LEHMANBROWN

律 華 會 計 師 事 務 所

International Accountants

Issue 2, Year 2002

"PEELING THE ONION - Part 2"

How Transfer Pricing can be the icing on your cake!

Imagine a cake with pieces of onion in it! The onion represents taxation payable and the cake mix is the sweet profits from conducting business. Which piece of cake would you most prefer to eat, the piece with less onion and the more sweet mix of course. **Taxation planning**, including transfer pricing, is geared towards this.

Through formulating inter-company service and purchasing contracts, organisations are able to realise profits in low-taxation countries and shift profits around to assist in offsetting losses in others - thereby giving you more cake and less onion! Whilst transfer pricing has long been an acceptable taxation strategy in China, the current government is **tightening the tax loop-holes** at a rapid pace, and catching many companies in breach of the law at the same time.

Through increasing the reporting requirements of Foreign Enterprise Income Tax Returns and conducting aggressive tax audits of foreign firms, the Chinese State Administration of Taxation ("SAT") is making sure that it gets its fair share of the global taxation cake. With the government also **abolishing the dual-track corporate taxation** system and phasing out preferential tax rates and tax holidays in line with WTO requirements, it may appear that China is no longer the lucrative business environment it was in the late 1990's.

On the contrary, it simply means that foreign companies must now be even more up-to-date with current laws and regulations. Similarly, firms must now, more than ever, formulate a **water-tight international taxation strategy** and have the **audit trail** and documentation to justify it.

What does the Tax Man say?

Transfer pricing in China is governed by **Article 13** of Income Tax Law for Foreign Investment Enterprises and Foreign Enterprises, and **Article 24** of the Law Concerning the Administration of Tax Collection.

Since this legislation was first introduced in 1991, a time when China was attempting to lure as many Foreign Invested Enterprises (FIE) as possible into China, the regulations have been further tightened through the SAT issuing a series of rulings ("Guoshuifa"). Through these regulations the PRC government has adopted international practices to govern transfer pricing based on **comparable uncontrolled transaction principles**, such as the OECD and US methodologies. Using these as guides, Chinese regulations stipulate that inter-company transactions, and transactions between 'associated entities' should be priced using **"arm's length principles".**

The test of "**association**" between entities is based on control and ownership. Essentially entities are considered as associated if they fall into any of the following:

Ownership:
?Not less than 25% shareholding.
? A provision of loans which accounts for not less than 50% of the owner's capital.
? A provision of a guarantee on loans accounting for not less than 10% of the company's total loans.

Control:
? The legal representative or not less than half of the directors or executive management are appointed by another organization.
? The business operations are dependant on the provision of proprietary technology of another enterprise.
? The purchase of raw materials or components or the sales of products are controlled by another enterprise.

Once entities are regarded as being "associated", the firm must classify all related inter-entity transactions and account for them according to the "arm's length transaction" principle. This applies to **tangible assets, intangible assets and inter-company service** transactions.

? According to legislation, **tangible assets** must be priced based on a "**transaction basis**", using one of three methods:

1) Comparable Uncontrolled Price Method (CUPM), whereby the price is determined according to comparable transactions between unrelated parties. This could be based upon market price or an internal price using the price paid

or charge to independent third parties.

2) Resale Price Method, whereby gross profit margin is determined according to what is appropriate profit if it were an independent business. This is based upon the functions performed, the assets used and the risks assumed by the reseller.

3) Cost-plus Method, whereby the price is based upon a mark-up comparable with a similar transaction with an independent seller.

However, given the difficulty in sourcing realiable public data in China, in reality the tax authorities also consider "other methods" to price transactions as appropriate. These use a **"profit-base"** approach, where price is determined based upon performance measures of a comparable company and/or industry, and include:

1) Comparable profits method, where the price is based upon profit measures taken from uncontrolled tax payers that engage in similar business activities.

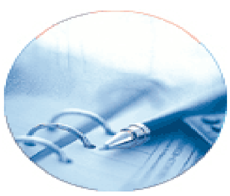
2) Profit split method, where the price is based upon the allocation of group profits by relative contribution to the combined profits.

3) Global Profit Allocation, where the price is based upon a formula using a yardstick to allocate the group profits. Such could be costs, turnover, capital, etc.

? **Intangible assets** - no method is specified, but it must be based upon agreeable charges between unrelated parties.

? **Services** - these should be charged at standard rates (i.e arm's length) as with unrelated parties where no influence can be exerted over the price.

The idea behind the move towards using the "arm's length transaction" principle is that it provides parity of tax treatment for FIE's and local enterprises. Whilst China is conforming with WTO requirements to open its market and lower barriers to entry for foreign firms, it would only appear reasonable that it also assists in providing a more level playing field for its own burgeoning domestic corporations.



The Strategy

With new legislation expanding tax collection powers to a greater number of local government bodies, provincial governments offering differing preferential tax incentives and the central government announcing a **crackdown on FIE's** dodging tax burdens, there has never been a more opportune time for companies to get there taxation strategy in order.

Before embarking on trying to reduce taxes in one country, move profits to another, repatriating funds etc, a company must determine what its objectives are. These must be determined globally before local objectives can be clarified.

Additionally, there are significant risks involved for companies that do not ensure methodology in their taxation and **transfer pricing decisions**, not just in China. One example of this risk is where a local company had been using transfer pricing to repatriate "management fees" for a number of years, only to be audited by authorities who decided that fees are not deductible for tax purpose. The company suddenly was faced with a massive tax bill plus interest payments and, even more importantly, penalties of up to five times the amount of under-reported taxation.

In China the taxation authorities have a duty to **audit:**

a) companies who report losses for more than two consecutive periods;

b) enterprises showing fluctuating profits;

c) enterprises showing profits lower than industry standards; and,

d) enterprises having transactions with affiliated companies in tax havens.

Given that the holding companies of most foreign companies' China operations come from various tax havens (e.g B.V.I , Cayman Islands) or Hong Kong, which in itself allows tax free status for holding entities, the tax department has a lot of audits to perform in the coming years. But, having trained more than **1000 employees** for transfer pricing audits alone, they are well on their way.

With this in mind, the best way for FIE's to minimize their risk of a transfer pricing adjustment is to **prepare, prepare and prepare**. Taking the view that you will be audited at some stage in the future is always the safest way to play the tax game.

To be pro-active, organisations should prepare an **"Advance Pricing Agreement"** (APA), stipulating its dealings with associated entities to present to the taxation authorities for sign-off. This APA can both be presented to cover future dealings as well as past transactions. It also provides organisations with the chance to plead their case if there is a legitimate reason that their transfer pricing costs differ from industry norms, thus avoiding unnecessary scrutiny at later stages.

Similarly, companies should take the opportunity to upgrade and tighten their **internal controls and financial systems**. Whilst incorrect transfer pricing may well be an unintentional mistake, the government will most likely take the hard-nosed approach and classify such errors as intentional misreporting.

Firms must also ensure that they record and maintain all documentation to support their transactions in case of an audit. By being able to present authorities with a clear audit trail and information (preferably in Chinese) companies may be able to avoid an otherwise arduous and unpleasant experience.

Finally, companies who operate in the China, or have dealings with Chinese entities, must ensure that they fully understand the law and implications for their organisation. **Ignorance** is certainly no excuse for illegal transfer pricing policies, and the SAT will certainly not be terribly understanding of companies who claim that they 'just did not realise".

The End Game

Whether you are already in the China market or looking to enter, determine what your **priorities** are first and then seek **professional advise** in ensuring that these are met within the context of the prevailing taxation rules and regulations.

Gone are the days when foreign firms could bask in tax havens and take advantage of extended tax holidays. Now if you want to have your cake, you may have to eat some of the onion too!

Cameron Hume , LehmanBrown - Beijing.

"Peeling the Onion" is a series of newsletters designed to assist in the financial and accounting control of your China operations. We would love to hear what issues you would like to know about in coming articles, so please contact us with any questions."

We have taken the liberty of sending you this article as we believe that it may be of interest to you. If you do not wish to receive future articles from LehmanBrown, we have provided you with the facility below to un-subscribe.

Professional Services	Financial Accounting	Management Accounting	Systems Solutions	Business Management

"Providing an alternative in China"

Visit Us | Contact Us | E-mail Us