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Large payments to overseas in the spotlight

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Key points

- » Service fee and royalty payments of a substantial amount by China companies to their overseas affiliates are subject to scrutiny
- » Companies are urged to review the reasonableness and sufficiency in documentation well in advance.

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1) Background

Once again service fee and royalty payments of a substantial amount by China companies to their overseas affiliates are subject to scrutiny, under the recent notice sent by State Administration of Taxation (SAT) to all local tax authorities throughout China, called the "Notice on Anti-Tax Avoidance Audit Regarding Substantial Payments to Overseas", issued on 29 July 2014 (ref. Shui-Zong-Ban-Fa [2014] 146).

This SAT notice requires nationwide local tax authorities to probe into cases of significant payments of royalty or service fees to overseas affiliates, especially those fee recipients locating in low tax countries or regions. The investigation is required to cover a period of ten years, from 2004 to 2013, and an investigation result shall be submitted to SAT by 15 September 2014. The notice highlights the following cases of a higher tendency to avoid taxes, and instructs that a transfer pricing audit should formally be launched against cases of obvious tax avoidance.

For service fee payments:

1. Payments to shareholders for services rendered by the shareholders
2. Payments to the group for shared services organized by the group
3. Payments for services which normally can be handled by the China entity itself or for services duplicated with those provided by its independent service provider in China
4. Payments for services which do not match with the China entity's functionality / risk level, nor with its operation or business cycle
5. Payments for services co-existing with other transactions which have charged for the same fees

For royalty payments:

1. Payment of royalty to tax havens
2. Payments of royalty to overseas affiliates which assume none or simple functions
3. Payments of substantial royalty to overseas for rights that the China entity has made significant contribution to its value, or for rights which have significantly depreciated in value

2) WTS observation

It can be recalled that a similar audit has happened in early 2009, ordered by SAT's rule then (Guo-Shu-Fa [2009] 32). Local tax authorities were asked to probe into cases of non-trade payments from China to non-residents which could potentially trigger withholding tax obligations. The current investigation has extended the arm of laws, examining the substantiality and deductibility of these payments from transfer pricing perspective.

Under the current disclosure practice, all agreements involving payments or service fee / royalty are required to be registered with local tax authorities within 30 days of execution. Therefore, it would not be surprising that local tax authorities can identify targets from their existing record. Companies involving in substantial service fee / royalty payments to overseas are urged to review their payments' reasonableness and sufficiency in documentation well in advance.

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