

Administrative Regulations on Special Tax Adjustments in China – What You Should Know



January 2009

It has been over 9 months since the State Administration of Taxation (“SAT”) issued the draft Administrative Regulation on Special Tax Adjustments for accounting practitioners’ comments. The final version has recently been released under a tax notice *GuoShuiFa (2009) No.2* (“the Notice”).

When compared with the draft version, some of the core contents of the Notice are modified. This article attempts to provide you with some core information of the Notice which you should be aware of when planning the transfer pricing strategies in China.

1. Effective Date and Deadlines

The Notice is effective retrospectively from 1 January 2008, therefore enterprises are required to comply with the transfer pricing requirements for year 2008 onward.

For tax year 2008, it is important to bear in mind of the following two deadlines.

First of all, according to *GuoShuiFa (2008) No 114*, enterprises are required to submit various related party transactions declaration forms together with their annual Enterprise Income Tax (“EIT”) returns on or before **31 May 2009**.

Secondly, enterprises are required to prepare and maintain the transfer pricing contemporaneous documents for related party transactions on or before 31 May of the following year. However, special extension is granted for the first year of execution, and accordingly the deadline for enterprises to prepare the contemporaneous documents for year 2008 is extended to **31 December 2009**.

2. Definition of Related Party Relationship

The Notice lists out eight main categories of related party relationship. While the common criterion is on the percentage of shareholding (i.e. holding more than 25% shareholding, either directly or indirectly), the SAT will also look into other factors to determine the existence of related party relationship, like financing, common management, major suppliers and customers, family relationships etc.

3. Related Party Transactions

Focus is on four types of related party transactions:

- The purchase and sale, transfer and use of tangible assets
- The transfer and use of intangible assets
- Financing
- Provision of labour services

4. Annual Declaration of Related Party Transactions

As mentioned in Section 1 above, enterprises are required to submit the annual related party transactions forms on 31 May every year together with the annual EIT returns. The forms are quite complicated. Enterprises are requested to provide very detailed related parties information.

In summary enterprises are required to complete the following nine forms:

- Form 1: Related Party Relationships
- Form 2: Summary of Related Party Transactions
- Form 3: Sales and Purchases
- Form 4: Provision of Labour Services
- Form 5: Intangible Assets
- Form 6: Fixed Assets
- Form 7: Financing
- Form 8: Outbound Investments Status
- Form 9: Outbound Payment Status

5. Administration of Transfer Pricing Contemporaneous Documents

Perhaps this is the part that most enterprises doing businesses in China are concern about.

According to the Notice, enterprises should prepare, maintain and submit (upon tax bureaus' request) the transfer pricing contemporaneous documents for each year after 2008. These documents should be maintained for 10 years. Upon tax bureaus' request, enterprises are required to submit the documents within 20 days.

Transfer pricing contemporaneous documents include the following five broad categories:

- Organization structure
- Status of business operations
- Status of related party transactions
- Comparable analysis
- Selection and application of transfer pricing methods

The above documents have to be prepared in Chinese.

However, not all enterprises doing business in China are required to prepare and maintain the above transfer pricing contemporaneous documents. An enterprise is exempt from the transfer

pricing contemporaneous documents requirements if it meets one of the following conditions:

- Its annual related party sales and purchases transactions (i.e. tangible assets) is below RMB200 million, and all other related party transactions (i.e. services, interests, royalties etc) is below RMB40 million
- The related party transactions are covered by an Advanced Pricing Arrangement (“APA”)
- The foreign shareholding is less than 50% and the enterprise only has related party transactions with Chinese related parties

The above conditions enable enterprises with limited related party transactions to be exempt from the transfer pricing contemporaneous documents requirements, which is complicated and time consuming. The exemption threshold is now much relaxed, since based on the draft consultation paper exemption will only be granted to enterprises with annual related party transactions amounted to below RMB20 million.

6. Transfer Pricing Methods

According to the Notice, SAT recognizes the following six methods, which are generally in line with international practice:

- Comparable uncontrolled price method
- Resale price method
- Cost plus method
- Transactional net margin method
- Profit split method
- Other methods that comply with the arm’s length principle

The Notice also stipulates the following factors enterprises should consider when selecting the most appropriate transfer pricing method:

- Characteristics of the assets or the services involved
- Functions and risks of each involved related parties
- Contract terms
- Economic conditions
- Business strategies

The Notice does not indicate which method is mostly preferred, therefore it gives enterprises flexibility to choose the most appropriate method to present their case. Of course, enterprises need to justify the appropriateness of choosing a particular transfer pricing method and the rationale may be subject to tax authorities’ challenge.

7. Transfer Pricing Investigations and Adjustments

An enterprise with one or more of the following characteristics will be classified as target enterprise for transfer pricing investigations:

- Various types of related party transactions or with significant amount of related party transactions
- Suffer from long term losses, low profit or having a fluctuating profit pattern
- Its profit level is lower than industry average
- Its profit level is obviously not in line with its functions performed and risks associated

- Transacts with related parties registered in tax heaven
- Fails to declare related party transactions or prepare transfer pricing contemporaneous documents
- Transactions are obviously not in accordance with the arm's length principle

The Notice indicates that, in principle, domestic related party transactions will not be subject to transfer pricing adjustments, provided that the related domestic enterprises are subject to the same effective tax burden and such transactions will not directly or indirectly reduce China's overall tax revenue.

Effective 1 January 2008, the unified EIT rate across China is at 25%, so it is anticipated that most of the domestic enterprises will be subject to the same EIT rate and hence the related party transactions between these domestic related enterprises would be immune from transfer pricing adjustments. Of course, related party transactions with domestic related enterprises with lower effective EIT rates (e.g. with enterprises located in Shenzhen or with high / new technology enterprises) may still be exposed to transfer pricing adjustments.

The Notice contains some provisions which may pose difficulties to enterprises:

- When conducting transfer pricing investigations, tax authorities can use both public and non-public information
- SAT expects that enterprises with relatively simple manufacturing functions (e.g. contract processing, toll processing etc) should in general maintain a certain profit level, even in the cases that foreign related parties are making losses
- SAT uses inter-quartile range to assess the profit level of enterprises. However, unlike international practice (which the 25th to 75th quartile range is considered as the "arm's length range"), the Notice indicates that the acceptable "arm's length range" is from median to 75th quartile. Therefore enterprises with profits below the median will still be subject to transfer pricing adjustments to the value at least equal to median

In case an enterprise is subject to transfer pricing adjustments, tax authorities will impose a 5-year supervision period. The enterprise is required to submit transfer pricing contemporaneous documents to the tax authorities before 20 June of each year following the years during the 5-year supervision period.

If transfer pricing adjustments occur, daily late payment interest will be imposed on the associated additional tax. The interest charging period counts from 1 June of the following year until the additional tax is settled.

The interest rate is calculated based on the basic RMB lending rate published on 31 December (of the relevant tax year) by the People's Bank of China, plus a 5% additional interest. If an enterprise is able to provide the transfer pricing contemporaneous documents according to the regulations, the 5% additional interest can be waived.

8. Advanced Pricing Arrangements (“APA”)

According to the Notice, APA is generally applicable to enterprises with all of the following characteristics:

- Annual related party transactions above RMB40 million;
- Comply with the related party disclosure requirements; and
- Fulfill the obligations of the preparation and the maintenance of transfer pricing contemporaneous documents.

In general APA applies to the related party transactions for 3 to 5 consecutive years after the year the formal APA application is filed.

The Notice indicates that as long as an enterprise complies with the terms and requirements set forth in the APA, this APA should be recognized by both state and local tax bureaus across China.

The Notice also contains provisions protecting the information provided by APA applicants. It stipulates that in case an APA cannot be reached, tax authorities cannot use the non-factual information gathered during the APA process for future tax investigations.

Conclusion

The Notice signifies China’s attempts to raise its transfer pricing policies to match with the international standards. It is no doubt that the issuance of the Notice poses new challenges to enterprises doing business in China, especially we are still in the midst of the global financial tsunami.

Taxpayers should understand China’s transfer pricing regulations and formulate the appropriate tax and transfer pricing strategies with a view to minimize the transfer pricing risks.

The deadline for the preparation of transfer pricing contemporaneous documents for year 2008 extends to 31 December 2009, while the deadline for year 2009 will be on 31 May 2010. With such close deadlines for 2008 and 2009, enterprises should consider reviewing the transfer pricing issues and preparing the contemporaneous documents for 2008 and 2009 at the same time.

Mazars can assist you in the following services:

- Assessing enterprises’ transfer pricing risks in China
- Preparing the transfer pricing contemporaneous documents
- Helping enterprises to deal with transfer pricing investigations

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