

# China



## KPMG Observation

In China, we continue to see many new circulars regarding the implementation of the new transfer pricing regulations released. The general focus is on transfer pricing issues among large enterprises, as well as targeted investigations of certain industries. In addition, circulars have covered tax havens (as they relate to controlled foreign corporations) and losses related to the economic downturn. Advance pricing agreement (APA) applications are also increasing, and China has just seen its first Bilateral APA with a European Country (Denmark). China's tax authorities aim to expand their team to 500 full time transfer pricing specialists.

## Basic Information

### Tax authority name

State Administration of Taxation.

### Citation for transfer pricing rules

Corporate Income Tax Law (CIT Law) (2007); Implementation Rules for the CIT law (2007); Circular Guoshuifa [2009] No. 2, Implementation Measures of Special Tax Adjustments (Provisional) (Circular 2) (2009).

### Effective date of transfer pricing rules

1 January 2008.

### What is the relationship threshold for transfer pricing rules to apply between parties?

Twenty-five percent ownership, be it direct or indirect ownership, or control. This applies whether one party owns another or two parties are owned by a third party. The formula for calculating indirect shareholding percentage has been changed: 25 percent ownership is now counted as 100 percent when multiplying the shareholding percentages of each level of indirect shareholdings. Other criteria including loans, control of management, or other types of control can also be taken into account.

### What is the statute of limitations on assessment of transfer pricing adjustments?

Ten years.

## Transfer Pricing Disclosure Overview

### Are disclosures related to transfer pricing required to be prepared or submitted to the revenue authority on an annual basis (e.g. with the tax return)?

Yes.

### What types of transfer pricing information must be disclosed?

Description and amounts of related-party and non-related-party transactions broken down by type (purchases, sales, services, intangible assets, tangible assets) as well as by counterparty location (domestic or overseas). For tangible assets and intangible assets, the information must be further broken down into several sub-categories.

Information on financing received from related parties including time period, interest rate and expenses, and guarantor information such as guarantee fee and fee rate.

A full list of all related parties as well as the address, taxpayer number, legal representative and type of related-party relationship.

Extensive information on outbound investment (outbound from China) including information on the invested enterprise, including its profit level, income tax payable, effective tax rate shareholders.

Information on outbound payments to related and unrelated parties broken into 17 subcategories, along with information on taxation of these payments.

## Transfer Pricing Study Overview

### Is preparation of a transfer pricing study required – i.e. can the taxpayer be penalized for mere failure to prepare a study?

Yes, for all transactions.

### Other than complying with a requirement per the previous question, describe the benefits, if any, of preparing and maintaining a transfer pricing study?

Protection from interest surcharge in the event of a tax adjustment, shifting of burden of proof.

To satisfy the requirement and/or obtain the benefits, are there any requirements on when the transfer pricing study must be prepared and submitted?

Must be prepared contemporaneous with the tax return, must be submitted within 20 days of request.

What are the major elements required or recommended to be included in a transfer pricing study?

The following elements are required: organizational structure, overview of business operations, information on related-party transactions, comparability analysis, transfer pricing method selection and application. Functions and risks; information on assets employed; explanation of assumptions, "judgments" and adjustments are also required.

## Transfer Pricing Methods

Which transfer pricing methods are acceptable?

Comparable uncontrolled price, resale price, cost plus, profit split, transactional net margin method, and other methods in compliance with the arm's-length principle.

Is there a priority among the acceptable methods?

No.

If there is no priority of methods, is there a "best method" rule?

According to Guoshufa [2009] No 2 Implementation Measures of the Special Tax Adjustments (Provisional) (Circular 2), a comparability analysis shall be conducted in order to select reasonable transfer pricing methods. A comparability analysis covers characteristics of assets transacted or services provided; the functions performed and risks assumed by the parties in transactions; contractual terms, economic circumstances; and business strategies.

## Transfer Pricing Audit and Penalties

When the tax authority requests a taxpayer's transfer pricing documentation, how long does the taxpayer have to submit its documentation?

Twenty days.

If an adjustment is proposed by the tax authority, are dispute resolution options available to the taxpayer outside of competent authority?

Direct discussion/negotiation with the tax authorities is an available recourse in addition to administrative appeal and court remedy.

If an adjustment is sustained, can penalties be assessed? If so, what rates are applied and under what conditions?

No penalties on the tax adjustment, some non-compliance fines in line with the general tax law.

However, interest imposed on tax adjustments which relate to transactions which occur after 1 January 2008. This interest rate will be equal to the People's Bank lending rate plus five percent. This interest is non-deductible. However, if the company supplies "relevant materials" the five percent extra charge may be dropped.

In addition, companies that do not provide proper documentation may have their income adjusted "on a deemed basis."

To what extent are transfer pricing penalties enforced?

No penalties from transfer pricing adjustment; fines and interest rates specified in the regulations.

Can transfer pricing penalties be reduced or removed for reasons other than documentation?

No.

## Special Considerations

Are secret comparables used by tax authorities?

Yes.

What level of interaction do tax authorities have with customs authorities?

Low.

Are management fees deductible?

No. People's Republic of China (PRC) tax regulations do not allow the deduction of "management fees." While not clearly defined in the law, the Chinese concept of "management fees" can generally be interpreted as a shareholder activity. In addition, PRC tax authorities are likely to reject the deductibility of fees that are literally classified as "management fees", even if they are not related to shareholder activities.

Are management fees subject to withholding?

Management fees cannot be remitted from the People's Republic of China. Within China, management fees are not subject to withholding.

Other unique attributes?

According to Circular Guoshuifa [2008] No. 86, parent companies will need separate signed agreements with subsidiaries in order for service charges to be deductible.

Circular Guoshuifan [2009] No. 363 says that China-based enterprises with limited functions and risks should not bear market or "business" risks related to the financial crisis, and if such companies do generate losses, they must submit documentation by 20 June.

## Other Recent Developments

The State Administration of Tax (SAT) recently issued Circular 323 setting out the procedures for the local tax authorities

to request and examine 2008 and 2009 transfer pricing contemporaneous documentation reports as well as provide feedbacks to SAT on the level of compliance by the taxpayers. It is expected that following this review, SAT may issue further guidance on documentation preparation.

The SAT also concluded a mutual agreement procedure (MAP) case with Japan for an automotive original equipment manufacturer's (OEM's) transactions between the two countries. The SAT's focus on transfer pricing issues in the automotive industry is increasing and large scale audits across the industry are under way.

The SAT also started an industry survey on the transport and logistics industry which is believed will lead to more investigations into taxpayers in that industry.

## Tax Treaty/Double Tax Resolution

What is the extent of the double tax treaty network?

Extensive.

If extensive, is the competent authority effective in obtaining double tax relief?

Limited experience.

When may a taxpayer submit an adjustment to competent authority?

After receiving a written notice of adjustment.

May a taxpayer go to competent authority before paying tax?

No.

## Advance Pricing Agreements

What advance pricing agreement (APA) options are available, if any?

Advance pricing agreement options are unilateral, bilateral and multilateral APAs. In order to be eligible for APA, applicants must have over RMB40 million in annual related-party transactions and have prepared and/or submitted annual filing and contemporaneous documentation according to the law.

Is there a filing fee for APAs?

No.

## Language

In which language or languages can documentation be filed?

Chinese.

### KPMG in China

#### Shanghai

#### **Cheng Chi**

Tel. +86 21 2212 3433

Email: [cheng.chi@kpmg.com.cn](mailto:cheng.chi@kpmg.com.cn)

As email addresses and phone numbers change frequently, please email us at [transferpricing@kpmg.com](mailto:transferpricing@kpmg.com) if you are unable to contact us via the information noted above.