New TP Regulations

KPMG's Analysis

On January 8, 2009, China's new transfer pricing regulations, the Implementation Measures of Special Taxation Adjustments (the "regulations") were brought into force when Circular Guoshuifa [2009] Number 2 was signed. These regulations clarify the Transfer Pricing and other so called special tax adjustment provisions introduced in the Corporate Income Tax ("CIT") law and its Implementation Rules, which both became effective on January 1, 2008. The regulations cover many aspects of transfer pricing, including Annual Reporting, Documentation, Audit, Cost Sharing Agreements ("CSA"), Controlled Foreign Corporations, Thin Capitalization, Advance Pricing Arrangements ("APA"), and General Anti-Avoidance.

Key updates include certain relaxations of the procedures relating to APAs. There will be a grace period for the first year's production of contemporaneous documentation (until December 31, 2009), and more companies will be completely exempt. However, all companies must now submit a set of annual filing forms on related party transactions, consisting of nine forms.
According to Steven Tseng of KPMG China, taxpayers may need to make a careful review of their own situation before diving into the details of the new regulations. "Using a more holistic approach, taxpayers can make sure they're viewing the requirements from the right perspective," says Mr. Tseng, "Chinese regulations cannot be looked at in isolation – there are other regional and global TP risks that may take priority." Mr. Tseng accordingly recommends taxpayers should start with a risk assessment approach, and then act on identified risks, rather than hypothetical situations.

"Taxpayers in China appeared to be focused on managing transfer pricing risks in China by ensuring sufficient profitability for their Chinese entities. As the economy turns south and group consolidated profits narrow, many tax authorities outside China may challenge the current profitability reported by MNCs' Chinese entities. It is important for taxpayers to review counterparty adjustment risks before rushing to documentation by justifying status quo."

"Historically, transfer pricing audits in China mostly targeted foreign investment enterprises," said Lilly Li, a partner in KPMG China's Guangdong office. "With the consolidation of income tax laws for domestic enterprises and foreign investment enterprises and the increased global exposure of Chinese private enterprises, Chinese entrepreneurs are adding transfer pricing management into their business agenda."

"Currently, the awareness of global transfer pricing risks amongst the Chinese domestic enterprises appears to be low. Management is equipping itself with sufficient knowledge and experience in dealing with foreign competent authorities on transfer pricing issues as well as the authorities at home country in the course of managing the global business expansion."

The following is a chapter by chapter analysis of the new regulations.

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Chapter 1: General Provisions

This chapter gives a basic legal context for the regulations i.e. that they are based on the Corporate Income Tax Law ("CIT Law") and its Implementation Rules ("Implementation Rules"); the Tax Collection Law and its implementation rules; and international treaties where applicable. It also gives short descriptions, not specific enough to be called definitions, of some of the terms used later, specifically "special tax adjustments," "transfer pricing administration," "advance pricing arrangements," "cost sharing agreements," "controlled foreign corporation," "thin capitalization" and "general anti-avoidance administration."

Chapter 2: Annual Filing Requirements

Chapter 2 covers "Annual Filing," one of the two types of reporting requirements introduced by the CIT Law (the other, "Contemporaneous Documentation," is covered in Chapter 3). Annual Filing was introduced by Article 43 of the CIT Law, and confirmed by Circular Guoshuifa [2008] No. 114, which also provided the nine official filing forms. As no exceptions are listed for these requirements, it should therefore be assumed that all companies will be required to complete the "annual filing forms." In addition, the due date for the annual filing forms is five months after the end of the year, i.e. May 31, 2009 for the 2008 tax year filing. Although a grace period will apply for the first year's submission of contemporaneous documentation, no such grace period has been authorized for the annual filing requirement.

The titles of the nine forms are listed in the regulations:

- Related parties
- Related-party transactions
- Sales and purchases
- Services
- Transfer of intangible assets
- Transfer of fixed assets
- Financing
- Outbound investment
- Outbound payments.

A draft of these regulations was circulated in March (the "March draft") and said that "enterprises involved in related-party transactions" should complete this requirement: however the text of the finalized regulations does not specify whether companies without related-party transactions should prepare these forms. However, even if enterprises without related-party transactions are expected to complete these forms, it would not represent a significant burden for such enterprises. The draft also provided for 10 forms instead of 9: two have been merged into other forms and one form (transfer of assets) has been split.

Article 11 reiterates the requirements of Circular 114, i.e. that enterprises are now required to submit, at the same time as their tax returns, nine different filing documents detailing their transactions and the parties involved on an annual basis. Chapter 2 also gives, in Article 9, an extensive definition of related party, which includes seven different criteria. Most of these criteria already appeared in Circular Guoshuifa [2005] No. 143:

1. Direct or indirect control, or both parties controlled by a third party. The threshold for this criterion was lowered by the March draft from 25% to 20%, but will be maintained at 25%. However, indirect holdings will now be counted as direct ownership if a party has more than 25% ownership in an intermediate party
2. Substantial inter-party loans (loans equivalent to 50% of paid-in capital or guarantees equivalent to 10% of all loans)
3. Senior management personnel appointed by another enterprise (50% of senior management or one controlling board member)
4. Shared senior management personnel (again, 50% of senior management or one controlling board member)
5. Control of licenses
6. Control over purchase and sales activities

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7. Control over services offered or received
8. Other relations that involve actual control of the production, operation or transactions of the enterprise, or other affiliations in terms of interests, including relationships with family members or relatives.

Delays are mentioned in Article 12, and in the case of special circumstances, extended time limits may be approved by the authorities, in accordance with the general tax code.

Chapter 3: Contemporaneous Documentation Requirements

On top of the annual filing requirements just described, the new regulations require some (not all) companies to prepare a large volume of contemporaneous documentation (records kept concurrently with the actions performed). The whole of Chapter 3 is devoted to this documentation, which should have the signature or seal of the "legal representative" and be prepared in Chinese, although a translation is acceptable (Articles 17 and 19 respectively).

Article 15 lists three exceptions to this requirement: if the total of annual related-party purchases and sales is less than RMB 200 million and other related party transactions total less than RMB 40 million, if an Advance Pricing Arrangement (APA) is in place, or if foreign-owned shares account for less than 50% and related-party transactions are with domestic related parties only. Related-party transactions covered by cost sharing agreements (CSA) or APAs are exempted when calculating amounts of related party transactions.

The expected contents of this report are outlined in Article 14. There are five categories of required information (Organizational structure, business operations, related party transactions, comparable analysis and transfer pricing methodology) and 26 subcategories of required information, as listed below.

Table 1: Subcategories of required information

1	Group structure (including shareholding information)
2	Change of related party relationships during the year
3	Information on related parties
4	Taxation (income tax) of related parties (including rates and incentives)
5	Business overview
6	Main business of enterprise
7	Industry position and market competition
8	Internal organizational structure
9	Group consolidated financial statement
10	Basic data of related-party transactions
11	Trade terms of related-party transactions
12	Comparison of business processes between related and unrelated transactions
13	Intangible assets
14	Copies of agreements relating to related-party transactions
15	Economic and legal factors
16	Allocation of revenues, cost, expenses and profits
17	Factors to be considered in the comparability analysis
18	Functions, risks and assets of comparables

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Table 1: Subcategories of required information	
19	Comparable transactions
20	Selection of comparables
21	Adjustments
22	Transfer pricing methods
23	Support for transfer pricing method
24	Assumptions in defining comparable price or profit
25	Calculation of arm's length price or profit
26	Other information supporting the methods used

As with the annual corporate income tax filing, the new CIT law and the regulations are effective from January 1, 2008, more than a year ago, and the due date for the annual filing forms and contemporaneous documentation is five months after the end of the year, i.e. May 31. However, there will be a grace period of seven months for 2009, so that the first set of contemporaneous documentation for 2008 tax year must be prepared before December 31, 2009. It is not necessary for contemporaneous documents to be submitted by the due date, but just that they be completed by that time and maintained for a period of 10 years, (including through any splits or mergers), during which time they must be submitted on request to the authorities within 20 days.

The Regulations do not specifically provide the possibility for time limit extensions. If there exists a *force majeure*, the Regulations provide that the documentation should be provided 20 days after the end of the *force majeure*.

Chapter 4: Transfer Pricing Methods

In the past, Chinese laws listed acceptable methods for comparability analysis without giving any guidance on how to perform the analysis itself. Instead, companies performing TP analysis were left to appeal to "international standards" which normally meant the US or the OECD. In contrast, Article 22 of the new regulations specifies in detail what an analysis should cover, giving explanations for each of the sections that the analysis should contain. The explanations are largely in line with the OECD guidelines,[1] and use the same five headings:

- Characteristics of the properties transferred or services provided
- Functional and risk analysis
- Contractual terms and conditions
- Economic circumstances
- Business strategies

Articles 23 through 27 give detailed information about how to use each of the listed methods, which as in earlier laws include Comparable Uncontrolled Price method (CUP), the Resale Price Method (RPM), the Cost Plus Method (CPLM), the Transactional Net Margin Method (TNMM) and the Profit Split Method (PSM). Although no clear hierarchy is given by the regulations, they do list examples of circumstances where the different methods might be used, and note that the CUP method can be used in all circumstances. For TNMM, four examples of profit level indicators are given: return on assets, operating margin, net cost plus and the berry ratio (Article 26).

[1] i.e. the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

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Chapter 5: Audits, Adjustments and Appeals

The audit section is more a continuation than a break from previous laws, and provides guidance into what the tax authorities are looking for and the procedures a company can use to defend its transfer pricing policies in the event of investigation. This is the second longest chapter both in numbers of words and number of articles (Chapter 6 on APAs is longer). Like the chapter on APAs, this chapter is mostly procedural.

The regulations go into significant details on how audits will be conducted and how auditors should conduct comparability analyses (to check if pricing plan is arm's length) including four statements (Articles 38-41) that have elicited some notice from transfer pricing specialists.

1. Adjustments on differences in operating profits caused by differences in capital employed should not be made without approval from the SAT
2. Pure manufacturers should "not assume any risks or losses caused by wrong decisions, deficiency of operations and unmarketable products" and should maintain "a certain level" of profitability
3. If payments were netted-off the transactions should be restored
4. During the analysis and evaluation of a company's profit, if profit is found to be below the median of the inter-quartile range of comparable companies, it should generally be adjusted to a level not lower than the median.

The regulations also made clear that non-public comparable data can be used for the purpose of audit.

The procedure for the audit itself – informing the targeted companies, gathering information, evaluation, adjustment etc. – is given in Articles 31 through 37 and 42 through 45.[2] Taxpayers and other witnesses will be informed of the legal liabilities of providing inaccurate information, in accordance with "Inquiry (Investigation) Records" form. An acknowledgement of this warning should be "confirmed" by the taxpayers and "signed or sealed" by the witnesses. The time limit for TP audit targets to provide documents will be governed by a "Notice on Provision of Specific Information Concerning Business Transactions with Associated Enterprises"; previously this depended on the discretion of the tax authority.

A list of seven types of enterprises that the tax authority will use as potential audit targets is given in Article 29 (see below). These are similar to an earlier list given in Circular Guoshuifa [2004] No. 143. However, expanding operations despite low profitability, control by related parties, and profitability lower than related parties in the group no longer appear as criteria. Failure to prepare contemporaneous documentation has been added as a new criterion.

Table 2: Audit targeting criteria	
1	Enterprises with large or diverse related party transactions
2	Enterprises experiencing continuous losses or low or fluctuating profitability
3	Enterprises with lower than industry-standard operating profits
4	Enterprises with profitability not matching functions performed and risks assumed
5	Enterprises that engage in transactions with related parties in tax havens
6	Enterprises failing to file related party transaction documentation or to prepare contemporaneous documentation
7	Enterprises that are clearly in breach of the arm's length principle

[2] Chapter 4 of the PRC Administration of the Levy and Collection of Taxes Law and Chapter 6 of the Tax Collection and Administration Law Implementation Rules

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After initial examination, adjustment plans will be given to the enterprise for review and negotiation, and it should be noted that enterprises who oppose the final decision can take decisions to court after the final administrative review. However, after the "Notice on the Preliminary Adjustment Plan of Special Tax Investigation," has been received, enterprises only have seven days to lodge a disagreement. Tax authorities should "follow-up" for five years after the adjusted year (previous legislation required three years), and if they discover abnormal transfer pricing during this period they should contact the enterprise to request an adjustment or launch another audit.

Chapter 6: Advance Pricing Arrangements (APAs)

Along with the introduction of CSAs and reporting requirements, the re-introduction of APAs is the re-introduction of APAs marks an important change in Chinese law. Official APAs rules were promulgated in Circular Guoshuifa [2004] No. 118, but the new law goes a great deal further in describing how APA will actually be implemented in China, and as noted earlier, is the longest chapter of the rules, covering 25% of the text. Chapter 6 identifies six stages for the APA (Pre-filing meetings, Formal Application, Examination and Evaluation, Negotiations, Signing of Agreements, and Supervision of Implementation) and as with the audit section goes into a great deal of detail about the procedures for each step.

The detailed descriptions are found in Articles 50-56. Enterprises can now participate in pre-filing meetings anonymously (Article 50), and will have to provide ten types of information as part of the "Formal Application for APA," including three years worth of financial statements, whether the enterprise has been involved with any double-taxation issues in the past, and of course, justification for the transfer pricing methods proposed for the APA (Article 51).

In terms of timing, enterprises will have three months to prepare the Formal Application, while the tax authorities will have five months (plus a three-month extension for "special cases") to reply (the "Examination and Evaluation" stage), after which the Tax Authorities "should carry out APA negotiations" within 30 days. In total, allowing an extra month or so for negotiations, the process will probably take about 10-14 months from formal application to formal agreement.

With respect to the final part, "Supervision of Implementation," the enterprises should provide annual reports showing the taxpayer's operations in that year, and the clauses of observed APAs including all the terms required by the APA, and any amendments or changes. The tax authorities are expected to "periodically" inspect the implementation of the APA, and make sure the assumptions about the APA are true, that the enterprise is complying with its requirements, and that information provided by the enterprise is correct. "Periodically" is given as "generally every six months."

Much attention has been paid by taxpayers and tax practitioners alike to the requirements given in Article 48 about which companies can or cannot apply for APAs. The March draft would have required candidates for APA to have annual related party transactions that exceed RMB 100 million and an "actual operation period" exceeding 10 years. The current law reduces the related party transaction requirement to RMB 40 million in annual related party transactions and removes the operating period requirement. The March draft and the finalized version both cite "documentation completed in accordance with the law" as a pre-requisite for APA, although a requirement that companies had "no significant tax evasion" was dropped.

While the actual law does not use the words "require" or "requirements," instead using the word "一般" (yiban) which can be translated as "commonly" or "generally," it could be assumed that these criteria are basic requirements.

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While an APA will only apply to future years (for a period of three-to-five years), and will have "no influence" on the current year or previous years, Article 49 states that the policies and methods included in the APA can also be applied to related party transactions from the current or previous years that are "identical or similar," if the enterprise applies for this and the tax authority approves. APAs cannot be renewed automatically, but the tax authorities are required to reply to applications within fifteen days, which should be made during the last 90 days of the old APA (Article 57).

Chapter 7: Cost Sharing Agreements (CSA)

In the law which brought CSA into existence (the CIT Law) it was only given one paragraph in the law itself and three paragraphs in the implementation rules.[3] The current law is a significant expansion and devotes a full chapter, consisting of twelve articles, to the subject.

Participants to a CSA will not have to pay royalty for use of intangible property (Article 65). CSAs must be submitted to the SAT through the various levels within 30 days of the agreement being signed (Article 69), and cost sharing for services "generally applies" to group purchasing and marketing (Article 67). An earlier stipulation that R&D expenses could not be used as the basis of a bonus deduction tax incentive has been removed.

Article 75 specifies five scenarios where costs are not deductible:

1. Lack of commercial purpose and economic substance
2. Failure to comply with the arm's-length principle
3. Costs fail to be compensated by expected benefits
4. Enterprise fails to record the CSA or enterprise fails to prepare, preserve and provide contemporaneous documentation for the CSA
5. Enterprises with operating periods less than 20 years from the signing of the CSA.

Article 72 lists the tax treatments:

1. Costs allocated to the enterprise under the agreement can be deducted in each year as stipulated in the agreement for CIT purpose
2. The compensation amounts should be included in the taxable income in the year of compensation adjustment
3. When intangible assets are involved, buy-in payment or buy-out compensation and termination of the agreement shall be treated in accordance with the relevant provisions for asset purchase or disposition.

In addition to contemporaneous documentation, participants to a CSA should also submit a set of "records and documents" by June 20 of the year after the applicable tax year (Article 74). Among other things, these should document any payments by non-participants for using the results of the agreements, detail payments for buy-in or exit, contain copies of all agreements, track any changes and the overall costs and benefits of the agreement, and compare forecasted and actual benefits as well as the corresponding adjustments made.

Chapter 8: Controlled Foreign Corporations (CFC) Rules

Another requirement is that CFC dividend income must be included along with the Chinese income and taxed accordingly. In Chinese law, CFC refers to foreign enterprises controlled by a "Chinese-resident shareholder" (i.e. resident enterprises or groups of enterprises and individuals) and located in a country which has a tax rate less than half of China's (i.e. less than 12.5%). This is in contrast to the definition used in the US and elsewhere, where the tax rate of the entity is not a determining factor as to whether it is a CFC or not.

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[3] Article 41 of the CIT Law and Article 112 of the Implementation Rules

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The new rules give an expanded definition of control in Article 77. This new explanation should bring more enterprises into consideration by including a formula for indirect control; however, there are also exceptions for enterprises whose profits are below RMB 5 million, who operate in "non-low tax rate countries or regions" as recognized by the competent tax authorities or whose revenue is "mainly derived from active business operations" (Article 84).

The formula for calculating deemed dividends is given in Article 80 as:

$$\text{Chinese shareholder current income} = \frac{\text{Deemed dividend income} \times \text{percentage of shares held} \times \text{actual number of share holding days}}{\text{number of days of controlled foreign enterprise's tax year}}$$

Chapter 9: Thin Capitalization Rules

Another complication for transfer pricing analysis is the thin capitalization requirement, explained in Chapter 9. This requirement follows the thin-capitalization rules first introduced in last year's CIT Law and Circular 121[4] (which provided the debt-to-equity safe-harbor ratios) closely,[5] but provides further clarification. Article 86 provides information on calculating the debt-to-equity ratio, while Article 89 provides details on documentation that must be produced by companies whose debt-to-equity ratios exceed the safe harbor limits.

In such circumstances, the relevant parties will have to provide the following additional documentation in order to demonstrate that excess debt-equity ratios are in fact arm's length:

1. Analysis of the borrower's solvency and financing capacity
2. Analysis of the financing capacity and financing structure of the group.
3. An explanation for the changes in equity investment e.g. registered capital
4. The nature, purpose, and market situation of the
5. The currency, amount, interest rate, term and financing conditions of related party debt financing
6. The conditions and terms of the collateral provided by the enterprise
7. The conditions of guarantor and terms of the guarantee
8. The interest rate and financing conditions of loans of similar nature and term
9. The conversion conditions of any convertible bonds
10. Other documents which can support the compliance with the arm's length principle

Finally, the regulations make clear that interest should include "interest, guarantee fees, mortgage interest charges and other costs of interest actually paid for the direct or indirect related party debt investment," (Article 87) and specify that excess fees "shall not be carried forward to the next tax year" but "should be regarded as a dividend distribution" and taxed accordingly (Article 88).

Chapter 10: General Anti-Avoidance Rules (GAAR)

The chapter on anti-avoidance rules includes more information on who should be targeted (Article 92) and how to decide if tax-avoidance exists (Article 93). Besides companies that "abuse tax benefits" or "abuse tax treaties," companies that use "tax-avoidance havens" are notably mentioned as potential targets. It is also interesting to note that the tax authorities are supposed to use a "substance-over-form" principal: this is an addition since the March draft.

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[4] Circular Cai Shui No. 121, "Notice on Deducting Related-Party Interest Expenses When Calculating Taxable Income," issued on 23 September, 2008

[5] Article 41 of the CIT law

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Tax authorities are enabled (Article 94) to redefine arrangements and cancel tax benefits. The March draft allowed them the ability to "reconfirm or reallocate each party's income, cost, and profit, loss or tax exemption" but this was dropped from the final version. Tax authorities are also enabled to request information from "planners" of tax avoidance arrangements (Article 96).

The chapter on GAAR contains a small amount of procedural information (such as which form should be served), and also a clause specifying that all investigations and adjustments should be reported to and approved by the SAT (State Administration of Taxation). The time limit for responding to a GAAR notice is 60 days; this is not exactly the same as the audit time limit which is an agreed upon period up to 60 days, depending on the tax authority.

Chapter 11: Corresponding Adjustments

This short chapter of the regulations outlines the procedures for attempts to mitigate double taxation. It should be noted that enterprises must apply for corresponding adjustments within three years, and that taxes paid in relation to interest, rent, and royalty payments will not be adjusted (Article 101), nor do the rules apply to thin capitalization adjustments (Article 104). As with earlier areas which emphasized the appeal options available in the event of audit, the existence of this section serves to remind businesses that there are opportunities available for improving unfavorable tax adjustments or other situations. In terms of procedure, applicants should submit in writing an "Application for Initiating Mutual Negotiation Procedure" to both the State Administration of Taxation and the in-charge tax authorities at the same time.

Chapter 12: Legal Responsibilities

Fines, discussed in Chapter 12, will be dealt with in accordance with the Tax Collection Law and its Implementation Rules.

An interest rate, equal to the People's Bank benchmark lending rate on December 31 of the year of the underpaid tax, plus an additional 5%, is levied on any adjustments, calculated from the June 1 after the end of the adjusted year until the date of the payment. However, if the enterprise supplies contemporaneous documentation the 5% extra charge can be dropped. This interest is non-deductible. If the enterprise is exempted from preparing contemporaneous documentation, then it can simply provide other "relevant materials" to avoid the 5% extra charge.

Chapter 13: Supplementary Provisions

Perhaps the most important article in this chapter is Article 116, which allows a grace period for preparation of the Financial-Year 2008 of contemporaneous documentation until December 31, 2009.

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