

China's transfer pricing system

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Introduction

- With the integration of China's economy into the world, more and more MNEs have entered into the Chinese market.
- At the same time, outbound investments by Chinese domestic company have been exponentially growing.
- Consequently, transfer pricing has been becoming a more and more pressing issue for Chinese tax authority.



Outline

- The development of China's transfer pricing legal framework ▶
- The development of China's transfer pricing practice ▶
- Special considerations on Chinese factors ▶
- Development trend of China's transfer pricing system ▶



The development of China's transfer pricing legal system

- On July 1 1991, the Income Tax Law for Foreign Investment Enterprises and Foreign Enterprises (known as “the FEIT Law”) and its implementing rules came into force.
- FEIT law adopts arm's length principle as the basis for china's transfer pricing system and tax authorities are authorized to adjusted a Foreign Investment Enterprise and Foreign Enterprise's taxable income where it has been reduced as a result of non-arm's length prices.



The development of China's transfer pricing legal system

- In 2007, China promulgated Corporate Income Tax law (“CIT”) and its implementing rules ,which have been in force since Jan 1, 2008.
- The new CIT merges the Enterprise Income Tax Law (which previously applied to domestic enterprises) and the Foreign Enterprise Income Tax Law (which previously applied to foreign enterprises).



The development of China's transfer pricing legal system

- In the new CIT law and its implementation rule, Chapter 6 “special tax adjustment” is aimed at regulating transfer pricing issues.



The cornerstone of “special tax adjustment” Chapter

- **Arm’s length principle**
- The CIT Law provides the arm’s length principle standard as the guiding principle for related party transactions, and empowers the tax authority to adjust a taxpayer’s taxable income if the taxpayers fails to comply with the arm’s length principle in dealing with related parties.

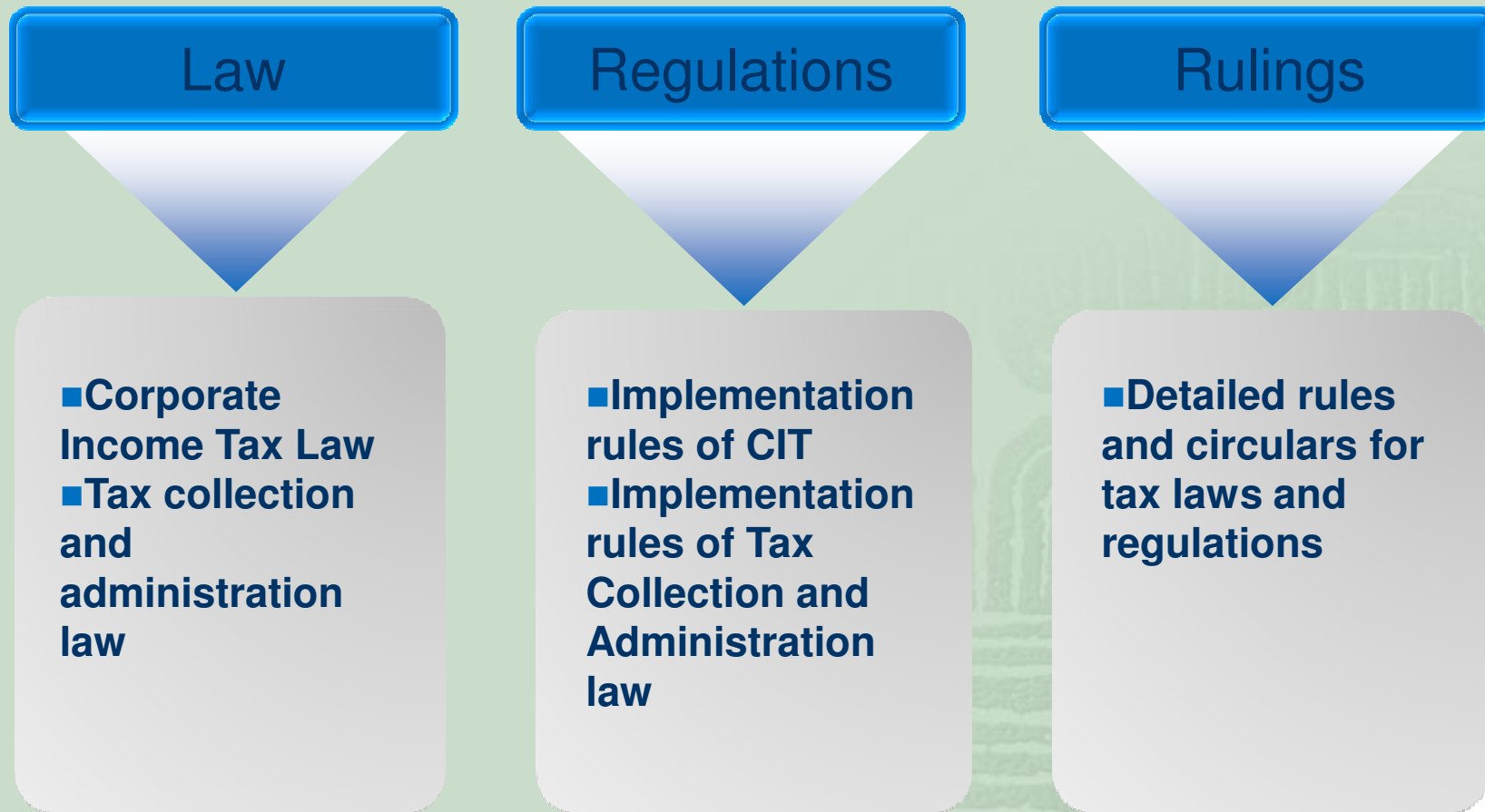


The scope of “Special Tax Adjustment ”chapter

- Transfer pricing
- Advance pricing agreement
- Cost sharing arrangement
- Annual disclosure of related transactions and contemporaneous documentation
- Controlled foreign enterprises
- Thin capitalization
- General tax avoidance
- Special interest Levy



The current legal framework



The development of China's transfer pricing practice

- The first case was initiated in 1986
- In the early years, transfer pricing audits are mainly focused on transfer of tangible good.
- In recent years, audit targets have been broadened with transfer of intangible good, services, equity shares as well as tangible goods.



Practical guidance for transfer pricing auditors

- Circular Guoshuifa [2009] No 2, “The implementation measures of Special Taxation Adjustment”, which is a detailed transfer pricing audit directive.



Investigation cases closed in recent years

	2006	2007	2008	2009	2010	2011
Number of adjustments	177	174	152	167	178	207
Average adjustment (RMB millions)	3.84	5.75	8.16	12.51	14.5	11.8
Approximate total adjustment (RMB millions)	458	680	1,000	1,240	2,089	2,581

APA annual report

- In December 2010, SAT issued the first ever annual report on APA in China for 2009, which initiated China's annual APA reporting system.



Number of APA Signed in recent years

Year	Unilateral APAs	Bilateral APAs	Multilateral APAs	Total
2005	13	1	0	14
2006	10	0	0	10
2007	7	3	0	10
2008	6	1	0	7
2009	5	7	0	12
2010	4	4	0	8
Total	45	16	0	61

The creation of “three in one ” anti-tax avoidance system

- In order to optimize the limited transfer pricing audit resources and achieved the goal of “both prevention and investigation”, SAT created a “three in one” anti-avoidance administrative system which includes administration, service and investigation.



Administration

- Rely on mechanism such as mandatory related-party transaction reporting, examination of contemporaneous documentation and follow-up measures to encourage taxpayer to perform a self-examination and self-correction of their transfer pricing policies.
- In order to minimize transfer pricing risks from the beginning.



Service

- APA: provide certainty for taxpayers on its transfer pricing policy
- Map: create a channel for taxpayer to resolve disputes and minimize the risk of double taxation



Investigation

- Strengthening investigation on MNS with huge amount of related transactions and unreasonable transfer pricing policies
- Joint investigation



Standardized working procedure

- In order to run the transfer pricing administration in a more efficient and effective manner and with a high degree of consistency and transparency, all transfer pricing cases must be reported to the SAT for final review and assessment after they have been examined by different tax authorities at various levels.



The weakness in applying OECD guideline

- Difficult to find perfect comparables due to the limited amount of Chinese listed companies in china and lack of information sharing mechanism among different administration authorities and different regions.
- Difficult to make reasonable adjustment between Chinese companies and comparables located overseas.



The ways to overcome the weakness

- Besides searching for desirable comparable for tested party, we tend to analyze the profit of the tested party in the context of whole supply chain.
- By doing so, we want to rationalize the appropriateness of allocation of Chinese company's profit in the whole supply chain of MNEs, unaffected by their related position.



The ways to overcome the weakness

- Therefore, we need to focus on the value drives with unique Chinese characteristics which contributes to the residual profit of the whole supply chain.



Special consideration on Chinese factors

- Location saving
- Market premium
- Unpaid pollution



Location Saving

- Lower cost of labor
- Better infrastructure and logistics



Location Saving

- More importantly, location saving is reflected in the unique contribution made by low-paid Chinese engineers and technicians who improve and refine the technology provided by the associated company and fostered incomparable intangibles which cater to the needs of customers.



Market premium

- Huge population
- Exponential growth of Chinese middle class



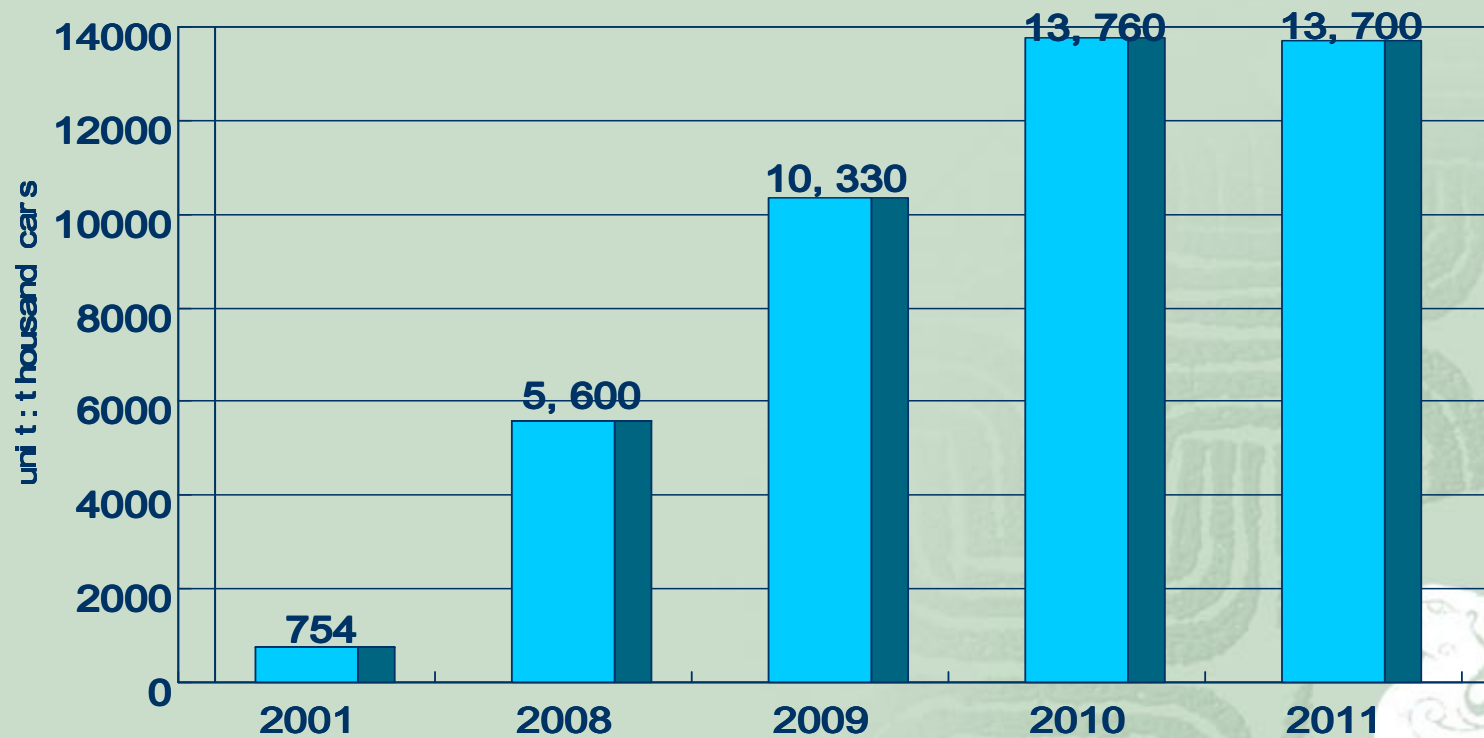
Environmental cost

- High emission of pollution by MNC
- As a manufacturer, the cost of manufacturing is more than what is recorded on the book.



Taking the car manufacturing as an example

China passenger car sales

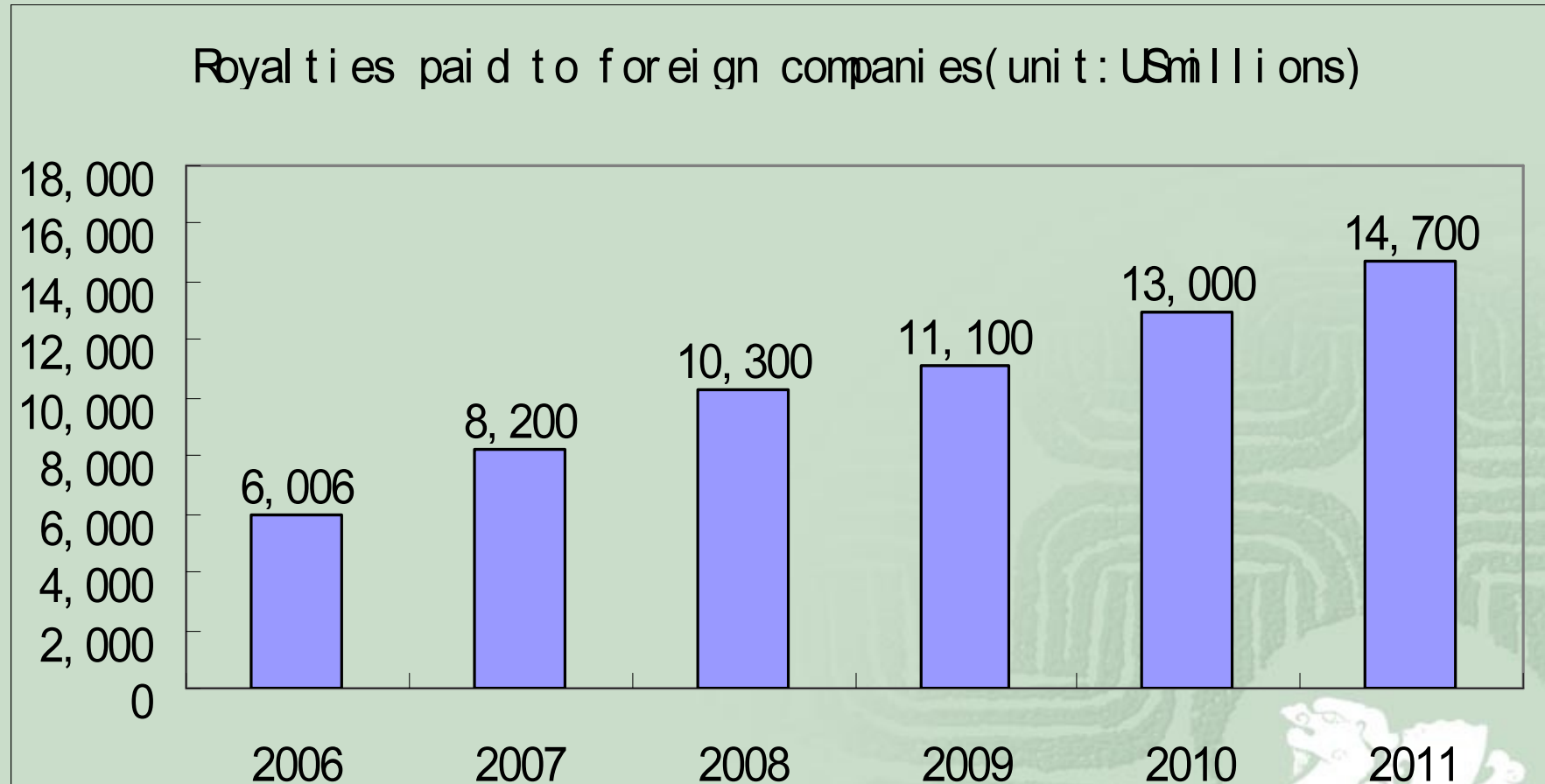


Are we simply contract manufacturers?

- In the MNEs' supply chain, Chinese companies are usually characterized as contract manufactures.
- However, concerned with the unique factors with Chinese characteristics, should we be rewarded simply as contract manufacturer?



Issues we concern



Issues we concern

- Is technology the most important value drivers of the profit of the company?
- Do we really need it?
- How much contribution does the technology make to the profit of the supply chain?
- How about the local R&D value?



Issues we concern

- Huge amount of meticulous fees paid by Chinese companies to their associated companies.
- If the Chinese companies are characterized only as contract manufactures, do we really need so many sophisticated services?



Solution

- More frequent use of Profit split method or hybrid methods to test whether or not the result reflects the reasonable allocation of profit of whole supply chain



Development trend of transfer pricing system

- Further refining the anti-avoidance legal framework



Development trend of transfer pricing system

- Expanding the database
 - Greater cooperation in the area of exchange of information with other administration authorities.
 - Creation of a national database which allows for the sharing of tax filing information among tax authorities in different regions.



Development trend of transfer pricing system

- More efforts will be put on prevention of tax avoidance.
- Engaging in more bilateral APAs to reduce the uncertainties for taxpayers.
- Encouraging the use of MAP to resolve transfer pricing controversy



Development trend of transfer pricing system

- Expanding the target of audit from Enterprises with foreign investment or Foreign enterprises to domestic enterprises which made outbound investment.
- Expanding the focus from manufacturing operations to intangible assets, financial transactions, corporate restructuring and special services.
- Expanding the enforcement measures from transfer pricing and APA to cost sharing arrangement (CAS), Controlled Foreign Company (CFC) rule, Thin Capitalization rule and General Tax Avoidance rule (GAAR).



Talents development plan

- Deployment of a national expert committee
- Intensive training for experienced and newly recruited transfer pricing auditor.



Thank you

