CRA Insights: Transfer Pricing

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Defending valuations for equity transfers of Chinese enterprises: the intersection of transfer pricing and business valuation analyses

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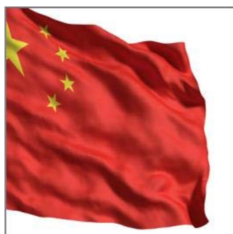

Overview

As has been well-documented, over the past several years the Chinese tax authorities have made tremendous strides in terms of the resources dedicated to examining intercompany transactions entered into by Chinese enterprises, the regulatory framework that has been promulgated regarding transfer pricing, and the level of technical competency of China's State Administration of Taxation (SAT) and local government officials with respect to transfer pricing issues. The guiding principle underlying these efforts is that the prices charged in controlled transactions entered into by Chinese taxpayers must be consistent with prices that would have been charged at arm's length.

Until recently, however, transfers of equity interests in Chinese foreign investment enterprises (FIEs) were generally permitted at cost, even in cases where the fair value of the shares was arguably well in excess of book value. As highlighted by recent events outlined in this article, transfers of shares of Chinese enterprises at cost are unlikely to be accepted by tax authorities moving forward. Consistent with the arm's length principle that guides Chinese tax authorities' administration of intercompany pricing, most equity transfers should now be priced in a manner consistent with the fair value of the subject shares.

Using the discounted cash flow (DCF) analysis conducted by local authorities in a recent widely publicized audit as a case study, the SAT has made clear its intention to apply widely accepted business valuation techniques to determine the value of FIEs' transferred shares. With the issuance of Circular 698[1], taxpayers must be cognizant of the SAT's new valuation approach not only for direct transfers of FIE shares but also for indirect share transfers (i.e., sales of any equity interests whose value is derived in part through holdings of FIEs).

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[1] Admittedly, Circular 698 imposes only an information reporting requirement and does not change the substantive tax rules. However, with the requirement that foreign investors now have to report the disposition of even indirect interests in their ownership in FIEs, the implication is clear: the SAT intends to use the information to challenge those transfers that they believe to be without business substance.

Given these developments, the rapidly emerging consensus view is that positions taken by multinationals with respect to the value of shares of Chinese enterprises must be corroborated by reliable and supportable valuation studies. In order to ensure reliability, these valuation studies should comply with well-established business valuation techniques and principles. However, a standard business valuation analysis by itself may not be sufficient to provide highly supportable valuation positions for Chinese tax purposes. Given that FIEs are often party to material intercompany transactions with controlled affiliates, it is crucial to develop support for the arm's length nature of intercompany pricing assumptions embedded in DCF and similar valuation analyses. As demonstrated in this article, the valuation results derived for FIE shares can be extremely sensitive to even minor modifications of intercompany pricing. In some cases, the intercompany prices used in valuation analyses can represent the single most important input in the entire study. For this reason, it is essential that taxpayers incorporate both business valuation and transfer pricing expertise in the analyses used to support their valuation positions for FIE equity transfers.

The Dalian case, Circular 698, and other related developments

Under the Corporate Income Tax Law (CITL)[2] that became effective in 2008, corporate restructuring transactions are required to be effected at fair value so that any capital gain or loss is recognized as of the date of the transaction. This marks a sharp difference from the prior regime in which an effective safe harbor was provided allowing Chinese equity shares to be transferred at cost as long as sufficient commercial purpose was provided.[3]

In 2010, the Dalian State Tax Bureau audited a taxpayer that was party to an internal restructuring involving the transfer of shares to a foreign affiliate at cost. The authorities determined that the pricing of the shares was unreasonably low and performed their own DCF analysis, with the approval of the SAT. The DCF analysis resulted in a significantly higher valuation of the transferred shares and the assessment of material additional taxes.

The SAT has reportedly used the Dalian case as guidance for other local Chinese tax authorities in the use of income-based valuation methods for their audits of the value of equity transfers of Chinese enterprises. While local tax regulations do not exist for such analyses, the China Appraisal Society has published a variety of literature with respect to business valuation. These publications are highly consistent with the guidance issued by Western appraisal institutions such as the American Society of Appraisers and the International Institute of Business Valuers, incorporating the use of income-based, market-based, and cost-based approaches as the primary acceptable valuation methods for business valuation analyses and the principle that the former two approaches are likely to be more appropriate for the valuation of going concern operations. The China Appraisal Society's stated principles with respect to the derivation and application of appropriate discount rates for income–based valuation analyses are highly consistent with those that have long been employed by valuation analysts in the US and other Western countries.

As described above, taxpayers should expect that Chinese tax authorities may apply DCF and other standard business valuation approaches in the audit of shares of Chinese enterprises that are transferred offshore as part of internal restructurings. However, perhaps prompted by the Indian Vodafone case, China is now pursuing capital gains assessments for third party and related party

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[2] The CITL is also sometimes referred to as Enterprise Income Tax Law (EITL).

[3] Through the end of 2007, under the old Foreign Enterprise Income Tax Law which expired December 31, 2007, the practice of allowing "cost" in the transfer of FIE interests among related parties was expressly sanctioned by SAT tax circular(s). Circular 207 provided for this treatment of restructurings prior to the implementation of the new CITL. The new CITL had the effect of invalidating Circular 207.

transactions involving sales of any equity interests whose value is derived in part through holdings of FIEs. The Indian case involved Vodafone's acquisition of a firm (Hutchison) whose operating assets were primarily India-based; the transaction was structured as a purchase by a Cayman Island-based Vodafone affiliate of a Cayman-based Hutchison affiliate that owned the Indian operating assets. The Indian government asserted that the deal in substance involved the transfer of Indian assets even though the shares purchased were not Indian shares. Vodafone was assessed capital gains tax of about US$2 billion; the assessment was also recently upheld by an appellate court.

Shortly after the Vodafone decision, the SAT issued Circular 698 that established extensive disclosure requirements for transactions involving entities that hold Chinese-based affiliates and also provided for the look-through and assessment of Chinese tax for such transactions that are deemed abusive and without business purpose. The scope of this rule is vague but allows for application to an extremely wide variety of transactions. One key sector where it has been applied to date is private equity where firms have historically avoided capital gains tax by structuring acquisitions and disposals using offshore vehicles. But any internal restructuring or acquisition that involves Chinese affiliates could potentially be caught within the scope of this rule.

Magnification of potential distortions of intercompany prices in valuation analyses

As Chinese authorities increase the use of income-based valuation approaches in their audits of FIE share transfers, the development of reliable support for valuation positions taken by taxpayers has increased materially. As described below, the pricing of intercompany transactions is of paramount importance in the application of income-based valuation approaches.[4] Relatively minor changes in intercompany prices can result in highly significant changes in valuation results when employing such approaches.

The use of a range of prices is widely accepted for the evaluation of the arm's length nature of intercompany pricing. The OECD Transfer Pricing Guidelines, Section 482 of the Internal Revenue Code in the US, and many countries' national regulations directly incorporate the use of ranges in their guidance for the administration of the arm's length standard.[5] Implicitly, the use of ranges represents tacit acceptance of the difficulty of precisely identifying arm's length pricing in most cases.

In some cases, the defined range of arm's length prices can be rather broad. In the case of business valuation analyses, however, in most situations it is necessary to derive a single point estimate of the pricing for intercompany transactions. The use of intercompany prices that may fall within a broadly defined arm's length range but significantly deviate from the single point estimate that is most strongly supported by market evidence can result in large distortions of business valuation results.

Example: minority shareholder valuation dispute involving the pricing of intercompany transactions
A useful illustration of the potential sensitivity of valuation results to changes in embedded intercompany pricing assumptions is provided in a lawsuit filed by minority shareholders of a Canadian subsidiary of a US parent company. In this case, the transfer price charged by the US parent to its Canadian affiliate for the sale of tangible product was not challenged by Canadian tax authorities in its audit of the affiliate's tax returns. However, as part of a corporate restructuring, the parent company purchased the shares of the affiliate that it did not already own. The price per share at which it purchased the shares was based on the results of a DCF analysis that incorporated and accepted the transfer price as applied.

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[4] The same principle also applies to market-based valuation approaches that make use of income-based market multiples.

[5] Circular 2, issued by the SAT in 2009 and which was effective retroactive to January 2008, directly specifies the use of the interquartile range as a means of testing the arm's length level of profitability in TNMM analyses. However, it also provides that entities with profitability results below the median of the range may be subject to transfer pricing adjustments.

The minority shareholders of the Canadian affiliate filed a lawsuit that argued that the transfer price was excessive and led to an under-valuation of their shares by artificially reducing the profit streams used to determine the purchase price. The court ruled that the Canadian affiliate would not have accepted the pricing terms had it operated as an independent entity. Using a revised discounted cash flow analysis with a modified assumption for intercompany prices, the court concluded that the fair value per share was more than 40% higher than the price than the shareholders had received from the parent company.

Hypothetical example: technical illustration of the sensitivity of valuation results to changes in transfer pricing assumptions
Such a material modification to valuation results based on an adjustment to a transfer pricing position that had previously been implicitly blessed by local tax authorities is striking. In order to further illustrate from a technical perspective the sensitivity of business valuation analyses to changes in transfer pricing adjustments, we present this hypothetical example.

Assume the simple case of a hypothetical Chinese FIE that purchases all of its products from foreign affiliates and resells them to third parties in China. As shown in Figure 1, the FIE reports revenues of $100 and pays $75 for the products purchased from affiliates. After deducting selling, general, and administrative (SG&A) expenses and taxes, it reports net income of $7.5. (For simplicity, we assume that net income is equal to cash flows). Assuming a discount rate of 10% and a perpetual 2% growth rate, a valuation analysis would produce a result of $93.8 for the enterprise value of the affiliate.

However, after evaluating the arm's length pricing of the intercompany transaction more closely based on market evidence, the valuation practitioner determines that the transfer price paid by the FIE was insufficient and should be increased by approximately 10% in order to best approximate the price that would be expected at arm's length. As shown below, after increasing the price paid to its affiliates by 10% (from $75 to $82.5), the valuation result computed for the Chinese entity decreases from $93.8 to $23.4, a reduction in the calculated entity enterprise value of 75%.

Figure 1: Hypothetical Example
Sensitivity of FIE's Valuation Result to Changes in Transfer Price Assumptions

	As Reported	**After Adjusting Intercompany Prices to Arm's Length Levels**
a) Sales	100.0	100
b) Purchases from Affiliates	75.0	82.5
c) SG&A	15.0	15.0
d) Operating Profit *[a-b-c]*	10.0	2.5
e) Taxes *[d * 25%]*	2.5	0.6
f) Net Income *[d-e]*	7.5	1.9
g) Discount Rate	10%	10%
h) Growth Rate	2%	2%
i) Enterprise Value *[f / (g-h)]*	93.8	23.4
j) Reduction in Valuation Result		75%

The chief takeaway from this hypothetical example is that relatively modest changes in the pricing of intercompany transactions can result in highly magnified changes in the valuation results of an enterprise. In this case, the increase of the intercompany price paid for purchases of product by 10% resulted in the reduction of the calculated enterprise value result by 75%.

Intellectual property

The pricing of intercompany transactions involving the exploitation, license, and development of valuable intangible assets can have a material impact on the level of income reported by FIEs. Unsurprisingly, the pricing of these types of transactions within the valuation analysis can represent the single most important determinant of the concluded valuation results.

In these cases, it is highly recommended to develop substantial analytical support for the intercompany pricing assumptions embedded in equity valuation positions taken. For example, consider a situation where the shares of an FIE are transferred based on a valuation methodology that assumes that valuable intellectual property (IP) is economically owned by a non-Chinese affiliate. Chinese authorities may challenge that assumption by employing a valuation methodology that allocates the value of the IP to the FIE. The resulting value of the shares using the latter methodology may be many times higher than the value derived through the former approach.

In order to defend the reasonableness of a valuation position in such a case, it is necessary to accumulate and document market-based evidence supporting the reasonableness of the transfer pricing policy in place. In addition, factors surrounding the financing of the development of the subject IP and the allocation of associated risks within the controlled group of companies must be identified and compared with the market-based evidence. Finally, it is recommended that the economic substance of the intercompany arrangement be evaluated to verify that the functions and risks of the non-Chinese entities are consistent with the transfer pricing policies and to confirm that, at arm's length, the subject transaction could be expected to have been priced on comparable terms given the relevant facts and circumstances.

Conclusion

Over the past several years, the scale of the resources and expertise administered by Chinese tax authorities to the application of the arm's length standard for purposes of transfer pricing audits have increased materially to the point where the vast majority of multinationals prepare transfer pricing documentation for their FIEs and incorporate evidence of market-based pricing into their transfer pricing policies. The transformation of the tax authorities' approach to transfers of FIE equity shares is still in its early stages but has the potential to be just as significant and potentially even more so.

While only a few years ago the vast majority of FIE equity transfers were executed at cost, the effective extension of the arm's length standard to equity transfers summarized in this article requires the application of reliable, well-accepted business valuation methodologies such as the DCF in order to support equity valuation positions moving forward. Given the provisions of Circular 698, it may be necessary to prepare such support not only for direct transfers of FIE shares but also in cases of indirect transfers (i.e., the transfer of any equity interests whose value is derived in part through holdings of FIEs).

To ensure reliability, such analyses must incorporate careful and well-documented validation of the arm's length nature of the prices employed for intercompany transactions. As demonstrated in this article, the impact of even modest changes in intercompany pricing assumptions embedded in valuation analyses can result in highly magnified changes in the valuation of an enterprise. The importance of this dynamic is heightened in cases of intercompany transactions involving intellectual property given that large

percentages of enterprise value in many industries are often attributable to intangible assets. As a result, support for the valuation positions taken in FIE equity transfers must incorporate reliable business valuation approaches and principles in combination with expertise in the pricing of intercompany transactions.

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