New rules for transfer pricing transparency in China – challenges and change for pharma and life sciences companies

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The pharmaceutical and life sciences (PLS) industry is a priority industry for China's State Administration of Taxation, and as such is subject to close scrutiny with PLS multinationals facing sweeping transfer pricing audits across the country.

In June 2016, China introduced new transfer pricing compliance rules around the same time the Organisation for Economic Co-operation and Development (OECD) released its Guidance on Implementation of Country by Country Reporting (Action 13 guidance). Reflecting China's support of Action 13, the new rules overhaul the related party transaction disclosure forms and introduce country by country reporting (CbCR), as well as Master File and Local File transfer pricing documentation requirements.

Current regulatory and tax environment in China

Although China has become one of the world's largest and fastest growing pharmaceutical and life sciences (PLS) markets, growth has slowed in recent years. General economic headwinds have undoubtedly played an important part, and pressure from recently introduced government cost containment measures and investigations into anti-competitive practices also factor into the equation. PLS is one of the most heavily regulated sectors in China, and new regulatory initiatives such as the "two invoices" system and the introduction of government-negotiated drug prices into medical insurance are expected to put downward pressure on multinationals' drug prices in China. Chinese regulators such as the National Development and Reform Commission are also closely examining the pricing methods of local and foreign PLS companies for potential anti-trust violations, looking for price manipulation among competitors or through the distribution chain.

PLS multinationals operating in China also face a difficult and uncertain Chinese tax and transfer pricing environment. Unfortunately, China's new transfer pricing requirements may only serve to further increase the compliance and administrative burden. The PLS industry is a priority industry for China's State Administration of Taxation (SAT), and as such is subject to close scrutiny, with PLS multinationals facing sweeping transfer pricing audits across the country. This is particularly the case for PLS multinationals with more than one Chinese subsidiary undertaking different types of activities (e.g., manufacturing, distribution, research and development), which may face simultaneous centrally coordinated national and local audits. Securing tax certainty in China is difficult, with limited opportunity to pursue unilateral or bilateral advance pricing agreements (APAs) given the long and congested queue of outstanding cases and the low number of PLS APAs successfully concluded to date. To further add to the uncertainty, depending on the location of your Chinese operations, an APA application may invite a transfer pricing audit for historical years. The rigidity of the Chinese customs regime restricts the ability of

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multinationals to adjust their transfer prices into and out of China for fear of customs authority challenge, and the existence of foreign exchange controls further limits the options for multinationals to make year-end price adjustments. These challenges are significant enough to have caused some PLS multinationals to seek alternative methods to achieve arm's length transfer pricing results – for example, with service fee arrangements. This creates additional complexity and challenge for multinationals trying to maintain a globally consistent and cohesive transfer pricing model.

The new Chinese requirements

The new rules introduce a range of additional transfer pricing filing and disclosure requirements covering potentially sensitive and subjective data and analysis. The CbCR requirement will typically be addressed through tax authority exchange of information provided the general conditions described in the Action 13 guidance are met. The Master File documentation also generally follows the Action 13 guidance, with a few additional China-specific disclosures covering items such as changes in operational structure and the functions, assets, risks, and personnel of the group's research and development (R&D) facilities. The Local File, on the other hand, replaces the old Chinese contemporaneous documentation rules and contains potentially significant new disclosure requirements, including the following:

- **Value chain analysis**, which is generally described in the new rules to include group transaction flows, latest financial statements, measurement, and attribution of "location specific factors" contributing to value creation and the allocation of group profit across the global value chain (including the allocation basis).
- **Key factors affecting pricing of transactions**, including intangibles, and an analysis of location specific factors such as local China cost savings and China market premium (described below). The Chinese authorities typically consider aspects such as labour costs, environmental costs, market size, market competition, consumer purchasing power, substitutability of goods or services, and regulatory controls in analysing these topics.

The Local File replaces the old Chinese contemporaneous documentation rules and contains potentially significant new disclosure requirements.

As is commonly the case in China, the new rules are light on detail and are therefore open to interpretation. In particular, the value chain analysis requirement remains somewhat ambiguous. Regardless of this uncertainty, with the first China local file due for all taxpayers by 30 June 2017, PLS multinationals must immediately study these new rules, evaluate the potential implications for your business, and develop a strategy to comply.

Chinese tax authority views on value chain analysis

The new Chinese disclosure requirements differ from the Action 13 guidance in certain key respects, reflecting the Chinese tax authorities' unique and results-oriented views on value chain analysis and location specific factors in particular. They are specifically designed to enable the Chinese authorities to obtain additional information on multinationals' global and commercial value chains to support these types of analyses and ultimately support proposed tax adjustments.

Most multinational tax departments will already be familiar with the Action 13 guidance on the importance of identifying value drivers and analysing intangible property (IP) development, maintenance, protection, and exploitation activities (the so-called DEMPE functions) across the value chain. This forms the cornerstone of understanding intangibles in a multinational organisation and is a key part of the value chain analysis required to be included in the Master File. Aligned with this, the new Chinese rules require a description of value drivers and the locations where DEMPE functions are performed across the worldwide value chain. This differs from the approach typically adopted up to now, which

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has relied on one-sided tests to support the returns of the Chinese operations on the basis that they are generally characterised as less complex than their foreign counterparts.

With the new Chinese rules, it appears the SAT is focused on trying to identify value created and contributed by local Chinese entities through local enhancement, exploitation, and promotional activities (e.g. R&D, marketing, and sales) with a view to justifying higher local returns or profit allocations. Although it is not clear that PLS multinationals necessarily or generally perform high value-adding activities in China, you should anticipate these types of China tax authority positions and be prepared to defend against them. The Chinese authorities emphasise the importance of location specific factors, suggesting additional returns should be allocated to China – the two most common being local cost savings as compared with other countries and higher prices of foreign goods and services in China (China market premium) as compared with other markets. Interestingly, the fact that labour is not typically a highly significant cost for PLS multinationals may weigh against the local cost savings argument, and Chinese price regulations and anti-trust investigations may serve to limit the potential to attribute additional profits to China. The fact that new PLS products are usually launched with premium prices in more developed markets before they are introduced in China with lower prices may also serve as a counterargument against the existence of a China market premium. Nevertheless, the burden of proof rests with the taxpayer in an audit situation, and the authorities are likely to ask the taxpayer to provide more than one-sided tests to defend its transfer pricing, including, potentially, an analysis of system profit allocation.

Additionally, Chinese tax authorities may attempt to use a holistic analysis approach to argue the existence of synergies among multiple functions being performed in China (e.g., manufacturing, distribution, and R&D), whether in one or more entities. Their hypothesis is that analysing the returns of these transactions separately using one-sided tests would result in under-recognition of China's contribution to the global value creation and hence in an under-allocation of profit to China. As a PLS multinational with operations in China, you should be prepared to address this through your value chain analysis.

Specific PLS value chain challenges

PLS multinationals operating in China face a particular set of challenges due to the regional principal company models they commonly adopt, where strategic business management activities and value creation are concentrated in centralised locations. These types of principal models will be the subject of particular scrutiny by the Chinese tax authorities going forward. Given the 30 June 2017 China local file deadline for FY2016 documentation, PLS multinationals need to begin preparing for potential challenges immediately.

Take the following simplified example — a US PLS multinational with an Asia regional principal located outside China and four Chinese subsidiaries performing contract R&D, contract manufacturing, licensee manufacturing and limited risk distribution. Group operating margin is 25% and the Chinese entities earn margins of 3–15% depending on their activities.

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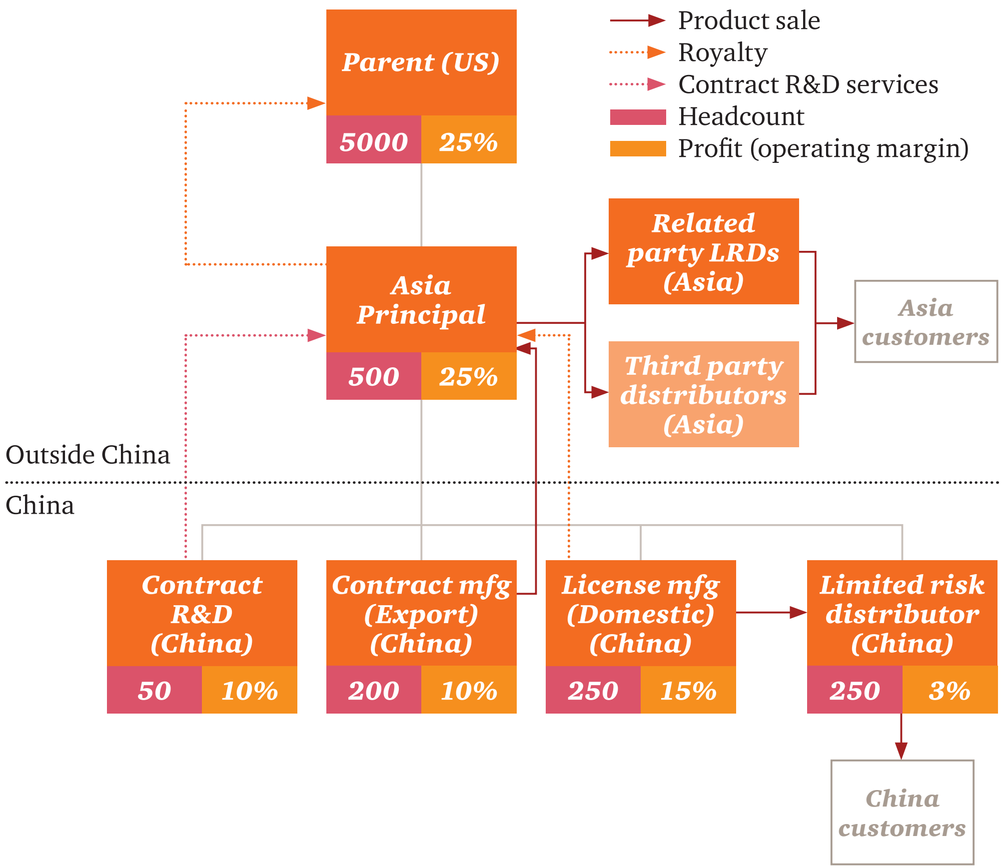

Are there any synergies for your organisation associated with having a range of activities (e.g., R&D, manufacturing and distribution) in China?

As a PLS multinational under audit, you should expect the Chinese tax authorities to focus on the following types of questions and analysis:

- Compare the Chinese returns (3% – 15%) with global and regional returns (25%). How do you explain and support the lower profits of the Chinese affiliates?
- Investigate the nature and cost base of China R&D and manufacturing activities. Are there any local IP or process enhancement, exploitation or promotional activities, or cost savings due to the location of these activities?
- Analyse sales and marketing activities and expense levels of the limited risk distributor. Are there any unique China market development activities that might create marketing intangibles? Do your products command a price premium in China?
- Are there any synergies for your organisation associated with having a range of activities (e.g., R&D, manufacturing and distribution) in China?

These are the types of arguments the Chinese authorities typically pursue to support their position and propose tax adjustments. Anticipating these questions and developing a strategy to address them will be crucial for PLS multinationals in supporting their tax and transfer pricing positions in China.

PwC's value chain analysis approach – VCA

There are two main schools of thought on how best to conduct value chain analysis – the traditional "formulaic" approach and the empirical approach. The formulaic approach is essentially a global profit split using weighting and scoring techniques to allocate system profit based on value drivers. This approach is quite practical for taxpayers, but may be susceptible to tax authority challenge given its inward focus and reliance on internal management reporting data. In contrast, the empirical approach is based primarily on third party data. PwC has developed our own empirical value chain analysis approach, which we call VCA, to assist multinationals meet the standards of the Action 13 guidance and ensure they are prepared to address potential tax authority questions or challenges such as those described above for China. In light of all of the BEPS developments and the new environment of tax transparency, multinationals will be best served with a single value chain analysis providing a globally consistent story that can be provided to any tax authority around the world, rather than attempting to develop different analyses or arguments to serve different purposes or

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for different jurisdictions. The key to our empirical VCA approach is maximising the use of arm's length industry and third party publicly available information, applying traditional transfer pricing analysis to industries and peers, and supplementing this with appropriate internal management information where necessary. This approach seeks to minimise inward-looking subjectivity and risk of successful tax authority challenge by tying as much as possible back to industry and third party data and analysis.

Our VCA comprises four steps: peer group analysis, core competencies, entity mapping and evaluation. The objective of the peer group analysis is to identify competencies or attributes that are a source of sustainable competitive advantage for a multinational. The core competencies analysis involves analysing the associated functions, assets, and risks to identify appropriate profit or loss outcomes for each competency. To address China-specific considerations, a PLS industry analysis may cover, for example, public labour cost data and the findings of Chinese government anti-trust investigations to help shed light on true value drivers and defend against Chinese tax authority arguments on location specific factors. Entity mapping explains how profits or losses map to types of entities based on factors such as functions, risks, investments, assets, and contractual relationships. Evaluation essentially compares the multinational-specific VCA findings back to the industry and peers, identifying any gaps and opportunities for alignment where appropriate. The resulting output is a strategic and thoughtful empirical VCA supporting the multinational's allocation of profits across the global value chain. An executive summary describing the VCA findings would be included in the master file and this could also be used to also support local country compliance requirements (e.g., China local file) where required. Elements of the more detailed VCA report may also be extracted and used as part of local country audit defence where appropriate.

Next steps – navigating the compliance and audit cycle

As a PLS multinational with operations in China, your next steps are critical and your strategic assessment of the impact of the new Chinese rules on your positions should start immediately. Given the 30 June 2017 China local file deadline, you should move quickly to develop your value chain analysis, ensuring you fully understand and can support the allocation of profit across your global value chain, taking remediation steps to address any gaps if necessary. You should begin to consider whether you have any particular challenges in China as well as how these might be addressed and incorporated into your global value chain analysis using industry and third party empirical data and analysis to the extent possible. The road ahead remains complex and challenging, but an early start on your value chain analysis should help to ensure you enter the new China compliance and audit cycle with your best foot forward.

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