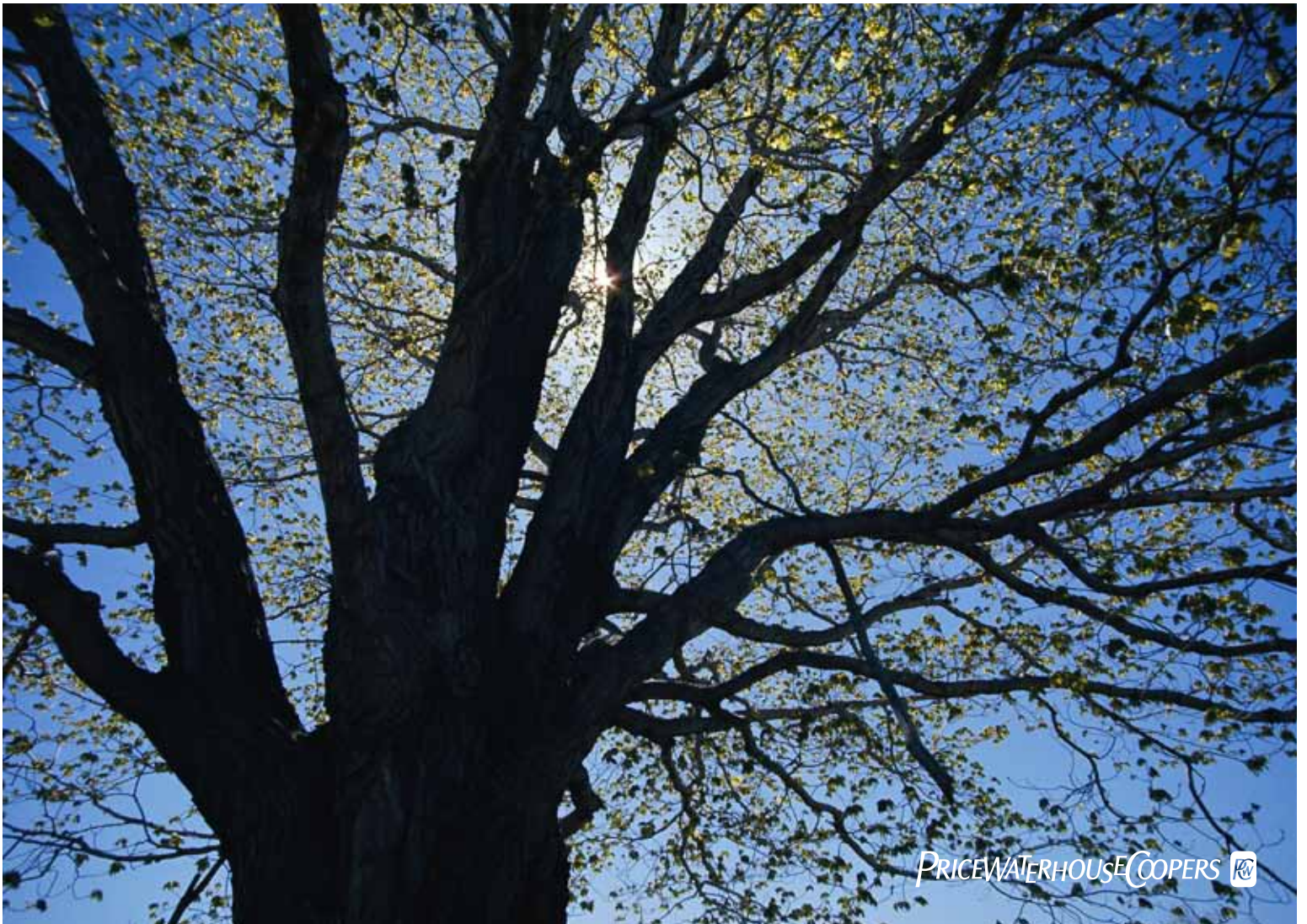


New entrants— Increased enforcement—
The Chinese perspective

Transfer pricing perspectives

Re:solutions
moving towards certainty



New entrants—Increased enforcement— The Chinese perspective

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After years granting tax holidays and incentives to many multinational companies operating in China, the erosion of China's tax base has become a top priority for China's State Administration of Taxation (SAT). As tax authorities around the world increase enforcement of tax regimes, China has followed suit and toughened its tax laws, particularly its transfer pricing regulations. China's new corporate income tax (CIT) law, together with its detailed implementation regulations (DIR), introduced a set of anti-avoidance measures under Chapter 6—Special Tax Adjustments. It may well be the most complex chapter of the CIT law, encompassing audit procedures, the introduction of cost sharing agreements, the administration of thin capitalisation, the definition of controlled foreign enterprises and thin capitalisation, and above all, the imposition of mandatory transfer pricing documentation requirements that could demand much greater attention from taxpayers. The new CIT law applies from 1 January 2008.

The new regulations seek to ensure consistency of transfer pricing enforcement and administration throughout China. The SAT has consolidated its past experiences in audit cases into a single document establishing a high-level framework for future transfer pricing policy developments.

With the transfer pricing regulatory framework in China now formalised, companies operating in China will need to review and manage their transfer pricing risks and fulfil their compliance obligations.

This article provides a summary of China's transfer pricing regulatory landscape under the new CIT law. Our interpretation of the regulations and recommendations are based on our recent experiences in applying the law and our ongoing dialogue with the SAT.

The measures

On 9 January 2008, the SAT issued a circular entitled Guo Shui Fa [2009] No. 2, which contains the Implementation Measures of Special Tax Adjustments (Trial) (the measures). The measures detail China's framework for administering special tax adjustments relating to transfer pricing, thin capitalisation, controlled foreign corporations, and general anti-avoidance.

While the measures do not provide all the answers to the uncertainties raised by the new CIT law and the DIR, they do offer valuable insight and additional guidance on the direction of the Chinese tax authorities in their anti-tax avoidance administration efforts.

The taxpayers required to file the RPT forms include not only enterprises residing in China, but also non-tax resident enterprises with an establishment or a place of business in China that file corporate income tax returns with tax authorities and pay income taxes based on their actual accounts.

Definition of related party

The measures define related parties to include a party directly or indirectly owning more than 25% of the shares of another party, or a common third party directly or indirectly owning more than 25% of the shares of both parties. Chinese enterprises should carefully evaluate their own relationships (e.g., major suppliers, customers, financiers) as well as the relationships of their directors and high-level management in light of this definition of related parties.

Annual disclosures of related-party transactions

The final version of China's new related-party transactions disclosure (RPT) forms (required by Article 11 of the measures) were released by the SAT in December 2008 under Guo Shui Fa [2008] No. 114. They place a significantly heavier information disclosure burden on Chinese taxpayers; there are now as many as nine different forms that need to be filed as part of the taxpayer's annual CIT return, due on 31 May 2009. The RPT forms also require companies to indicate whether they have contemporaneous transfer pricing documentation (TPD) in place to substantiate their intercompany arrangements.

The taxpayers required to file the RPT forms include not only enterprises residing in China, but also non-tax resident enterprises with an establishment or a place of business in China that file corporate income tax returns with tax authorities and pay income taxes based on their actual accounts.

The RPT forms require large amounts of information that must be provided precisely in the manner prescribed by the SAT. As a result, they require significant time to comprehend, collate, and complete. In addition, certain sections of the RPT forms can be confusing for those filing for the first time. We recommend taxpayers take a reasonable and commercial approach in interpreting the forms in the absence of specific guidance from the measures.

At an SAT seminar on 31 March 2009, taxpayers were advised that disclosures made in the RPT forms should be supported and closely correlated with the taxpayer's CIT return, its TPD, audited financial statements, and information filed by taxpayers' other related parties in China.

Contemporaneous transfer pricing documentation

The measures require enterprises to prepare and maintain TPD if its related-party transactions exceed RMB200 million (US\$29 million) for purchase and sale of goods transactions or RMB40 million (US\$6 million) for other transactions such as royalties, services, etc. TPD is not required if an advance pricing arrangement (APA) is in place or the foreign shareholding of the enterprise is below 50% and the enterprise has only domestic related-party transactions.

TPD must be submitted to the SAT in Chinese, and the taxpayer has 20 days to provide tax officials with TPD once it has been requested.

For the 2008 year, taxpayers have a one-time extension until 31 December 2009 to prepare TPD; however, after this year, taxpayers will be required to have TPD prepared by the CIT return filing deadline of 31 May.

The measures list as “appropriate methods” for conducting transfer pricing investigations the same six methods provided in the OECD’s transfer pricing guidelines (i.e., the comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method, profit split method and other methods that are consistent with the arm’s length principle). However, there is not any preference or hierarchy of transfer pricing methods.

Audits and penalties

In 2008, the Chinese tax authorities formally initiated transfer pricing audits of 174 companies, and concluded 152 audit cases resulting in total tax adjustments of RMB1.24 billion on total income adjustments of RMB15.55 billion, with the single-largest tax adjustment being RMB423 million.³⁰

In 2010, the SAT said audit targets would be selected based on the information disclosed by taxpayers in their RPT forms and TPD.

The measures provide the SAT with the authority to conduct a transfer pricing audit of enterprises if considered necessary. They also detail how the auditors may conduct the investigations, specifically allowing the use of secret comparables.

³⁰ <http://www.chinatax.gov.cn/n8136506/n8136548/n8136623/8817242.html>

According to the measures, the SAT searches for the following transfer pricing audit flags when identifying enterprises for investigation:

- Significant amounts or numerous types of related-party transactions
- Long-term losses, low profitability, or fluctuating pattern of profits/losses
- Profitability lower than those in the same industry, or with profitability that does not match functions/risks
- Business dealings with related parties in a tax haven
- Lack of preparation of contemporaneous documentation or complete transfer pricing-related tax return disclosures
- Obvious violation of the arm's length standard

If taxpayers fail to provide the tax authorities with TPD when requested, the CIT law allows the tax authority to deem the taxpayer's taxable income and assess a 5% penalty, in addition to the interest levy. Although enterprises with annual related-party transactions below the de minimis thresholds for contemporaneous documentation requirements are not subject to the penalty interest, such protection does not apply for enterprises that originally fell below the threshold, even if the restated amount of related-party transactions as a result of a transfer pricing adjustment exceeds the prescribed threshold.

The measures also give the SAT authority to adjust the income of taxpayers if their results fall below the median, even if they are within an interquartile range, a commonly accepted measure of an arm's length range. How the SAT will use this authority remains to be seen, but it will likely cause difficulties in devising transfer pricing policies or determining the amount of a voluntary taxable income adjustment.

Article 39 of the measures states that enterprises that conduct contract or toll manufacturing activities should not bear risks or suffer operating losses as a result. At the SAT seminar, tax officials generally agreed that despite the economic downturn, all enterprises performing routine functions and bearing routine risks should maintain a certain level of profitability to avoid having their taxable income deemed by the SAT.

The measures do not allow taxpayers to make adjustments on differences in operating profits caused by differences in capital employed without approval from the SAT.

SAT officials have said that the introduction of the concept of cost sharing arrangements to the Chinese income tax regime will be helpful in attracting more advanced intellectual property and sophisticated services from overseas enterprises.

Advance pricing arrangements (APA)

At the SAT seminar, tax officials said that they consider an APA to be a very good tool for the taxpayer to manage their transfer pricing adjustment and double taxation risks. In the eyes of the tax officials, this is also considered a more collaborative approach compared with the adversarial tax audit approach.

The measures provide guidance with respect to the various requirements and procedures associated with applying for, negotiating, implementing, and renewing APAs.

In general, the threshold for APAs is RMB40 million or higher. However, enterprises that were non-compliant with documentation and annual reporting requirements will not be accepted for the APA process. The APA term covers three to five years following the application year and rollbacks are subject to tax authority approval.

For enterprises with more than one entity in China, the measures provide that the SAT will centrally coordinate the joint negotiation and implementation of advance pricing arrangements across the various provincial, municipal, and other “local” tax bureaus.

In 2009, the SAT will engage in bilateral negotiations on advance pricing arrangements with the competent authorities of Japan, Korea, Singapore, the US, and Denmark.

Cost sharing arrangements

SAT officials have said that the introduction of the concept of cost sharing arrangements to the Chinese income tax regime will be helpful in attracting more advanced intellectual property and sophisticated services from overseas enterprises. However, to prevent possible abuses, the SAT will closely scrutinize cost sharing arrangements. The measures state that the costs borne by the participants in a cost sharing agreement should be consistent with what an independent enterprise would bear for obtaining the anticipated benefits under comparable circumstances, and that the anticipated benefits should be reasonable, quantifiable, and based on reasonable commercial assumptions and common business practices. Failure to comply with the benefit testing will be subject to adjustment by tax authorities in the event of an audit assessment.

The measures state that at this stage, service-related cost sharing arrangements should be limited to group procurement or group marketing planning services. At the SAT seminar, tax officials said that once the Chinese tax authorities gain more practical experience with cost sharing arrangements, the SAT will be receptive to other types of service cost sharing arrangements.

Controlled foreign corporations

Article 45 of the CIT law provides for the inclusion in a Chinese enterprise's taxable income the relevant profits of controlled foreign corporations of that Chinese enterprise that are established in countries with effective tax burdens that are substantially lower than China's. However, these controlled foreign corporation rules may not be a concern to most foreign multinational companies, since they are not inclined to use a China-based company to invest outside of China.

Thin capitalisation

China's thin capitalisation rule is designed to disallow the deduction of related-party interest expense pertaining to the portion of related-party debt-to-equity ratio that exceeds a certain prescribed debt-to-equity ratio.

In October 2008, the Ministry of Finance and the SAT jointly issued the circular, Cai Shui [2008] No 121(Circular 121), which set out the prescribed debt-to-equity ratios as 2:1 for nonfinancial institutions and 5:1 for financial institutions.

Circular 121 suggested that interest expenses for related-party financing in excess of the prescribed ratios may still be deductible if:

- The taxpayer can provide documentation supporting the higher debt to equity ratio complies with the arms' length principle, or
- The effective tax rate of the domestic borrowing enterprise is not higher than that of the domestic lending enterprise

Taxpayers are required to disclose their thin capitalisation ratios as part of the RPT forms.

China is committed to continuously learning and improving its enforcement operations in its bid to catch up with the tax authorities of developed nations.

Going forward

The themes of pragmatism and gradualism have always been the hallmark of China's economic reform programme which began in the late 70s. Moving forward, the transfer pricing regulations reform is expected to be no different, with the SAT taking a gradual and pragmatic approach in introducing the regulations. Indeed, this is reflected in the title of the measures, which indicates the measures are a "trial" version, implying that an improved version is intended once the results of the "trial" version have been analysed and tested.

At the SAT seminar, the Director of International Taxation delivered the following key messages summarising the SAT's plans for the future:

- Chinese tax authorities will further explore new anti-avoidance measures concerning contemporaneous transfer pricing documentation, cost sharing arrangements, thin capitalisation, and controlled foreign corporations.
- The SAT will intensify efforts to collect information by leveraging their internal and external databases (e.g., databases containing information on corporate income tax returns and export tax refunds) as well as exchanging information with treaty partners.
- The SAT plans to expand its specialised team of tax anti-avoidance to 500 expert officials over the next three years.

The SAT has gained a remarkable level of sophistication in a very short time. The officials have also engaged in dialogue with the OECD.

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