CHINA UPDATES – DRAFT TRANSFER PRICING RULES

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A set of administrative measures for transfer pricing documentation ("Contemporaneous Documentation Requirements") has been drafted and may be launched soon after long deliberation of the PRC authorities. The Documentation Requirements will have a retroactive effect from 1 January 2008. The requirements will certainly put compliance burden on PRC taxpayers, especially for those who are involved in related party transactions in significant amount.

TP Documentation Requirements

The draft regulations are drawn largely based on OECD Transfer Pricing Guidelines. Under the regulations the definition of a related party is not limited to shareholding or controlling relationship but has been broadened to include suppliers, creditors, licensors and service providers, etc.

1. Annual Filing of Related Party Transactions

Enterprises involved in related party transactions will be required to submit the following reports annually when filing annual tax returns to PRC tax authorities:

i) Relationship with related parties;
ii) Transaction summary;
iii) Purchasing;
iv) Services;
v) Financing;
vi) Asset transfer;
vii) Thin capitalization;
viii) Payment to overseas parties;
ix) Overseas investment; and
x) Controlled foreign companies.

2. Contemporaneous Documentation

Enterprises will be required to prepare and maintain contemporaneous documents regarding related party transactions for each taxable year unless they satisfy the exemption conditions. The contemporaneous documentation is not required to be submitted to PRC tax authorities in support of the annual tax return but it should be submitted within 15 days upon request by the PRC tax authorities. The contemporaneous documentation is expected to include the following information:

i) Global organizational structure, including the effective tax rates of the related parties;
ii) Details of business operations;
iii) Details of related party transactions;
iv) Comparability analysis;
v) Selection and application of transfer pricing method, including reasons why other transfer pricing methods are rejected; and
vi) Other relevant documents.

For enterprises with annual related party transaction amounts from RMB 20 million to 100 million, they will only be required to submit a simplified version of documentation which is expected to contain the following information:

i) Organizational structure;
ii) Pricing policy;
iii) Functional and risk analysis;
iv) Details of major related party transactions;
v) Basis of section of transfer pricing methodology and comparable information; and
vi) Factors affecting the arm's length prices and profits.

Exemption will apply if one of the following conditions is satisfied:

i) the annual related party amount is lower than RMB 20 million;
ii) the transaction is covered under the advanced pricing agreement; or
iii) the taxpayer only has related party transactions with domestic related parties.

Non-compliance Drawback

Transfer pricing adjustments made by tax authorities will be subject to interest and is charged on daily basis. For taxpayers who have not prepared and maintained contemporaneous documentation, there will be a 5% top-up charge in addition to the interest rate levied on transfer pricing adjustments.

Strategy

PRC tax regulations are complex and subject to rapid changes. Time is running out, in particular, the draft regulations will have retroactive effect. By the time when the regulations are formally promulgated, it may already be too late for taxpayers to have the contemporaneous documentation available. If the final regulations will stay as it is now in the draft, taxpayers are expected to have the contemporaneous documentation ready the latest by **1 June 2009** and they will have to submit the documents within 15 days unless they have obtained extension approval.

By taking a proactive approach, taxpayers can avoid unwelcome surprises and be well prepared for a transfer pricing audit. Taxpayers, especially those who are involved in related party transactions and the relevant transaction is of significant volume/amount, are recommended to conduct a transfer pricing review as soon as possible and be well prepared to meet the contemporaneous documentation requirements, which may be launched very soon.

A transfer pricing review provides an overall assessment of whether the inter-company transactions will be considered arm's length in case of a transfer pricing audit. The objective of a transfer pricing review is to ensure that the inter-company transactions reflect the internal economic realities of its business and conform to arm's length standard under the prevailing PRC transfer pricing regulations and international transfer pricing principles.

Please do not hesitate to contact your usual business contacts in Mazars if you have any questions on this topic.

T002-OCT08

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