

March, 2018

TRANSFER PRICING IN CHINA: 5 THINGS ALL FOREIGN COMPANIES DOING BUSINESS IN CHINA SHOULD KNOW

MS Advisory

ACT. INNOVATE. SHARE.

Fueled by initiatives such as the BEPS ('Base Erosion and Profit Shifting') Action Plan by the OECD and newly implemented transfer pricing local rules and regulations by OECD- and non-OECD member countries, transfer pricing has become a topic of increasing importance for companies all over the world. Though China is not a member of the OECD, they have also followed the recommendations by the OECD and have implemented via 'Bulletin 42' in 2016 many rules and regulations in terms of transfer pricing, including the requirements for transfer pricing documentation as set out in the BEPS Action Plan 13 (when certain thresholds are met).

Though in the past transfer pricing was mostly a topic of concern for larger multinationals, as a result of these global developments transfer pricing has also become a topic of increasing interest for small and medium sized enterprises. In practice, however, many SMEs still lack the knowledge and understanding of transfer pricing, and as of our experience we learned that not many companies have sufficient knowledge about this, particularly in a China setting.

To help increase the understanding of transfer pricing in China, we have compiled a list of 5 things all foreign companies at least should know about transfer pricing:

1. Basic Transfer Pricing Terminology

When two associated enterprises do business with each other, the prices used in between are referred to as the 'transfer price'. As of this relationship and to increase profitability, companies could choose to manage to have high profits in countries with low tax rates, and lower profits in countries with higher tax rates. To prevent this, countries have implemented various rules and regulations to make sure companies via this relationship avoid to pay the wrong amount of corporate income taxes on their corporate income.

The fundamental principle in transfer pricing is the "arm's length principle". In Article 9, paragraph 1 of the OECD Model Tax Convention, this term is described as follows:

[Where] conditions are made or imposed between the two [associated] 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.

Basically this means that any commercial transactions between associated companies, should not have any impact on the (transfer) price of the goods or services and should be priced according to similar or identical market conditions. To determine the amount of profits to be allocated in transactions between associated enterprises, this also determined based on the functions, risks and assets of the companies in concern. In other words, this means according to

transfer pricing rules and regulations that high (profit) margin on commercial transactions between associated cannot be shifted to 'shell holdings' (no activities or employees) registered into countries with either no or low Corporate Income Tax is levied.

2. Master file and Local file

Following Bulletin 42, companies that meet the thresholds are required to prepared mandatory Transfer Pricing documentation in China. The main mandatory reports are what is called the 'Master File', which generally serves the purpose as an overview of multinational group's Transfer Pricing policies and activities, and the 'Local File' which focuses on the local company (i.e. in China) and intercompany transactions between the local company and associated companies in other jurisdictions.

The specific thresholds for these reports are as follows:

(A) Master File: Companies that either have annual intercompany transactions with a total amount exceeding RMB 1 billion or their ultimate holding company has prepared the Master File, would need to prepare this document. This document should be completed within 12 months after the end of the fiscal year of the ultimate holding company and should be submitted to relevant tax authorities within 30 days upon their request. This document needs to be delivered in Chinese.

When the Master file of a foreign company would be requested by the Chinese tax authorities, this document needs to be professionally translated and drafted according to Chinese standards.

(B) Local File: This document needs to prepared when transactions exceed for tangible goods 200 million RMB, financial assets transactions exceed 100 million RMB, transactions for intangible assets exceed 100 million RMB and any other type of related party transactions exceed 40 million RMB. This document needs to prepared

per 30 June after the fiscal year wherein the related party transactions take place. In addition, this document would need to be submitted within 30 days upon request from the tax authority in China and delivered in Chinese.

This document investigates more in detail the intercompany transactions whether they are according to arm's length principle and would be tested via a benchmark study which Transfer Pricing method applies to the intercompany transaction. Also within this document a value chain analysis would be required.

3. Other TP files: Country-by-Country Report, Special File, Advanced Pricing Arrangements

Tax authorities might also request other TP files, which are Special Files, Country-by-Country Report and Advanced Pricing Arrangements (APAs). These documents are, however, mostly of concern for large Chinese enterprises or very large foreign multinationals active in China. Foreign SMEs should normally not be required to prepare any of these files. To provide a better understanding, we have explained these reports briefly in below section:

(A) Country-by-Country Report: Companies that need to prepare this report are the ultimate holding company of multinational groups with consolidated financial statements of the last accounting year exceeding RMB 5.5 billion RMB or when the Chinese enterprise has been named the Reporting entity. If a company is not required to file the CbCR reporting, the MNE group it belongs to is required to prepare the CbCR, which the tax authorities have the right to request during special tax investigations under various circumstances.

Though this document is not of primary concern for small enterprises, it remains important for enterprises of different sizes to have a good understanding of the CbCR. This report provides an overview of all the financial results, tax planning, and relevant information regarding all operating subsidiaries in different countries. This

report provides an accurate overview of the financial information of the company, therefore small enterprises that belong to large groups, even if their activities in China are very limited, should bear in mind that this financial information can be requested by the tax authorities.

(B) Special File: Companies that have cost sharing arrangements and is recording a debt-equity exceeding the prescribed limit, are required to prepare a Special File per 30 June following the year when these related party transactions has taken place or within 30 days after request of the relevant tax authorities. Since for foreign companies in China their overseas borrowings cannot exceed the prescribed debt-equity ratio, these files are expected not to become a burden for foreign companies in China.

(C) Advanced Pricing Arrangements (APAs): As the name mentions, these are advanced arrangements with the Chinese government about their pricing arrangements and has been confirmed that the pricing is according to arm's length principle. Companies which have entered into these agreements, do not need to prepare local or special files and the related party transactions covered into these agreements is not covered in the related party transaction amount. Approximately around a 100 APAs have been concluded in China and is mostly of concern for large enterprises which have the resources to establish these agreements with the local government. For most foreign SMEs in China, this would not be of their concern.

4. Transfer Pricing with 'Chinese characteristics'

Though most recommendations following the OECD BEPS Action Plan have been followed, Chinese tax authorities have used on several aspects their own interpretation and requirements on Transfer Pricing.

For instance, within the Local file a value chain analysis is specifically requested, and which of course many companies are not willing to provide

that actively. To deal with this particular request, you should strategically decide which information or detail to provide exactly. An experienced TP consultant should be able to draft the value chain according to the requirements set by the local tax authorities.

Also, specific emphasis is put on the location-specific advantages of China. The tax authorities are under the impression that the sheer size of the Chinese market and the opportunities to sell products locally, i.e. market premium, and the vast array of workers and production opportunities would provide more functions to the Chinese entity and therefore more profit need to be allocated to the local enterprise. Particularly companies active within the automotive industry in China have experienced these interpretations in their dealing with the tax authorities.

5. Trends of Transfer Pricing in China

Though preparing Transfer Pricing documentation is not of concern to all foreign enterprises active in China, it remains important – by Chinese law – that all commercial transactions are priced according arm's length principle. If not, the tax authorities can request the companies to make an adjustment accordingly.

The global tax landscape is developing more and more toward a world where companies need to have substance, which is also of concern for China and Hong Kong. Having, for instance, your intellectual property rights and patents owned by British Virgin Islands (BVI) Holdings which do not have any significant activities rather only exist for ultimate tax benefit, is something which becomes harder and harder to manage and seems to come to an end soon. This development will also be of concern for Hong Kong registered companies, which in the past has been used in relation to China many times for this purpose.

As of the sheer size of the Chinese market, the ultimate amount of people working at the

Chinese tax authorities remains still limited, however the tax authority will become with the support of technologies and better processes more equipped to investigate transfer pricing issues and is expecting to gain a more tightening grip on these practices.

At this moment, companies which can provide wide range of Transfer Pricing services remains

limited to few boutique firms and the Big Four companies. These companies can have the resources and projects to take on these assignments with their staff. Many companies can provide consulting support on Transfer Pricing, but rather have the ability to provide full TP documentation support according to Chinese standards.

Our thoughts

Though Transfer Pricing documentation is not of concern to all companies active in China, all companies should be aware of the basic principles and requirements as promulgated by the Chinese tax authorities. Enforcement on transfer pricing is not only increasing within China, but within jurisdictions all over the world. Particularly when looking at this development is that maintaining substance and reasonable profitability of the companies within the group becomes very important. It is therefore vital that companies have formulated their right transfer pricing strategies and policies to be in line with these global developments.

Within Moore Stephens we have the qualified professionals to provide you strategic advice and consultation on transfer pricing. If you are not sure if your company is well in line with the transfer pricing policies or want to understand if your company is meeting the transfer pricing documentation thresholds, please do not hesitate to contact us at info@msadvisory.com.