

China's special tax adjustment regulations: An action plan

China's new transfer pricing regime raises documentation costs but presents opportunities for cost sharing.

More than 50 percent of the world's trade involves transfer pricing – the pricing of transactions that occur between subsidiaries of the same group. Transfer pricing can also mask what has become the most significant form of global tax evasion; simply put, multinational corporations (“MNCs”) can use transfer pricing to shift profits out of one country by overpaying affiliates in other countries for products purchased and undercharging for products sold. Because transfer pricing evasions are so hard to detect, tax authorities around the world have begun to demand that MNCs prepare specific documentation for transfer pricing purposes, which is an expensive burden.

Quick glance

- China's Implementing Measures for Special Tax Adjustments contain important information for transfer pricing compliance and cost-sharing opportunities.
- A multinational corporation's entities that operate in China must file disclosure forms on related-party transactions and, if their activities exceed new thresholds, submit contemporaneous documentation.
- Using appropriate functional, financial and comparable company analyses – and in-sourcing when possible – can cut costs and reduce the likelihood of an audit.

A significant recent change to the global transfer pricing landscape is the release of the Implementing Measures for Special Tax Adjustments (“the measures”), which include new transfer pricing regulations. The PRC State Administration of Taxation (“SAT”) finally released the measures on January 9, 2009, and they take effect retroactively to cover all transactions in 2008. Two aspects of the measures are important for MNCs: the significant compliance burden of the new transfer pricing documentation requirements and the opportunities provided by cost sharing.

The implementing measures provide the details necessary to implement the transfer pricing provisions of China's Enterprise Income Tax ("EIT") Law, which took effect January 1, 2008. To help monitor transfer pricing compliance, the law requires entities to prepare, keep and – at the request of the tax authorities – submit contemporaneous documentation to demonstrate that their intercompany pricing is fair and reasonable, or comparable to what a third party would pay. The EIT Law, however, does not provide details on who should prepare documentation and in what format; these questions are addressed in the Implementing Measures for Special Tax Adjustments.

Documentation

An important aspect of the measures was the transfer pricing documentation requirements and the threshold level at which documentation would be required (see Table). Under Article 14, non-exempt entities (entities that exceed the thresholds) must prepare contemporaneous documentation for five areas: organizational structure, business operations, related-party transactions (see Defining "Related Party" for definition of related parties), comparable analysis, and selection and application of transfer pricing methods. The deadline to complete the preparation of contemporaneous documentation for the 2008 tax year is December 31, 2009. Article 11 of the measures requires all entities to submit nine transfer pricing disclosure forms by May 31, 2009 as part of their annual EIT filing. The raising of these thresholds shows that SAT, alarmed by the economic crisis, has scaled back the requirements in response to investor concerns. The documentation requirement is still a staggering burden, however, and comes as companies are slashing tax consulting budgets and instituting hiring freezes. To make matters worse, documentation is on a by-entity basis and must be filed in Chinese. (Most MNCs have multiple legal entities in China, because entities formed there have narrowly defined business scopes. MNCs that pursue different businesses must operate many entities.)

Strategies for documentation

The most important aspects of contemporaneous documentation are the functional analysis, financial analysis and comparable company analysis. Determining the allocation of functions and risks among related parties is at the heart of any transfer pricing analysis. The more functions performed (in terms of quantity and importance), the higher the expectation of profits. The measures emphasize the importance of functional analysis by requiring taxpayers to complete a "Functional and Risk Analysis" form as part of the contemporaneous documents.

SAT also requires each non-exempt entity to prepare a "segmented financial analysis form of annual related-party and third-party transactions". This analysis requires firms to allocate selling and administrative expenses appropriately, as SAT will likely assess whether net profit on related-party transactions is less than that on third-party transactions.

Use Chinese comparable companies

Whether PRC authorities view a company's transfer pricing as legitimate often comes down to whether the company uses comparable company data

Risks of not filing

Entities may incur several penalties if they fail to submit documentation.

- **Fines** The fine for failure to prepare documentation is RMB 2,000 – RMB 10,000 (US\$292 – US\$1,462) and can rise to RMB 50,000 (US\$7,311) if the taxpayer "refuses" to provide this information.
- **Interest penalties** If the taxpayer provides no documentation, it will be subject to a 5 percent interest penalty on the amount of tax adjustments in addition to the normal People's Bank of China lending rate.
- **Deemed profit** According to Article 115 of the Implementing Regulations of the EIT Law, if the taxpayer has not provided contemporaneous documentation, the tax bureau may apply the deemed profit method and levy tax accordingly.
- **Audit** Article 29 of the measures states that "enterprises that fail to prepare contemporaneous documentation should be selected for audit".

to support the position that profits in China are reasonable. The quality of comparable studies done in China varies widely, however. (Comparable studies analyze similar transactions by entities of a similar size in a similar industry, preferably in the same country.) Often, a comparables search of China's market is done in the United States using a generic type of database or by someone unfamiliar with the Chinese market. Given the peculiarities of the Chinese stock market and the fact that annual reports are usually available only in Chinese, the results of such studies are frequently unsatisfactory. At their most basic level, comparables need to be reasonable from an intelligent layman's perspective. The local PRC tax authorities tend to reject studies they cannot understand or find unpersuasive because the comparable study uses data from a different industry or country. Comparable data should also be technically sound and based on correct statistical principles, because provincial- and central-level authorities are well-versed in comparable company analysis and will throw out comparables that are unreliable or appear to have been selected to support an entity's case.

Given recent economic conditions, the typical three-year comparable companies analysis that compares a company to the 2005-07 average of comparables will often result in a company being measured against an unrealistic benchmark. Instead, when submitting comparables, companies should

- Update and extrapolate the comparable companies' data to reflect the most recent and anticipated developments;
- Present internal group information to show that Chinese subsidiaries are making greater profits than their corporate headquarters or other subsidiaries; and
- Identify negative industry developments, such as bankruptcies and sales declines.

Minimize compliance costs

In this era of frozen budgets, companies need to think creatively. A traditional interview-based, prose document will only waste time and money. Excessive or incorrect information can be costly, time-consuming, and may prompt an investigation.

- **Match effort to level of risk** The amount of resources spent on documentation should be consistent with the level of exposure. If the entity has low audit detection risk (it is unlikely to be asked to submit contemporaneous documentation) and low adjustment risk (it is small and profitable), it should spend only a modest amount on preparation.
- **Use a tabular approach** To reduce translation and updating costs, preparers should use data tables rather than prose descriptions.
- **Apply China master files** Where entities perform the same function, the benchmark results and functional analysis should be shared across the group to ensure consistency and enhance efficiency.
- **Use technology** Take advantage of transfer pricing software, templates, and other tools to streamline the documentation process. For example, for detailed information on PRC companies, entities may consider a China-specific comparables database system.

- **In-source where possible** Given that consultant billing rates in China are higher than in most countries, including the United States, it makes sense to perform as many tasks as possible in-house, especially with regard to data collection, functional analysis, and updating. Through in-sourcing, companies may also capitalize on in-house experience and institutional knowledge.
- **Use SAT formats** Companies should avoid using a global template. SAT has prescribed specific forms and checklists that are unique to China. These requirements should be honored to enhance the likelihood that the local tax officer accepts the transfer pricing documentation and the information and analysis it contains. A global template will likely create resistance, generate confusion and invite questions.

Cost sharing

A notable, positive feature of the measures is that they allow intercompany cost sharing. Though cost-sharing arrangements are restricted in certain areas – for example, sharing intercompany services is limited to marketing and procurement arrangements – they can generally be used for intangibles, typically the research and development of intellectual property. MNCs that operate at a loss in their home markets but are profitable in China could minimize global taxes through these measures by, for instance, having their China entities buy into the multinational's preexisting intellectual property under an internationally recognized cost-sharing arrangement. This would provide a way to shift profits and cash out of China and back home.

Another common complaint among global tax directors is that service fees that China-based entities pay out of China are subject to taxes. The measures allow cost sharing for group marketing and procurement services but, unfortunately, this provision cannot be fully utilized with certainty until one crucial area is clarified – namely, the business tax and corporate income tax treatment associated with service cost-sharing payments. Service fees paid out of China are subject to withholding taxes if a permanent establishment exists in China. Whether a cost sharing payment would be exempt from such taxes is unclear, and MNCs should watch for further developments in this area.

Thin capitalization

Thin capitalization rules have become an important element in the corporate tax systems of developed countries as a way to counter the abusive use of loan-financing to reduce the taxable income of the borrowing enterprise. In its evolution toward an increasingly sophisticated tax regime, China introduced a thin capitalization requirement in the EIT Law. The measures (together with *Caishui* [2008] No. 121) address thin capitalization and set the allowable debt-to-equity ratio for financial enterprises at 5:1, and at 2:1 for other enterprises. Any interest paid on debt to related parties that exceeds the ratio shall be non-deductible. Transfer Pricing Management Consulting experience indicates that this circular may allow many MNCs to reduce the marginal effective tax rate of their subsidiaries in China through debt pushdown (adding more debt and getting a larger interest deduction); conversely, some entities will face the risk that interest expenses will be disallowed.

China's tax regime in transition

The measures come as China needs taxes to pay for its RMB 4 trillion (US\$585 billion) economic stimulus plan. At the same time, senior PRC leaders are emphasizing that job creation and continued economic growth remain the main priorities. Transfer Pricing Management Consulting believes that China will maintain its investor-friendly attitude and that tax inspectors will take a balanced and reasonable approach. The measures impose significant burdens on MNCs, but these burdens can and should be handled in a practical and cost-effective manner. On balance, the measures are a necessary step forward and signal that China's economy is becoming more developed and complex.

Defining "related party" in PRC law

The Implementing Measures for Special Tax Adjustments outline eight kinds of related-party relationships:

- One party directly or indirectly owns 25 percent or more of the other party or 25 percent or more of both parties are commonly owned directly or indirectly by a third party; where one party owns shares of the other party through an intermediary and owns 25 percent or more of the intermediary, the percentage held indirectly is the percentage of the other party's shares owned by the intermediary.
- Debt provided to one party (except to independent financial institutions) by the other party accounts for 50 percent or more of the debtor's paid-in capital or 10 percent or more of one party's debt is guaranteed by the other party.
- 50 percent or more of one party's high-level management (for example, directors and managers), or at least one senior director who is in a position to control the board of directors is appointed by the other party, or the above-mentioned personnel of both parties are appointed by a third party.
- 50 percent or more of one party's high-level management is also the high-level management of the other party, or at least one senior director of one party who is in a position to control the board of directors is also a senior director of the board of directors of the other party.
- Business operations of one party rely on the industrial patent, technological know-how, or other licensed intangible property provided by the other party.
- Buy-sell transactions of one party are primarily controlled by the other party.
- Receipt or provision of services of one party is primarily controlled by the other party.
- Other situations where one party has effective control over the other party's business operations and transactions or other relationships arising from mutual interests, such as relationships where the majority shareholder of both parties enjoy basically the same economic benefits and family relationships.

China's transfer pricing documentation requirements			
Compliance obligation	Content	Who should file	2008 documentation due date
Disclosure forms	<ul style="list-style-type: none"> • Related-Party Relationships: List of Associated Parties • Summary of Intercompany Transactions • Related-Party Transactions: Purchases and Sales • Related-Party Transactions: Services • Related-Party Transactions: Intangible-Assets Transfers • Related-Party Transactions: Fixed-Assets Transfers • Related-Party Transactions: Financing • Report of Outbound Investments • Related-Party Transactions: Offshore Remittances 	All entities	May 31, 2009
Contemporaneous documentation	<ul style="list-style-type: none"> • Organizational structure • Business operations • Related-party transactions • Comparable analysis • Selection and application of transfer pricing methods 	Entities with annual related-party sales and purchases totaling at least RMB 200 million (US\$29.2 million) or with other related party transactions totaling at least RMB 40 million (US\$5.8 million)	December 31, 2009

Source: Implementing Measures for Special Tax Adjustments

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