



Transfer Pricing Associates

China transfer pricing developments

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Background

Background

- Increasing focus of tax authorities on transfer pricing audits and adjustments
- Burden of proof rests with the taxpayer to support their position
- Intra-China variations in approach of tax authorities
- New EIT law - removal of many incentives = increased tax rate for many foreign multinationals
- New 10% withholding tax on dividends = tendency for MNCs to charge more service fees and royalties = greater potential for non-arm's length profit shifting
- Detailed tax return disclosures for all taxpayers with related party transactions
- No group relief of losses, no consolidated tax return filing

Legislative developments

Legislative developments

- “The Enterprise Income Tax Law of the People’s Republic of China” (EIT Law) issued on 16 March 2007 and effective from 1 January 2008;
- “The Implementation Regulations of the Corporate Income Tax Law of the People's Republic of China” published on 11 December 2007;
- “Annual Reporting of Related Party Transactions” - Guo Shui Fa [2008] No. 114 - issued on 17 December 2008, detailing the related party disclosure forms that will be required to be completed and submitted by taxpayers along with their 2008 tax return on or before 31 May 2009; and
- “The Implementation Measures of Special Tax Adjustments” - Guo Shui Fa (2009) No 2 – issued on 9 January 2009, (“STA Guidelines”).

**Special Tax Adjustment (STA)
guidelines**

STA Guidelines

- **Chapter 2 - Definition of related parties – very broad**
 - Direct equity interest of 25%
 - Indirect holdings
 - High level of indebtedness
 - Management and control
 - Dependent on another party's IP
 - Control over raw materials
 - Control over provision or receipt of services
 - Actual control over production, operation or trading activities

STA Guidelines

- **Chapter 3 – Contemporaneous documentation**
 - Generally OECD approach
 - Additional information required:
 - Details of related parties, their effective tax rates, tax incentives etc
 - Overview of the business operations – including the whole value chain and any business restructuring activities;
 - Revenue/profit from principal business operations and proportion of total
 - Consolidated financial statements of the Group (by 31 December)
 - Segmentation of revenue and profit between related and unrelated party transactions

STA Guidelines

- **Chapter 3 – Contemporaneous documentation**
 - Exemptions are for:
 - Annual tangible related party transaction amount below RMB 200 million
 - Annual intangible related party transaction amount below RMB 40 million
 - Covered under an effective APA
 - Only involved in domestic transactions and not majority foreign owned
 - Should be prepared before 1 June of the next year
 - Extension until 31 December for 2008 year only
 - Submitted to tax authorities within 20 days of request
 - Failure to submit – tax auditor can exercise discretion to decide taxable income
 - Should be submitted in Chinese
 - To be maintained for 10 years

STA Guidelines

- **Chapter 4 – Transfer pricing methods**
 - Follows OECD 5 comparability factors
 - OECD compliant methods, including the TNMM
 - Not the Comparable Profits Method (CPM)
 - Profit split method appropriate if transactions are highly integrated

STA Guidelines

- **Chapter 5 - TP investigation and adjustment**
 - Key targets for investigation:
 - ✓ Significant amounts or many different types of related party transactions
 - ✓ Long-term losses, marginal profits or fluctuating profits
 - ✓ Profit levels lower than the industry norm
 - ✓ Profit level not in accordance with functions performed or risks borne
 - ✓ Transactions with related parties in tax havens
 - ✓ Failure to declare related party transactions or prepare relevant TP documentation
 - ✓ Enterprises that “obviously” disobey the arm’s length principle
 - Normally not transactions between domestic enterprises with same effective tax rate
 - Loss-making contract manufacturers highlighted for audit and adjustment
 - No working capital adjustments;
 - Recognition of interquartile range, but generally adjust upwards to the median
 - 5 year follow up period after audit

STA Guidelines

- **Chapter 6 - Advanced Pricing Agreement (APA)**

- Relaxed eligibility criteria:

- ✓ **Related party transaction amount exceeds RMB 40 million**
- ✓ **No substantial tax evasion in previous tax years**
- ✓ **Fulfilled tax return disclosure obligations and contemporaneous transfer pricing documentation requirements**

- APA can be used to evaluate and adjust previous years as well if circumstances and transactions are similar
- Pre-filing meetings can be held anonymously
- Period from 3 to 5 years
- Renewal will be considered
- Provides detailed process map and timeframes for application and monitoring
- Only 3 bilateral APAs concluded to date – Toshiba Duplicator (Shenzhen), Samsung Semiconductor (Suzhou), Wal-Mart (Shenzhen)

STA Guidelines

- **Chapter 7 - Cost sharing arrangement**
 - Joint development or transfer of intangible assets
 - Provision or receipt of services – group procurement or marketing
 - Costs to be borne should correspond with the benefits derived
 - Buy-in and but-out payments may need to be calculated
 - Only prospective – CSA must be executed first
 - Ongoing documentation requirements – to be filed by 20 June
 - Must be in place for 20 years or more

STA Guidelines

- **Chapter 8 – Controlled Foreign Corporations**
 - Applies when effective tax rate of controlled company lower than half China tax rate and profit not distributed or under-distributed
- **Chapter 9 – Thin Capitalisation**
 - Ratio of 2:1 (5:1 for financial institutions)
 - Need documentation to support deduction of interest in excess of above ratios
 - Excess interest deemed as dividend distribution
- **Chapter 10 – General Anti Avoidance**
 - Very general coverage of any potential tax avoidance activity
 - Substance over form approach

STA Guidelines

- **Chapter 11 - Adjustments and international consultation**
 - Corresponding adjustments are allowed
 - Recognition of role of competent authority in such cases
 - 3 year time limit
 - Written application plus relevant documents to support the negotiation
 - No relief possible for disallowed interest under thin capitalisation rules
 - No relief possible for interest and penalties on transfer pricing adjustment
- **Chapter 12 – Legal obligations**
 - Interest based on People’s Bank of China base rate
 - Penalty of 5 percentage points (waived if documentation in place)
 - Interest not deductible

Issues arising

Approach to meeting the transfer pricing documentation requirements

- **Adopt a strategic risk management approach**
 - Be aware of the specific risk factors eg losses, high-risk transactions
 - Prepare on the assumption that will be investigated in future
- **Leverage existing documentation as far as possible eg global masterfile**
- **Consider China masterfile if several entities with similar functional profile**
- **China specific benchmarking important**
- **Pay close attention to Appendix 1 & 2 of the STA Guidelines**
- **Information provided in the disclosure forms must be consistent**
- **Act now – to give enough time to rectify problems for 2009 and potentially 2008**
- **In-source tasks to control costs as far as possible**
 - TPA tools and templates are available

Importance of the compulsory related party transaction disclosure forms

- **Nine very detailed forms re 2008 for completion by 31 May 2009**
 - **Related party relationships**
 - **Transaction summary**
 - **Detailed form for each type of related party transaction**
 - **Split between related parties/unrelated parties, overseas and domestic**
 - **TPA tool available to assist in collation and analysis of data**
- **Many MIS systems will not automatically provide such information**
- **Required for all taxpayers with related party transactions**
 - **No exemptions for low level of transactions**
 - **No extension of time for submission**
- **“Goldmine” of information for the SAT**
 - **Expect more effective selection of audit targets**
 - **Greater efficiency in identifying issues**

Benchmarking strategies and issues for China

- **China specific benchmarking required**
 - Approach can be leveraged from global searches
- **Acceptable databases – OSIRIS, ORIANA(?)**
- **Private company data reliable/acceptable?**
- **Beware selection of industry codes**
- **Use of secret comparables specifically allowed in STA Guidelines**
- **No working capital adjustments unless specific permission given**
- **Arm's length range vs use of median**

Transfer pricing enforcement action by the SAT

- **Guo Shui Han [2007] No 363 – conduct of transfer pricing audits**
 - **Functional analysis questionnaires issued – ramp up of activity**
- **Guo Shui Han [2005] No 239 – centralisation of transfer pricing audits**
 - **Greater exchange of information**
 - **Industry focus – food and beverage, semiconductors, apparel, office equipment ...**
 - **Enhanced consistency of approach and sharing of expertise**
- **Guo Shui Fa [2008] No 114 – disclosure forms**
- **Establishment of new specialist large business unit at SAT**
 - **Headed by former leader of transfer pricing unit**
- **Increased focus on “larger” issues**
 - **Economic substance over legal form**
 - **Generation of local marketing intangibles, deductibility of royalties eg Giordano**
 - **Greater confidence in raising larger adjustments**

Risk minimisation strategies

- **Adopt the four-box approach to transfer pricing management**
- **Box 1 – business context**
 - **Ensure full knowledge of facts and background**
- **Box 2 – system design and implementation**
 - **Ensure legal, economic and accounting realities are aligned**
 - **Ensure system operating consistently throughout China entities**
- **Box 3 – documentation**
 - **Ensure full compliance with the documentation requirements**
 - **Consider China or Asia masterfile approach to documentation**
- **Box 4 – risk mitigation**
 - **Consider APA to mitigate unacceptable risks**
 - **Additional documentation, or revise transfer pricing system?**
 - **Correct understanding of facts and business context?**



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Asia transfer pricing developments

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Malaysia

- **Changes effective from 1 January 2009 (but final regulations are still pending)**
- **Burden on taxpayers to prove that related party transactions are arm's length**
- **Requirement for contemporaneous transfer pricing documentation**
 - **Threshold of transactions – TBA pending finalisation of the regulations**
- **Formal recognition of APAs**
- **Introduction of thin capitalisation regime**
 - **Safe harbour debt to equity ratio likely to be 3:1**
- **More resources directed to transfer pricing enforcement**

Thailand

- **Transfer pricing guidelines issued in 2002, covering APA application procedure in brief**
- **No specific provision for APAs in the legislation**
- **First two bilateral APAs signed – both with Japan**
 - **Three year duration**
 - **Strong business links between Thailand and Japan**
- **No unilateral APAs in Thailand**
- **Most audit cases settled by negotiation still**

Korea

- **Potential 10% penalty on under-reported tax**
- **Applicable to tax years commencing after 26 December 2008**
 - **Statute of limitations is 5 years**
 - **Taxpayers are subject to new rules for all open tax years including 2003**
- **Exemption from the 10% penalty is allowed where**
 - **Taxpayers documents the selection of the most reasonable transfer pricing method**
 - **Apply the chosen method to arrive at taxable income in the tax return**
 - **All relevant documents are maintained on a contemporaneous basis**
- **Increase in enforcement expected in 2009**
- **Return to tough line on tax and transfer pricing audits**

Singapore

- **TP Guidelines issued on 23 February 2006**
 - **Recommending contemporaneous documentation**
 - **Follows OECD Transfer Pricing Guidelines**
- **Further detail published in 23 February 2009**
 - **Certain services can be priced at cost plus 5% unless benchmarking is performed to suggest a different mark-up**
 - **Intra-group loans will need an arm's length interest rate - transitional period to 1 January 2011 to comply, including where necessary re-structuring of loans**
- **Transfer Pricing Consultation program started in 2008**
 - **Questionnaire-style; includes review of documentation, interviews and recommendations**
- **No TP specific penalty, no documentation requirement in legislation, no disclosure forms for related party transactions**

Q&A

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