

China's Transfer Pricing Tax System



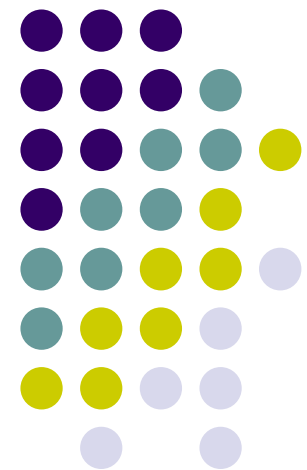
WANG Wenqin

Deputy Director General

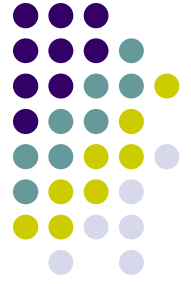
International Taxation

State Administration of Taxation

People's Republic of China

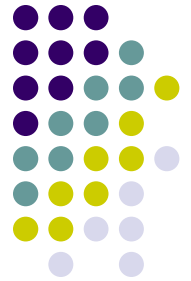


Outline



- Legal framework
- Practice
- Challenges

Part I: Legal Framework



Law

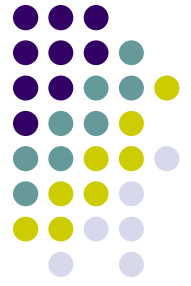
- Corporate Income Tax Law (Chapter 6)
- Tax Collection and Administration Law (Article 36)

Regulations

- Implementation Regulations of the CIT Law (Chapter 6)
- Implementation Rules of the Tax Collection and Administration Law (Article 51-56)

Rules

- Implementation Measures of Special Tax Adjustments (Guoshuifa [2009] 2)
- Other rules issued by MOF and SAT



Part I: Law

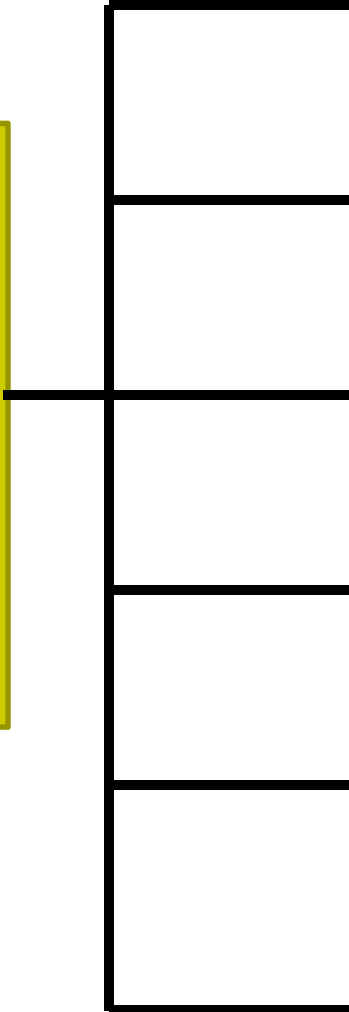
Special Tax Adjustments

– Chapter 6 of the CIT Law

- Article 41:
 - Arm's length principle
 - Cost sharing arrangement (CSA)
- Article 42: Advance pricing arrangements (APA)
- Article 43:
 - Disclosure of related party transactions
 - Transfer pricing documentation
- Article 44: Deemed taxable income
- Article 45: Thin-capitalisation rule
- Article 46: Controlled foreign corporation (CFC) rule
- Article 47: General anti-avoidance rule (GAAR)
- Article 48: Special interest levy

Part I: 6 Measures

**Special Tax
Adjustment**



TP

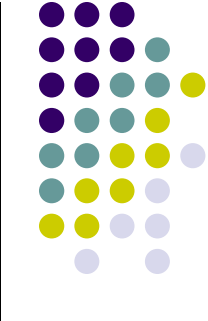
APA

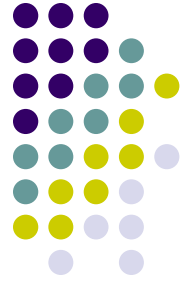
CSA

CFC

Thin-cap

GAAR





Part I: Law

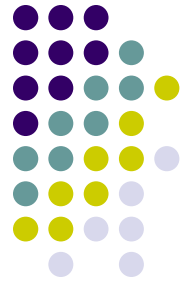
Tax Collection and Administration Law

➤ Article 36: ALP

The earliest law which adopted ALP:

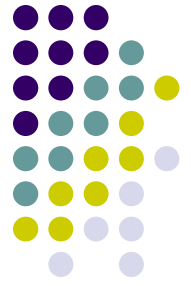
On July 1 1991, the Income Tax Law for Foreign Investment Enterprises and Foreign Enterprises (known as “the Law for FIEs and FEs”) and its implementing rules came into force. The law adopted ALP as the basis for china’s transfer pricing system and tax administrations were authorized to adjust an FIE or an FE’s taxable income where it had been reduced as a result of non-ALP transaction.

Part I: Rules Issued by MOF and SAT



- **Rules on The Deduction of Interest Payments to Related Parties (Caishui [2008] 121)**
- **Implementation Measures of Special Tax Adjustments (Guoshuifa [2009] 2)**
- **Related Transactions Annual Reporting Form (Guoshuifa [2008] 114)**
- **Circular on Determining The Actual Tax Burden in The Resident Countries of Foreign Companies Controlled by Chinese Residents (Guoshuifa [2009] 37)**
- **Circular on Strengthening Transfer Pricing Follow-up Administration**
(Guoshuihan [2009] 188)
- **Circular on Intensifying Monitoring and Auditing of Cross-border Related Transactions (Guoshuihan [2009] 363)**
- **Internal Working Rules and Procedures for Special Tax Adjustments**
(Guoshuifa [2012] 13)
- **Rules and Procedures for Panel Review of Major Cases under Special Tax Adjustments (Guoshuifa [2012] 16)**

Part I: Implementation Measures of Special Tax Adjustments (“The Measures” or “Circular 2”)



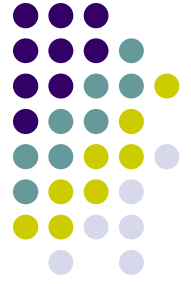
- Issued on 8 January 2009 by the SAT with the aim to “carry out and implement the CIT Law as well as its Implementation Rules, regulate and strengthen the administration of special tax adjustments”
- Including 13 chapters and 118 articles
- Covering all areas under Chapter 6 Special Tax Adjustments of the CIT Law and its Implementation Rules
- Effective retrospectively on 1 January 2008

Part I: Implementation Measures of Special Tax Adjustments (“The Measures” or “Circular 2”)



- Chap 1 – General Provisions
- Chap 2 – Reporting of Related Party Transactions
- Chap 3 – Administration of Contemporaneous Documentation
- Chap 4 – Transfer Pricing Methods
- Chap 5 – Transfer Pricing Investigations and Adjustments
- Chap 6 – Administration of Advance Pricing Arrangements
- Chap 7 – Administration of Cost Sharing Agreements
- Chap 8 – Administration of Controlled Foreign Corporations
- Chap 9 – Administration of Thin Capitalisation
- Chap 10 – Administration of General Anti-Avoidance
- Chap 11 – Corresponding Adjustments and International Consultation
- Chap 12 – Legal Obligations
- Chap 13 – Supplementary Provisions

Part II: Practice



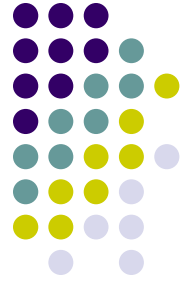
- Central TP Control
- “Three-in-one” Mechanism



Part II: Central TP Control

Before the year 2005

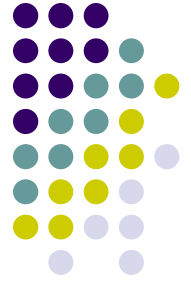
- Decentralized
- Inconsistency
- Numbers unclear
- Pressure from Stakeholders



Part II: Central TP Control

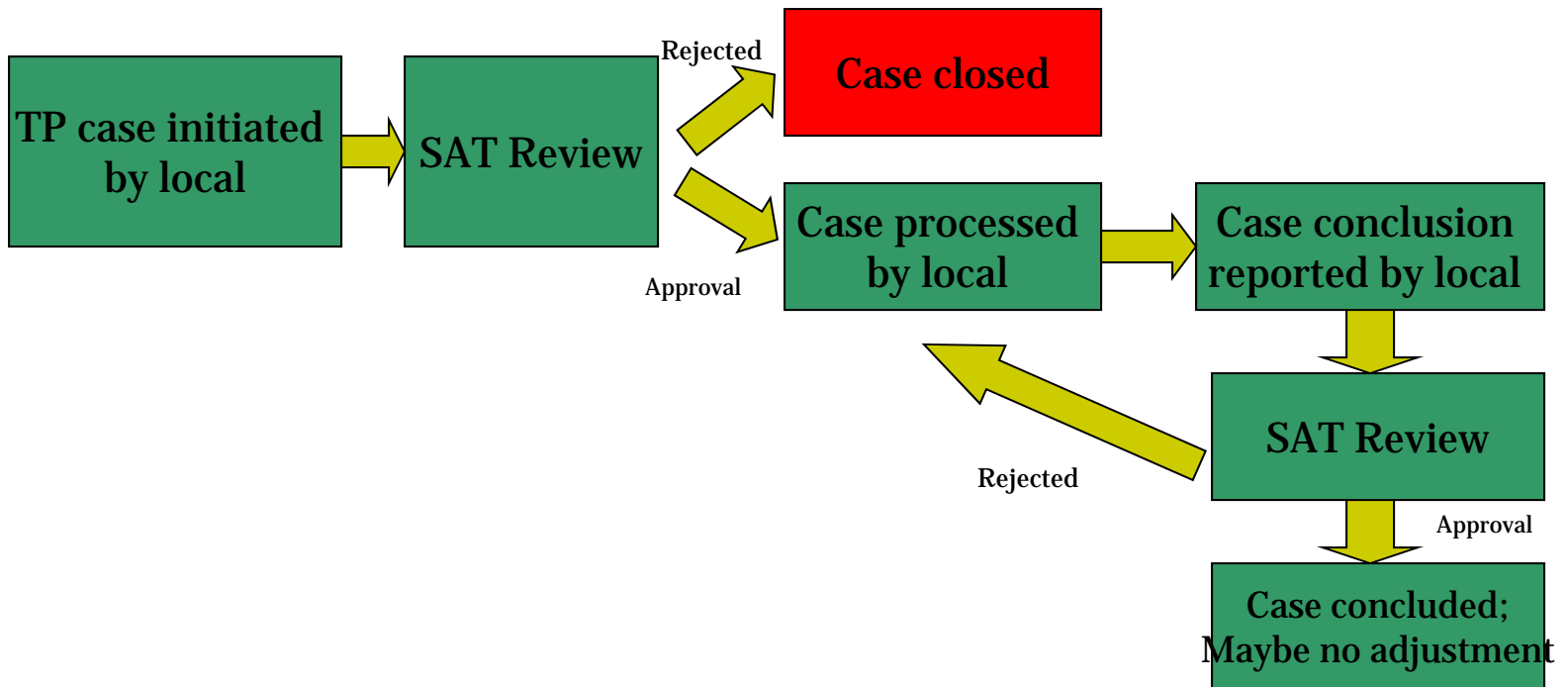
The 2005 change: Central TP control

- Guarantee consistency across TP cases in China;
- Improve the quality and efficiency of TP cases;
- Flexible use of the limited TP specialists;
- Good flows of knowledge and information among TP specialists;
- Transparency.

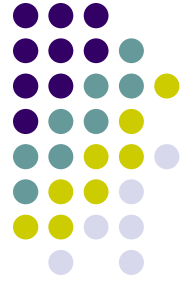


Part II: Central TP Control

Working Procedure



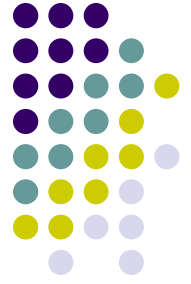
Part II: Central TP Control



Panel Review Mechanism

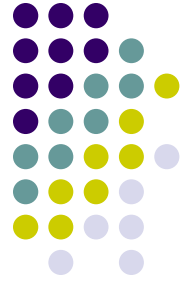
requiring that one case should be reviewed by TP experts of three levels, tax authorities in-charge, the provincial level, and the headquarter level.

Part II : “Three-in-one” Mechanism



- Integrated administration, service and investigation activities with equal emphasis on prevention and investigation

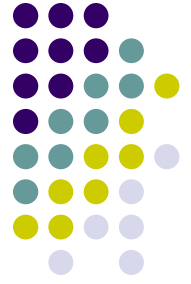
Part II : “Three-in-one” Mechanism



Administration

- Mandatory related-party transaction reporting;
- Examination of contemporaneous documentation;
- Follow-up administration

Part II : “Three-in-one” Mechanism



Service

- APA to provide certainty; and
- TP MAP to resolve disputes and to eliminate double taxation.



Part II : “Three-in-one” Mechanism

APA Annual Report

In December 2010, SAT published its first annual report on APA in China for 2009, which initiated China’s annual APA reporting system.

The latest one - 2011 version:

<http://www.chinatax.gov.cn/n8136506/n8136608/n9947993/n9948014/n12181382.files/n12181384.pdf>

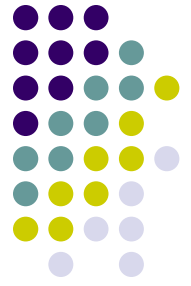
Part II : “Three-in-one” Mechanism



Number of APAs 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
2011	8	4	0	12
2012	3	9	0	12
Total	56	29	0	85

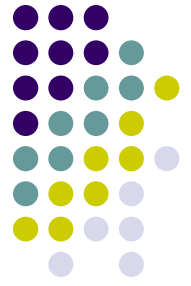
Part II : “Three-in-one” Mechanism



TP MAP

- 2010, TP MAP 13, double taxation elimination 5.03 billion RMB
- 2011, TP MAP 4, double taxation elimination 3.2billion RMB
- 2012, TP MAP 9, double taxation elimination 6.4 billion RMB

Part II : “Three-in-one” Mechanism



Investigation

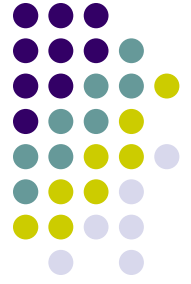
- On multinationals with frequent related-party transactions
- On taxpayers whose balance sheets report abnormal losses or gains
- On taxpayers who report losses but continue to do business as usual
- On taxpayers who do not report documentation or report non-trustworthy documentation
- On taxpayers with unreasonable transfer pricing policies

Part II: “Three-in-one” mechanism



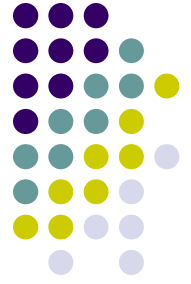
TP investigation in recent years

	2006	2007	2008	2009	2010	2011	2012
Number of adjustments	177	174	152	167	178	207	175
Average adjustment (RMB millions)	3.84	5.75	8.16	12.51	14.5	11.8	26.2
Approximate total adjustment (RMB millions)	458	680	1,000	1,240	2,089	2,581	4,600



Part III: Challenges

- Lack of comparables
- Quantification and allocation of LSAs
- Identifying and pricing intangibles
- Miscellaneous
 - Single function subsidiaries
 - Contract R & D
 -



Part III: Lack of comparables

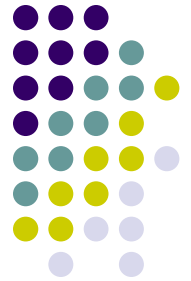
➤ Reasons

- Limited number of public companies
- Vertical simple-function FDI

➤ Reactions

- Adjustments to account for the differences in geographical comparability when applying TNMM
- Different methodology (profit split replacing CUP)

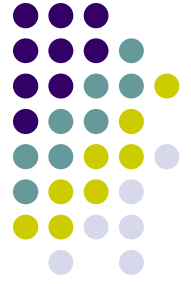
Part III: Quantification and Allocation of LSAs



- Location Specific Advantages (LSAs)
 - Cost Savings
 - Market Premium

- Quantification and allocation of LSAs

Part III: Intangibles

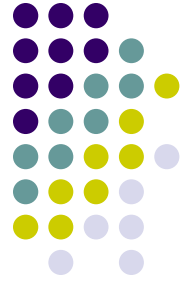


- Overpricing
- Marketing for materializing brand name
- Know-how force attenuation VS royalty decrease
 - 3% royalty payment in 2002
 - 3% royalty payment in 2012 ?

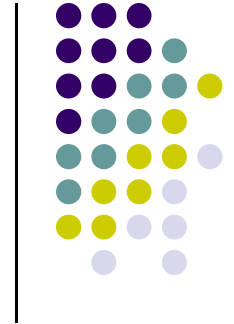


Part III: Miscellaneous

- Sole function entities should not share losses of the group if
- A group with multiple single function entities in China are considered in entirety for the returns of the entities.
- Cost plus not adequate for contract R&D, profit split more appropriate.
-



Fair distribution of profit !



Thank you