) Related-party transactions under advance pricing arrangements;

(iii) Foreign-owned shares account for less than 50 percent and related-party transactions are conducted with domestic related parties only.

Article 16 Subject to Chapter 7 of the Measures, enterprises shall prepare contemporaneous documentation before 31 May of the year after the related-party transactions occur, and the documentation shall be submitted within 20 days of the tax authorities' request. If they cannot provide such documentation on time due to force majeure, they shall do so within 20 days of the elimination of the force majeure.

Article 17 Contemporaneous documentation submitted as required by tax authorities shall be duly stamped with the company chop and signed or sealed by the enterprises' legal representative or someone authorised by the legal representative. If contemporaneous documentation contains quotations, sources should be referenced.

Article 18 Contemporaneous documentation shall be maintained by the successor enterprise after a merger or spin-off if tax registration is changed or tax deregistration is conducted due to mergers or spin-offs.

Article 19 Contemporaneous documentation shall be prepared in Chinese. If the source material is in a foreign language, a Chinese copy shall be submitted as well.

Article 20 Contemporaneous documentation shall be maintained for 10 years from 1 June of the year after the related-party transactions occur.

Chapter 4 Transfer Pricing Methods

Article 21 Enterprises involved in related-party transactions and tax authorities evaluating related-party transactions shall adopt reasonable transfer pricing methods on an arm's-length basis.

In accordance with Article 111 of the Implementation Rules, the transfer pricing methods

include the comparable uncontrolled price method (CUP method), the resale price method (RPM), the cost plus method (CPLM), the transactional net margin method (TNMM), the profit split method (PSM), and other methods in compliance with the arm's-length principle.

Article 22 A comparability analysis shall be conducted in order to select reasonable transfer pricing methods. A comparability analysis mainly covers the following five aspects:

(i) Characteristics of assets transacted or services provided, including the physical characteristics, quality, and quantity of tangible assets; characteristics and scope of services provided; as well as types, transactional forms, terms and scopes, and expected returns of intangible assets;

(ii) The functions performed and risks assumed by the parties in transactions. Functions primarily include research and development, design, procurement, processing, assembly, manufacture, inventory management, distribution, after-sale services, advertising, logistics, storage, financing, finance, accounting, legal affairs and human resources management. When performing a functional analysis, the similarity of the assets employed by the parties for performing the functions shall also be examined. Risks to be analysed include research and development risks, procurement risks, manufacturing risks, distribution risks, marketing risks, and management and finance risks;

(iii) Contractual terms, including transaction targets, transaction amounts, prices, modes and conditions of charges and payments, consignment conditions, scopes and conditions of after-sale services, agreements to provide additional services, the right to change and revise contracts, contract durations, and the right to terminate or renew contracts;

(iv) Economic circumstances, including industry profiles, geographic locations, market scales, market segments, market shares, degree of market competition, consumers' purchasing power, substitutability of products and services, prices of production factors, logistics costs, and government control;

(v) Business strategies, including strategies for innovation and research and development, business diversification, risk-avoidance, and market share.

Article 23 Under the CUP method, price setting based on the prices for the same or similar transactions conducted between independent enterprises can be regarded as arm's-length prices of related-party transactions.

Comparability analyses should particularly investigate the differences between related-party transactions and third-party transactions in respect of assets transacted, services provided, contractual terms and the economic environment. The comparability analysis, by the different categories of transactions, should include the following information, according to different categories and substance of business transactions:

(i) Sale, purchase, or transfer of tangible assets:

(a) Processes of sales, purchases, or transfers, including the time and location of transactions, transactional terms, transactional procedures, payment conditions, transaction amounts, time and location of warranty services, etc;

(b) Stages of sales, purchases or transfers of tangible goods, including ex-factory, wholesale, retail, and export stages, etc;

(c) Tangible goods sold, purchased or transferred, including brand names, trademarks, specifications, models, functions, structures, exteriors, and packaging, etc;

(d) Environment of sales, purchases, or transfers of tangible goods, including social customs, consumer preference, political stability, financing policies, taxation, and foreign exchange policies, etc;

(ii) Use of tangible assets, including:

(a) Functions, specifications, models, structures, types, depreciation methods of the property;

(b) The time, period, and the place that the property is provided for use;

(c) The investment expenditure and maintenance fees, etc. of the property owner.

(iii) Transfer and use of intangible assets, including:

(a) Type, purpose, applicable industries, expected return of the intangible properties;

(b) Investment in development, conditions of transfer, degree of exclusiveness in possession, extent and period of protection under relevant State laws, costs and expenses of transfer, functions and risks, and substitutability of the intangible assets.

(iv) Financing, including: amount, currency, term, guarantee, credit worthiness of the borrower, method of repayment, method of calculating interest.

(v) Provision of services, including: nature of the business, technical requirements, level of specialisation, liability borne, terms and method of payment, direct and indirect costs, etc.

If related-party transactions differ significantly from uncontrolled transactions in terms of the afore-mentioned aspects, reasonable adjustments shall be made for the influence of such differences on the prices. If reasonable adjustments cannot be made, other appropriate transfer pricing methods shall be selected pursuant to the provisions specified in this Chapter.

The comparable uncontrolled price method is applicable to all types of related-party transactions.

Article 24 Under the resale price method, the arm's-length price for goods purchased from a related party is determined by deducting the gross profit of a comparable unrelated-party transaction from the resale price to unrelated parties for goods purchased. The formula for calculation is as follows:

Arm's-length price = resale price to unrelated party X (1 – gross margin of comparable unrelated party transaction)

Gross margin of comparable unrelated party transaction = gross profit of the comparable unrelated party transaction / net sales of the comparable unrelated party transaction X 100%

The comparability analysis shall focus on the differences in functions, risks, and contractual terms between the related-party transactions and the unrelated-party transactions, as well as other factors influencing the gross profit, including sales, advertising and service functions, inventory risk, the value and useful life of instruments and equipment, the use and value of intangible properties, stage of wholesale or retail, business experience, accounting treatment and management efficiency.

If related-party transactions differ significantly from unrelated-party transactions in terms of the afore-mentioned aspects, reasonable adjustments shall be made for the influence of such difference on the gross margin. If reasonable adjustments cannot be made, other

appropriate transfer pricing methods shall be selected pursuant to the provisions specified in this Chapter.

The resale price method shall apply where the resellers engage in simple processing or buy-sell activities that do not involve substantial value-added processing such as the alteration of appearance, functionality, structure or a change of trademark.

Article 25 The cost plus method determines the arm's-length price of related-party transactions by adding a gross margin derived from the comparable unrelated-party transactions to a reasonable cost base of the related-party transaction. The formula for calculation is as follows:

Arm's-length price = reasonable costs of related party transactions X (1 + cost mark-up rate of comparable unrelated party transactions)

Cost mark-up of comparable related party transactions = gross profit of comparable unrelated party transactions / cost of comparable unrelated party transactions

The comparability analysis shall focus on the differences in functions, risks, and contractual terms between the related-party transactions and the unrelated-party transactions as well as other factors influencing the cost mark-up rate, including such functions as manufacturing, processing, installing and testing, market and foreign exchange risks, the value and useful life of machinery and equipment, the use and value of intangible property, commercial experience, accounting treatments and management efficiency.

If related-party transactions differ significantly from unrelated-party transactions in terms of the afore-mentioned aspects, reasonable adjustments shall be made for the influence of such differences on the cost mark-up. If reasonable adjustments cannot be made, other appropriate transfer pricing methods shall be selected pursuant to the provisions specified in this Chapter.

The cost plus method shall apply to related-party transactions involving purchases and sales, transfer and use of tangible assets, provision of services, and financing.

Article 26 The transactional net margin method determines the net profit of related-party transactions by using profit level indicators of comparable unrelated-party

transactions. Profit level indicators include return on assets, operating margin, net cost plus, and berry ratio.

The comparability analysis shall focus on the differences in functions, risks and economic environment between related-party transactions and unrelated-party transactions as well as other factors influencing operating profit, including the functions performed, the risks borne, the assets employed, industry and market conditions, business scale, economic cycle and product life cycle, cost, expense, the allocation of income and assets among respective transactions, accounting treatments and business management efficiency.

If related-party transactions differ significantly from unrelated-party transactions in terms of the afore-mentioned aspects, reasonable adjustments shall be made for the influence of such differences on the operating profits. If reasonable adjustments cannot be made, other appropriate transfer pricing methods shall be selected pursuant to the provisions specified in this Chapter.

The transactional net margin method shall apply to related-party transactions that involve the buy-sell, transfer and use of tangible assets, the transfer and use of intangible assets, and the provision of services.

Article 27 The profit split method determines the profit to be allocated to each party in the related-party transaction based on their contribution to the consolidated profits derived from the related-party transaction. The profit split method can be categorised into the general profit split method and the residual profit split method.

The general profit split method allocates profit to participants in the related-party transaction according to the functions performed, the risk borne and the assets employed by each party.

The residual profit split method first determines residual profit by deducting the routine profit allocated to each participant from the consolidated profits earned by all participants in the related-party transaction. The residual profit is then allocated based on each participant's contribution to the residual profit.

The comparability analysis shall focus on the functions performed, risk borne and assets employed by each participant; the allocation of costs, expenses, income, and assets to each participant; the accounting treatment; and the reliability of the information and assumptions used to determine the contribution of each participant to the residual profit.

The profit split method shall apply to situations where related-party transactions are highly integrated and where it is difficult to separately assess the transaction result of each participant.

Chapter 5 Transfer Pricing Investigation and Adjustment

Article 28 The tax authorities are empowered to select enterprises for investigation, and conduct transfer pricing investigations and adjustments pursuant to the provisions of tax inspection as specified in the Tax Collection Law and its Implementation Rules. The enterprise under investigation shall accurately disclose its related-party transactions and provide relevant information without refusal or concealment.

Article 29 Transfer pricing investigations shall focus on the following types of enterprises:

- (i) Enterprises with significant amounts of related-party transactions or several types of related-party transactions;
- (ii) Enterprises with continuous losses, low profitability or fluctuating profitability;
- (iii) Enterprises with profit levels lower than those of other enterprises in the same industry;
- (iv) Enterprises with profit levels which do not correspond with the functions performed and risk assumed;
- (v) Enterprises that engage in transactions with related parties incorporated in a tax haven;
- (vi) Enterprises that fail to file their related-party transactions reporting forms or to prepare contemporaneous documentation;
- (vii) Enterprises that are clearly in breach of the arm's-length principle.

Article 30 A transfer pricing investigation and adjustment will not be made in principle between two domestic enterprises whose tax rate is equal, as long as the transactions do not directly or indirectly decrease the overall tax revenue of the country.

Article 31 Tax authorities shall carry out desktop reviews in connection with the day-to-day tax administration to determine investigation targets. Desktop reviews shall be mainly based on the prior year's annual tax returns for corporate income tax and annual reporting forms for related-party transactions submitted so as to conduct a comprehensive assessment and analysis of the business operations and the related-party transactions.

Enterprises can submit contemporaneous documentation to the tax authorities during the desktop review period.

Article 32 Tax authorities shall conduct on-site investigations of selected enterprises in accordance with Chapter 6 of the CIT Law and its Implementation Rules, as well as Chapter 4 of the Tax Collection Law and Chapter 6 of its Implementation Rules.

- (i) On-site investigations shall be carried out by two or more tax officials.
- (ii) Tax investigators shall present a "Tax Investigation Certificate" and deliver a "Tax Inspection Notice".
- (iii) On-site investigations, by complying with certain legal procedures, could involve inquiry, requests for book records and field check if necessary.
- (iv) A specific tax official shall be assigned to prepare the "Inquiry (Investigation) Records". The interviewee shall be informed of the legal liabilities that may arise should he/she not provide true and accurate information. The "Inquiry (Investigation) Records" should be confirmed by the interviewee.
- (v) In accordance with Article 86 of the Tax Collection Law, when it is necessary to obtain accounting books and relevant documents, tax authorities shall complete the "Accounting Books Request Notice, and "Accounting Information Request List", follow the relevant legal procedures, safeguard the accounting books and relevant materials and return them to the enterprise within the time period stipulated by law.
- (vi) The tax authorities shall keep the "Inquiry (Investigation) Records" in relation

to the problems and issues found during the on-site investigations. The records shall be signed by two or more tax investigators and confirmed by the investigated enterprises if necessary. If the investigated enterprises refuse to sign the records, the records can be signed by two or more tax investigators for filing.

(vii) Note-taking, voice-recording, video-recording, photo-recording and photocopying are allowed when necessary to request information related to the investigation, however the sources and holders of the original data must be noted and shall be confirmed by the keeper or provider with a written statement of “checked and confirmed to be the same as the original” and shall be sealed or stamped.

(viii) If witnesses are required, the tax authorities should inform the witnesses of the legal consequences they may bear should they fail to provide truthful information. The information provided by witnesses shall be signed or sealed by the witness themselves.

Article 33 Pursuant to Article 43 Paragraph 2 of the CIT Law and Article 114 of its Implementation Rules, tax authorities are empowered to collect information from the investigated enterprises, their related parties and other relevant enterprises (hereinafter referred to as “comparable companies”), provide relevant documents and issue a written “Notice on Tax-related Matters”.

(i) The investigated enterprise shall provide information upon request within the period prescribed by the “Notice on Tax-related Matters”. Where timely submission of the required documents is impossible under special circumstances, the enterprise shall file a written application for extension to the tax authorities. An extension of no more than 30 days may be granted upon approval. The tax authorities shall reply in writing to the extension application of the enterprise within five days of receipt. Where such a reply is not delivered within five days, it shall be deemed that the tax authorities have granted the extension.

(ii) The related parties of the investigated enterprise and comparable enterprises shall provide information within the time frame agreed with the tax authorities, generally no more than 60 days.

The enterprise, its related parties, and its comparable companies shall provide the information completely, truthfully and accurately.

Article 34 The tax authorities should verify the enterprise's filing information, and require the enterprise to complete the "Comparability Factors Analysis Form," in accordance with the relevant provisions in Chapter 2 of the Measures.

According to the enterprise's related party filing information and the materials provided, the tax authorities must complete the "Form for Determination of Related Party Relationships," the "Form for Determination of Related Party Transactions," and the "Form for Determination of Comparability Factors," which should be confirmed by the enterprise under investigation.

Article 35 If the tax authorities need to take evidence from related parties and comparable companies during the investigation of related-party transactions, the competent tax authorities must issue and serve a "Tax Inspection Notice" to the enterprise for investigation and evidence collection.

Article 36 The tax authorities should analyse relevant documents provided by the enterprise, its related parties, and comparable companies and confirm their accuracy via a field survey, issuing a written request for investigation assistance by reference to public information. If overseas documents are required, information exchange procedures under the relevant tax treaties can be initiated pursuant to relevant rules. Chinese agencies residing in overseas countries can also be contacted to help collect relevant information and materials. When dealing with relevant documents of related parties overseas, the tax authorities can ask the enterprises for notarised proof.

Article 37 The tax authorities should analyse and evaluate whether the related-party transactions comply with the arm's-length principle by reference to the transfer pricing methods provided in Chapter 4 of the Measures. The tax authorities can use public information as well as non-public information in their analysis and evaluation.

Article 38 When analysing and evaluating related-party transactions, the tax authorities should not make adjustments in principle on differences in operating profits caused by differences between the enterprise and comparable companies in terms of working capital employed. If such adjustments are required, approval from the State Administration of Taxation (SAT) must be obtained.

Article 39 For enterprises that are engaged in processing and manufacturing to the order of related parties and do not undertake functions such as management decision, research and development, and sales, they should not assume any risks or losses caused by wrong decisions, capacity under utilisation and unmarketable products. The profit margin of these enterprises should be kept at a certain level. For enterprises suffering losses, tax authorities should select appropriate comparable prices or comparable companies to determine the profit level based on economic analysis.

Article 40 Where the respective transactions involving payments and receipt between related parties are being offset, tax authorities conducting comparability analysis and making tax adjustments should, in principle, restore the transactions and evaluate related-party transactions separately.

Article 41 When the tax authorities analyse and evaluate an enterprise's profit by using the inter-quartile method, an adjustment should generally be made to no lower than the median if the profit is found to be lower than the median of the comparable companies' inter-quartile range.

Article 42 Based on the investigation, the tax authorities should reach their transfer pricing investigation conclusions and send it via the "Notification of Special Tax Investigation Conclusion" to the enterprise whose related-party transactions do not comply with the arm's-length principle.

Article 43 If investigations show that related-party transactions were not conducted in compliance with the arm's-length principle, resulting in a reduction in enterprises' taxable income and tax payable, the tax authorities should make transfer pricing tax adjustments following the procedures detailed below:

(i) A preliminary special tax adjustment plan should be drafted based on testing, verification and comparable analysis;

(ii) Negotiations should be conducted according to the preliminary adjustment plan. The tax authorities and the enterprise should respectively appoint their chief negotiators and the "Negotiation Records" issued by the tax investigators should be signed and confirmed by both chief negotiators. If the enterprise refuses to sign the record, two or more tax investigators can sign it instead for filing purposes;

(iii) If the enterprise disagrees with the preliminary adjustment plan, further related information should be provided within the time period prescribed by the tax authorities. The tax authorities should review the information and make prompt, appropriate conclusions;

(iv) The tax authorities should issue a “Notice on Preliminary Adjustment Plan of Special Tax Investigation” to the enterprise based on their conclusions. If the enterprise disagrees with the preliminary adjustment plan in the Notice, it should issue an objection in writing within seven days of receiving the Notice. The tax authorities should review and negotiate again after receiving the comments from the enterprise. If the enterprise fails to raise an objection within the seven-day time limit, it is deemed to have agreed to the preliminary adjustment plan;

(v) The tax authorities should confirm the finalised adjustment plan, and send a “Notice on Special Taxation Investigation Adjustment” to the enterprise.

Article 44 After receiving the “Notice on Special Taxation Investigation Adjustment,” the enterprise should pay the taxes due and interest within the specified time limit.

Article 45 After the execution of the transfer pricing adjustments, the tax authorities will follow up with the enterprise for five years from the year after the most recent year for which the taxable income was adjusted. The enterprise should provide contemporaneous documentation for each of the follow-up years before 20 June of the year after the relevant follow-up year. The tax authorities should focus on analysing and evaluating the following according to the contemporaneous documentation and tax filing information:

- (i) Enterprise’s investment, operation and related changes;
- (ii) Changes in the value as shown on the tax return submitted by the enterprise;
- (iii) Changes in the enterprise’s business results;
- (iv) Changes in related-party transactions.

If the tax authorities identify abnormal transfer pricing issues during the follow-up period, the tax authorities should contact the enterprise immediately and request a self-adjustment,

or start a transfer pricing investigation pursuant to the provisions in this Chapter.

Chapter 6 Advance Pricing Arrangements Administration

Article 46 In accordance with Article 42 of the CIT Law, Article 113 of its Implementation Rules, as well as Article 53 of the Implementation Rules of the Tax Collection Law, an enterprise can reach an advance pricing arrangement (APA) with the tax authorities regarding the pricing policies and calculation methods of its related party transactions in future years. Negotiation and execution of APAs usually involves six stages: pre-filing meetings, formal application, examination and appraisal, negotiation, signing of arrangements, and supervision of implementation. An APA can be one of three types: unilateral, bilateral or multilateral.

Article 47 The application of an APA should be dealt with by tax authorities above the municipal or autonomous prefecture² level.

Article 48 Advance Pricing Arrangements generally apply to enterprises that meet all of the following criteria:

- (i) Enterprises with annual related-party transactions exceeding RMB 40 million in value;
- (ii) Enterprises fulfilling the responsibility of related-party transactions reporting in accordance with the law;
- (iii) Enterprises that prepare, preserve, and submit contemporaneous documentation in accordance with the law.

Article 49 APAs are applicable for related-party transactions conducted in a period of three to five continuous years, starting from the year after the year during which formal written application is submitted.

The negotiation and signing of an APA has no influence on the tax authorities' transfer pricing investigation and adjustment of related-party transactions in the year of or before the formal application of an APA.

² KPMG Note – These are the levels immediately beneath the province level.

If the related-party transactions during the year of application or previous years are identical or similar to those in the years for which the APA applies, upon approval from the tax authorities, the transfer pricing policies and computation methods determined in the APA can also be applied to the evaluation and adjustment of the related-party transactions conducted in (those) year(s).

Article 50 Before formally applying for an APA, the enterprise should submit a written letter of intent to the tax authorities. The tax authorities will conduct pre-filing meetings on the related content of the APA and the feasibility of an APA with the enterprise on the basis of this written document, and prepare "APA Meeting Minutes." The pre-filing meeting can be conducted anonymously.

(i) Enterprises that apply for unilateral APAs should submit a written letter of intent to the tax authorities. During the pre-filing meeting stage, the tax authorities and the enterprise should discuss:

- (a) The applicable years of advance pricing arrangement;
- (b) The related parties and related-party transactions involved in the arrangement;
- (c) The enterprise's business operations in previous years;
- (d) An analysis of the functions and risks of the related parties involved in the arrangement;
- (e) Whether the transfer pricing issues of previous years are to be solved using the methods determined in the advance pricing arrangement;
- (f) Any other related items requiring explanation.

(ii) Enterprises that apply for bilateral or multilateral APAs should submit a written letter of intent to the SAT and the governing tax authorities at the same time. The SAT will organise the pre-filing meeting with the enterprise. Matters discussed in the pre-filing meeting should include the following topics in addition to those mentioned in the previous paragraph:

- (a) Matters relating to the application for pre-filing meetings with competent authorities of the counter-party country of the treaty;
- (b) Information about the business operation and the related-party transactions of the related parties in years before the APA application;
- (c) The pricing principles and calculation method in the APA to be submitted to the competent tax authorities of the country which is the counter-party of the treaty.

(iii) If a consensus is reached in the pre-filing meeting, the tax authorities should notify the taxpayer in writing within 15 days of reaching such a conclusion to start the formal negotiation of the APA and issue the "Notice on Formal Negotiation of the APA." If no consensus is reached, the tax authorities should notify the taxpayer in writing within 15 days of the end of the last pre-filing meeting, issuing the "Notice on Rejection of APA Application of the Enterprise" to explain the rejection.

Article 51 The enterprise should submit the written APA application report to the tax authorities within three months of receiving the notice of formal meeting from the tax authorities, and submit the "Formal Application for APA." If the enterprise applies for a bilateral or multilateral APA, the "Formal Application for APA" and "Application for Initiating Mutual Agreement Proceeding" should be submitted to the SAT and the competent tax authorities at the same time.

- (i) The written application report of the APA should include the following:
- (a) Organisational structure of the group, internal organisational structure of the enterprise, a description of the relationship between related parties, and details of the related-party transactions;
 - (b) The enterprise's financial statements for the last three years, product functions, and information about assets (including intangible and tangible assets);
 - (c) Types of related-party transactions and tax years to be covered in the APA;
 - (d) Allocation of functions and risks between the related parties, including the enterprises, human resources, expenses, and assets that the allocations depend on;
 - (e) The transfer pricing policy and calculation methods applied in the APA, and the supporting functional and risk analysis, benchmarking analysis, and assumptions;
 - (f) Illustration of the market condition, including industry development trends and the competitive environment;
 - (g) The enterprise's annual operating scale, forecasted operating performance, and operating plans during the period for which the APA is to apply;
 - (h) Related-party transactions, operating arrangements and financial performance information including the profit level to be covered by the APA;

- (i) Whether the APA is to cover any double taxation issues;
- (j) Issues in relation to domestic and international laws or tax treaties.

(ii) If, due to any of the following circumstances, the enterprise cannot submit the written application report on schedule, it can submit a written application to the tax authorities for an extension, together with the "Application for Extension on Submission of APA Formal Application":

- (a) Certain information must be specially prepared;
- (b) The preparation of the application report involves technical processing such as translation;
- (c) Other non-subjective reasons;

The tax authorities should reply in writing to the application for extension within 15 days of receiving the written application from the enterprise, and issue the "Response to the Application for Extension on Submission of APA Formal Application." If no reply is made within the period specified above, the tax authorities are deemed to have accepted the enterprise's application for extension.

(iii) The enterprise and the tax authorities should properly maintain all the documentation and information specified above, including the supporting documents for the pricing policies and calculation methods and any other documents supporting the fact that the enterprise meets the requirements for an APA.

Article 52 The tax authorities should review and evaluate the formal application for the APA within five months of receiving the written application and all the required materials from the enterprise. Depending on the actual review status, the tax authorities may request the enterprise to provide further information necessary for them to conclude the application.

If the review and examination period needs to be extended under special circumstances, the tax authorities should issue a written "Notice on Extension of APA Review and Evaluation" to the enterprise in a timely manner. The extension period shall not exceed three months.

The tax authorities should review and evaluate the following contents:

- (i) Historical operating status - analyse and evaluate documents in relation to the enterprise's operation plans, development trends, and operation scope. Special

attention should be paid to examining the feasibility study report, investment budget (forecasted and finalised), and decisions of the board of directors. The tax authorities should comprehensively analyse documents related to the enterprise's operating performance, for example, financial statements or audit reports;

(ii) Functional and risk profile - analyse and evaluate the enterprise and the share of functions performed by each enterprise in the related party arrangement of procurement, manufacturing, transportation, sales, research and development of intangible assets, and their risks assumed, including inventory risk, credit risk, foreign exchange risk, and market risk;

(iii) Comparable information - analyse and evaluate the enterprise's domestic and overseas comparable price information and identify any substantial differences between the comparable enterprises and the applicant (tested party) and make any necessary adjustments. If the enterprise is not able to prove the reasonableness of its comparable transactions and operating activities, the tax authorities should request the enterprise to provide the necessary documentation and information to justify that the transfer pricing policies and calculation methods adopted fairly reflect the nature of the related-party transactions and the operating status of the enterprise, and have been proven by related financial and operational information;

(iv) Assumptions - analyse and evaluate the factors affecting industry profitability as well as the significance of their influence on the enterprise's particular operation. The tax authorities should justify the reasonableness of the assumptions applied in the APA;

(v) Transfer pricing policies and calculation methods - analyse and evaluate whether and how the transfer pricing policies and calculation methods chosen were applied, are being applied and will be applied to past, present and future related party transactions respectively and relevant financial and operating information, as well as whether they comply with relevant laws and/or regulations;

(vi) Expected arm's-length prices or profit range - further examine and evaluate the comparable prices, profit margins and comparable enterprises' transactions, and estimate the prices or profit range acceptable to both the tax authorities and the enterprise.

Article 53 The tax authorities should negotiate with the enterprise within 30 days of the date they draw a conclusion on the unilateral APA application. If both parties reach an agreement, the draft APA and the assessment report should be submitted to the various higher level tax authorities for the final examination and approval by the SAT.

For bilateral or multilateral APAs, the SAT negotiates with the competent tax authorities of the tax treaty counterparty. In the case that both parties reach an agreement, the draft APA should be prepared according to the negotiation memorandum.

The draft APA should cover the following:

- (i) Basic information of related parties, including name, address, etc;
- (ii) Related-party transactions and the applicable years covered in the proposed APA;
- (iii) Comparable prices or transactions, transfer pricing policies and calculation methods, and forecasted operating results selected in the proposed APA;
- (iv) A glossary of the terms in relation to the application of transfer pricing methods and calculation basis;
- (v) Critical assumptions;
- (vi) The enterprise's obligations on annual filing, records maintenance, and disclosure of changes in assumptions;
- (vii) Legal effects, confidentiality of documentation and information in the proposed APA;
- (viii) Mutual responsibility clause;
- (ix) Revisions to the proposed APA;
- (x) Methods and approaches to resolve disputes;
- (xi) Effective date of the proposed APA;
- (xii) Supplementary provisions.

Article 54 If the tax authorities and the enterprise reach an agreement on the draft unilateral APA, the legal representatives or the representatives delegated by the legal representatives of both sides should sign the unilateral APA. If the SAT and the competent authorities of the tax treaty counterparties have reached an agreement on a bilateral or multilateral APA draft, the representatives delegated by the competent authorities should sign the bilateral or multilateral APA. The competent tax authorities should sign an "Agreement on the Implementation of the Bilateral (Multilateral) APA" with the enterprise according to the bilateral or multilateral APA.

Article 55 Both the tax authorities and the enterprise can suspend or terminate the negotiation anytime before signing the APA. For a bilateral or multilateral APA, the tax authorities can suspend or terminate the negotiation upon consent. In a termination, both sides should return all the information and materials provided in the negotiation.

Article 56 Tax authorities should establish a monitoring and management system to monitor the implementation of the APA.

(i) During the implementation period of the APA, the enterprise should maintain all relevant documents and information (including accounting books, related records, etc.) and should not lose, destroy or transfer any of the documents and information. The enterprise should provide to the tax authorities an annual report on the implementation status of the APA within five months of the end of the tax year.

The enterprise should illustrate in the report its operations during the year, and how it has complied with the relevant provisions of the APA, and any request for modification or de facto termination of the APA. The enterprise should explain any outstanding issues to be resolved or issues that are forthcoming in the annual report for negotiation with the tax authorities on the need to amend or terminate the APA.

(ii) During the implementation period of the APA, the tax authorities should regularly (once every six months in general) check the enterprise's implementation status of the APA. The inspection should cover the following issues: whether the enterprise complies with the provisions and requirements of the APA; whether the information and annual reports provided for the application of the APA reflect the actual operations of the enterprise; whether the information and the calculation methods used as the basis of the transfer pricing method are correct; whether the

assumptions stated in the APA remain effective; and whether the enterprise's application of transfer pricing is consistent with those assumptions.

If the tax authorities discover any general violations of the APA by the enterprise, they should take necessary measures, which could include the termination of the arrangement. If the enterprise is found to have hidden any matters in relation to the APA or refused to implement the APA, the tax authorities should deem that the APA is void from its inception.

(iii) During the implementation period of the APA, if the actual operating results of the enterprise fall outside the price or profit range stipulated by the APA, the tax authorities shall, after reporting to the higher level tax authorities for verification, adjust the actual operating results so that they fall within the range of prices or profits stipulated by the APA. In the case of a bilateral or multilateral APA, the deviation should be reported to the higher level of tax authorities in order to obtain final approval from the SAT.

(iv) During the implementation period of the APA, the enterprise should submit a written report to the tax authorities detailing any substantial changes that may influence the APA. The enterprise should submit the report within 30 days of the changes taking place and provide a detailed explanation of the impact of the changes on the APA implementation, together with relevant supporting materials. The submission deadline of the report may be extended for non-subjective reasons. The extension period shall not exceed 30 days.

Within 60 days of receiving the taxpayer's written report, the tax authorities should evaluate and take any steps necessary, including reviewing the changes, negotiating with the taxpayer to revise the APA terms and relevant conditions, or amending or terminating the arrangement based on the extent of impact of such substantial changes on the execution of the APA. After the termination of the original APA, the tax authorities can arrange for the negotiation of a new APA according to the procedures and requirements in this Chapter.

(v) During the implementation period of an APA signed with the enterprise by both the state tax bureaus and the local tax bureaus, the enterprise should submit the annual report of the APA implementation and actual changes to the state tax bureaus and the local tax bureaus respectively. The state tax bureau and the local tax bureau

should jointly inspect and examine the implementation of the agreement by the enterprise.

Article 57 The advance pricing arrangement will become invalid immediately after the period is due. If the APA needs to be renewed, the enterprise should submit the renewal application 90 days before the end of the APA implementation period, submitting the "Application for Renewal of APA", as well as providing reliable supporting evidence to prove that the facts and environment as described in the current APA have not undergone any substantial changes, and that it has been complying with the various terms and stipulations of the APA. The tax authorities should prepare a written response on acceptance or not within 15 days of receiving the renewal application and issue the "Response to the Application for Renewal of APA". The tax authorities should examine and evaluate the application materials of the renewal application, draft an advance pricing arrangement with enterprises, and finish the renewal of the arrangement in accordance with the agreed renewal time and place as agreed between the parties.

Article 58 The negotiation and implementation of an APA that involves more than two provinces, municipalities, directly governed city regions, and cities specifically designated in the state plan, or that involves both the state taxation bureau and local taxation bureau should be organised and coordinated by the SAT. The enterprise can submit a written letter of intent to the SAT directly.

Article 59 All state and local tax bureaus shall accept and implement an APA that is concluded between the tax authorities and the taxpayer, provided that the taxpayer abides by all the terms and requirements of the APA.

Article 60 Both the tax authorities and the enterprise are responsible for maintaining the confidentiality of all the information obtained throughout the process, from pre-filing meetings to the official signing, including the examination and analysis. The tax authorities and the enterprise should prepare a written memorandum of the negotiation content every time, and prepare a record of the number of documents and content provided to each other, signed or stamped by the chief negotiators of both parties.

Article 61 If the tax authorities and the enterprise fail to conclude an APA, the non-factual information, such as suggestions, assumptions, concepts and judgments, obtained by the tax authorities during the meeting or negotiation process cannot subsequently be used for a tax investigation related to the transactions covered by the intended APA.

Article 62 During the execution of the APA, if there are disagreements between the tax authorities and the enterprise, the two parties shall solve the disputes through negotiations. If the negotiations fail, the issues should be reported to the higher level tax authorities for coordination; in the case of a bilateral or multilateral APA, the issues should be reported to the SAT through escalated reporting for coordination. The lower level tax authorities should execute the result or decision made by the upper level tax authorities. If the enterprise still does not agree, the execution of the arrangement should be stopped.

Article 63 Within 10 days of the official signing, the tax authorities should submit the official copy of the unilateral APA or the Implementation Agreement of the bilateral or multilateral APA to the SAT for filing. The same should be done within 20 days for any modifications, termination and other matters during the execution of the APA.

Chapter 7 Cost Sharing Arrangements Administration

Article 64 Pursuant to Paragraph 2 of Article 41 of the CIT Law and Article 121 of its Implementation Rules, an enterprise that signs a cost sharing arrangement with its related parties on joint development, transfer of intangible assets, or provision and receipt of services should act in accordance with this Chapter.

Article 65 Participants in cost sharing arrangements can exploit the benefits of developed or transferred intangible property or the participation of services, and assume the corresponding costs. The costs borne by the related parties should comply with the costs paid by unrelated parties for the benefits mentioned above in comparable circumstances.

Participants who use intangible property developed or transferred under a cost sharing arrangement do not need to pay royalties separately.

Article 66 An enterprise should have reasonable and measurable expected benefits of its right to the intangible property and services involved in a cost sharing arrangement based on reasonable commercial assumptions and normal business practices.

Article 67 A cost sharing arrangement on services generally applies to group procurement and group marketing activities.

Article 68 A cost sharing arrangement should mainly include:

- (i) Participant's name, country (region), related parties, rights and obligations in the arrangement;
- (ii) Content and scope of the intangible assets or services involved in the cost sharing arrangement, the party that performs the research and development or provides the services involved in the cost sharing arrangement as well as its responsibilities and tasks;
- (iii) Duration of the arrangement;
- (iv) Computation methods and assumptions of the participants' expected benefits;
- (v) Amount, form and valuation method for the initial costs as well as subsequent costs paid by the participants, and explanations for the arm's-length nature;
- (vi) Specification of the accounting policy application and any changes;
- (vii) Procedures and treatments for the entry or exit of the participants;
- (viii) Terms and treatment for compensatory payments between participants;
- (ix) Terms and treatment for changes to or termination of the arrangement;
- (x) Rules for non-participants using the results of the arrangement.

Article 69 The enterprise should report the cost sharing arrangement to the SAT within 30 days of the arrangement being concluded. The tax authorities will report to the SAT to review whether the cost sharing arrangement complies with the arm's-length principle.

Article 70 For a cost sharing arrangement that has already been executed and has led to the creation of certain assets, if there are changes in participations or the arrangement is terminated, the following actions should be taken in accordance with the arm's-length principle:

- (i) For the buy-in payment, the new participant should pay a reasonable fee to obtain the benefits in the existing results of the arrangement;
- (ii) For the exit compensation, the original participants who exit the arrangement will transfer the benefit to other participants which warrant a reasonable compensation;
- (iii) After the changes of participants, the benefits and costs shared by each party should be adjusted accordingly;
- (iv) When the arrangement is terminated, the existing results should be allocated among all the participants on a reasonable basis.

If an enterprise does not comply with the arm's-length principle in making the above-mentioned treatments, and thus decreases its taxable income, the tax authorities are empowered to make adjustments.

Article 71 During the execution period of a cost sharing arrangement, the participant's costs should be commensurate with the expected benefits; otherwise a relevant compensating adjustment should be made.

Article 72 The tax treatments for a cost sharing arrangement in compliance with the arm's-length principle are as follows:

- (i) The costs allocated to the enterprise under the arrangement should be deducted in each year as stipulated in the arrangement for corporate income tax purposes;
- (ii) The compensating adjustment amount should be included in the taxable income in the year it is made;
- (iii) For a cost sharing arrangement involving intangible assets, buy-in payments, exit compensation or the allocation of the existing results when the arrangement is terminated, all shall be treated in accordance with the relevant provisions for asset purchase or disposition.

Article 73 Enterprises can reach a cost sharing arrangement in the form of an APA in accordance with Chapter 6 of the Measures.

Article 74 During the execution of the cost sharing arrangement, besides the provisions as stipulated in Chapter 3 of the Measures, the enterprise should also prepare the following contemporaneous documentation for the cost sharing arrangement:

- (i) Copy of the cost sharing arrangement;
- (ii) Other agreements reached for the implementation of the cost sharing arrangement;
- (iii) Non-participants' use of the results and the amount and form of payment;
- (iv) Overview of the current year's new participants and exiting participants, including the name, country (region), related parties, amount and form of the payment for the buy-in or exit payments;
- (v) Overview of changes to or termination of the cost sharing arrangement, including the reasons, treatment or distribution of the achieved results;
- (vi) The current year's total costs and their composition pursuant to the cost sharing arrangement;
- (vii) Overview of the current year's cost allocation to each participant, including the amount, form and objectives of the cost payment, and the amount, form, and objectives of any compensatory payments or receipts;
- (viii) Comparison of the annual forecasted benefits and actual results as well as the corresponding adjustments made for the current year;

During the execution of the cost sharing agreement, whether or not the cost sharing agreement is in the form of an APA, the enterprise should submit related contemporaneous documentation on the cost sharing agreement to the tax authorities before 20 June of the next year after the applicable tax year.

Article 75 For an enterprise that signs a cost sharing arrangement with related parties, if one of the following scenarios applies, the costs allocated should not be deducted when computing the enterprise's taxable income:

- (i) Lack of reasonable commercial purpose and economic substance;

- (ii) Failure to comply with the arm's-length principle;
- (iii) Failure to comply with the cost-revenue matching principle;
- (iv) Failure to file or prepare, preserve and provide contemporaneous documentations for the cost sharing arrangement pursuant to the relevant provisions of the Measures;
- (v) The operating period is shorter than 20 years from the signing of the cost sharing arrangement.

Chapter 8 Controlled Foreign Corporation Administration

Article 76 A controlled foreign corporation, as stipulated in Article 45 of the CIT Law, refers to a foreign enterprise established in a country (or region) where the actual tax rate is lower than 50 percent of the tax rate set out in Paragraph 1 of Article 4 of the CIT Law, whose profits are not distributed or are distributed at a reduced rate due to reasons other than viable business needs, and is controlled by a resident enterprise or by a resident enterprise jointly with Chinese individual residents (hereinafter collectively referred to as "Chinese resident shareholders" which includes both Chinese resident enterprise shareholders and Chinese resident individual shareholders).

Article 77 The "control" referred to in Article 76 of the Measures means substantial control in terms of shares, capital, operation, purchase and sales. Of these, control in shares means that a Chinese resident shareholder directly or indirectly holds no less than 10 percent of the voting shares of a foreign enterprise in any single day of a taxable year, and jointly holds no less than 50 percent of the total shares of the foreign enterprise.

Shares indirectly held by Chinese resident shareholders are accumulated by multiplying each proportion of the shares held by each level together. If the proportion exceeds 50 percent, then 100 percent should be used for the calculation.

Article 78 For annual corporate income tax filing purposes, Chinese resident enterprise shareholders shall submit information about overseas investments, submitting the "Outbound Investment Form" together with their annual tax reporting.

Article 79 The tax authorities are responsible for collecting and reviewing the information about overseas investments reported by Chinese resident enterprise shareholders. The tax authorities should deliver the “Confirmation Notice of Chinese Resident Enterprise Shareholders of Controlled Foreign Corporation” to Chinese resident enterprise shareholders who are recognised as shareholders of a controlled foreign corporation, and impose taxes on the Chinese resident enterprise shareholders that satisfy the taxation conditions as specified in Article 45 of the CIT Law.

Article 80 The deemed dividend income from the controlled foreign corporation should be included in the taxable income of the Chinese resident enterprise shareholder. The calculation formula is as follows:

The current period income of the Chinese resident enterprise shareholder = (deemed dividend income × actual number of share holding days) ÷ (number of days of the controlled foreign corporation’s tax year × percentage of shares held)

For multi-level indirect shareholding by Chinese resident shareholders, the proportion will be calculated by multiplying each proportion of the shares held by each level together.

Article 81 If there is a difference in taxable years between the controlled foreign corporation and the Chinese resident enterprise shareholder, the deemed dividend income should be included in the revenue generated in the taxable year of the Chinese resident enterprise shareholder to which the ending date of the taxable year of the CFC can be attributed.

Article 82 If the Chinese resident enterprise shareholder has already paid income tax overseas for the current period income of the deemed dividend, credit or exemptions can be granted pursuant to the relevant provisions in the CIT Law or tax treaties.

Article 83 The actual distribution of profit by the CFC already taxed pursuant to Article 45 of the CIT Law can be excluded from the taxable income of the Chinese resident enterprise shareholder for the current period.

Article 84 If the Chinese resident enterprise shareholder can provide information to prove that the foreign corporation under its control satisfies one of the following conditions, the profits of the foreign corporation that are not distributed or are distributed at a reduced rate can be exempted from being regarded as the deemed dividend and can be

excluded from the taxable income of the Chinese resident enterprise for the current period:

- (i) Located in a non-low tax rate country (or region) as recognised by the SAT;
- (ii) The revenue is mainly generated from active business operations;
- (iii) The annual profit does not exceed RMB 5 million.

Chapter 9 Thin Capitalisation Administration

Article 85 As stipulated in Article 46 of the CIT Law, the interest expenses which shall not be deducted from taxable income should be calculated as follows:

Non-deductible interest payments = annual actual interest paid to related parties × (1 - standard ratio / related party debt to equity ratio)

In the formula above, the standard ratio refers to the ratio stipulated in “The MOF and the SAT’s Notice on Deducibility of Interest Payment to Related Parties” (Caishui [2008] No. 121).

Pursuant to Article 46 of the CIT Law and Article 119 of its Implementation Rules, the related party debt to equity ratio is the portion of the debt investment received from all its related parties (“related party debt investment”) to the equity investment (“equity investment”). The related party debt investment includes all types of debt investment guaranteed by related parties in any form.

Article 86 The related party debt to equity ratio is calculated as follows:

Related party debt to equity ratio = sum of monthly average related party debt investment in a year / sum of monthly average equity investment in a year

Of which:

Monthly average related party debt investment = (book opening balance of related party

debt investment at the beginning of the month + book ending balance of related party debt investment at the end of the month) / 2

Monthly average equity investment = (book opening balance of equity investment at the beginning of the month + book ending balance of equity investment at the end of the month) / 2

Equity investment is the owner's equity on the balance sheet. When the owner's equity is less than the sum of paid-in capital (capital stock) and paid-up capital, equity investment equals the sum of paid-in capital (capital stock) and paid-up capital; when the sum of paid-in capital (capital stock) and paid-up capital is less than paid-in capital (capital stock), equity investment is equal to paid-in capital (capital stock).

Article 87 Interest expense as stipulated in Article 46 of the CIT Law includes the interest, guarantee fees, mortgage charges and other costs of an interest nature in relation to the direct or indirect related party debt investment.

Article 88 As stipulated in Article 46 of the CIT Law, the interest expense which cannot be deducted from the taxable income shall not be carried forward to the next taxable year. The allocation of the interest expense among related parties should be made in accordance with the proportion of actual interest paid to each related party in the total interest paid to related parties. For any of the non-deductible interest expense that can be allocated to a domestic related party with higher effective tax rate, a deduction will be allowed. Actual interest paid to overseas related parties directly or indirectly should be regarded as a dividend distribution, and enterprise income tax should be levied based on the difference between the income tax rates of dividend and interest. There shall be no tax refund if the withheld income tax exceeds the income tax calculated for deemed dividends.

Article 89 To apply for the deduction of interest expenses when the related party debt to equity ratio of the enterprise exceeds the standard ratio to be deducted from the taxable income, the enterprise should, in addition to what is required pursuant to the relevant provisions in Chapter 3 of the Measures, prepare, preserve, and, based on the requirements of the tax authorities, submit contemporaneous documentation. It should demonstrate that the debt investment amount, interest rate, term, financing conditions and

debt to equity ratio are in line with the arm's-length principle by including the following contents:

- (i) An analysis of the borrower's solvency and borrowing capacity;
- (ii) An analysis of the borrowing capacity and the financing structure of the group;
- (iii) An explanation of any changes in equity investment, such as the enterprise's registered capital;
- (iv) The nature, purpose, and market situation of the related party debt investment;
- (v) The currency, amount, interest rate, terms, and financing conditions of the related party debt investment;
- (vi) The conditions and terms of the collateral provided by the enterprise;
- (vii) The conditions of guarantor and terms of the guarantee;
- (viii) The interest rate and financing conditions of loans of similar nature and terms;
- (ix) The conversion condition of the convertible bonds;
- (x) Other supporting documents that can prove compliance with the arm's-length principle.

Article 90 For an enterprise which has not prepared, maintained or provided contemporaneous documentation to prove that its investment amount, interest rate, term, financing conditions and debt to equity ratio of related party debt investment comply with the arm's-length principle, the interest expense for the debt that exceeds the standard ratio cannot be deducted from the taxable income.

Article 91 The "actual interest payment" refers to the interest booked as cost or expense on an accrual basis by enterprises. If there are transfer pricing issues regarding the interest actually paid to related parties, tax authorities should first conduct a transfer pricing investigation and make any necessary adjustments pursuant to Chapter 5 of the Measures.

Chapter 10 General Anti-avoidance Administration

Article 92 Pursuant to Article 47 of the CIT Law and Article 120 of its Implementation Rules, the tax authorities can launch a general anti-avoidance investigation on enterprises where the following tax avoidance arrangements are identified:

- (i) Abusive use of tax preferences;
- (ii) Abusive use of tax treaties;
- (iii) Abusive use of the forms of enterprise organization;
- (iv) Tax avoidance by means of tax havens;
- (v) Other arrangements without reasonable business purposes.

Article 93 In order to identify whether an enterprise has a tax avoidance arrangement, the tax authorities should examine the following factors, following the principle of “substance over form”:

- (i) The form and the substance of an arrangement;
- (ii) The time and effective period of an arrangement;
- (iii) The implementation method of an arrangement;
- (iv) The connection of each step or part of an arrangement;
- (v) The changes in each party’s financial situation involved in an arrangement;
- (vi) The tax result of an arrangement.

Article 94 The tax authorities should redefine the tax avoidance arrangements in

accordance with the enterprise's economic substance, and annul the tax benefit obtained by the enterprise from such tax avoidance arrangements. For enterprises without economic substance, especially those incorporated in tax havens and enabling tax avoidance by their related parties or non-related parties, the tax authorities are empowered to deny the existence of the enterprises from a tax collection perspective.

Article 95 The tax authorities should issue the "Tax Inspection Notice" to the enterprise in accordance with the relevant provisions in the Tax Collection Law and its Implementation Rules when launching a general anti-avoidance investigation. The enterprise shall present supporting evidence for justifying its reasonable business purposes within 60 days of receiving the Notice. If the enterprise fails to provide documentation within the period or the evidence provided fails to justify the reasonableness of its business purpose, the tax authorities can make an adjustment based on the information obtained and deliver a "Notice on Special Tax Investigation Adjustment."

Article 96 In conducting a general anti-tax avoidance investigation, the tax authorities may request the planners of the tax avoidance arrangement to provide relevant materials and supporting evidence in accordance with the provisions of Article 57 of the Tax Collection Law.

Article 97 Any general anti-avoidance investigation and corresponding tax adjustment shall be reported level by level upward to the State Administration of Taxation for approval.

Chapter 11 Corresponding Adjustments and International Negotiation

Article 98 If one party involved in the related-party transaction has had a transfer pricing adjustment imposed upon it, the other party should be allowed to make corresponding adjustments to avoid double taxation. If the corresponding adjustment involves related parties in a tax treaty country or region, upon an application from the enterprise, the State Administration of Taxation will undertake negotiations with the competent tax authorities of the other party of the tax treaty pursuant to the mutual agreement procedures provided in the tax treaty.

Article 99 In the case of the corresponding adjustment of the related party located in the tax treaty country (or location), the enterprise should submit in writing an

“Application for Initiating Mutual Negotiation Procedure” to both the State Administration of Taxation and the competent tax authorities at the same time, with copies of the adjustment notice of the enterprise or its related parties and other relevant materials.

Article 100 The enterprise should apply for corresponding adjustments within three years of the day the enterprise or its related parties receives the transfer pricing adjustment notice. Any overdue applications will be inadmissible.

Article 101 Taxes paid relating to overseas related party interest, rent, and royalty payments involved in a transfer pricing adjustment will not be subject to a corresponding adjustment.

Article 102 Where the State Administration of Taxation accepts an application for a bilateral or multilateral APAs in accordance with Chapter 6 of the Measures, it should undertake negotiations with the competent tax authorities of the other party of the tax treaty pursuant to the mutual agreement procedures provided in the tax treaty.

Article 103 The corresponding adjustments or results of mutual agreement procedures are to be delivered by the State Administration of Taxation in written form through the governing tax authorities to the enterprise.

Article 104 Corresponding adjustment as provided by this chapter does not apply to the interest that is not deductible in calculating taxable income and the interest expenses deemed as dividend distribution as described in Chapter 9 of the Measures.

Chapter 12 Legal Responsibility

Article 105 Enterprises that fail to submit the annual reporting forms for the related-party transactions to the tax authorities or fail to preserve contemporaneous documentation or other related documents in accordance with the provisions in the Measures will be dealt with pursuant to Articles 60 and 62 of the Tax Collection Law.

Article 106 If an enterprise refuses to provide contemporaneous documentation and other information on related-party transactions to the tax authorities, or provides false or incomplete information that cannot truthfully reflect its actual related-party transactions, it will be dealt with pursuant to the provisions in Article 70 of the Tax Collection Law and

Article 96 of its Implementation Rules as well as Article 44 of the CIT Law and Article 115 of its Implementation Rules.

Article 107 If the tax authorities make a special tax adjustment for the enterprise pursuant to the provisions in the CIT Law and its Implementation Rules, an additional interest payment should be charged for additional tax levied on transactions after 1 January 2008.

(i) The period for interest calculation is from 1 June of the year after the tax year applicable to the date of the tax payment (pre-payment).

(ii) The interest rate shall be calculated based upon the RMB loan benchmarking rate published by the People's Bank of China on 31 December of the tax year(s) to which the underpaid tax belongs for a loan of the same term as the period for which additional tax is payable ("base rate"), plus 5 percent. The benchmarking rate will be converted to a daily interest rate based on a 365-day year.

(iii) Where the enterprise can provide both the contemporaneous documentation and relevant materials, or the enterprise is exempted from preparing contemporaneous documentation in accordance with Article 15 of the Measures, yet it provides other relevant materials requested by the tax authorities, the interest rate can be calculated based on the benchmarking rate alone.

If the tax authorities levy an interest on the additional tax payment when an enterprise is exempt from preparing contemporaneous documentation in accordance with Paragraph 1 Article 15 in the Measures and where the enterprise's actual amount of related-party transactions reaches the threshold of preparing contemporaneous documentation, the provisions in Paragraph 2 of this Article should be applied.

(iv) The interest charges prescribed in this Article cannot be deducted when calculating taxable income.

Article 108 If an enterprise has prepaid tax before the tax authorities make a special tax adjustment, in case additional tax should be paid after receiving the tax payment notice, the tax year to which the prepaid tax belongs should be determined according to the order of the tax years to which the additional tax payment belongs. The interest should also be calculated up to the date of the prepaid tax.

Article 109 The enterprise should pay the additionally levied tax and interest within the time limit prescribed in the adjustment notice issued by the tax authorities. If the enterprise fails to pay the tax and interest due within the time limit due to special circumstances, an application for an extension of the tax and interest payment should be submitted in accordance with the provisions in Article 31 of the Tax Collection Law as well as Article 41 and Article 42 of its Implementation Rules. If the enterprise does not apply for an extension or pay the tax and interest due, the tax authorities shall deal with it pursuant to Article 32 of the Tax Collection Law and other relevant provisions.

Chapter 13 Supplementary Provisions

Article 110 Procedures for investigations and adjustments of the special tax adjustment issues other than the transfer pricing administration and APA administration can be found in Chapter 5 of the Measures.

Article 111 The state tax bureaus and local tax bureaus at all levels should strengthen their cooperation during the implementation of special tax investigation and adjustments. If needed, joint investigation teams can be formed to conduct such investigations.

Article 112 The tax authorities and the tax officials should preserve and use the information and documents provided by enterprises in accordance with the Circular of the State Administration of Taxation on the Provisional Measures for the Tax-related Confidential Information Management of Taxpayers (Circular Guoshuifa [2008] No. 93) and other relevant provisions on confidentiality.

Article 113 If the last day of the prescribed period in the Measures is a legal holiday, the next day after the holiday should be deemed as the last day of the prescribed period. If there are more than three continuous legal holidays in the period, the last day should be postponed for the length of the holidays.

Article 114 Figures given in this Regulation using the phrases: "above", "below", "within a certain number of days", "on the day of", "before", "less than", "lower than", and "more than" are inclusive of the figure provided.

Article 115 In principle, if the investigated enterprises apply to change business address or deregister its tax registration during the special tax investigation and adjustment period, the tax authorities will not approve such changes or deregistration until

the conclusion of the investigation.

Article 116 The preparation of contemporaneous documentation regarding related party transactions during the 2008 tax year in accordance with Chapter 3 in the Measures can be extended to 31 December 2009.

Article 117 The Measures are subject to explanation and modification by the State Administration of Taxation.

Article 118 The Measures come into effect on 1 January 2008. Meanwhile, the “Administration of Tax on Business Transactions Between Affiliated Enterprises Rules” (Guoshuifa [1998] No. 59), “Administrative Regulations for Tax on Business Transactions Between Affiliated Enterprises Rules (Revised)” (Guoshuifa [2004] No. 143) and “Notice of the State Administration of Taxation on Distributing the (Trial) Implementing Rules for Negotiated Pricing for the Transactions Among Associated Enterprises” (Guoshuifa [2004] No. 118) will be annulled. If the previous provisions are different from the Measures, the Measures shall prevail.