# CHINA TRANSFER PRICING IMPLEMENTING MEASURES - BEYOND THE COMPLIANCE REQUIREMENTS

JANUARY 2009

In our Newsletter of 12 January 2009, we reported that the China State Administration of Taxation ("SAT") had finally released the long expected *Special Tax Adjustment Implementing Measures (Trial)* (the "TP Measures") and we reviewed specifically the annual reporting and documentation requirements introduced by the TP Measures.

In this Newsletter, we now complete the review of the TP Measures with a short discussion of the following topics:

- Transfer pricing methods;
- Investigation and adjustment;
- Advance pricing arrangement;
- Cost sharing arrangement;
- Controlled foreign companies;
- Thin capitalisation rule;
- General anti-avoidance rule;
- Corresponding adjustment and international consultation; and
- Legal liabilities.

## TRANSFER PRICING METHODS

**What is a transfer pricing method?**

Under the TP Measures, a transfer pricing method generally refers to the method used by taxpayers and the tax authority to determine the arm's length prices or assess the arm's length nature of related party pricing.

**What are the transfer pricing methods available under the TP Measures?**

The TP Measures comment specifically on five transfer pricing methods.

| Method | | Application Guideline |
|---|---|---|
| **1** | Comparable Uncontrolled Price Method | May apply to all types of related party transactions |
| **2** | Resale Price Method | Usually applies to simple processing or pure buy-sell related party transactions that do not result in substantial value add to the relevant commodities |
| **3** | Cost Plus Method | Usually applies to buy-sell/transfer/lease of goods, services and financing related party transactions |
| **4** | Transactional Net Margin Method | Usually applies to buy-sell/transfer/lease of goods, services and transfer/ license of intangibles |
| **5** | Profit Split Method | Usually applies to related party transactions where the related parties' functions/risks/contributions are highly integrated and can not be assessed separately |

Those familiar with the topic will recognise that the framework adopted by the TP Measures closely follows the guidelines of the OECD on transfer pricing. Also in line with the approach proposed by the OECD, the TP Measures allow for other methods provided it can be shown that the proposed method will adequately reflect the arm's length principle.

**How to select from the available transfer pricing methods?**

The TP Measures generally require that taxpayers use an "appropriate" transfer pricing method for their related party transactions and for the tax authority to also use an “appropriate” method in assessing related party transactions. It may well be that the “appropriate” method used by each will be different.

In addition to the application guidelines for each method, the TP Measures suggest the following compatibility factors, as between the related and the third party transactions, to assess whether a particular method is an "appropriate" transfer pricing method.

- Features of the related goods/assets or services;
- Functions and risks of the transaction parties;
- Contractual terms;
- Economic environment; and
- Business strategy.

## TRANSFER PRICING INVESTIGATION AND ADJUSTMENT

**What is the general transfer pricing investigation process under the TP Measures?**

Generally, the investigation process under the TP Measures is not significantly different from the one under the previous transfer pricing regulations. Specifically, the steps of an investigation by the tax authorities would include the following:

- Investigation target selection;
- Desktop review;
- Investigation notice;
- Investigation and consultation;
- Initial adjustment notice;
- Formal adjustment notice and tax payment; and
- Follow-up monitoring.

The difference is that there will be a lot more documentation available to the authorities early in the process as was highlighted in our 12 January Newsletter.

On investigation target selection, again not much change with candidates for review being still enterprises with any of the following features:

- Significant amount or multiple types of related party transactions;
- Long term losses or low profit;
- Profit lower than industry average;
- Unbalanced functions/risks and profits;

- Transactions with related parties in a tax heaven; and
- Absence or incomplete annul filing or annul documentation.

**What is new regarding transfer pricing investigation and adjustment under the TP Measures?**

The following should be noted:

- Submission of documentation;

  Taxpayers are allowed to take initiative and submit their documentation to the tax authority at the desktop review stage. We note that, in our experience, this stage is often crucial in avoiding full-blown investigation or consultation. If the taxpayer can then present a compelling case to defend its transfer pricing policies, it may avoid turning what is often a simple inquiry into a much more expensive and time-consuming exercise.

- Notarisation;

  Foreign documentation may be required to be notarised.

- Use of non-public comparable information;

  The tax authority is specifically authorised to use non-public comparable information ("secret comparables") to assess the arm's length nature of related party transactions.

- Inter-quartile range and median; and

  The inter-quartile range is formally introduced in the TP Measures as a method to assess taxpayers' profit level. However, the TP Measures also provide that, if the investigated taxpayer's profit level is below the median of the comparable companies, tax adjustment in principle should be applied at least based on the median.

- Post investigation monitoring period.

  The TP Measures extend the previous three-year monitoring period after a transfer pricing investigation to five years. During the monitoring period, the taxpayer is required to submit annual documentation to the tax authority on or before 20 July of the following year for each of the monitored year.

## ADVANCE PRICING ARRANGEMENT ("APA")

**What is an APA?**

An APA is a binding agreement between the taxpayer and the tax authority whereby they agree in advance, and for a fixed period, on appropriate criteria (i.e., method, comparables and appropriate adjustment, critical assumption as to future events, etc) to regulate the pricing of the related transactions of the taxpayer. Once an APA is in place, to the extent that the taxpayer meets the agreed target range of price or profit, the related party transactions of the taxpayer will be deemed to respect the arm's length principle and be free from any transfer pricing adjustment.

**Who may apply for an APA?**

An APA must be initiated by the taxpayer. The application procedure generally includes six steps: pre-filing meeting, formal application, review and assessment, consultation, signature and monitoring.

Taxpayers satisfying the following three conditions may apply for an APA:

- An annual value of related party transactions over RMB 40 million (approximately US$ 5.8 million);
- Compliance with the mandatory annual reporting requirement; and
- Compliance with the mandatory annual documentation requirement.

**Can a taxpayer file APA application on an anonymous basis?**

The TP Measures now allow taxpayers to initiate an APA application anonymously. However, anonymity cannot be maintained very long since it would be admissible only for the pre-filing meeting. As soon as a formal application is required, all information will have to reveal the relevant taxpayer.

**How many years can an APA period cover?**

The TP Measures allow for an APA to be applicable for between three to five years from the year following the submission of formal application.

Subject to the taxpayer's application and the tax authority's approval, the pricing principle and calculations agreed in the APA may also be extended to apply to related party transactions in the year of the formal application or prior years, if it can be shown that the related party transactions in those years are the same or similar to those covered in the APA.

Taxpayers may apply for renewal of an APA within ninety days of its expiration.

**What are the taxpayer's obligations during the APA period?**

During the APA period, the taxpayer is required to maintain and safe keep all of the documents (including ledgers, legal documents, etc) related to the APA. They must also submit an annual APA execution report to the tax authority within five months after each year. The tax authority will also review the taxpayer's implementation of the APA on a regular basis (usually bi-annually).

## COST SHARING ARRANGEMENT ("CSA")

**What is a CSA?**

Generally, a CSA is an agreement under which parties agree (i) to share the costs and risks of developing, producing or obtaining assets, services or rights, and (ii) to determine the nature and extent of the rights of each participant in such assets, services or rights. From tax perspective, contributions to a qualified CSA are generally considered to be a deductible expense.

**What constitutes a qualified CSA under the TP Measures?**

According to the TP Measures, a qualified CSA should respect the following basic principles:

- Participants must be entitled to the rights arising from the relevant intangibles and services as well as bear corresponding costs;
- Where comparable, a participant's share of cost must be consistent with a third party's cost for obtaining the same or similar right;
- Participants must not be required to bear a separate royalty fee for using the intangibles developed or derived from a CSA project; and
- Participants must have a reasonable and measurable expectation of the benefits derived from the CSA based on business practices and appropriate assumptions.

In addition, the following should be noted:

- A service related CSA is generally limited to group procurement and group marketing services. Application for a CSA in relation to other types of services, such as management services and IT supporting services, may not be accepted by the tax authority; and
- A CSA participant should expect a continued business operation for at least 20 years from the signature date of the CSA.

**Does a CSA require advanced application with the tax authority?**

The TP Measures do not specifically require pre-approval from the tax authority. However, the TP Measures imply that taxpayers should follow the APA application procedure for establishing a CSA. We note that taxpayers are required to file a recordal with the local tax authority and the SAT within 30 days after the signature of the CSA.

**What are the taxpayer's obligations during the CSA period?**

During the CSA period, the taxpayer must prepare specific comprehensive documentation regarding the implementation and status of the CSA. In that regard, whether or not the CSA is established through an APA application procedure, the CSA participants are required to submit the documentation to the tax authority before 20 June of the following year to any each calendar year where the CSA is in force.

## CONTROLLED FOREIGN COMPANIES ("CFC")

**What is a CFC under the TP Measures?**

A CFC is defined as a company effectively controlled by Chinese residents (including resident companies and individuals) and incorporated in a tax jurisdiction with an effective income tax rate lower than 12.5% (i.e. 50% of the prevailing rate of taxation in the PRC).

If a CFC does not distribute dividend or it reduces dividend distribution without a reasonable business need, the tax authority may collect income tax from the Chinese controlling entity on a deemed dividend basis.

**How is the deemed dividend from a CFC calculated?**

The TP Measures provide that if the CFC rule is applied, the deemed dividend will be determined as follows:

$$\text{Deemed dividend income of the Chinese resident shareholder} = \text{Deemed dividend distribution from the CFC} \times \frac{\text{Number of shareholding days}}{\text{Number of days of the CFC's tax year}} \times \text{Shareholding percentage}$$

**Is there any exception for the CFC rule?**

The TP Measures provide that income tax on deemed dividends from a CFC does not apply if the Chinese entity can establish any of the following:

- The CFC is incorporated at a "non low-tax-rate jurisdiction" identified by the SAT;
- The CFC's revenue is mainly derived from active business operations; and
- The CFC's annual profit is less than RMB 5 million (approximately US$ 714,000).

## THIN CAPITALISATION RULE

**What is the thin capitalisation rule under the TP Measures?**

A company is said to be thinly capitalised when its working capital is made up of a disproportionate amount of debt compared to its equity. In such case, the concern is that the company becomes entitled to excessive interest deduction.

The purpose of the thin capitalisation rule is then to disallow deduction of interest expenses from related party borrowings exceeding the prescribed debt-equity ratios. Specifically, the ratio is of the "liability investment" over the "equity investment" from related parties. "Liability investment" generally refers to all types of interest bearing loans, guarantees or other financing methods, while "equity investment" refers to non-interest-bearing investment in relation to ownership of the taxpayer's equity interest.

**What are the prescribed related party debt-equity ratios?**

The prescribed related party debt-equity ratios are set by Circular Cai Shui [2008] No. 121 at 5:1 for financial institutions and 2:1 for non-financial institutions.

**What is the tax consequence for exceeding the prescribed related party debt-equity ratios?**

Generally, if a taxpayer's related party debt-equity ratio exceeds the prescribed debt-equity ratios, its interest expense in relation to the excessive portion is not deductible nor eligible for carry forward for income tax purpose. In addition, the excessive interest expense to the overseas shareholders is deemed to be a dividend distribution, subject to withholding income tax (at the higher of withholding income tax rates on interest and dividends).

By way of exception, excess interest expenses may still be deductible if a taxpayer is able to evidence the arm's length nature of its liability investment from related parties by providing the mandatory annual documentation and the following information:

- Analysis of the company and company group's borrowing and repayment capacity;
- Analysis of the company group's financing structure;
- Description of the company's equity investment movement;
- Nature and purpose of related party liability investment and temporal market conditions;
- Currency, amount, interest rate, period and financing terms of the related party liability investment;
- Terms and details of collateral, guarantee and convertible bonds as relevant; and
- Interest rate and financing terms of similar contemporaneous loans.

## GENERAL ANTI-AVOIDANCE RULE

**What is the General Anti-avoidance Rule?**

The General Anti-avoidance Rule is a provision authorising the tax authority to challenge and re-construct any transaction deemed to be for avoidance of tax in China.

As provided in the TP Measures, the tax authority may initiate a general anti-avoidance investigation, if a taxpayer has any of the following behaviours:

- Abuse of preferential tax treatments;
- Abuse of tax treaties;
- Abuse of corporate structure;
- Use tax heavens for tax avoidance; and
- Any other arrangements without reasonable business purposes.

Similar to a transfer pricing investigation, the tax authority may require the taxpayer's submission of information on the relevant business arrangement.

**What is the tax implication of the General Anti-avoidance Rule?**

In a general anti-avoidance investigation, if it is determined that the taxpayer has an anti-avoidance behaviour, the tax authority may disregard the tax benefit derived from the taxpayer's relevant business arrangement. Where the taxpayer's business arrangement relates to a company without business substance, especially those incorporated in a tax heaven and designed for tax avoidance, the tax authority may disregard the existence of the company for tax purpose. In either case, the investigation may result in additional tax payable by the taxpayer.

## CORRESPONDING ADJUSTMENT AND INTERNATIONAL CONSULTATION

**What is a corresponding adjustment and international consultation?**

A corresponding adjustment is a remedy for taxpayers to eliminate double taxation from transfer pricing tax adjustments.

For example, if a Chinese taxpayer is subject to a transfer pricing tax adjustment and the relevant related party is located in a tax treaty jurisdiction, the Chinese taxpayer may apply with the SAT to start a Mutual Agreement Procedure under the relevant tax treaty for eliminating the double taxation resulting from a transfer pricing adjustment. The SAT, on the request of the taxpayer, would approach the overseas competent tax authority for consultation according to the tax treaty. In a successful corresponding adjustment procedure, the taxpayer's related party would receive a corresponding reduction in its tax payable, so that the group, as a whole, does not suffer from double taxation because of the transfer pricing adjustment.

**When and how to start a corresponding adjustment and international consultation?**

A taxpayer may submit an application to the tax authority for corresponding adjustment within three years after receipt of the transfer pricing adjustment notice. The tax authority may reject the application, if the application is filed beyond this statutory limitation.

For the application, the following should be noted:

- Where the corresponding adjustment relates to the taxpayer's overseas related parties in a tax treaty jurisdiction, the taxpayer must submit its application to the local tax authority and the SAT at the same time;
- Corresponding adjustment does not apply to additional withholding income tax (as a result of transfer pricing adjustment) on interest, rental and royalty; and
- Corresponding adjustment does not apply to transfer pricing adjustments based on the thin capitalisation rule.

## LEGAL LIABILITIES

As discussed in our previous newsletter on the TP Measures:

- If a taxpayer fails to comply with the annual reporting requirement or fails to prepare the annual documentation within the prescribed timeline, the tax authority may impose a penalty of up to RMB 10,000;
- If a taxpayer refuses to provide the annual documentation or provides false or incomplete information, the tax authority may impose a penalty of up to RMB 50,000. Meanwhile, the tax authority will be entitled to determine the taxpayer's taxable income on a deemed basis; and
- If a tax adjustment is made, the tax authority may also levy a late payment interest on the short payment of tax, which is to be calculated at the benchmark loan interest rate of the People's Bank of China. In addition, the tax authority may also impose a 5% penalty interest rate on top of the benchmarking loan interest rate, if the taxpayer fails to provide the annual documentation or other relevant documents requested in the investigation. The late payment interest and penalty interest levied are not deductible for income tax purpose.

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## CONTACT

For further information about the contents of this publication, please contact:


**Daniel Chan**
Partner
China Corporate and Tax
**T:** +852 2103 0821
**E:** daniel.chan@dlapiper.com

**Patrice Marceau**
Partner
Hong Kong and Regional Taxation
**T:** +852 2103 0054
**E:** patrice.marceau@dlapiper.com

**Peng Tao**
Of Counsel
**T:** +1 212 335 4932
**E:** peng.tao@dlapiper.com

**Windson Li**
Transfer Pricing Specialist
Senior China Tax Consultant
**T:** +86 10 6561 1788 ext. 884
**E:** windson.li@dlapiper.com


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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)