

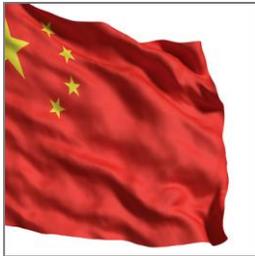


CRA Insights: Transfer Pricing

CRA Charles River
Associates

Recent transfer pricing developments in China

By Peter Guang Chen



It has been three years since China overhauled its corporate income tax system and enacted the new Enterprise Income Tax Law (EITL) of the People's Republic of China that took effect on January 1, 2008. The 2008 tax law also brought about the then much-anticipated contemporaneous documentation requirements for transfer pricing purposes. Where do things stand today? What should multinational corporations that are doing business in China expect in the area of transfer pricing? In this issue of *CRA Insights: Transfer Pricing*, Vice President and Practice Leader in the Asia Pacific region, Peter Guang Chen,

seeks to answer these questions and more with a discussion of the latest transfer pricing developments in China.

China's State Administration of Taxation's three-point strategy

In an April 2011 article in the *China Tax News*—a newspaper officially recognized and supported by China's State Administration of Taxation (the SAT)—the SAT announced its work strategy for the year along with the annual summary of the transfer pricing (TP) enforcement activities in 2010.

In 2010, the SAT continued to follow its three-point strategy in dealing with transfer pricing and has made considerable achievements in terms of getting results (i.e., collecting significantly more tax revenue through these efforts).

SAT's three-point strategy is:

- Administration
- Investigation
- Services

Administration

"Administration" or "compliance administration" is simply another term (or rather, euphemism) for informal TP audits. After reviewing the tax returns submitted by the taxpayers along with the related party disclosure forms that are attached to and part of the tax returns, and, in some cases, the transfer pricing documentation, the SAT would then contact the taxpayer companies for "follow-up discussions." In these discussions, the taxpayers would be asked to review and perhaps modify their transfer pricing arrangements. As a result of many of these cases, additional tax revenue was due as a result of the taxpayers' companies changing their transfer pricing structure.

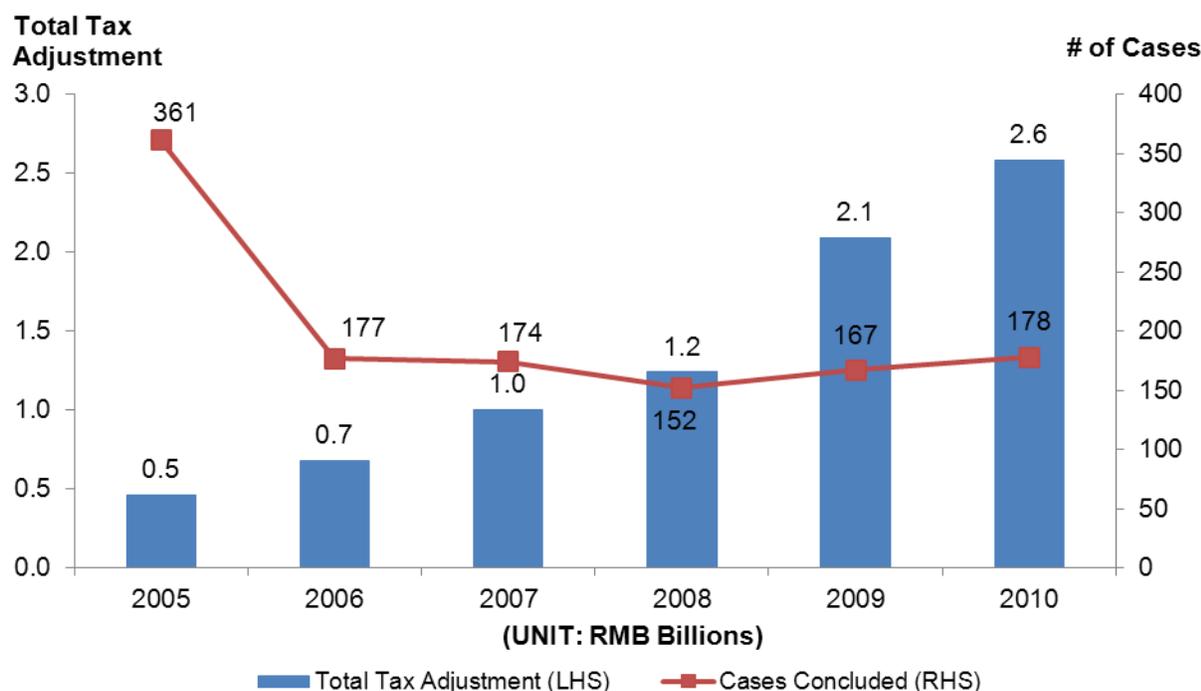
Investigation

“Investigation” refers to a formalized transfer pricing audit. In 2010, there were a total of 178 transfer pricing audit cases concluded, yielding a net tax adjustment increase of RMB 2.58 billion. This was an increase of 30% from the RMB 2.1 billion collected from TP cases in 2009. If we are to look at the audit statistics beginning from 2005, what we see is a clear trend of fewer cases but with higher net tax adjustments. In 2005, there were 361 transfer pricing cases completed, resulting in a total of 0.46 billion of tax adjustment. The year 2010 had almost 50% fewer cases concluded yet with greater than five times more in tax revenue collected. See Figures 1 and 2 below for the audit cases statistics.

Figure 1: China transfer pricing cases statistics

	2005	2006	2007	2008	2009	2010
Cases Concluded	361	177	174	152	167	178
Average Tax Adjustment (RMB Millions)	1.27	3.84	5.75	8.16	12.51	14.5
Total Tax Adjustment (RMB Millions)	458.5	679.7	1,000.5	1,240.3	2,089.2	2,581

Figure 2: China transfer pricing cases



The significance of the audit cases statistics is that the SAT is clearly devoting their transfer pricing audit resources to targeting the larger companies with the potential to net higher tax adjustments to get “more bang for the buck” through their audit efforts.

The SAT is much more focused and intent on improving the quality of the TP audits. It is our understanding that they plan to increase their nationwide transfer pricing specialists to 500 within the next couple of years—an increase of approximately three times the present level of about 150.

Services

By “services,” the SAT is referring to APAs (Advanced Pricing Agreements) and MAPs (Mutual Agreement Procedures) because these are considered services to the taxpayers.

In December 2010, the SAT issued its first-ever annual APA Report. It provides a description of China’s APA program with details on how to initiate and conduct an APA in China. A statistical survey of China’s APA program from 2005 through 2009 is also included and shows that a total of 53 APAs were signed in that period. Of the 53 APAs, 41 were unilateral APAs and 12 were bilateral APAs. Within the 12 bilateral APAs, 9 were with Asian countries and the remaining three were with European countries and the US.

In 2010, according to informed (but not officially published) sources, there were about 30 APAs that were initiated with three or four officially signed off. At present, there are apparently 20 or more APAs pending review or negotiation. There were approximately 12 MAP cases in discussion stage during 2010.

SAT’s transfer pricing enforcement focus for 2011

Based on the report in *China Tax News*, the SAT will emphasize the following approaches in tackling its transfer pricing enforcement program this year:

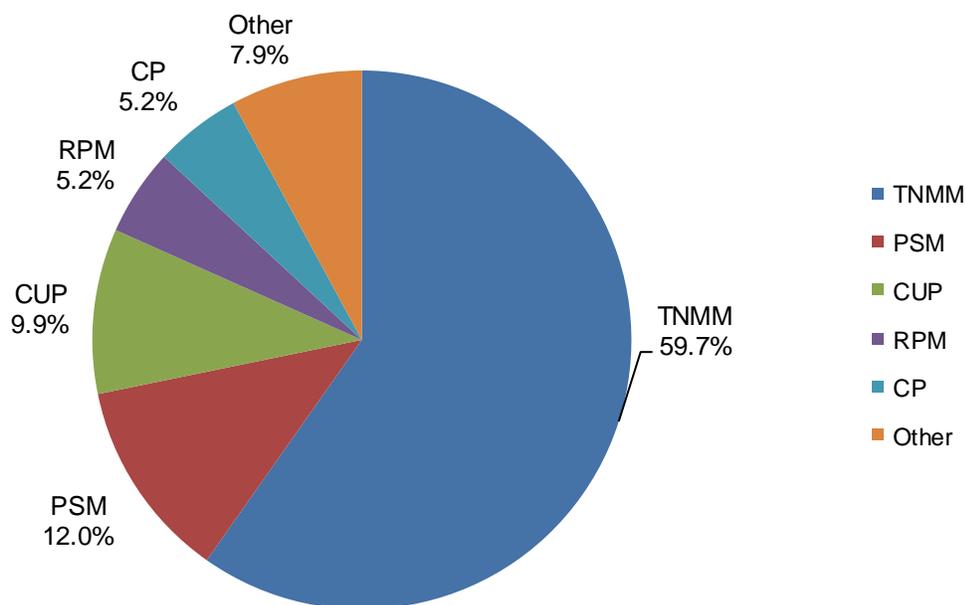
- Domestic companies will be scrutinized more closely, particularly those that are starting business operations outside of China. Previously, the TP focus was, in most cases, on the foreign invested enterprises (FIEs).
- The types of transactions to be examined will expand from the traditional “buy-sell” transactions to include intangible (intellectual property) transfers, intra-group companies’ share transfers, group financing transactions, as well as other types of transactions.
- “Industry-wide transfer pricing investigation” will continue to be conducted. With its experience in the automotive industry, the SAT believes—and rightly so—that gaining deeper understanding of a particular industry will allow it to become more effective in tackling TP issues for the taxpayers in that industry. In 2010, the SAT organized TP training for its agents in Changsha with the focus on the automotive industry. Using the automotive industry as an example, the SAT is developing the view that certain significant characteristics of the China market are different from the rest of the world and that TP economic analysis and methodologies have to reflect those differences when used in China. (General Motors’ much-publicized, highly profitable operations in China, compared to other places such as the US, no doubt contributed to the SAT’s attitude that China should capture a heftier portion of that profit in China’s tax base.)
- The focus on transactions such as controlled foreign corporations, thin capitalization, cost-sharing arrangements, use of intermediate holding companies, and tax havens will be increased.

SAT’s theories about transfer pricing methods reflecting “China characteristics”

Due in part to the publicity about China increasingly being a profit center for many multinational corporations and in part to the growing sophistication of SAT in transfer pricing matters, China’s tax authority is coming up with new concepts as to why a higher level of profit earned by some multinationals should be captured in the China tax base from a transfer pricing perspective.

The Transactional Net Margin Method (TNMM) is the TP method used most often by companies with transfer pricing arrangements. However, the SAT is reviewing whether other methods, such as the profit split method, may be more appropriate in some of these cases.

Figure 3: China transfer pricing methodology (TPM) composition of methods used in practice



Note: CUP: Comparable Uncontrolled Price Method, RPM: Resale Price Method, PSM: Profit Split Method, CP: Cost Plus Method, TNMM: Transactional Net Margin Method

The following concepts are being developed by the SAT to adapt the transfer pricing related economic analysis and methodology to reflect the characteristics of the China market:

- **China market premium.** The combination of factors of consumer demand, perception of brands, and value in China actually contribute to a higher profitability to some multinationals' business operations in China. This premium should be reflected in TP analyses and methods used to shift a higher percentage of the profits toward China. The General Motors example is cited in support of this concept.
- **Location savings.** With the efficiency of its infrastructure and labor force, the related Chinese manufacturing entity should receive a higher compensation, translated into higher prices for the products it manufactures, to reflect the "location savings" when a multinational conducts manufacturing/processing in China.
- **Marketing intangibles.** It has been a few years since the GlaxoSmithKline case on marketing intangibles has attracted the attention of the SAT. A deputy director in the Anti-Tax Avoidance Division of the International Taxation Department actually wrote an article in a tax journal about the GSK case and discussed how the marketing intangibles concept should apply in China, resulting in more profits being attributed to the China marketing function. The SAT will be increasing its focus on marketing intangibles in the China market and asserting its recognition if it deems appropriate.

For a multinational company operating in China, the expectation should be that the China tax authority will become more aggressive and sophisticated in the transfer pricing area. Through the expansion of the SAT's resources—increase in headcount of transfer pricing specialists/agents, more training and research, accumulation of more taxpayers' data from the tax returns and TP documentation submitted, and more experience—the SAT is developing the tools to improve its effectiveness in dealing with TP investigations, APA applications, and MAP resolutions. The multinational companies in China need to have a clear understanding of where the battle lines are and be prepared.

What are the transfer pricing compliance/disclosure requirements today?

There are two distinct sets of transfer pricing disclosure requirements for China enterprises with related party transactions:

- (I) Even if a China enterprise is exempt from the “transfer pricing contemporaneous documentation” (TPCD) requirements, it will need to prepare and submit up to nine (9) forms together with its annual enterprise income tax returns, if it has related party transactions. See Figure 4.

Due date: The forms are due by May 31st after the end of the enterprise’s tax year. (Note: in China, virtually all enterprises are required to adopt the calendar year as the tax year, with almost no exceptions to this rule.)

- (II) Unless a China enterprise qualifies for one of the three exemptions (see Figure 4), then “transfer pricing contemporaneous documentation (TPCD) needs to be provided.

Due date: Since by definition the documentation has to be prepared “contemporaneously” with the tax returns, this means they have to be completed by May 31st after the enterprise’s tax year. Then, the enterprise must submit the TPCD to the SAT within 20 days if so requested.

Figure 4: Table of annual related party forms for attachment to enterprise tax return (required of all taxpayer enterprises regardless of whether enterprise is exempt from contemporaneous documentation requirements)

Form No.	Description
1	Related party relationships
2	Summary of related party transactions (see sample of Form II in Figure 5)
3	Sales and purchases
4	Services
5	Financing
6	Transfer of intangible assets
7	Transfer of fixed assets
8	Outbound investments
9	Outbound payments

Exemptions from transfer pricing contemporaneous documentation (TPCD) requirement

There are three possible exemptions from the TPCD requirements:

- 1) Enterprises with annual related party sales and purchases of tangible property totaling less than RMB 200 million, AND, other types of related party transactions totaling less than RMB 40 million
- 2) Enterprises with related party transactions subject to advance pricing agreements (APAs)
- 3) Enterprises with foreign-owned shares accounting for less than 50% and only engage in related party transactions with related parties within China

A company meeting any one of the three exemptions above will not be required to have TPCD. However, note that even if an enterprise is exempt from the TPCD requirement, it will still need to prepare and submit the related party disclosure forms (i.e., up to 9 forms) together with its annual tax returns.

Figure 5: Form II: Related party transaction summary form

1. Whether contemporaneous documentation has been prepared according to requirements in the current year Yes No
2. Exempted from preparing contemporaneous documentation in the current year
3. Whether Cost Sharing Agreement has been executed in the current year Yes No

Must disclose whether TP documentation has been prepared or exempt

___ Units RMB

Transaction Type	Total Transactions Amount	Related Party Transactions		Overseas Related Party Transactions			Domestic Related Party Transactions		
		Amount	Per-centage %	Amount	Per-centage %	Per-centage %	Amount	Per-centage %	Per-centage %
		1	2-4-7	3-2-1	4	3-4/1	6-4/2	7	8-2/7
Purchase of Materials/Goods									
Sales of Goods/Materials									
Service Income									
Service Expense									
Acquisition of Intangible Assets									
Disposal of Intangible Assets									
Acquisition of Fixed Assets									
Disposal of Fixed Assets									
Interest Income (accrued) from Financing									
Interest Expenses (accrued) from Financing									
Others									
Total									

Prepared by (Signature and Official Stamp)

Legal Representative

Penalties for failure to comply with related party reporting and TP documentation requirements

If a taxpayer enterprise is required to prepare transfer pricing contemporaneous documentation (TPCD) (i.e., does not meet one of the three “exemptions” from TPCD), then the following “penalties” can potentially apply:

- **Monetary penalty:** A fine of RMB 2,000 to 10,000 can be imposed for the failure to prepare the TP documentation or the annual TP forms (for attachment to the tax return). If the taxpayer enterprises “refuses” to provide the required reporting, then a fine of RMB 50,000 can result.

- **Interest penalty:** If a taxpayer enterprise does not have the required TPCD in place, an added interest penalty of 5% per annum can be imposed on the net resulting transfer pricing tax adjustment on top of the PBOC (People's Bank of China) RMB loan base interest rate.

The above are the statutory monetary and interest penalties where a taxpayer enterprise fails to comply with the related party reporting and TP documentation requirements and may seem relatively mild when compared to the other less quantifiable but potentially much more serious consequences of non-compliance of reporting and disclosure and result in a TP tax adjustment (see discussion below).

Other potential consequences of not complying with related party annual reporting or TP documentation requirements

- **TP audit:** A taxpayer enterprise (not otherwise exempt from the TPCD requirements) that fails to have the documentation in place will most likely be selected for audit. This is provided in the TP regulations under Circular 2 (Guoshuifa [2009] 2, Article 29).

Note that beginning in 2010, the SAT has been collecting TP documentation reports from many companies even if an audit has not been initiated. In July 2010, the SAT issued Circular 323 (Guoshuihan [2010] 323), which mandated local tax authorities to “collect and review” the TP documentation reports. Therefore, for those companies that cannot supply the documentation when requested, an audit is almost certain.

- **Adjust taxable income using various methods:** If a taxpayer enterprise fails to report and provide the required documentation, the SAT is empowered to adjust the taxpayer's taxable income using any of these methods: (a) referring to profit margins of companies in similar industries, (b) cost plus reasonable profit (i.e., “deemed profit”), (c) extending the profits of the affiliated group by a percentage, or (d) other reasonable methods. SAT's authority comes from the Enterprise Income Tax Implementing Rules (EITIR) Article 115, which refers to Article 44 of the tax law itself (Enterprise Income Tax Law (EITL), triggered by a failure to disclose or report.

Peter Guang Chen
Vice President

New York
+1-212-520-7261

Hong Kong
+852 8127 7500

pchen@crai.com

www.crai.com/transferpricing



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