

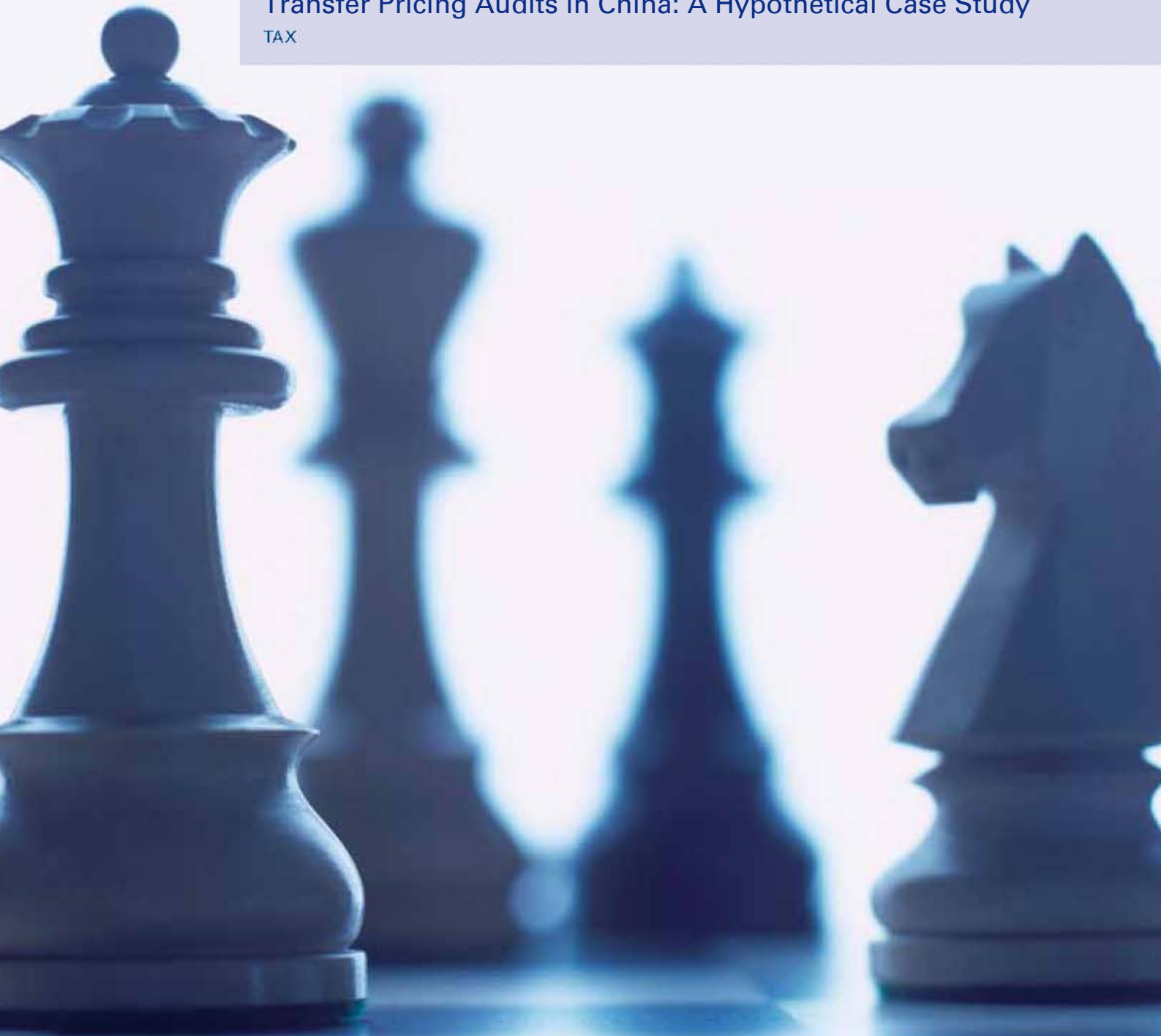


GLOBAL TRANSFER PRICING SERVICES

# A Meeting of Minds – Resolving Transfer Pricing Controversies

Transfer Pricing Audits in China: A Hypothetical Case Study

TAX



# Transfer Pricing Audits in China: A Hypothetical Case Study

Differences in national transfer pricing regulatory environment can lead to double taxation that may be hard to eliminate. Yvonne Chen (KPMG in China), Brian Cody (KPMG in the United States), Matthias Kaut (KPMG in Germany), and Steven Tseng (KPMG in China) explore the intricacies of a three-country relationship.<sup>1</sup>

China's role in the world economy has been evolving and expanding for several years now. Multinational enterprises (MNEs) have been focusing their attention on China as a key hub for operations in the Asia Pacific region. This growing importance of China has led to Chinese affiliates of MNEs assuming larger functional responsibilities and bearing greater risks. Furthermore, the expansion of operations in China has led to increased scrutiny and attention from Chinese tax authorities. The end result is the current transfer pricing environment in China, one where new guidelines have been formulated and where Chinese tax authorities are focused on operations of MNEs in China.

This case study examines this new transfer pricing environment in China. The case study deals with a hypothetical situation for an MNE with its parent operations in the United States and foreign operations in Germany and China. The case explores the audit procedures a typical company would face from the Chinese tax authorities. It also examines the situation from the U.S. and German perspectives and explores potential impacts and recourses available to the MNE.

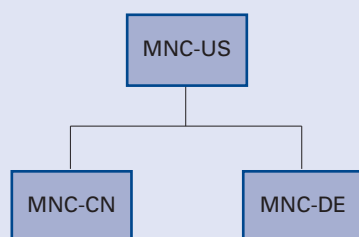
Overall, the case study explores a highly likely situation for an enterprise with large operations in China, and how this affects its transfer pricing on a global level.

## Background

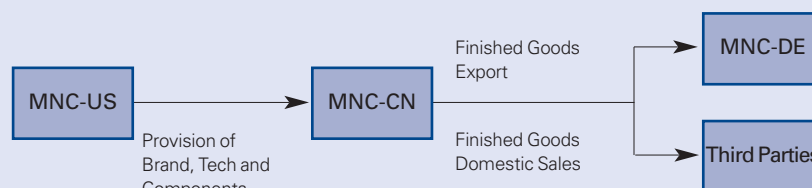
MNC-US is a multinational company in the consumer products industry with proprietary technology and a globally recognized trade name. It is based in the United States, but sells its products all over the world. It has a Chinese manufacturing subsidiary, MNC-CN, which imports key components from its parent. MNC-CN manufactures products for export to an affiliate in Germany, MNC-DE. MNC-CN also sells in China to unrelated parties. The MNC group's organizational structure is shown in Figure 1.

Figure 2 shows the flow of transactions.

<sup>1</sup> The authors also wish to express their gratitude to Alexey Manasuev (KPMG in the United States) and Brian Soloway (KPMG in China) for their invaluable assistance in preparation of this article.

**Figure 1** MNC group's organizational structure

Source: For illustration purposes only, KPMG in China.

**Figure 2** MNC flow of transactions

Source: For illustration purposes only, KPMG in China.

## Cross-Border Transactions

MNC-US is both the legal and economic owner of MNC's technology and intangible marketing assets. It has given MNC-CN the right to use its brand name, trademarks, and know-how to manufacture and sell MNC products in return for an annual royalty. MNC-CN also purchases key components used in the manufacturing process from MNC-US.

MNC-CN exports most of its output to MNC-DE, but it also sells some goods to unrelated consumers in China. Thanks largely to successful local brand-building advertising paid for by MNC-CN, domestic sales have been rising strongly within China.

MNC-CN is currently enjoying a tax holiday under the old income tax laws in China, but because of its very low margins on exports, high royalty payments, and domestic advertising, it has not generated any taxable income since start-up. Under China's old income tax regime, MNC-CN enjoyed a two-year tax holiday and could pay tax at half the standard rate for three years after the year it became profitable. Under transition rules in China's new income tax law, however, MNC-CN will now become a taxable entity.

Table A shows a simplified income statement for MNC-CN.

## Engagement

After the release of China's new income tax law, a local Chinese tax official phones MNC-CN's tax director to arrange a meeting.

Before calling, the local tax official undertook some research and identified MNC-CN as a potential audit target based on criteria set out in Circular 143<sup>2</sup> (most of which are included in the draft Transfer Pricing [TP] regulations). The criteria that would have caused the enterprise to be flagged for attention include:

2. Article 12 of Guoshuifa [2004] 143 – Administration of Tax on Business Transactions between Affiliated Enterprises Rules (Circular 143).

**Table A** Simplified Income Statement for MNC-CN

MNC-CN	2000	2001	2002	2003	2004	2005	2006	2007	2008
<b>Revenue</b>	100.0	112.3	127.0	145.1	167.9	197.7	237.6	292.6	370.2
Export to MNC-DE	95.0	104.5	115.0	126.4	139.1	153.0	168.3	185.1	203.6
Domestic Sales	5.0	7.8	12.0	18.6	28.9	44.7	69.3	107.5	166.6
<b>Cost of Goods Sold</b>									
Purchases from MNC-US	76.7	85.7	96.4	109.2	125.2	145.5	172.1	208.0	257.9
Local Purchases	10.0	11.2	12.7	14.5	16.8	19.8	23.8	29.3	37.0
<b>Royalty Paid to MNC-US</b>	5.0	5.6	6.3	7.3	8.4	9.9	11.9	14.6	18.5
<b>Advertising Expenses</b>	2.0	2.0	2.0	2.0	3.0	3.0	3.0	5.0	5.0
<b>Admin Expenses</b>	9.8	10.2	10.7	11.3	17.0	17.6	18.4	24.3	25.2
<b>EBIT</b>	<b>(3.4)</b>	<b>(2.5)</b>	<b>(1.2)</b>	<b>0.8</b>	<b>(2.4)</b>	<b>1.9</b>	<b>8.5</b>	<b>11.4</b>	<b>26.6</b>
<b>Operating Margin</b>	<b>-3.4%</b>	<b>-2.2%</b>	<b>-0.9%</b>	<b>0.5%</b>	<b>-1.4%</b>	<b>1.0%</b>	<b>3.6%</b>	<b>3.9%</b>	<b>7.2%</b>

Source: For illustration purposes only, KPMG in China.

**Table B Extract from the Circular 363 Financial Forms for Export Sales****MNC-CN: Export Sales**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Revenue	95.0	104.5	115.0	126.4	139.1	153.0	168.3	185.1	203.6
Cost of Goods Sold									
Purchases from MNC-US	73.7	81.0	89.1	98.1	107.9	118.7	130.5	143.6	157.9
Local Purchases	9.5	10.5	11.5	12.6	13.9	15.3	16.8	18.5	20.4
Royalty to MNC-US	4.8	5.2	5.7	6.3	7.0	7.6	8.4	9.3	10.2
Advertising									
Admin Expenses	4.8	5.2	5.7	6.3	7.0	7.6	8.4	9.3	10.2
EBIT	2.3	2.6	2.8	3.1	3.4	3.7	4.1	4.5	5.0
Operating Margin	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.4%	2.5%	2.5%

Source: For illustration purposes only, KPMG in China.

**Table C Extract from the Circular 363 Financial Forms for Domestic Sales****MNC-CN: Domestic Sales**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Revenue	5.0	7.8	12.0	18.6	28.9	44.7	69.3	107.5	166.6
Cost of Goods Sold									
Purchases from MNC-US	3.0	4.7	7.2	11.2	17.3	26.8	41.6	64.5	99.9
Local Purchases	0.5	0.8	1.2	1.9	2.9	4.5	6.9	10.7	16.7
Royalty to MNC-US	0.3	0.4	0.6	0.9	1.4	2.2	3.5	5.4	8.3
Advertising	2.0	2.0	2.0	2.0	3.0	3.0	3.0	5.0	5.0
Admin Expenses	5.0	5.0	5.0	5.0	10.0	10.0	10.0	15.0	15.0
EBIT	-5.8	-5.1	-4.0	-2.3	-5.8	-1.8	4.3	6.9	21.6
Operating Margin	-115.0%	-65.3%	-33.3%	-12.6%	-20.0%	-4.1%	6.3%	6.4%	13.0%

Source: For illustration purposes only, KPMG in China.

**Table D Summary Operating Margin of MNC-CN from Related and Non-related Party Transactions****Operating Margin**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
RPT	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%
Non-RPT	-115.00%	-65.32%	-33.27%	-12.60%	-20.04%	-4.06%	6.25%	6.39%	12.99%
Overall	-3.42%	-2.23%	-0.93%	0.52%	-1.42%	0.98%	3.56%	3.90%	7.19%

Source: For illustration purposes only, KPMG in China.

A local tax official initiates an audit by submitting an audit case plan to the provincial tax bureau for approval.











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