

## The Latest Insight

### **New transfer pricing regulations and their impact on foreign businesses in China**

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China has finally unveiled a set of highly comprehensive rules and regulations governing Related Party Transactions under the newly unified legislations for Corporate Income Tax. On January the 8th 2009, the State Administration of Taxation published the 'Implementation Regulations for Special Tax Adjustments - abbreviated to the 'Implementation Regulations'. The Implementation Regulations establish a basis for the tax authority to make tax adjustments in relation to areas such as thin capitalisation, controlled foreign corporations and transfer pricing. It also provides detailed guidance for Chinese enterprises on entering Cost Sharing Agreements (CAS) and Advanced Pricing Arrangements (APA). In addition, the long awaited Contemporaneous Transfer Pricing Documentation requirement is also set out in the Implementation Regulations.

Apart from the new contents, the Implementation Regulations also supersedes previous major tax circulars governing the administration of Transfer Pricing. With the Implementation Regulations now established, those tax circulars have been revoked.

The Implementation Regulations set the milestone in the development of Transfer Pricing regulations in China. It demonstrates that the Chinese tax authority is strengthening governance of anti-avoidance. The Chinese tax authorities are increasingly capable and competent in dealing with sophisticated Transfer Pricing issues and are moving towards an international standard.

In the following, we highlight some of the key contents of the Implementation Regulations, which could have significant impacts on foreign investors.

#### **Contemporaneous Transfer Pricing Documentation Compliance**

The requirement to prepare Contemporaneous Transfer Pricing Documentation is for the first time being formally introduced into China's Transfer Pricing legislation. Currently, such requirement is only imposed on entities with a significant amount of cross-border Related Party Transactions. The previous regulations though did include the criteria for documentations that should be kept by companies and the Transfer Pricing basis relative to companies Transfer Pricing practices.

The criteria for which is defined as below:

\* Annual amount of Related Party purchase and sales is not less than RMB 200 million; OR

## Upcoming LB Events

### • **Russell Brown to meet MBA students of IPADE Business School**

Venue: Beijing

Date: 15th April 2009

### • **LehmanBrown to welcome Lipscomb University during their 2009 China tour**

Venue: Beijing

Date: 27th May 2009

\* Annual amount of other Related Party transactions is not less than RMB 40 million.

The Contemporaneous Transfer Pricing Documentation shall include:

- \* An Organisational Structure of the Group
- \* A Summary of Business Operations
- \* Information on the Related Party Transactions
- \* A Comparability Analysis
- \* A Selection and Application of Transfer Pricing Methods

Each obligated entity shall prepare the documents on an independent basis. Each entity within the same group shall submit its own set of contemporaneous documents, no consolidated documentation on the group level shall be accepted. Entities shall submit the documentation for the current fiscal year by May 31 of the following year. The deadline for 2008 has been extended to Dec 31st 2009. Refusal or failure to submit the Transfer Pricing documentation within the time limit could lead to a fine of RMB50,000. In addition, a penalty interest of 5% per annum could be imposed on the tax payment due from the special adjustments, however this penalty may be waived where if the Contemporaneous Transfer Pricing Documentation is available.

### **Transfer Pricing Audit**

Detailed selection criteria for the targets of Transfer Pricing audits are set out in the Implementation Regulations. The tax authority tends to focus on enterprises with the following features:

- \* Enterprises with Related Party Transactions of large amounts and multiple types;
- \* Enterprises with long-term loss, slight profit or fluctuating profit;
- \* Enterprises with profit lower than the industry level;
- \* Enterprises with profit mismatching the function and risk assumed;
- \* Enterprises which have transactions with Related Parties based in tax havens;
- \* Enterprises which fail to declare Related Party Transactions or which fail to prepare contemporaneous documentations;
- \* Enterprises which obviously violate the arm's length principle.

The Implementation Regulations permit tax authorities to use public as well as non-public information when carrying out a Transfer Pricing assessment. The tax authority will present a formal conclusion on whether the Transfer Pricing of the enterprise is reasonable or if tax adjustment is necessary. If an enterprise is required to carry out a tax adjustment, it will enter a 5-year tracking period, during which it should submit annual contemporaneous information and documents to the tax authority.

### **Enterprises with single function of processing activities**

The Implementation Regulations reiterate the position that a contract manufacturer, which takes orders solely from Related Parties and which manufactures products for Related Parties, and which does not take on any other functions should not be taking losses resulted from management issues, such as the insufficient capacity, product obsolescence etc. A steady level of profits is expected for such type of entity if the related transactions are conducted on the arm's length basis.

### **Thin Capitalisation Rule**

Prior to 2008, there was no thin capitalisation rule imposed on foreign invested enterprises.

Since the unification of the Corporate Income Tax legislation however, foreign invested enterprises are also subject to the thin capitalization requirement. A safe-harbor debt-to-equity ratio of 5:1 for financial enterprises and 2:1 for all other enterprises has been announced. Interests attributable to the excessive leverage portion shall not be deductible for Corporate Income Tax.

The Implementation Regulations further provide detailed guidance on determining whether an enterprise is thinly capitalised. The Related Party debt-to-equity ratio is defined as the sum of the average monthly Related Party debt divided by the sum of the average monthly equity. The back-to-back loans through unrelated parties (e.g. entrusted loans) and debt with third parties that have been guaranteed or supported by a Related Party is also included in the scope of "Related Party Debt". In determining the equity component of the equation, the book value of equity is used rather than the fair market value of equity.

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