

Latest Developments on Transfer Pricing Taxation by the State Administration of Taxation of the People's Republic of China

I. Introduction

The Agreement between the Government of Japan and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income was concluded in 1983, and entered into force in 1984. In China, transfer pricing legislation was introduced in 1991. With the strengthening of legislative enforcement in recent years, avoidance of double taxation due to transfer pricing issues between the two countries has become an increasingly important issue for many Japanese enterprises. China's State Administration of Taxation ("SAT") has been conducting competent authority negotiations periodically with Japan's National Tax Agency ("NTA"). The SAT also issued a circular on mutual agreement procedures ("Guoshuifa [2005] No.115") in July 2005. It is believed that several cases, including advance pricing arrangements ("APA"), are currently under negotiation between the two tax authorities. On March 30 this year, we asked Mr. He Liantang (chief) and other officials of the Anti-avoidance Section of SAT's International Taxation Department, who are responsible for transfer pricing taxation, to deliver lectures at our seminar "Transfer Pricing Taxation in China." This article provides a summary of their lectures regarding the latest developments on transfer pricing taxation in China.

II. Latest developments on the enforcement of transfer pricing taxation

1. Enforcement activities in 2005

(1) Standardization of the legislation

The year 2005 was an important milestone in the enforcement of transfer pricing legislation. There was a major breakthrough in the standardization of the legislation, with many enforcement measures taken. This is evidenced by the fact that information on transfer pricing accounts for about one third of the 9000-character documents used at a national taxation conference. In addition, newspapers and other media, as well as senior officials of the SAT, took a strong interest in the standardization.

In the past, the number of officials in charge of enforcement activities was quite limited. The SAT has increased the number of these officials along with the expanding their areas of responsibility. In addition, the SAT has tried to enhance their credentials through professional, high-level training activities. The SAT has promoted training and exchange programs for examiners in cooperation with foreign tax authorities, including the NTA, aiming at qualitative improvements in field audits.

In the circular on transfer pricing released last year (Guoshuihan [2005] No. 239), the SAT adopted a policy of strengthening enforcement activities, implementing centralized control, and improving the quality of enforcement activities. The number of new audits last year was 222. The amount of tax assessed in each case has increased from millions of RMBs in the past to a substantially higher level since transfer pricing audits were strengthened during the period from the second half of 2004 through 2005. As a result, the number of requests for mutual agreement procedures has increased.

(2) APA

Most of the enterprises which were selected as targets for transfer pricing audits and received tax assessments requested mutual agreement procedures. In 2005, Japan and China concluded their first bilateral APA. The conclusion of this agreement in such a short period is attributable to the friendly and cooperative attitudes of the tax authorities of the two countries. However, partly because of the SAT's limited experience in bilateral APAs, it is expected that the SAT will require more time for each bilateral APA case in the future.

Last year in 2005, the SAT received 18 requests for unilateral APAs. This year, however, the SAT has not received any such APA requests to date. In terms of bilateral APAs, the SAT received three requests from enterprises of Japan, the U.S., and South Korea in 2005. Currently, there are about 10 cases in the pre-filing consultation stage. Five officials at the Anti-avoidance Section are responsible for administering transfer pricing audit cases throughout China and reviewing requests for unilateral and bilateral APAs as well as those for reinvestigation. These activities have put enormous burdens on these officials.

(3) SAT's attempt to strengthen its centralized control

In 2005, the SAT issued an important internal rule for local tax bureaus: regardless of the size of

enterprises, governing tax bureaus are required to submit reports on all transfer pricing audit cases to the SAT and are allowed to start information gathering or investigations only after receiving approval from the SAT. In the case of proposed tax assessments, local tax bureaus are required to submit reports to the SAT and are allowed to execute assessments only after receiving approval from the SAT. Thus, the SAT has reinforced its central role in controlling and overseeing the activities of local tax bureaus. As a result, quality and efficiency of local enforcement activities have been improved. This rule has also been effective in preventing misconduct, based on personal relationships or connections, which occurred in the past when transfer pricing audit cases were opened or closed.

(4) Improved quality of enforcement activities

The above-mentioned internal rule issued in 2005 was intended as a means of quality control of enforcement activities so that, based on the lessons of the past, enterprises subject to transfer pricing audits would be selected more carefully. With respect to APAs, the STA issued guidelines in 2004 to establish concrete procedures. As a result, the division of responsibilities between the STA and local tax bureaus in each case became clearer. Local tax bureaus are now required to submit reports to the SAT for approval. The quality of APA procedures has also improved, with the SAT issuing an operational improvement order to a certain provincial local tax bureau in order to remedy its unauthorized actions.

Moreover, administrative cooperation, coordination and information-sharing between the SAT and local tax bureaus have been strengthened since 2005. The SAT has started to focus its attention on intangible assets, in addition to conventional tangible assets, for transactions subject to tax audits.

(5) Administration of tax audit cases

The SAT considers that improved quality of the selection of enterprises subject to tax audits and a reinforced follow-up procedure of audits can be achieved through establishment of a more centralized and uniform administration of audit cases. The SAT is aware that enhancement of these administrative and supervisory abilities is one of the challenges of the years to come. One of the current problems is that many enterprises selected as targets for transfer pricing audits move to other provinces or stop making additional investments. The SAT is determined to create a legislative environment in which enterprises comply with laws and regulations and both enterprises and tax bureaus consider audit results as reasonable.

Up until now, the SAT has conducted long-term joint audits of large enterprises. The SAT continues to reinforce these activities, aiming to achieve more efficient examinations of specific industry segments with which the SAT is sufficiently familiar, and by doing so also resolving the issue of the lack of experienced examiners.

(6) Contemporaneous documentation rule

Since last year, the SAT has spent considerable time examining the draft contemporaneous documentation rule carefully. The following list covers the main contents of the rule, which consists of dozens of articles.

[1] Enterprises are required to prepare related documents concurrently with transactions.

[2] Enterprises are required to prepare, store and submit related documents to tax authorities.

[3] Enterprises are required to demonstrate through related documents that they have followed the arm's length principle.

[4] If enterprises fail to submit related documents to tax authorities, they will be punished.

2. Main challenges for future enforcement activities

(1) Legislative enforcement and control

For future audits, the SAT will not focus on enterprises if the monetary value of their transactions with related parties is small. The SAT intends to draw conclusions after examining transfer pricing issues more carefully. For audit procedures, the SAT will make fair and reasonable adjustments in accordance with the arm's length principle with respect to prices or profits.

In order to improve laws and regulations, the SAT is now considering several measures such as integration of the income tax law for domestic enterprises and that for foreign-invested enterprises, and review of tax exemptions for foreign-invested enterprises. The Anti-avoidance Section will continue to be responsible for establishing and improving the transfer pricing legislation. In addition, the SAT will invest both human and physical resources in improving the rules on thin capitalization taxation, cost-sharing and other issues. The tax laws and

regulations to be improved by the SAT will be based on international practice. Since the SAT plans to use tax legislation of other countries, including Japan, for reference, Japanese enterprises may find it easy to understand the future Chinese tax laws and regulations.

The SAT plans to foster enforcement officers' abilities through activities such as training and international exchange programs. The SAT has already conducted nation-wide training activities on transfer pricing at its tax training center, where experts from accounting firms, the OECD, tax authorities of foreign countries and other organizations were invited as lecturers. In addition, the SAT has dispatched its examiners to England and other countries in overseas training programs. With the ever-increasing number of APAs and competent authority negotiations with foreign countries, the SAT plans to expand personnel exchange opportunities.

The SAT has spent large sums of money to purchase databases created by the National Bureau of Statistics of China, Bureau van Dijk, and other sources, in order to maintain and improve its own databases. With the use of this publicly-available data, the SAT believes that it can enforce taxation which is fair and reasonable to both the tax authorities and taxpayers, rather than only through secret comparables based on information unavailable to taxpayers.

(2) Establishment of the enforcement control structure

The SAT plans to expand its review and approval system, which covers a series of activities, from planning to completion of audits, so that procedures will become more efficient and simpler. In particular, the SAT intends to create an environment where an enterprise can be prevented from, for example, hinting that the enterprise will change its place of business or stop making additional investments unless a local government puts political pressure on the governing tax bureau.

In order to ensure fairness in audits, the SAT plans to, for example, give an order for nation-wide audits directly to a certain group of enterprises, so that unfair treatment of similar enterprises in the selection of targets for audits, due to regional differences, will be eliminated. If a certain industry sector has continued to report an abnormal loss for a long time, the SAT will focus its audits on this sector.

The SAT will focus on reinforcing the standardization of internal operational control in its efforts to improve the internal enforcement control structure, which is one of the challenges the future holds for the SAT. The SAT will also establish detailed procedures to be implemented at each

stage of transfer pricing audits, and further clarify where the responsibility of each examiner lies. If enforcement activities are not performed properly, the SAT may ask other provinces to, for example, provide additional personnel. If it is clear that an audit has not been conducted despite the fact that an enterprise intended to avoid taxation, then the SAT may provide direct instructions.

(3) SAT's approach to transfer pricing taxation

When reporting the details of transactions with related parties, enterprises are required to attach Schedule 13A or Schedule 13B to their income tax returns. Currently, however, many enterprises fail to do so. The SAT is now considering increasing the likelihood that such enterprises will be subject to tax audits.

One of the problems in transfer pricing audits is that many enterprises do not submit related documents promptly. In many cases, they postpone the deadline for submission of information requested by tax authorities to the fullest extent and then reply, for example, that they prefer not to submit information if possible, or that relevant documents do not exist. However, in order for both enterprises and the tax authorities to establish a mutual relationship of trust by solving problems efficiently and reasonably, enterprises should submit documents autonomously in accordance with related laws and regulations and cooperate with the tax authorities so that there will be no need for compulsory execution by the tax authorities.

With respect to requests for reinvestigation, it is desirable that the tax authorities continue to seek a reasonable solution and exchange opinions with enterprises, thereby achieving a mutually acceptable solution. In some cases, it is possible for an enterprise to submit a request for reinvestigation directly to the SAT. If the SAT finds the enterprise's opinion reasonable and appropriate, the SAT will be prepared to accept the opinion.

III. Major issues

1. Contemporaneous documentation rule

Since the SAT has not disclosed internal discussions on the draft documentation regulation, which is expected to cover a wide range of topics, it is not possible at this moment to provide a clear explanation as to the year from which it will be implemented, or other issues. Unless any problems arise, the SAT is scheduled to enact the regulation within this year. Although the

regulation increases administrative burden for enterprises, the SAT considers that the regulation can be an effective safeguard in demonstrating the appropriateness of their transfer prices. The SAT intends to issue a circular after a thorough study. If any specific problem is indicated by enterprises after the circular is issued, the SAT will be prepared to consider an amendment of the circular.

2. Comparable companies

Prior to 2004, many tax cases were based on data which was not available publicly. In recent years, publicly available data has been increasingly used in audits. However, the SAT has no intention of rejecting the use of secret comparables entirely. On the whole, there is an increasing trend to consider the use of publicly available data in audits in cooperation with enterprises.

3. Royalty

There is no universal standard to determine at what level a royalty rate is considered to be appropriate. Instead, royalty rates should be examined on a case-by-case basis according to a functional and risk analysis etc. The SAT understands that royalty rates should be determined on the basis of each enterprise's policy. Any attempt by enterprises to use royalty rates to manipulate or transfer profit must not be allowed. The SAT will focus on the audit of royalty rates.

4. Audits of domestic transactions

Refund of tax payments associated with transfer pricing taxation and corresponding adjustments for domestic related-party transactions is described in Article 39 of the relevant circular issued in 2004 (Guoshuifa [2004] No.143).

5. Requests for APAs

A request for an APA does not suspend an audit in progress. A local tax bureau can accept the request after the audit is closed. This is intended not to waste the time and effort spent on the audit for previous years. In principle, rollback on previous years is not allowed in APAs. However, if a profit level in the past does not change in the future, rollback may be considered on a case-by-case basis.

6. Costs of contract manufacturing services

If a contract manufacturing service is provided to a foreign related party, and if it can be concluded that enterprises should make payments of royalties or considerations of services, molds or facilities provided without charge in accordance with the arm's length principle even if such payments are not made in actuality, the SAT considers that the royalties or considerations should be included in the cost base of sales prices to the relevant related party.

IV. SAT's advice for Japanese enterprises

It is desirable that enterprises continue favorable operations and development in China. Profits which are attributable to China in accordance with the arm's length principle should be left in China. Profits which are not attributable to China should not be left in China. China has encouraged foreign capital investments by providing outstanding resources and excellent locations. However, enterprises are not allowed to transfer any profits attributable to China to foreign countries through related-party transactions. The SAT sincerely hopes that Japanese enterprises with substantial investments in China will understand that they have close economic relationships with China, and that they will establish relationships of trust and cooperation with the Chinese tax authorities.

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