

CHINA RELEASES LONG AWAITED TRANSFER PRICING IMPLEMENTING MEASURES

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On 8 January 2009, the China State Administration of Taxation ("**SAT**") formally released the long awaited *Special Tax Adjustment Implementing Measures (Trial)* ("**the TP Measures**"). In the past three years, the SAT has circulated several versions internally and externally for discussion and comments, including a most publicized discussion draft in March 2008.

The TP Measures are the master piece of transfer pricing regulations under China's new Enterprise Income Tax Law ("**EIT Law**"). To implement the relevant transfer pricing related provisions under the EIT Law, the TP Measures are set to take effect retroactively from 1 January 2008 together with the EIT Law. Accordingly, certain former transfer pricing regulations ("**Former Regulations**") are repealed.

With 13 chapters and 118 articles, the TP Measures cover a wide range of transfer pricing topics, including:

- Related party definition
- Annual reporting of related party transactions
- Contemporaneous documentation requirement
- Transfer pricing methods
- Transfer pricing investigation and adjustment
- Advance pricing arrangement
- Cost sharing agreement
- Controlled foreign companies
- Thin capitalization
- General anti-tax avoidance
- Corresponding adjustment and international consultation
- Legal liabilities

This alert is to share with you a summary and our observations on the related party definition, the mandatory annual reporting of related party transactions, and the mandatory annual documentation requirement, which will have an immediate impact on most Chinese taxpayers.

COMPLIANCE OBLIGATIONS UNDER THE TP MEASURES

Who should review their compliance obligations under the TP Measures?

All Chinese taxpayers with related party transactions shall review their compliance obligations under the TP Measures, including compliance with the annual reporting requirement and the annual documentation requirement.

What constitutes related parties under the TP Measures?

The related party definitions under the TP Measures begin with shareholding relationship between two parties.

- Where a third party holds 25% or more shares of the two parties, or where one party directly or indirectly holds 25% or more shares of the other, the two parties will be recognized as related.

In the case of indirect shareholding between one party and another party, where one party owns 25% or more shares in an intermediary party which in turn holds the other party, the first party's ultimate shareholding percentage in the other party should be deemed as being equal to the intermediary party's shareholding in the other party.

Other effective relationships between two parties that can trigger related parties generally include:

- Substantial borrowing or loan guarantee;
- Assignment of senior management personnel ;
- Overlap of senior management personnel;
- Dependence on the other party's industrial property rights or proprietary technology for business operation;
- Control of purchase or sale activities;
- Control of provision or acceptance of services; or
- Effective control of production, operation or transactions, or other related relationship in benefit or interest, including family relationship, kinship, or relationship where one party enjoys basically the same economic benefits as the other party's major shareholder.

Similar to the Former Regulations, as some relationships defined under the TP Measures have certain opacity, they generally require the taxpayers as well as the tax authorities to exercise appropriate judgments to determine whether a business partner is related or not.

What constitutes related party transactions under the TP Measures?

Generally, all transactions between two related parties are related party transactions. Under the TP Measures, the typical related party transactions are:

- Buy-sell, transfer and lease of goods, such as sales of products and commodity, lease of equipment and transfer of real estates;
- Transfer and license of intangibles, such as transfer or license of technology, trademark, product design, industry know how, patent and client list;
- Financing, such as borrowings, guarantees, and interest bearing prepayments and deferred payments; and
- Services, such as surveys, marketing, management consulting, technology support, maintenance, design, agency, R&D, legal and accounting services.

MANDATORY ANNUAL REPORTING REQUIREMENT

Who shall comply with the mandatory annual reporting requirement?

All Chinese taxpayers with related party transactions shall comply with the annual reporting requirement, by way of completing the provided reporting forms on annual related party transactions ("**Reporting Forms**").

What are the information to be reported?

The TP Measures, together with the Circular Guoshuifa [2008] No. 114 issued on 5 December 2008, now require all Chinese taxpayers with related party transactions to complete the following 9 Reporting Forms.

| | Title | Information required |
|---|---------------------------------------|---|
| 1 | Recognition of related parties | Identify and label related party relationship based on the related party definition |
| 2 | Summary of related party transactions | Value of related party transactions, detailed by domestic/cross-border and transaction type. |
| 3 | Buy-sell transactions | Breakdown of import/export, related/unrelated, material/goods buy-sell transactions |
| 4 | Service transactions | Breakdown of related/unrelated, domestic/cross border, provision and receipt of services |
| 5 | Intangible transactions | Breakdown of related/unrelated, domestic/cross border, license/transfer of intangibles by types |
| 6 | Fixed asset transactions | Breakdown of related/unrelated, domestic/cross border transfer of fixed assets by types |
| 7 | Financing transactions | Breakdown of related/unrelated, domestic/cross border financing |
| 8 | Offshore investment | Details of outbound investment in overseas |
| 9 | Payment summary | Breakdown of payments both related and unrelated by types |

Notably, in addition to detailed transaction amount and related party information, the Reporting Forms request for parallel information on unrelated party transactions. In case of a transfer pricing investigation, such information may lead to the establishment of internal comparable transactions. Therefore, any parallel unrelated party transactions must be carefully reviewed against the taxpayers' transfer pricing studies or policies before such unrelated party transactions are reported in the relevant forms.

What is the timeline of the mandatory annual reporting requirement?

The reporting forms shall be completed and submitted to the tax authority by 31 May after each calendar year as part of the annual income tax filing package.

What is the consequence of non-compliance?

Taxpayers may not be able to close the annual income tax filing properly without completing the reporting forms, which could lead to penalties, delay of dividend distribution and controversies. In addition, non-compliance with the annual reporting requirement may also lead to tax or transfer pricing investigations.

MANDATORY ANNUAL DOCUMENTATION REQUIREMENT

Who shall comply with the mandatory annual documentation requirement?

All Chinese taxpayers, including foreign invested enterprises, will be caught by the mandatory documentation requirement, unless they satisfy one of the following three conditions.

- A. With an annual related party buy-sell transaction value less than RMB 200 million (approximately US Dollar 28.6 million), and an annual value of other types of related party transactions less than RMB 40 million (approximately US Dollar 5.7 million).

In other words, if a Chinese taxpayer records an aggregated related party buy-sell transaction amount of more than or equal to RMB 200 million, or an aggregated amount of related party non-buy-sell transactions of more than or equal to RMB 40 million, it shall prepare documentation on the corresponding year;

- B. With related party transactions covered by an Advance Pricing Arrangement; and
- C. With a foreign shareholding ratio below 50% and only have domestic related party transactions.

For Situation A, it should be noted that:

- The aggregate transaction amount presumably should include both payment and receipt from related parties (i.e. value from both purchase and sales, provision and receipt of services shall be counted separately);
- Where a taxpayer has certain related party transactions covered by existing Advanced Pricing Arrangement or Cost Sharing Agreement, the relevant related party transaction value does not count towards the thresholds;
- For taxpayers engaged in consignment bonded processing services for related parties, the related party transaction value should be identified based on the taxpayer's material/product import/export prices reported to the customs, instead of the processing service fee; and
- For taxpayers with related party financing transactions, the relevant related party transaction value should be the aggregate amount of interest payment and collection.

What are the information required to be included in the documentation?

According to the TP Measures, documentation in general should mainly cover the following 5 sectors of information:

- *Organization structure*, including group organization structure and shareholding structure, changes of related party relationship, general information and tax treatments of related parties, etc.;
- *Production and business operation*, including company history, industry feature, group value chain, business structure, market situation, company organization structure, functions, risks, assets, and consolidated financial statements of the group, etc.;
- *Related party transactions*, including transaction specifications, changes of transactions, transaction flow, intangibles involved, execution of related agreements, and analysis of influencing factors on prices, etc.;
- *Comparable analysis*, including analysis of comparable factors, functions/risks/assets of comparable companies, features of comparable transactions, selection of comparable information, and adjustment of difference in comparable data, etc.; and
- *Election and use of transfer pricing method*, including reasons for using selected method, use of comparable data when applying the selected method, assumptions and judgement to determine comparable uncontrolled prices or profits, identification of comparable uncontrolled prices or profits, illustration of consistency with the arm's length principle.

Most of these requirements have been observed in the current common documentation practice in China. Nevertheless, it should be noticed that the TP Measures emphasize on the following key information:

- Information on related parties, including company registration, management, applicable income tax rate, and preferential tax treatments of the related parties;
- Detailed related party transaction flow, including operation steps, flow of information, goods and cash, as well as comparison with those in unrelated party transactions;

- Segmental profit and loss of the taxpayer by related party and unrelated party transactions based on reasonable revenue, cost and expense allocation; and
- Comparability of selected comparable data, and use of proper transfer pricing method.

Also, the TP Measures seem to emphasise on provision of detailed rather than general information. In practice, the attempt of including only general information in the documentation may not satisfy the tax authority. That said, it is still unclear how these content requirements will be enforced in practice. It would not be surprising that tax authorities at different localities may have different interpretations on the content requirement. Reportedly, the SAT has been drafting a model documentation for reference by taxpayers and local tax authorities.

What are the timeline and language requirement for documentation?

Taxpayers are required to complete annual documentation within 5 months after each calendar year, which is consistent with the timeline of annual EIT filing.

As 2008 is the first year of documentation requirement, the TP Measures have specifically provided a concession that extends the deadline to 31 December 2009 for preparation of the documentation for year 2008.

Taxpayers are generally not required to submit the documentation as part of the annual EIT filing package. Instead, taxpayers should keep the documentation in safe for 10 years, and submit it within 20 days upon the request of the tax authority in charge.

The documentation must be prepared in Chinese. If the documentation includes certain information originally in foreign language, a Chinese translation is also required.

What is the consequence of non-compliance?

If a taxpayer fails to provide documentation upon the tax authority's request, the tax authority may:

- Impose a fine up to RMB 50,000;
- Determine the taxable income based on a deemed taxable income; and
- Levy a late payment interest on unpaid income tax calculated at the benchmark loan rate of the People's Bank of China, plus a 5% penalty interest, starting from 1 June after the relevant calendar year in question until the payment of the taxes.

RECOMMENDED ACTIONS AND ATTENTION POINTS

In the context of the TP Measures, it is now necessary and important for taxpayers to:

- Review 2008 related party relationship to confirm compliance obligation under the TP Measures as soon as possible, and
- Formulate action plans to meet the compliance timeline.

In the process, it should be noted that:

- The related party definition, the annual reporting requirement and the annual documentation are closely related to each other;
- Consistency between related party recognition, the reporting forms and the documentation are crucial to avoid unnecessary transfer pricing controversy; and
- As the reporting forms in practice will be the starting point of most transfer pricing investigations, the preciseness and completeness of information provided therein is critical for management of transfer pricing risks.



OUR TRANSFER PRICING SERVICES

DLA Piper is a global law firm of over 60 offices around the world. We have a dedicated transfer pricing team in China, as well as in the America and Europe, that has been providing comprehensive transfer pricing services to our clients, including many world top 500 enterprises.

To assist you in facing the challenges from the TP Measures, we will be glad to have a complimentary session with you and help you identify your obligations. Our transfer pricing team may also go further and help you lay out your specific action plan with the following services at favourable and fixed fees.

- Compliance of the mandatory annual reporting requirement
- Compliance of the mandatory documentation requirement

Where appropriate and required, we are also able to provide the following comprehensive transfer pricing services in line with your global transfer pricing strategies.

- Functional/risk analysis and alignment
- Benchmarking service
- Transfer pricing risk and opportunity review
- Transfer pricing structure modelling
- Transfer pricing investigation defence
- Advanced pricing arrangement application
- Cost sharing arrangement structuring and application



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Our tax team in Asia provides international and domestic tax-efficient planning advice for all organisational models. Our tax specialists advise on the different types of tax including corporate, individual (both local and expatriate employees) income, business (applicable to certain industries) and VAT. We advise in relation to other tax-related scenarios such as withholding taxes on cross-border licensing and services, import VAT and custom duty applicable to imported items and local real property related charges.

RECOGNITION

In Asia, our tax team:

- jointly won, with DLA Phillips Fox, the International Tax Firm of the Year Award at the Asia Tax Awards 2008 hosted by *International Tax Review* (2008)
- was ranked by *Asia Pacific Legal 500 (2008/2009)* as a leading law firm in Hong Kong tax and trusts
- was short listed for the Law Firm of the Year for Tax/Trusts Deal of the Year by *Asian Legal Business* (2008)
- has partners ranked by *asialaw* as Asia's Leading Lawyers in Tax (2008)

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