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SHANGHAI BUSINESS REVIEW

LehmanBrown understands that easy access to accurate business intelligence can make the difference between success and failure for foreign companies in the complex and changeable China business environment.

Consistent with our objective of providing our clients with up-to-date expert advice and professional services that add real value to their China business operations, LehmanBrown has launched a new business publication, Shanghai Business Review. The publication provides business intelligence and useful information for FIEs in Shanghai, helping your company to sort fact from fiction and get ahead in China!

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New Transfer Pricing Development in China

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Overview

Recently the Chinese tax authorities have started investigating and auditing transfer pricing policies of FIEs conducting inter-company transactions. The State Administration of Taxation (SAT) recently issued Circular 370 to all the subordinate tax bureaus on the various aspects of anti-avoidance/transfer pricing audit to be undertaken in 2004. Before this, circular 70 was issued on June 9, 2004 aimed at strengthening transfer pricing enforcement efforts nationwide. The circulars provide clear evidence and measures that the SAT has become increasingly sophisticated in the transfer pricing area since Circular [1998] 59, which contains China's transfer pricing rules, was issued.

This is predominately due to the fact that many FIEs use transfer pricing to realize profits offshore and for avoiding taxation. The development of the Chinese transfer pricing laws and regulations were formulated largely on the recommendations set out by the Organization for Economic Cooperation and Development (OECD). According to Article 9 of the OECD Model, the "arm's length principle" is defined as "Where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".

Information Sharing and Use

There will be greater co-operation among tax officials in-charge of anti-avoidance audits in different locations. For example, tax officials in different locations would share information on high-risk taxpayers and provide to the SAT suggested targets for national joint transfer pricing audits.

The anti-avoidance tax officials are also required to share information with tax officials in-charge of other taxation such as income tax, turnover tax and customs, and other regulatory bodies, e.g. Ministry

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(Business Tax)

Filing requirements

When related parties transactions (RPT) occur, the taxpayer has an obligation to submit a declaration form. If there is only one category of transaction with the related party, declaration form A should be submitted. This should be completed on an annual basis and returned to the tax authorities within four months of the end of the tax year. Where there is more than one category of RPT conducted, form B should be submitted. If the form cannot be filed within the stated time limit, an extension should be applied for to the tax authorities. The maximum postponement of filing the declaration form is 30 days. If the taxpayer fails to submit the declaration form within the time limit (i.e. 30days), then a new limit may be set, but a fine of up to RMB 2,000 will be imposed. A fine of RMB 2,000 - 10,000 will be imposed for application of further postponement according to Article 62 under <Law of the PRC Concerning the Administration of Tax Collection, Order [2001], No.49 of the President of the PRC>.

Document requirements

There are no statutory requirements for documentation to be submitted apart from the abovementioned proforma. Based on practical experience, the following principal documentation is usually requested by the tax authorities. This documentation should be continuously updated where required.

- An overview of the taxpayer's business;
- A description of the taxpayer's organizational structure (including an organization chart);
- A description of the pricing method selected and an explanation of why that pricing method was selected;
- A description of the alternative pricing methods that were considered and an explanation of why they were not selected;
- A description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions;
- A description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made;
- An explanation of the economic analysis and projections relied upon in developing the method; and
- Background documents that support the assumption, conclusions, and positions contained in the principal documents.

Compensatory adjustments

After a transfer pricing investigation has been completed, the tax authorities may adjust the relevant taxable amount if it is deemed that the RPT does not abide by the "arm's length" principles. The adjustments may be based on the following four (4) principles including: the pricing of the same or similar business transactions between unaffiliated enterprises (uncontrolled transactions method), the profit margin obtainable if the goods were resold to a non-affiliated party (resale price method), the cost plus a mark-up% (cost-plus method) and other reasonable methods (non-specified methods).

Penalties

There are no specific penalties detailed in taxation laws or regulations. However, if the taxpayer has any tax payable, resulting from a transfer pricing investigation, the taxpayer must settle the payment within the time limit prescribed by the authorities. If the taxpayer fails to do so within the time limit, a surcharge of 0.05% per day will be imposed. For serious violations, the taxpayer may face tax penalties of up to five (5) times the amount of understated taxation.

Special circumstance affecting the period of tax audit investigation

In April 2003, the State Administration of Taxation ("SAT") issued (Guoshuifa (2003) No. 47), which extended the transfer pricing adjustment period to 3 years or under special circumstances up to ten years. Special circumstances were then defined as:

- Cumulative **inter-company transactions > US\$12,000**
- Inter-company transactions with companies **incorporated in tax havens**
- Company has **not provided sufficient documentation** (on pricing for example)
- SAT is expected to **adjust income from inter-company transactions > US\$60,000**

Given that most foreign companies in China have an intercompany or related party transaction over US\$12,000 in any given year, it is not a matter of "if" but more "when" will FIE's transfer pricing practices be investigated. Therefore companies should ask themselves the following questions:

- 1) Have you conducted a review of your current transfer pricing practices?
- 2) Do you have supporting documentation should your company be investigated?
- 3) Do you have intercompany agreements in place to support service agreements and does your head-office maintain supporting documentation for their invoicing?
- 4) Do you have processes in place to support your annual related party transactions and the annual reporting requirements?

"Providing an alternative in China"

insights@lehmanbrown provides updates of the latest business news, taxation and accounting regulations in the People's Republic of China. It is designed to provide you with interesting and informative information to assist in your dealings with China or any China-related issues that you may encounter. If you do not wish to receive this newsletter, we have provided an un-subscribe facility below.

LehmanBrown also provides a monthly newsletter *Peeling the Onion* which investigates certain topical issues affecting businesses in China, particularly for those companies and individuals with operations in the PRC, or looking to establish a presence in-country.



Recent editions include:

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