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Introduction

The transfer pricing regime in China is generally consistent with the OECD Guidelines and has developed rapidly over the past few years. China's corporate income tax (CIT) law, together with its detailed implementation regulations (DIR), contain the key transfer pricing and anti-avoidance concepts that govern transfer pricing enforcement in China.

In January 2009, China's State Administration of Taxation (SAT) issued a circular titled *Guo Shui Fa* [2009] No. 2 (Circular 2), the "Implementation Measures of Special Tax Adjustments – trial version", which provides further guidance on the above concepts. Circular 2 marked a significant step up in China's transfer pricing enforcement regime.

Statutory rules

The CIT law

The highest level of legislation in China is represented by laws, which can be enacted only by the National People's Congress (NPC).

The current CIT law was promulgated on 16 March 2007 by the NPC and became effective on 1 January 2008. Articles relevant to transfer pricing are found mainly in Chapter 6, "Special Tax Adjustment". The CIT law provides the arm's-length principle as the guiding principle for related party transactions and empowers the tax authorities in China to adjust a taxpayer's taxable income if it fails to comply with the arm's-length principle in its dealings with related parties.

The DIR of the CIT law

The second level of tax legislation is represented by detailed implementation regulations, which are promulgated by a super-ministerial organisation known as the State Council.

The DIR of the CIT law, promulgated on 6 December 2007, provides more specific guidance relating to all aspects of the CIT law.

Specifically with respect of Chapter 6, the DIR not only expands on various concepts in the CIT law (such as cost-sharing, controlled foreign corporations, thin capitalisation and general anti-avoidance), but also imposes contemporaneous transfer pricing documentation requirements and a special interest levy that could create a significant impact for taxpayers.

Circular 2

The third level of tax legislation is represented by circulars issued by the SAT. The formal circulars issued by the SAT are usually designated as *Guo Shui Fa* and the

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SAT also issues less formal letter rulings (known as *Guo Shui Han*) that can take the form of replies by the SAT to specific issues raised to them by one of their underlying tax bureaux.

Circular 2, promulgated by the SAT in January 2009 with an effective date of 1 January 2008, lays out detailed rules on administering all the aspects covered by special tax adjustments. Circular 2 supersedes past notices, affirms prior positions and introduces a set of new obligations.

Circular 2 also sets the foundation for future developments. In fact, the connotation that its contents are a “trial version” (as stated in the title) provides the SAT with flexibility to issue further circulars to interpret and clarify the concepts.

Burden of proof

In China, the burden of proof that a related party transaction was conducted at arm’s length rests with the taxpayer. According to Paragraph 2 of Article 43 of the CIT law, if the tax authorities conduct a transfer pricing investigation, the taxpayer under investigation, its related parties and other relevant companies are obligated to provide “relevant information” upon request. If the taxpayer under investigation fails to provide information in relation to its related party transactions or provides false or incomplete information that does not truly reflect the situation of its related party transactions, the tax authorities are authorised to deem the taxpayer’s taxable income.

According to the DIR, information required by the tax authorities during a transfer pricing investigation may include the following:

- The taxpayer’s contemporaneous transfer pricing documentation;
- Relevant overseas information regarding resale price (or transfer price) and/or ultimate sales price of tangible goods, intangible goods and services involved in the related party transactions; and
- Other relevant information relating to related party transactions.

Information reporting

Annual tax return disclosure of related party transactions

China’s annual related party transaction disclosure forms (required under Article 11 of Circular 2) were officially introduced by the SAT in December 2008 under *Guo Shui Fa* [2008] No. 114 (Circular 114). Circular 114, which took effect on 1 January 2008, contains the following nine transfer pricing-related forms that Chinese taxpayers must file as part of their new CIT returns:

- Form 1: Related Party Relationships Form;
- Form 2: Summary of Related Party Transactions Form;
- Form 3: Purchases and Sales Form;
- Form 4: Services Form;
- Form 5: Financing Form;
- Form 6: Transfer of Intangible Assets Form;
- Form 7: Transfer of Fixed Assets Form;
- Form 8: Foreign Investment Status Form; and
- Form 9: Foreign Payments Status Form.

These forms, which generally need to be filed along with the Chinese CIT returns, require taxpayers to indicate whether they have contemporaneous documentation in place to substantiate their inter-company arrangements and to provide detailed information on each type of related party transaction (including specifying the applicable transfer pricing method).

In addition, a “special tax adjustment” option in the annual CIT return package allows taxpayers to make voluntary upward adjustments to their taxable income.

While the statutory filing deadline for CIT returns is 31 May, some local-level tax authorities may impose an earlier filing due date. Therefore, it is essential for taxpayers to closely monitor and follow the local requirements specified by the local-level tax authorities.

Contemporaneous transfer pricing documentation

Under Circular 2, Chinese taxpayers generally are required to have contemporaneous transfer pricing documentation in place unless they meet any of the following criteria:

- The annual amount of related party purchases and sales transactions is less than RMB 200 million and the annual amount for all other types of transactions (i.e. services, royalties, interest) is less than RMB 40 million;
- The related party transactions are covered by an advance pricing arrangement (APA); and
- The foreign shareholding of the enterprise is below 50%, and the enterprise has only domestic-related party transactions.

The contemporaneous transfer pricing documentation requirement was expanded by a subsequent circular to include certain loss-making companies with limited functions or risks, as discussed later in this section.

According to Article 14 of Circular 2, the contemporaneous transfer pricing documentation package should contain 26 specific items grouped under the following five areas:

- Organisational structure (four items);
- Description of business operations (five items);
- Description of related party transactions (seven items);
- Comparability analysis (five items); and
- Selection and application of transfer pricing method (five items).

(Additional items are required for contemporaneous cost-sharing and/or thin capitalisation documentation.)

According to Circular 2, Chinese contemporaneous documentation must be:

- Prepared and maintained for each tax year;
- Completed by 31 May of the following year (e.g. 31 May 2010 for 2009 tax year) and kept for 10 years (e.g. until 31 May 2020 for 2009 tax year);
- Provided within 20 days of a request (or within 20 days of elimination of any force majeure); and
- In Chinese (including any source materials provided in English as part of the documentation).

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As with the annual filing, some local-level tax authorities may impose due dates or submission timelines other than those listed above, and taxpayers should be prepared to submit documentation earlier if required by the in-charge tax authorities.

Tax underpayments that result from special tax adjustments (including transfer pricing adjustments) are subject to an interest levy that includes a 5% penalty component. That penalty component can be avoided if the taxpayer prepares and submits contemporaneous documentation in a timely manner upon request, or if the taxpayer is otherwise exempted from the documentation requirement. The interest levy is discussed in more detail later.

Documentation requirement for loss-making companies with limited functions/risks

According to Article 39 of Circular 2, companies engaged in simple manufacturing activities based on orders from related parties must earn a stable rate of return and should not be expected to bear the risks or suffer the losses associated with excess capacity, product obsolescence and other such factors. In July 2009, the SAT issued *Guo Shui Han* [2009] No. 363 (Circular 363). Circular 363 re-emphasises the SAT's position towards losses incurred by companies with limited functions and risks, and even goes one step further than Circular 2 by requiring all loss companies with limited functions and risks to prepare and submit contemporaneous documentation to their in-charge tax authorities by 20 June following the loss-making year – regardless of whether the amount of related party transactions exceeds the materiality thresholds. It is worth noting that, through Circular 363, the SAT has expanded the focus of scrutiny to trading companies and contract R&D service providers in addition to simple manufacturers.

Collection and review of contemporaneous transfer pricing documentation

On 12 July 2010, the SAT issued Circular *Guo Shui Han* [2010] No. 323 - Notice of the SAT Regarding the Sample Review of Contemporaneous Transfer Pricing Documentation (Circular 323), mandating local-level tax authorities to carry out a nationwide evaluation of taxpayers' 2008 and 2009 contemporaneous transfer pricing documentation. Circular 323 specifies that the local-level tax authorities must select for collection and review the documentation of at least 10 percent of taxpayers which are subject to the documentation requirements for each year. Various tax authorities have provided feedback based on this review including common problem areas seen in documentation reports. This review process has continued in 2011 with review of the 2010 documentation.

Tax authorities in certain locations have shown distinct interests in collecting contemporaneous documentation. A number of local-level tax authorities have taken either a “blanket” approach (whereby all taxpayers exceeding the thresholds have been required to submit documentation) or a “targeted” approach (e.g. focusing on large multinational companies with significant related party transactions, or creating a list of potential audit targets and requesting them to provide documentation) to the collection of documentation. The documentation collection efforts may have multiple objectives, including the creation of an internal database, identification of potential audit targets and proactive tax compliance enforcement.

Audit targets

Circular 2 provides insight into the procedural aspects of a Chinese transfer pricing audit, from the tax authorities determining which enterprises will be subject to audit and conducting the audit to issuing a “special tax adjustment notice”, collecting underpaid taxes (and interest) and a five-year post-audit follow-up period. These provisions are generally in line with China’s previous transfer pricing rules and the way that those prior rules were enforced in practice.

According to Circular 2, transfer pricing audits typically will focus on companies with the following characteristics:

- Significant amount or numerous types of related party transactions;
- Long-term consecutive losses, low profitability, or fluctuating pattern of profits/losses;
- Profitability lower than those in the same industry, or with profitability that does not match their functions/risks;
- Business dealings with related parties in a tax haven;
- Lack of contemporaneous documentation or transfer pricing-related tax return disclosures; and
- Other situations clearly indicating a violation of the arm’s-length principle.

Circular 2 also provides that, in principle, no transfer pricing audits will be carried out on, and no transfer pricing adjustment will be made to, transactions between domestic-related parties that had the same effective tax burden, as long as such transactions did not result in the reduction of the country’s total tax revenue.

It is also worth noting that the SAT has been continuing to strengthen its focus on nationwide and industry-wide transfer pricing audits. In a nationwide audit, companies within a multinational group are simultaneously audited, whereas industry-wide audits focus on companies in specific industries. The automotive, real estate, hotel chain, shipping/logistics, pharmaceutical, tires and computer contract manufacturing industries are examples of industries recently identified as targets in Circular *Guo Shui Han* [2011] No. 167, expanding on other circulars such as *Guo Shui Fa* [2009] No. 85 (Circular 85), which focused on the automotive and pharmaceutical industries.

Audit information request

According to the CIT law, its DIR and Circular 2, not only the taxpayer under a transfer pricing investigation, but also its related parties and other relevant companies (i.e. potential comparable companies) are obligated to provide information as requested by the in-charge tax authorities.

As previously mentioned, the taxpayer under an investigation should provide contemporaneous documentation to tax authorities within 20 days of a request and should provide other relevant documents required during an investigation within the prescribed time frame, according to the “Notice of Tax Related Issues” from the tax authority. If timely submission of required documents is not possible due to special circumstances, the taxpayer under investigation shall apply in writing for an extension. An extension of up to 30 days may be granted, subject to the approval from the in-charge tax authority. Related parties of the taxpayer under investigation or comparable companies shall provide relevant information within the time frame as agreed with the tax authorities (which generally will not be longer than 60 days).

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If the taxpayer under audit fails to provide information within the prescribed time frame as required by the tax authority or refuses to provide information as requested, it may be subject to one or more of the following:

- An administrative penalty of up to RMB 10,000 in accordance with the Tax Collection and Administration Law;
- A special tax adjustment as determined by the tax authority by means of deeming the taxpayer's taxable income; and
- An additional 5% interest levy on the amount of underpaid tax resulting from the adjustment.

The audit procedure

Special tax investigation procedures

Tax audits in China may be conducted at the taxpayers' offices or at the tax authorities' offices. A transfer pricing audit (or a special tax investigation) procedure typically comprises the following main steps:

- Desktop review and selection of transfer pricing audit targets by the tax authority;
- Notification to the taxpayer of a transfer pricing audit and field investigation by the tax authority to raise inquiries, request accounting records and conduct on-site verification;
- Information request to taxpayer under investigation, its related parties, or other relevant companies for relevant documents;
- Negotiation and discussion with the taxpayer under investigation and the tax authority;
- Initial assessment notice issued by the tax authority;
- Further negotiation and discussion between the taxpayer and the tax authority, as needed;
- Final assessment and issuance of "Special Tax Adjustment Notice" if there is an adjustment or "Special Tax Investigation Conclusion Notice" if the related party transactions under investigation are considered to be at arm's length;
- Settlement of underpaid taxes and interest levy; and
- Post-audit follow-up management by the tax authority.

In addition, Article 123 of the DIR provides that adjustments may be made on a retroactive basis for up to 10 years as a result of a special tax investigation.

Post-audit follow-up administration

On 16 April 2009, the SAT issued tax Circular *Guo Shui Han* [2009] No. 188 (Circular 188), to further strengthen its transfer pricing follow-up administration. The circular reiterates the requirement found in Article 45 of Circular 2 that tax authorities are to follow up for five years after any adjustment, during which period post-adjustment enterprises must submit contemporaneous transfer pricing documentation by 20 June of each year. This documentation will be used by the Chinese tax authorities to closely monitor the related party transactions of the enterprises under transfer pricing follow-up administration. Decreases in operating profits or sustaining of business losses will be closely scrutinised and possibly disallowed by the Chinese tax authorities if the underlying nature of the related party transactions remains unchanged. If an APA is initiated, monitoring shall be continued until the APA is signed. This longer post-audit supervision period (previously three years) indicates that transfer pricing compliance violations are being taken more seriously.

Transfer pricing methods

Article 111 of the DIR lists six “appropriate methods” for conducting transfer pricing investigations. Those six methods, which are the same as those provided in the OECD Guidelines, are as follows:

- Comparable uncontrolled price method;
- Resale price method;
- Cost-plus method;
- Transactional net margin method;
- Profit split method; and
- Other methods consistent with the arm’s-length principle.

Chapter 4 of Circular 2 provides guidance on the application of each of the five specified methods. Circular 2 does not stipulate any hierarchy or preference in methods used by tax authorities during a transfer pricing audit assessment; instead, it endorses implicitly the selection of the most appropriate transfer pricing method. According to Article 22 of Circular 2, a comparability analysis should be carried out when selecting a transfer pricing method and the following five comparability factors should be taken into consideration:

- Characteristics of the assets or services involved in the transaction;
- Functions and risks of each party engaged in the transaction;
- Contractual terms;
- Economic circumstances; and
- Business strategies.

Use and availability of comparable information

As directed in a tax circular prior to the new CIT law, Chinese tax authorities are encouraged by the SAT to use the information databases of the National Bureau of Statistics and Bureau van Dijk in transfer pricing audits (Note that, in recent years, the SAT has subscribed to Bureau van Dijk’s OSIRIS database.)

However, Article 37 of Circular 2 specifically states that both public information and non-public information (i.e. “secret comparables”) may be used by the Chinese tax authorities during transfer pricing investigations and evaluations. The CIT law and its DIR also empower tax authorities to collect relevant information (e.g. contemporaneous documentation) from potential comparable companies in the same industry during an audit. Obviously, such information cannot be obtained in the public domain.

Other relevant provisions under Circular 2 regarding the use of comparable information involve the following:

- Although Circular 2 has introduced the interquartile range as a method of testing profitability, it is stated that in the context of a transfer pricing investigation, companies with profitability below the median level may still be subject to an adjustment to achieve at least the median profitability level of the comparables.
- During transfer pricing investigations, the use of working capital adjustments is discouraged and would require approval from the SAT if it is absolutely necessary.

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Assessments and appeal procedures

Transfer pricing audits in China are usually settled through negotiation. While the conduct of the taxpayer should not significantly affect the outcome, a friendly working relationship with the tax authorities is always to the taxpayer's advantage, as Chinese tax legislation gives broad discretionary powers to tax authorities.

When an enterprise under audit receives an initial assessment from the tax authority and disagrees with the assessment, it may provide written explanations and documents supporting the reasonableness of its transfer prices. Further discussions and negotiations may continue until the tax authority reaches a conclusion and issues a written notice of audit assessment in the form of a "Special Tax Adjustment Notice" or a "Special Tax Investigation Conclusion Notice". Once the written notice is issued, the decision is considered final and further negotiation is not possible.

If the taxpayer disagrees with the adjustment, such dispute could be resolved through the appeal procedures. China's Tax Collection and Administration Law provide both administrative and judicial appeal procedures for resolving tax disputes. The taxpayer may appeal to the tax authority at the next higher level within 60 days for an administrative appeal, and a decision on the appeal must be made within 60 days. Before proceeding with the appeal process, the taxpayer is required to pay the taxes, interest levy, and fine and surcharge (if any).

If the taxpayer is not satisfied with this decision, it may start legal proceedings in China's People's Court within 15 days upon receiving the written decision. There have been very few cases relating to transfer pricing brought before the People's Court at the local level. The local court has found in favour of the SAT. Because there is limited experience in court cases and the SAT has great discretionary powers, taxpayers generally should seek mutually satisfactory resolution before the issuance of the adjustment notice.

For related party transactions between China and a treaty country, mutual consultation between the SAT and the competent authority (CA) of the treaty country is available to taxpayers to resolve double taxation issues resulting from transfer pricing adjustments.

Interest levy and penalties

Special interest levy

Under the CIT law, special tax adjustments (including transfer pricing adjustments) are subject to a special interest levy. The special interest levy mechanism is different from surcharges and fines, which constitute the current penalty measures of tax collection and administration.

Article 122 of the DIR defines the rate for the special interest levy as based on the RMB loan base rate applicable to the relevant period of tax delinquency as published by the People's Bank of China in the tax year to which the tax payment relates, plus 5 percentage points. This interest levy is not deductible for CIT purposes.

Although companies with annual related party transactions below the materiality thresholds for contemporaneous documentation are not subject to the 5% penalty component of the interest levy, such protection does not apply in situations where the amount of related party transactions originally falls below the thresholds, but the restated amount of related party transactions as a result of a transfer pricing

adjustment exceeds the relevant threshold. Circular 2 further provides that the 5% penalty component of the interest levy would be waived if the taxpayer has prepared and provided contemporaneous documentation in a timely manner.

Fines

Taxpayers that fail to file the Annual Related Party Transactions Disclosure Forms to tax authorities or fail to maintain contemporaneous documentation and other relevant information in accordance with Circular 2 shall be subject to different levels of fines, ranging from less than RMB 2,000 up to RMB 50,000, in accordance with Articles 60 and 62 of the Tax Collection and Administration Law.

Taxpayers that do not provide contemporaneous documentation or relevant information on related party transactions or provide false or incomplete information that does not truly reflect the situation of their related party transactions shall be subject to different levels of fines, ranging from less than RMB 10,000 up to RMB 50,000, in accordance with Article 70 of the Tax Collection and Administration Law and Article 96 of the Tax Collection Regulations. In addition, tax authorities also have the authority to deem such taxpayers' taxable income by reference to the profit level of comparable companies, or the taxpayer's cost plus reasonable expenses and profit, or apportioning a reasonable share of the group's total profits; or the deemed profit determined based on other reasonable methods according to Article 44 of the CIT law and Article 115 of the DIR.

Surcharge

In the context of transfer pricing adjustments, taxpayers that have exceptional difficulty and cannot remit the tax payment on time shall apply for an extension in accordance with Article 31 of the Tax Collection Law and Articles 41 and 42 of the Tax Collection Regulations. A daily surcharge of 0.05% will be levied in accordance with Article 32 of the Tax Collection Law if they do not apply for an extension and fail to remit the underpaid taxes and interest levies before the deadline set by the tax authorities on the adjustment notice.

Corresponding adjustments

Circular 2 provides that corresponding adjustments should be allowed in the case of a transfer pricing adjustment to avoid double taxation in China. If the corresponding adjustment involves an overseas related party resident in a country with which China has a tax treaty, then the SAT will — upon application by the taxpayer — initiate negotiations with the CA of the other country based on the mutual agreement procedure (MAP) article of the treaty. (The statute of limitation for the application of corresponding adjustments is three years; an application submitted after three years will not be accepted or processed.) Application for the initiation of the mutual agreement procedures should be submitted to both the SAT and the local tax authorities simultaneously.

Where payment of interest, rent, or royalties to overseas related parties was disallowed as the result of a transfer pricing adjustment, no refund of the excessive withholding tax payment will be made. This treatment may result in double or even triple taxation for multinational companies in some cases.

If the original adjustment is imposed by the overseas tax authority, then the Chinese enterprise could submit a formal application for a corresponding adjustment to the

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relevant Chinese tax authority within three years of the overseas related party's receipt of the notice of the transfer pricing adjustment.

Circular 2 indicates that corresponding adjustments are not available in cases of income taxes assessed on deemed dividends that result from non-deductible interest expenses under the thin capitalisation rules.

Circular 2 also states that the results of a corresponding adjustment or mutual agreement will be sent to the enterprise in written form from the SAT, via the in-charge tax authority.

In 2010, the SAT concluded MAP cases that eliminated RMB 5.029 billion of cross-border double taxation for taxpayers. Since 2005, the Chinese tax authorities have had CA discussions with various countries and have concluded 25 mutual agreements of corresponding adjustments. The successful MAP cases so far are mostly with Japan and recently more MAP applications are being accepted. This is an important indication of the support of China's tax authorities for engaging in MAP procedures as a useful method for resolving tax and transfer pricing issues related to multinationals with operations in China. Taxpayers should be aware that this option is available as a way to resolve prior-year double taxation issues, and an important supplement to the bilateral APA programme, as will be mentioned later, which mainly focuses on elimination of double taxation *ex ante*.

Resources available to the tax authorities

China's tax authorities are organised in a multi-layer structure, with the SAT being the central office at the top, guiding provincial, municipal, and county or district level offices across the country. A dedicated group of officers are assigned at both the central and local levels to handle matters including transfer pricing and special tax adjustment cases. At the central level, the SAT currently has a small group of officials to monitor, develop and interpret transfer pricing regulations in China. These officials have frequent exchanges with tax authorities in other countries and with the OECD. Initiation and conclusion of a transfer pricing audit requires the approval of the central SAT officials, who will act in a supervisory and supporting role to local tax officials at various levels or locations who will directly conduct audits, with simultaneously orchestrated efforts leading to an increased burden on taxpayers. In cases involving mutual agreement procedures or bilateral/multilateral advance pricing arrangements, the SAT takes the lead role in the competent authority discussions.

The SAT has been advocating a three-pronged approach of "administration, services and investigation" in relation to transfer pricing administration. In administration, the focus is on taxpayers' compliance and prevention of transfer pricing abuses; in services, the focus is on APA and MAP as these are considered services by the tax authorities to taxpayers; and in investigation, the focus is on formal transfer pricing audits. For the SAT, this is a significant, philosophical change in tax administration, as historically the focuses have always been on tax administration and investigation, and providing services to taxpayers has become an emphasis only recently although the addition is certainly a welcome sign to taxpayers.

Advance pricing arrangements (APA)

Circular 2 provides guidance with respect to the various requirements and procedures associated with applying for, negotiating, implementing and renewing APAs. In general, these provisions are a restatement of the previous rules on APAs (i.e. *Guo Shui Fa* [2004] No. 118), with several modifications and amendments. The following points are worth noting:

- The SAT has specified that APAs will, in general, be applicable to taxpayers meeting the following conditions: 1) annual amount of related party transactions over RMB 40 million; 2) the taxpayer complies with the related party disclosure requirements; and 3) the taxpayer prepares, maintains and provides contemporaneous documentation in accordance with the requirements.
- The term for an APA will cover transactions for three to five consecutive years (the previous provisions provided that APAs normally cover two to four years).
- Upon approval of the tax authorities, an APA may be rolled back (i.e. the pricing policy and calculation method adopted in the APA may be applied to the evaluation and adjustment of related party transactions in the year of application or any prior years) if the related party transactions in the year of application are the same as or similar to those covered by the APA.
- An APA will be respected by the relevant state and local tax bureaus at all levels as long as the taxpayer abides by all the terms and conditions of the APA. This can be regarded as a positive sign from the SAT to ensure certainty of APAs.
- Pre-filing meetings with tax authorities may now be held anonymously.
- While a taxpayer with an effective APA is exempted from the contemporaneous documentation requirements under Chapter 3 of Circular 2 with respect to the covered transactions, it is required to file an annual APA compliance report that needs to be provided to tax bureaus within five months of the end of each tax year.
- For bilateral or multilateral APAs, taxpayers should submit their applications (including pre-filing and formal applications) to both the SAT and the in-charge municipal or equivalent level tax authorities simultaneously. Circular 2 also states that, where the SAT accepts an application for a bilateral or multilateral APA, the SAT will enter into negotiations with the competent authority of the treaty partner based upon the relevant treaty's mutual agreement procedures.
- Circular 2 states that, in the event that an APA is applied for but not ultimately reached, any non-factual information regarding the taxpayer that was gathered during the application and/or negotiation process may not be used for tax investigations.

The APA guidance under Circular 2, in particular the introduction of the rollback provision, anonymous pre-filing meetings, and dual application at both the SAT and in-charge municipal or equivalent tax authority level (for bilateral and multilateral APAs), makes China's APA programme more attractive to taxpayers through the removal of some of the uncertainty that has historically surrounded it. This guidance, together with the SAT's emphasis on services to taxpayers, demonstrates the importance and commitment that the SAT is placing on APAs and their desire to create a successful APA programme in China.

On 30 December 2011, the SAT released the first annual APA report providing official statistics on both in-progress and completed APAs for the period from 1 January 2005 to 31 December 2009. While many of the forms and procedural guidance were already contained in Circular 2, the report also contains much new content including statistics

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as well as a process flowchart detailing how an APA moves through the six phases in Circular 2. Key trends highlighted by the report include:

- The rise in the number of signed bilateral APAs, which overtook the number of unilateral APAs for the first time in 2009;
- The rise in the number of applications related to intangible assets or services, which now exceed the number of applications related to tangible goods transactions;
- The fast processing time for unilateral and bilateral APAs; and
- The popularity of the transactional net margin method (TNMM), which was used in 60% of signed APAs.

Cost-sharing arrangement (CSA)

It was a breakthrough that CSAs for joint development of intangibles and sharing of services were finally written into the CIT law. Similar to the OECD's transfer pricing guidelines, Circular 2 requires the following items to be contained in a cost-sharing agreement:

- Name of participants, their country (region) of residence, related party relationships, and the rights and obligations under the agreement;
- Content and scope of intangible assets or services covered by the cost-sharing agreement, the specific participants performing research and development activities or service activities under the agreement, and their respective responsibilities and tasks;
- Term of the agreement;
- Calculation methods and assumptions relating to the anticipated benefits to the participants;
- The amount, forms of payment, and valuation method of initial and subsequent cost contribution by the participants, and explanation of conformity with the arm's-length principle;
- Description of accounting methods adopted by participants and any changes;
- Requirements on the procedure and treatment for participants entering into or withdrawing from the agreement;
- Requirements on the conditions and treatment of compensating payments among participants;
- Requirements on the conditions and treatment of amendments to or termination of the agreement; and
- Requirements on the use of the results of the agreement by non-participants.

Circular 2 states that the costs borne by the participants in a CSA should be consistent with those borne by an independent company 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 test will be subject to adjustment by tax authorities in the event of an audit assessment.

Some other relevant provisions of Circular 2 with respect to CSAs include the following:

- Service-related cost-sharing agreements generally should be limited to group procurement or group marketing strategies.

- Buy-in and buy-out payments are required when there is a change to the participants of an existing cost-sharing agreement.
- During the term of a CSA, if there is a mismatch between the shared costs and the actual benefits, then compensating adjustments should be made based on actual circumstances to ensure the shared costs match the actual benefits.
- If a CSA is not considered arm's length or does not have a reasonable commercial purpose or economic substance, costs allocated under the agreement (as well as any appropriate compensating adjustments) will not be deductible for CIT purposes.
- Taxpayers may apply for an APA to cover a CSA.
- Participants to intangible development-related CSAs should not pay royalties for intangible properties developed under the CSA.
- The costs allocated under a CSA and deducted for CIT purposes by the taxpayer would need to be clawed back if its term of operation turns out to be less than 20 years from the signing of the CSA.
- In addition to the contemporaneous transfer pricing documentation requirements under Chapter 3, Circular 2 also includes specific requirements for preparation of contemporaneous documentation for CSAs, which needs to be submitted to the tax authorities by 20 June of the following year.

Controlled foreign corporations (CFC)

Article 45 of the CIT law provides for the inclusion in a Chinese taxpayer's taxable income the relevant profits of its CFCs established in countries with effective tax burdens that are substantially lower than China's.

Circular 2 provides guidance for calculating the amount of the deemed income and any associated tax credits. Pursuant to Circular 2, the deemed dividend income from a CFC attributed to its Chinese resident enterprise shareholder should be determined using the following formula:

$$\begin{array}{l}
 \text{Income attributed} \\
 \text{to a Chinese} \\
 \text{resident enterprise} \\
 \text{shareholder in the} \\
 \text{current period}
 \end{array}
 =
 \begin{array}{l}
 \text{Amount of deemed} \\
 \text{dividend distribution}
 \end{array}
 \times
 \frac{\begin{array}{l} \text{Number of} \\ \text{shareholding days} \end{array}}{\begin{array}{l} \text{Number of days in} \\ \text{the CFC's tax year} \end{array}}
 \times
 \begin{array}{l} \text{Shareholding} \\ \text{percentage} \end{array}$$

Circular 2 allows for the exemption from recognition as Chinese taxable income any deemed dividend from a CFC that meets at least one of the following criteria:

- Is established in a country with an effective tax rate that is not low, as designated by the SAT;
- Has income derived mainly from active business operations; and
- Has annual profit of less than RMB 5 million.

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Thin capitalisation

The newly introduced thin capitalisation rules under the CIT law are designed to disallow the deduction of excessive related party interest expense pertaining to the portion of related party debt that exceeds a certain prescribed debt-to-equity ratio.

Circular *Cai Shui* [2008] No. 121 (Circular 121), jointly published by the Ministry of Finance and the SAT in October 2008, sets out the prescribed debt-to-equity ratios (2:1 for non-financial enterprises and 5:1 for enterprises in the financial industry) and other associated rules. Circular 121 also emphasises that “excessive interest” from related party financing that exceeds the prescribed ratios may still be deductible if an enterprise can provide documentation to support that the inter-company financing arrangements comply with the arm’s-length principle, or if the effective tax burden of the Chinese borrowing company is not higher than that of the Chinese lending company.

Where the debt-to-equity ratio exceeds the prescribed ratio, the portion of related party interest expense relating to the excess portion would not be deductible. Furthermore, the non-deductible outbound interest expense paid to overseas related parties would be deemed as a dividend distribution and subject to withholding tax at the higher of the withholding tax rate on interest and the withholding tax rate on dividends.

Chapter 9 of Circular 2 provides specific thin capitalisation administrative guidance, which includes the following:

- Mechanics for how to calculate the debt-to-equity ratio (on a monthly weighted average basis); and
- Related party interest that is not arm’s length will be subject to a transfer pricing investigation and adjustment before being evaluated for thin capitalisation purposes.

Preparation of contemporaneous thin capitalisation documentation is required in order to deduct excessive interest expense. Circular 2 stipulates that such documentation should include the following in order to demonstrate that all material aspects of the related party financing arrangements conform to the arm’s-length principle:

- Analysis of the taxpayer’s repayment capacity and borrowing capacity;
- Analysis of the group’s borrowing capacity and financing structure;
- Description of changes to equity investment of the taxpayer, such as changes in the registered capital, etc.;
- Nature and objectives of debt investment from related parties, and the market conditions at the time the debt investment was obtained;
- Currency, amount, interest rate, term and financing terms of the debt investment from related parties;
- Collaterals provided by the enterprise and the relevant terms;
- Details of the guarantor and the terms of guarantee;
- Interest rate and financing terms of similar loans contemporaneous to the debt investment from related parties;
- Terms of conversion of convertible bonds; and
- Other information that can support the conformity with the arm’s-length principle.

SAT Announcement No. 34, issued on 9 June 2011 with effect from 1 July 2011, provides that, in order to obtain deductibility of interest expenses incurred in related party loans, enterprises are required to document that interest payments for loans to non-financial borrowers are “reasonable”, including standard interest rates for similar loans by financial institutions within the same province. The notice also addresses several other issues, including the implications of an investing enterprise’s reduction or withdrawal of its investment.

General anti-avoidance rules (GAAR)

By including GAAR, the CIT law formally authorises Chinese tax authorities to make an adjustment if a taxpayer enters into an arrangement “without reasonable commercial purpose”. This is the first time for China’s CIT law to include such rules representing a strong indication of the Chinese tax authorities’ growing scrutiny of business structures.

Pursuant to Circular 2, a general anti-avoidance investigation should focus on the following transactions/structures:

- Abuse of preferential tax treatments;
- Abuse of tax treaties;
- Abuse of organisational structures;
- Use of tax havens for tax avoidance purposes; and
- Other arrangements without reasonable commercial purposes.

Circular 2 places a special focus on the principle of substance over form and also provides details about the various procedures for conducting a “general anti-avoidance investigation” and making a “general anti-avoidance adjustment”, including the requirement that all general anti-avoidance investigations and adjustments be submitted to the SAT for final approval. In addition, Circular 2 provides that the Chinese tax authorities will disregard entities that lack adequate business substance (especially those in tax haven countries).

Anticipated developments in law and practice

The introduction of Chapter 6 under China’s CIT law and the DIR, along with the promulgation of Circular 2, marks a significant shift in China’s transfer pricing regime. Given that Chinese transfer pricing legislation is relatively new and untested, it can be expected that further tax circulars will be issued by the SAT over time in order to clarify various matters concerning transfer pricing administration and special tax adjustments.

In addition, with the unification of the tax system, some tax officials formerly practicing in other areas are being redirected into the area of transfer pricing and anti-tax avoidance. This suggests that audit activity will increase in the near future. As mentioned earlier, the guidance from the SAT to the local-level tax authorities under Circular 85 has brought the issues of royalty and service fee remittance (as well as certain industries such as pharmaceuticals, automobiles, retail, etc.) on the radar screen in terms of transfer pricing and tax investigation. In addition, the SAT has been requiring local-level tax authorities to build up transfer pricing auditor resources to undertake fieldwork and to negotiate with taxpayers during investigations. Currently a core team of more than 200 transfer pricing specialists across China is being formed to

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enhance consistency and technical competency, and specialised anti-avoidance “SWAT” teams dedicated to transfer pricing investigations are being set up in 14 coastal areas.

In May 2011, the SAT announced its transfer pricing enforcement plan for 2011, which can be categorised into five aspects:

- While continuing to monitor the activities of foreign-invested companies, the Chinese tax authorities have also begun paying greater attention to domestic operations.
- The industry-wide transfer pricing investigation approach will continue to be used. After several efforts on manufacturing and processing industries, the tax authorities now focus on trading, services and finance activities. The SAT is planning to build certain industry-specialised team(s) that will be handling relevant transfer pricing matters from particular industries.
- The types of transactions under review will be expanded from traditional buy-sell transactions to include inter-company share transfers, transfers of intangible property, financing arrangements and other types of transactions.
- The Chinese tax authorities have also expanded their focus to include cost sharing arrangements, controlled foreign companies, thin capitalisation, general anti-tax avoidance regimes, and especially tax planning activities involving overseas cost allocation and use of intermediate holding structures and tax havens.
- There is also a continuation of the trend of increased numbers of anti-tax avoidance cases in the Central and Western regions of China.

OECD issues

While China has observer status with the OECD, it has for the most part modelled its transfer pricing legislation after the OECD Guidelines. In general, China’s transfer pricing regulations reflect the same arm’s-length principle and support the same type of transfer pricing methodologies that are being adopted in the OECD member countries. However, a transfer pricing policy or practice that is acceptable in an OECD member country will not necessarily be followed in China (e.g. collaboration between the customs and tax authorities in determining the transfer price/import value of related party tangible goods transactions).

Joint investigations

China would not usually join another country in undertaking a joint investigation of a multinational group for transfer pricing purposes. However, the Chinese tax treaties generally contain an Exchange of Information article that provides the cooperation between the competent authorities in the form of exchanges of information necessary for carrying out the provisions of the treaty (including transfer pricing investigations). In practice, the methods of exchanging information include exchange on request, spontaneous exchanges and automatic exchanges.

In recent years, the Chinese tax authorities have also been exploring other forms of international cooperation, including joining the Joint International Tax Shelter Information Centre (JITSIC) as a member in 2010.

There are intra-country transfer pricing investigation cases in which authorities in different locations collaborate their efforts in conducting simultaneous audits on Chinese subsidiaries of a group corporation.

Special features

Multiple audits

In general, China does not allow consolidation of CIT returns for multinational companies. A multinational company with subsidiaries located in various parts of China may, therefore, be subject to multiple transfer pricing audits.

Management fees

Under Article 49 of the DIR, management fees paid to related parties are not deductible for CIT purposes. On the other hand, service fees are deductible. According to Article 8 of the CIT law, a taxpayer may deduct reasonable expenses (including service fees paid to its related parties) that are actually incurred and are related to the generation of income. As there is no clear guidance on how to distinguish between service fees and management fees, tax authorities in different locations may have different views and practices in this regard.

Business tax and other taxes

In establishing transfer pricing policies for China, it is important for foreign investors to realise that income tax is not the only tax issue. Besides the Chinese CIT, other taxes such as business tax, value-added tax, consumption tax and customs duties can be quite significant. Therefore, in China, transfer pricing arrangements also must consider the implications of other taxes.

New ideas taking shape in China

Transfer pricing specialists at the SAT have mentioned the following areas in which they are shaping their positions:

- **Location savings:** The SAT officials have raised the point in CA discussions that more profits should be attributed to China due to the great efficiencies of its labour force, and more broadly, advantages specific to China including those resulting from government policies.
- **China country premium:** Many multinationals in the automobile industry now generate a majority of their profits in China. The SAT officials are discussing approaches to reasonably quantify such premium and they believe that this unique country premium should be taxed in China. China being one of the largest, fastest-growing markets is also being used as a basis by the SAT officials to argue for a premium for companies catering to the China market.
- **Marketing intangibles:** The SAT officials think that luxury goods companies operating in China cannot be regarded as limited-risk distributors and the claim that all the marketing intangibles belong to the overseas parent may not be easily accepted.
- **Review:** A national group of elite transfer pricing specialists is being formed to review and approve all transfer pricing audit cases in China. The group will be formed from the most experienced transfer pricing auditors from around China at all levels including city, county, provincial and national. The SAT is also considering bringing in additional economists or analysts to handle high-profile/important cases such as those in the automotive industry, which currently may be considered the most high-profile industry in China.