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China's evolving transfer pricing regime and its implications for multinationals

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At rapid pace, China becomes the manufacturing hub of the world economy. It integrates itself in the global supply chains as a low-cost sourcing market. Meanwhile, market liberalization driven by WTO regulations has been pulling service and R&D activities onto the mainland platform. As a consequence, inter-company transactions between operations in China and their associates in- and outland are growing rapidly, which creates numerous chances and challenges in respect of transfer pricing ("TP").

Given the shortage in regulatory competence and resources, and due to the policy emphasis on attracting foreign investment and technology, Chinese tax authority has been inactive in enforcing TP until recently. The situation is changing fast in recent years. The expecting phase-out of investment-specific tax incentives and increased interest to defend its tax revenue base have prompted the State Administration of Taxation ("SAT") to engage a more proactive strategy towards TP. Chinese tax authority enlists TP as the primary choice of multinationals to avoid tax. Dedicatedly, the SAT churns out TP-related regulations and rules following the model of internationally recognized practices. Anti-avoidance actions focusing on TP are being taken in a more strengthened and coordinative manner.

This issue of **CHINA***journal* aims to give a brief review on China's evolving TP regime and assess its implication on the multinationals' China TP strategy.

Regulatory framework

Both corporate income tax laws that are applicable to foreign investment enterprises ("FIE") and foreign enterprises[1] ("FE") and those applicable to the domestic enterprises[2] have touched the TP topic and provided for the first time in history the general principles on TP transactions among associated parties. Although the loosely defined principles in these laws and regulations earmarked the birth of China's TP system, they remained largely in principle on paper and were hardly put into action due to the lack of implementing regulations.

China's TP master guide took shape in 1998 when the SAT issued Guoshuifa (1998) No. 59[3] ("Circular 59"), which sets out in details the groundwork for defining associated parties and transactions, selecting audit targets, conducting audit and applying TP adjustments. Circular 59 is the most comprehensive TP guideline in China. It follows international concepts and keeps consistent with the principles expounded in the revised *OECD Transfer Pricing Guidelines*. Circular 59 was supplemented and interpreted by a further SAT circular in 2004 – Guoshuifa (2004) No. 143[4] ("Circular 143").

[1] *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investments and Foreign Enterprises*, promulgated by the National People's Congress on April 9, 1991 and effective as of July 1, 1991, as well as its implementing rules promulgated by the State Council on June 30, 1991 and effective as of July 1, 1991 ("**Foreign EITL**").
[2] *Interim Provisions on Enterprise Income Tax*, promulgated by the State Council on December 13, 1993 and effective as of January 1, 1994 and its implementing rules promulgated by the Ministry of Finance on February 4, 1994 and effective as of January 1, 1994.
[3] *Tax Administration Rules and Procedures for Transactions between Associated Enterprises*, promulgated by the SAT on April 23, 1998 and effective as of the same date.
[4] Promulgated by the SAT on October 22, 2004 and effective as of the same date.

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Furthermore, for the sake of bolstering its nascent TP regime, the SAT has relentlessly produced numerous TP-related rulings addressing various issues such as taxation on services provided by holding companies to subsidiaries[5], advance pricing arrangement ("APA")[6], mutual agreement procedure ("MAP")[7], cost sharing arrangement ("CSA")[8] and capital intensity adjustment[9] etc. The issuance of these rulings indicates that the SAT keeps on updating itself to the increasing complication of TP practices in China and it determines to tackle tax-avoidance by coordination with tax payers, regional tax bureaus and home country tax authorities of multinationals.

In short, China's TP regime for multinationals is mainly built upon the Foreign EITL, Circular 59 and 143 and respective SAT rulings.

Criteria, procedure and methodology

Arm's length standard

Following suits after the OECD Transfer Pricing Guidelines, Chinese law respects the arm's length principle in administering TP, which requests that a transfer price should be the same as if the transacting parties were indeed two independents, not part of the same corporate structure. In fact, all the TP criteria and methodologies are unfolded with the arm's length principle as the most inner core.

Related parties

As only transactions among "related parties" are subject to TP administration, it is crucial to perceive the denotation of "related parties" under Chinese law. We do not intend to quote the lengthy legal definition on related parties[10]. It is well worth noting that Chinese definition of related parties are literally wider in scope than OECD's definition.

[5] Guoshuifa (2002) No. 128.
[6] Guishuifa (2004) No. 118.
[7] Guoshufa (2005) No. 115.
[8] A private ruling in summer 2004.
[9] Guoshuihan (2005) No. 745.
[10] Article 52, the implementing rules of Foreign EITL; article 4, Circular 59 and 143.

A direct or indirect 25% ownership would render enterprises as related parties under Chinese law, while that threshold suggested by the OECD guidelines is 50%. Considering that China's FDI regime in principle requests at least 25% foreign equity investment in a China-venture, such definition basically enlists all FIEs[11] under TP administration. Furthermore, China would deem enterprises are related in the evidence of effective control (due to the factors such as the composition of board, supply of key components, provision of technology and distribution channels etc.), even if no legal ownership among them exists. As such, multinationals may face a more extensive TP administration in China because enterprises are more easily captured as related parties than in other jurisdictions.

Related parties are obligated to file in their annual tax return reports to disclose the details of transaction among them.

TP audit procedure

TP audit consists of selection of targets, desk audit and field audit, price information investigation, evidence collection, applying adjustment methods, determination of TP adjustment and corresponding adjustment, reconsideration and litigation etc.

Enterprises that are most likely to trigger TP audit attention are those suffering continuous losses, incurring low proceeds or losses while continuously expanding their business, presenting an irregular profit or loss pattern, conducting transactions with enterprises located in tax heavens and reporting under-average margin in a given industry or region etc. In particular, the SAT has identified nationwide transfer pricing audit as en effective and efficient strategy. Therefore, high-profile multinationals with spreading subsidiaries across the country are exposed to a higher risk of being selected as audit targets. It is essential to manage such nationwide audit in a coordinative manner to ensure that consistent information should be delivered to the local tax bureaus so as to avoid unnecessary complications.

[11] Although enterprises with less-than-25% foreign equity do exist, such enterprises are not treated as FIEs in the legal sense.

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TP audits are conducted by means of "desk audit" based upon financial and operational data provided by the target company, and/or by "field audit" carried out at the target company's premise. Upon written requests of tax authorities, target companies should provide information on the facts relating to transactions with related parties and the pricing principles and compositions. Target companies have only 60 days to respond. The deadline could be extended for further 30 days subject to approval. Considering this rather short grace period and the comprehensiveness of requested information, Circular 59 and 143 effectually impose a contemporaneous documentation requirement despite this is not explicitly stipulated. The tax auditor should complete a TP audit within 3 years of the issuance of audit notice, with a possible extension up to 5 years.

Notably, the burden of proof lies on the target company to establish the normality and reasonableness of TP in question. Proper submission and presentation of evidence and defence during the audit process is vital for obtaining the optimal TP audit result.

Methodology

TP adjustment methods available to Chinese taxation authorities are essentially in line with the OECD guidelines, namely the comparable uncontrolled price method, resale price method and cost plus method. When these three basic methods are not applicable, alternative methods, such as transactional net margin method, profit split method and net profit method, will be applied. The SAT acknowledges that the three basic methods premise on thorough analysis of comparables that are very hard to find if not impossible.

In the absence of a reliable public company database in China, tax authorities have the tendency to resort to easily available information as possible benchmarks. Thus, statistics fed by the Customs, banks, commercial registries, FIE approval agencies, finance authorities, foreign exchange administration etc. are all eligible sources. Local tax authorities are encouraged to collect information and build database for their respective jurisdictions and share them with tax authorities in other regions. Comparables therein are in many cases secret and the access to them is only limited to in-charge tax authorities. Multinationals should be aware that the benchmark studies they prepare in the home countries might not be favoured by the Chinese tax authorities. Benchmark exercises involving China elements should consider using tailored database that is unique to China.

Resolution of TP disputes

If non-arms' length TP were identified, tax authorities would impose adjustments. TP adjustments are normally prospective. Adjustments could also be made retrospectively back to 3 years, in exceptional cases with maximum period back to 10 years. An audited company that is in disagreement with the imposed adjustment could appeal to a higher level of tax authority for review. If still not satisfied, the audited company could lodge suit with the People's court. However, due to limited judiciary avenue, litigation in practice is not an optimal solution for TP disputes. In-stage resolution during the TP audits remains to be the most-opted approach.

Advance pricing arrangement (APA)

China officially endorsed APA concept in Circular 59, although the final implementing rules were only released in 2004[12]. An APA is a legal agreement between the taxpayers and tax authorities that confirms appropriate TP methodologies, in advance, and their application to specific cross-border or intra-China non-arm's length transactions or arrangements for specified periods of time. An APA serves to resolve actual or potential TP disputes in a pre-ruled and cooperative manner, as an alternative to the traditional TP audit and defence process. Tax authorities benefit from APAs in that the audit resources and efforts could be largely reduced. Taxpayers benefit from APAs because of the certainty ensured, which essentially mitigates double tax risk.

A China APA process involves six major phases, namely the pre-filing negotiation, formal application, review and evaluation, formal negotiation, entering into APA and execution and

[12] Supra footnote 6.

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monitoring. APA in-charging authorities are above-county level tax bureaus. For those APA processes that involve related parties across three or more provinces, inter-company transactions with annual volume exceeding around USD 1.25 million or bilateral or multilateral APAs, the SAT must be involved. The term of an APA may range from 2 to 4 years starting from the year after formal application, meaning a taxpayer who has signed an APA would be protected from TP audit for 3 to 5 years provided that it properly adheres to the arrangement.

China has completed some 300 unilateral APAs since inauguration of the system. The first bilateral APA was signed in 2004 with Japan. Multinationals, in particular those who hold a history TP audits or have controversial related-party transactions, may consider to negotiate APAs with Chinese tax authorities to curtail potential TP risk.

Conclusion

The deregulation and liberalization in the aftermaths of WTO access has created new arena of tax planning and TP exercise in China. One of the recent developments in this aspect is the introduction of distribution FIEs, which could carry out import, export, wholesaling and retailing businesses within a single entity. This envisages a scenario where production sales of various ventures of multinationals in China could be consolidated through a common vehicle. Through properly placed TP planning, such consolidation has the potential to cut down the enterprise income tax and business tax. Cost sharing arrangement[13] presents another example.

At the meantime, the tax authorities are catching up with dedicated efforts. Regulatory and practical expertises are being built up rapidly. TP administration becomes more and more coordinative, sophisticated and streamlined. Multinationals should take proactive approach to revisit their TP strategies in relation to China so as to explore the potentials and minimize the risks.

[13] Please refer to the discussion on cost sharing arrangement in our September 2005 issue of **CHINA***journal*.

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