

CHINA LEGAL REPORT

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subject **Transfer Pricing Developments in China**

Introduction

“Transfer pricing” is an increasingly important and contentious area of the tax law in China and around the world. It deals with the pricing for “inter-company” transactions, that is, transactions between commonly controlled parties or between a parent corporation and its subsidiaries. Both China and almost all its major trade partners have tax laws designed to prevent multinational groups from reducing taxes inappropriately by entering into transactions among related parties, which are not in line with the arm’s length principle.

Transfer pricing typically involves international transactional flows among the members of a multinational corporate group, such as licensing intellectual property, sales of components for use in manufacturing products, and inter-company financings and loans.

Multinational taxpayers are often caught between jurisdictions making inconsistent tax claims as to the same cross-border transactions, which can result in “international double taxation.” As tax administrators become more aggressive in seeking revenues, transfer pricing examinations and litigation have increased in number and scope, and taxpayers have become increasingly vulnerable to double taxation.

China’s new Enterprise Income Tax Law (promulgated on 16 March 2007) and its Implementation Rules (promulgated on 11 December 2007) have both entered into effect as of 1 January 2008, and the current dual system for taxation of enterprise income with regard to foreign invested enterprises (“FIEs”), foreign enterprises (“FEs”) and domestic enterprises is abolished as from the same time¹. Both Enterprise Income Tax Law and its Implementation Rules contain provisions relevant for transfer pricing. Furthermore, a draft of the Transfer Pricing Contemporaneous Documentation Rules is presently under examination and is expected to be released soon. As a matter of fact, taxpayers including the FIEs and FEs are strongly required to pay more attention to the issue of transfer pricing.

¹ See: Article 60 of Enterprise Income Tax Law

1. Advantages of Transfer Pricing

The reasons why multinationals conduct transfer pricing are diversified. Profit allocation, minimization of taxable income in jurisdiction with high tax burden, reduction of customs duty, optimization of group overall tax burden, avoid restrictions on foreign exchange can be counted as the major advantages of transfer pricing. Furthermore, an increasing number of the multinationals choose transfer pricing to structure internal transaction at a price which they consider fairer than the market price. Finally transfer pricing is also a tool to correctly allocate costs within the various group companies of a multinational.

2. Affiliated Enterprise & Arm's Length Principle

The term of “affiliated enterprises” refers to any of the following types of companies, enterprises and other economic organizations²:

1. between which there exists direct or indirect proprietary or controlling relationship in terms of capital, business operation, purchase and sales;
2. which are directly or indirectly owned or controlled by an identical third party;
3. between which there are other relationships of interests.

The prevailing definition of affiliated enterprises is very broad in practice and lies in the discretion of the specific tax authority. This generally could include companies when³:

1. One directly or indirectly owns 25 % or more equity interest of another;
2. A third party owns 25 % or more equity interest of the two companies;
3. An inter-company loan exceeds 50 % of its capital or when 10 % of the total loan is guaranteed by another company;
4. More than half of the directors, managers or other senior management personnel or more than one (including one) executive director of a company are appointed by the other company;
5. The manufacture or business operation of one company depends on the industrial proprietary right or know-how provided by the other company;
6. Raw materials or spare parts etc that one company needs for its operation (including transaction price and conditions for purchasing such raw materials or spare parts) are controlled by the other company;

² See: Article 51 of the Detailed Rules for the Implementation of Law of the People's Republic of China on the Administration of Tax Collection

³ See: Article 4 of the Regulations on Administration of Taxation of Business between Affiliated Enterprises

7. Goods that one company manufactures or sells (including transaction price and conditions for such goods) are controlled by the other company;
8. One has control over another's production, operations, purchases or sales decisions or any other associations between the companies with mutual benefits including family relationship or relative relationship etc.

A taxpayer is obliged to offer the materials with regard to price, cost and standard concerning its businesses with affiliated enterprises to the local tax authority. Transactions between affiliated enterprises will be scrutinized by tax authorities using the arm's length price benchmark (price at which two unrelated parties would agree to a transaction)⁴ If a tax bureau considers that any transaction is not priced at an arm's length, it is empowered to adjust the prices for tax purposes.

3. Transfer Pricing Compliance Enforcement

According to the Enterprise Income Tax Law, when an enterprise submits its annual enterprise income tax returns to the tax authority, an annual report on the affiliated transactions between it and its affiliated parties shall be attached. When the tax authority investigates into the affiliated transactions, the enterprise and its affiliated parties, as well as other enterprises in relation to the affiliated transactions under investigation, shall, according to the related provisions, provide the related materials⁵

In case any enterprise refuses to submit the materials regarding transactions with its affiliated parties, or provides any false or incomplete material, on the basis of which the true information about the affiliated transactions cannot be reflected, the tax authority may determine upon check its taxable income amount.⁶

The Chinese tax authorities have been accelerating transfer pricing compliance enforcement efforts since they consider some FIEs to have been improperly applying transfer pricing to minimize tax liabilities and shift profits out of China. tax authorities are thus particularly concerned with the following corporate behaviors, which are most likely trigger a tax audit:

1. Loss-making or low profitability while paying (trademark) royalties.
2. Continuous (for more than two years) loss-making, however, expanding business scale.

⁴ See: Article 36 of the Law on Administration of Tax Collection

⁵ See: Article 43 of the Enterprise Income Tax Law

⁶ See: Article 44 of the Enterprise Income Tax Law

3. Having a dominant portion of business volume with affiliated enterprises.
4. Conducting transactions with companies registered in tax haven.
5. A company with a group, which compared with its affiliated enterprises has much lower profit.
6. Unnecessarily complex transactional structures, involving entities that do not carry much substance.
7. Making balancing payments to temporarily and artificially create a profitable position (to utilize losses carried forward), while suffering losses for the majority of other years.
8. Sudden loss-making after the expiry of tax holidays while primarily making profit during the period of tax holidays.

As interpretation of what is understood to be not at arm's length, the relevant Chinese tax regulations list up the following circumstances, under which the tax authority may adjust the taxable amount of a transaction between affiliated enterprises:⁷

1. Failing to evaluate the operations of purchase and sales according to those between independent enterprises;
2. The financing interests paid or collected are more than or less than the amount on which the unaffiliated enterprises could agree, or the financing interests are more than or less than the normal interest rate of the same type of operations;
3. Failing to collect or pay for the labor costs according to the business transactions between the independent enterprises in providing labor services;
4. Failing to evaluate, or collect, or pay according to the business transactions between the independent enterprises in the transfer of properties, offering property-use right, etc.;
5. Other circumstances of failing to evaluate the business transactions according to those between independent enterprises;
6. In case an enterprise makes any other arrangement not for any reasonable commercial purpose, which causes the decrease of its taxable revenue or income, the tax authority may, through a reasonable method, make an adjustment.⁸

Where a taxpayer and its affiliated enterprises fail to make payments according to the business transaction between the independent enterprises, the tax authority may regulate the business transaction within 3 years starting from the tax year in which it was conducted. Under special circumstances such as a tax haven shelter is involved or a false declaration is

⁷ See: Article 54 of the Detailed Rules for the Implementation of Law of the People's Republic of China on the Administration of Tax Collection

⁸ See: Article 47 of the Enterprise Income Tax Law

found, the business transaction may be subject to regulation within ten years as of the day when the transaction was conducted⁹

The main methods, which are in line with international practice, to regulate the taxable amount of the incomes or gains according to the Detailed Rules that the Tax Administration may adopt are¹⁰

- according to the price of the identical or similar business transactions between independent enterprises (Comparable Uncontrolled Price Method);
- according to the obtainable income and profit upon the sales price to a third party without association with it (Resale Price Method);
- according to the costs plus reasonable fees and profits (Cost Plus Method);
- according to net profit arising from transaction between independent enterprises (Net Profit Method)
- according to reasonable allocation of aggregate amount of profit and loss between independent enterprises during a transaction (Profit Split-up Method)
- according to other reasonable methods.

4. Recent Developments on Transfer Pricing

Some major tax jurisdictions in China such as certain districts in Shanghai, Guangzhou, Xiamen and Wenzhou have issued a new requirement on disclosure of inter-company transactions, under which FIEs and Fes will be obliged to file more detailed and comprehensive inter-company transaction information, dating back to the annual corporate income tax filing of fiscal year 2006. Even more importantly, taxpayers in those jurisdictions are now required to disclose information on both related and unrelated transactions of a similar nature, i.e. information that could facilitate the tax authorities to efficiently identify comparable transactions and effectively evaluate the arm's length nature of the transfer pricing practices adopted by the taxpayers. This new requirement echoes the message in the new Enterprise Income Tax Law of strengthening the transfer pricing compliance enforcement. It is expected that more local tax jurisdictions will follow this practice and implement it at the annual tax filing of fiscal year 2007.

On the other side, tax authorities become more concerned with enterprises with pure manufacture functions (e.g. processing trade enterprises) that are making losses. According to the Circular of the State Administration of Taxation on Investigation on Tax Payment

⁹ See: Article 56 of the Detailed Rules for the Implementation of Law of the People's Republic of China on the Administration of Tax Collection. See also Article 123 of the Detailed Rules for the Implementation of Enterprise Income Tax Law.

¹⁰ See: Article 111 of the Enterprise Income Tax Law Implementation Rules

Status of Foreign Invested Enterprises and Foreign Enterprises with Pure Manufacture Functions (Guoshuihan[2007]236), FIEs and FEs are defined as manufacturers with “pure manufacturing function” if they carry out the production according to the orders placed by related parties and the business plan of their overseas parent company, while all strategic management, R&D, sales and marketing, etc are carried out by their parent company or other related parties. Many of these losses arise because the companies are in start-up positions and may have initial one-off costs or low capacity utilization.

However, tax authorities are getting increasingly upset by the facts that many of such FIEs with pure manufacture functions have losses or make marginal profit though performing pure manufacturing activities according to their foreign parents’ overall operational plans. Tax authorities are of the opinion that these FIEs/Fes with pure manufacture functions should not bear the risks and losses caused by inappropriate decisions, under utilization of capacity or a sluggish market, and these FIEs and FEs should in principle maintain a reasonable level of profitability and not incur any loss.¹¹

Circular 236 demonstrates that the State Administration of Taxation is organizing a nationwide tax investigation campaign into the transfer pricing arrangements within these pure manufacture function FIEs/FEs. The major measures that are contemplated by the tax authorities include:

- emphasizing the association between function, risk and profitability of the FIEs/Fes
- imposing requirement on those FIEs/FEs to maintain reasonable profit
- carrying out tax audit on the loss-making or low profit FIEs/FEs

Furthermore, the Circular of the State Administration of Taxation on Strengthening Investigation and Analysis on Transfer Pricing (Guoshuihan[2007]363) unveils new function/risk checklists to be adopted by the tax authorities during the transfer pricing investigation. Three forms including the Enterprise Functional and Risk Analyses Form, the Enterprise Functional and Risk Analyses Characterization Form and the Enterprise Financial Analysis on Inter-Company Transactions Form are to be filled out during different phases of a tax audit. The above documentation processes emphasize that the importance have been placed on functional and risk analysis by tax authorities and its attempt to standardize and improve the quality and efficiency of transfer pricing investigation. This documentation requirement also serves as a foundation of the investigation into FIEs/FEs with pure manufacture functions as mentioned above.

¹¹ See: Context of this Circular

5. Advance Pricing Arrangement

Advance Pricing Agreement (“APA”) Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial process. An APA is a binding contract between the tax authorities and a taxpayer by which the tax authorities agrees not to seek a transfer pricing adjustment if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method.

An enterprise may propose the pricing principles and calculation methods for the transactions between it and its affiliated parties to the tax authority, the tax authority and the enterprise shall, upon negotiations and confirmation, achieve an advance pricing arrangement.¹²

Such advance pricing arrangement means that the enterprise shall apply to the tax authorities concerning its pricing principles and calculation methods for the related transactions in the future year, arm’s length nature shall be complied, and such arrangement shall be made upon negotiations and confirmation.¹³

A taxpayer may put forward the price fixing principle and calculating method of the business transactions between it and its affiliated enterprises to the competent tax authority, which shall, after granting approval upon examination, reach an agreement concerning price fixing in advance and supervise the implementation of the taxpayer.¹⁴

According to the Detailed Rules for the Implementation of Advance Pricing for the Transactions among Affiliated Enterprises, these Detailed Rules are applicable to the administration of tax collection relating to the negotiated pricing arrangements among affiliated enterprises. Such administration on tax collection refers to the specific administrative work such as talks, examination and appraisal, discussions, the formulating and approval of the negotiated pricing arrangements, as well as monitoring and enforcement, conducted by the competent tax authorities and the taxpayers, on the basis of free will, equality, and good faith. And according to the present Rules in the dealings between the taxpayers and their affiliated enterprises regarding the purchase and use of tangible assets, the transfer and use of intangible assets, the provision of labor services, and the financing, the taxpayers shall apply for determining in advance the principles of

¹² See: Article 42 of the Enterprise Income Tax Law

¹³ See: Article 113 of the Detailed Rules for the Implementation of the Enterprise Income Tax Law

¹⁴ See: Article 53 of the Detailed Rules for the Implementation of Law of the People’s Republic of China on the Administration of Tax Collection

negotiated pricing and ways of computation to be applied to the affiliated dealings so as to solve and determine the tax issues involved in the affiliated dealings in future years.¹⁵

6. Draft of Contemporaneous Documentation Requirements

Presently, the draft of the Transfer Pricing Contemporaneous Documentation Rules ("TPCDR") is being scrutinized and are expected to be issued soon. The TPCDR is broadly expected by the experts and scholars to take a two-step approach.

The first step deals with information disclosure and it occurs at the time of annual income tax filing, when taxpayers are required to submit a detailed transfer pricing disclosure form together with their annual enterprise income tax returns before the end of May in 2009.

This form is expected to consist of mainly the following elements, including: relationship with the related parties, location of the related parties, form of trade of the related parties, nature of related party transactions, amount of the related party transactions and the proportion of the related party transactions to the total amount of similar type of transactions, profit and loss positions of the related party transactions, transfer pricing methods adopted as well as a confirmation whether the company has transfer pricing documentation in place as at the time of annual enterprise income tax filing.

The second step of the TPCDR deals with transfer pricing documentation which a taxpayer is required to prepare and maintain by the time of annual tax filing for each tax year. This documentation is not required to be submitted to the tax authorities at the time of annual tax filing; it is only to be submitted within 30 days upon request by the tax authorities. Based on the above, the TPCDR gives clarity on the contemporaneous nature of the transfer pricing documentation required under the Enterprise Income Tax Law and its Implementation Rules.

The format of such documentation should comprise mainly the following sections, including: global organizational structure, the effective tax rates of the related parties, detailed analysis of business operations, details of related party transactions, comparability analysis, selection and application of transfer pricing method, including reasons why other transfer pricing methods are rejected, details of cost sharing arrangements ("CSAs"), if applicable, and other relevant documents.

¹⁵ See: Article 2 of the Detailed Rules for the Implementation of Advance Pricing for the Transactions Among Affiliated Enterprises

The documentation must be submitted within 30 days of the tax authorities' request. Taxpayers may apply in writing for a one-time extension of 45 days when there are special circumstances but this is subject to approval by the tax authorities.

Information to be submitted to the tax authorities at annual income tax filing, and upon request by the tax authorities must be in Chinese. Information submitted to the tax authorities under the second step must additionally be certified authentic with official stamps and signature. Where information is submitted with respect to overseas related party transactions, they must be notarized or certified true by certified public accountants.

Failure to file the relevant information would subject taxpayers to penalties under the general tax administration laws. In cases where taxpayers refuse to submit, or submit false information, the tax authorities are empowered to deem the amount of taxable income for adjustment purposes. In addition, an interest levy under the new Enterprise Income Tax Law would be applied to anti-avoidance tax adjustments.

On the other side, the TPCDR provides that taxpayers who have entered into advance pricing arrangements ("APAs") with the Chinese tax authorities are exempted from preparing transfer pricing documentation.

7. Conclusion

These new rules, together with the laws and regulations, demonstrate that transfer pricing enforcement is continuing to gain importance for the Chinese tax authorities as a counter-measure to combat the loss of tax revenue.

Obviously, the Chinese government has become more stringent and eager to develop more complete and comprehensive rules on serious transfer pricing of multinational corporations. The rules regarding transfer pricing that have been recently issued are getting closer to the international practice.

Taxpayers in China are believed now facing a more stringent transfer pricing environment, and the task of enhancing their transfer pricing position has become even more important.

Although the release of China Transfer Pricing Contemporaneous Documentation Rules has been delayed, Circular 236 and 363, the new annual tax filing requirements, and the information requests will lend support to the tax authorities in the collection of inter-company information and the extension of transfer pricing investigations. The Transfer

Pricing Contemporaneous Documentation Rules which will be eventually released will contain more detailed and comprehensive requirements on documentation of transfer pricing, paving a way for strengthened transfer pricing compliance enforcement. Consequently, taxpayers should internally pay more attention to their own documentation as well as function/risk analysis and externally regularly seek more effective and efficient communication with tax authorities.

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