



Transfer pricing in China

It's time for companies to prepare for the administrative ruling of special taxation adjustment

For the first time, China has formalized a transfer pricing mechanism under the new China corporate income tax law that took effect on 1 January this year. The law, along with a detailed implementation ruling, outlines transfer pricing arrangements in chapter six – special taxation adjustment – but taxpayers in China are still seeking clarification and guidance on many practical issues.

To address taxpayers' concerns, the State Administration of Taxation

issued a draft of the administrative ruling of special taxation adjustment on 20 March 2008. The draft ruling, released as a trial version for discussion, sends a clear signal that China will continue to focus on transfer pricing enforcement.

Although the final ruling may be revised, the material aspects of the draft ruling should remain intact, and taxpayers should start planning accordingly. Consisting of 13 chapters, the document links to the special

taxation adjustment chapter of the income tax law but also summarizes China's previous transfer pricing regulations.

Contemporaneous documentation

The requirement for contemporaneous documentation is probably the reason why many transfer pricing practitioners in China tend to call the ruling a "documentation ruling." It is now a legal obligation, rather than a voluntary



action. The draft ruling, however, provides *di minimis* (the minimal level below which there will be legal exemption) and two documentation thresholds – all based on the volume of related party transactions:

- Exemption: annual aggregated related party transactions of 20 million yuan as the *di minimis* or mere domestic (mainland China) related party transactions
- Simplified documentation: annual aggregated related party transactions between 20 million yuan and 100 million yuan
- Standard documentation: annual aggregated related party transactions of more than 100 million yuan

Simplified documentation requires standard items such as:

- Organizational structure

- Pricing policy, market condition and profit sharing information
- Functional analysis
- Related party transactions analysis
- Selection of transfer pricing method
- Comparable analysis
- Other factors affecting the arm's length price/profit

In contrast, standard documentation goes beyond the “standard items” to include a considerable amount of overseas information such as the group's global structure, resale prices and profit allocation of the whole supply chain of the related transactions. Such information is by nature sensitive and is not easily accessible by the local entity.

Once finalized, the new transfer pricing ruling will take effect retroactively from 1 January 2008. The legal deadline for completing documentation of fiscal year 2008, which must be in Chinese and be kept in-house, then becomes 30 May 2009. The papers must be submitted to tax authorities within 15 days upon request.

The draft ruling also introduces a set of transfer pricing filing forms applicable to all taxpayers, which must be submitted during the annual income tax filing. These forms include a list of related parties, related party transaction volumes (under each single transaction type), outbound investment, thin capitalization and controlled foreign corporation. Taxpayers are required to indicate in the transfer pricing filing package whether they have duly completed the relevant documentation.

Practitioners are speculating that the *di minimis* rule may be changed, but in the meantime, documentation and disclosure have become legally

obligatory for entities with significant cross-border related party transactions.

Transfer pricing audit and tax adjustment

China's tax authorities now have a more standardized approach for transfer pricing investigation and audit under the draft ruling. Taxpayers should note the following points:

- Transactions with domestic affiliates with the same effective income tax rate may not be chosen for transfer pricing audit.
- A number of standardized forms will be used in transfer pricing audit, including functional and risk checklists, segmented income statement for related and unrelated businesses, and entity characterization.
- Failure by taxpayers to prepare contemporaneous documentation could result in a transfer pricing audit.
- Tax authorities could use “deemed profit adjustment” (that is, mandate the arm's length profitability of a taxpayer) should the taxpayer fail to provide accurate and complete transfer pricing information when requested.
- The post-audit monitoring period has been extended to five years from three years.
- Should the audited entity's profitability fall below the median of the range established by comparables, the profitability should be adjusted to a level no lower than the median. This is very different from the international norm that the arm's length range extends from lower quartile to higher quartile, not from the median.

The threshold of documentation requirement should not be confused with that of a transfer pricing audit.

Transfer pricing

There is no minimum level for transfer pricing audits, which have been on the rise in the past few years. The trend will likely continue with the advent of the new corporate income tax law and the transfer pricing ruling.

China's tax authorities are becoming more sophisticated when handling transfer pricing audits. Besides tangible transactions, they are also targeting intangible transactions, like royalty and licensing, services and inter-company financing.

Tax adjustment resulting from transfer pricing audit is now subject to interest plus an additional penalty of 5 percent. The penalty, however, can be waived if the audited entity prepares contemporaneous documentation. This means even in the worse case scenario, when a taxpayer is transfer pricing audited and adjusted for income tax, well-prepared documentation will still reduce the company's cash flow loss.

The draft also expands the definition of related party, stipulates the qualifications for applying for advanced pricing arrangement and introduces some pioneering concepts such as cost contribution agreement, controlled foreign corporation and thin capitalization. We can expect more practical cases on these items once the final ruling is out.

Immediate implication for taxpayers

The recent updates to tax and transfer pricing laws means the rules have become more stringent and regulated. Although it is never too late to start diagnosing the transfer pricing system, taxpayers should start the exercise soon to avoid possible financial and administrative troubles.

For a newly established entity or a new business line, devising a do-able transfer pricing policy should be a top priority. With the transfer pricing



ruling in the pipeline, consulting external advisors and preparing transfer pricing studies can help new entities maintain a solid and arm's length mechanism from day one, while at the same time preparing for future compliance requirements.

Entities with significant amounts of related party transactions are advised to prepare transfer pricing documents appropriately and contemporaneously. For groups with a large number of subsidiaries in China, compliance can be even more time-consuming and burdensome, so they should immediately seek professional advice on the best documentation strategy.

Those with related party transaction volumes below the threshold are exempted from the legal documentation obligation. However, the following entities are advised to start their risk evaluations right away:

- Companies with recurring losses, especially when under contractual

relationships with related parties, such as contract manufacturers and service providers

- Companies with fluctuating profits, especially those with consecutive profit drops in recent years
- Companies with substantially different profitabilities on third party and related party transactions
- Companies that have transactions with domestic affiliates whose effective tax rates are different
- Companies whose profits drop upon expiry of tax holidays

Entities might want to prepare documentation immediately or plan at once if the evaluation shows a certain level of China transfer pricing exposure. This will help them prepare proper transfer pricing policies.

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