

Prescriptions

China Tax Developments

What Multinational Pharmaceutical Companies Need to Know About
New Contemporaneous Transfer Pricing Documentation Rules

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Statutory transfer pricing (TP) documentation requirements are changing the way global pharmaceutical companies operate in a growing number of Asia-Pacific and South Asian markets. China will soon join South Korea, India, Taiwan, and other jurisdictions in the region that have issued TP documentation rules over the past few years.

Though the long-anticipated TP rules will affect multinational companies across industries, tax authorities worldwide are inclined to focus on pharmaceutical companies because of their significant tax base and the complexity of transactions across the sector. Chinese authorities are no exception.

Pharmaceutical companies in China routinely conduct related-party transactions, for example:

- Royalty payments
- Service payments
- Active pharmaceutical ingredient (API) purchasing
- Contract R&D services agreements

Royalty and service revenues are increasingly attracting the tax authorities' attention and significant



controversies are likely to occur in these areas. Royalty payments that are considered related to the importation of raw materials may also be subject to customs duty, import value-added tax (VAT), and business tax and withholding tax concurrently.

A Look Back

Historically, tax authorities in China only requested certain elements of TP documentation during a transfer pricing audit. The first step toward broader TP documentation requirements occurred in 2004 in the form of Circular 80, which requires taxpayers to issue an explanation of the

All Eyes on API

China's tax authorities pay particular attention to the value attributed to active pharmaceutical ingredients (API).

Investigations have centered on whether the imported value of API of pharmaceutical companies in China charged by their overseas affiliates was determined on an arm's length basis.

In some TP audit cases, officials have requested comparable information for the imported value of API received from other countries. Executives should consider whether they have established effective trading models and defensible TP approaches with a view to achieve direct and indirect tax minimization and to mitigate transfer pricing risk.

interest rate paid on an intercompany loan by making a comparison with a third-party commercial loan interest rate. According to the circular, the explanation must be submitted in conjunction with the taxpayers' annual tax returns.

In early 2005, China's Administration of Taxation (SAT) began drafting contemporaneous TP documentation rules. The release of the rules has been delayed several times and there is currently no reliable release date for the rules. However, some developments are expected on this front during 2007, even though there may be some changes from the draft rules that have been seen by many. Tax officials say the draft rules would require the annual submission of basic contemporaneous TP documentation in conjunction with annual tax returns by April 30, the official filing deadline. The tax authority is able to grant an extension of not more than 30 days; however, the authority is also able to request further documentation after the April 30 submission.

A Look Forward

Based on Ernst & Young's current understanding, the documentation rules

would describe the basic documentation needed for submission alongside the annual tax returns and the full documentation that tax payers will need to maintain in their files. Though some degree of ambiguity exists about what these provisions will entail, basic documentation would likely include:

- Intercompany transaction disclosure forms
- Revenue and expense analysis for intercompany transactions, including purchase and sale of tangible goods, provision of services, financing, and asset transfer transactions
- Explanations for how the transfer pricing methodologies for the intercompany transactions adopted meet the arm's length standard

Full TP documentation, which taxpayers would need to keep on file, will likely consist of:

- Information related to the organizational structure of the company
- A description of its overall business operations
- Intercompany transactions for the past 3 years
- A functional and benchmarking analysis for the current tax year and information related to the selection of transfer pricing methodologies for the current tax year (designed to demonstrate that the taxpayer's current TP practices are conducted at arm's length and that no adjustments should be made by the tax authorities)

Penalties and Consequences

At present, the penalty for not submitting TP documentation is nominal; however, senior tax officials have indicated that they are looking to substantially enhance the penalty regime. Before the new penalty regime kicks in, tax authorities can disregard the transfer pricing methodologies as prescribed under the laws and can deem a profit for a taxpayer who failed to provide documentation, which could

result in a significant adjustment for the taxpayer.

Preparing the necessary documentation will help support the soundness of the taxpayer's TP policy and minimize the risk of potential adjustments. In many instances, additional penalties related to TP adjustments can be avoided if the taxpayer has prepared proper documentation.

Under the current TP rules, the taxpayer holds the burden of proof to justify the arm's length nature of the pricing adopted for its related-party transactions. The national tax authorities have up to 10 years to make TP adjustments if they disagree with the taxpayer's rationale. If an adjustment is made to an item or expense previously subject to withholding tax (e.g., royalties, service fees, or interest), the taxpayer will not receive a refund for the withholding tax previously paid on the adjusted amount and the deductibility of the expense will be disallowed.

In addition, adjusted profits will be considered a deemed dividend if no corresponding payments were made to the overseas related party. The deemed dividend will be subject to a penalty withholding tax of 20 percent. Depending on the applicable location incentive and applicable tax treaty, the penalty withholding tax may only be 10 percent. A recent SAT circular reinforced this position.

Outlook

The upcoming TP documentation requirements and penalty risk could have a major impact on the profits of multinational pharmaceutical companies operating in China. Taxpayers are subject to penalties if they fail to submit TP documentation by the prescribed deadline. Foreign investment enterprises with related-party transactions should begin preparing and maintaining the necessary TP documentation as soon as possible in order to reduce the ultimate transfer pricing adjustment risk and the related financial implications.

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Pharmaceuticals Practice Area Contacts

Philip Anderson
Ernst & Young China
Tel: (86) 2405 2269
philip.anderson@cn.ey.com

Terry Wang
Ernst & Young China
Tel: (86) 21 2405 2866
terry.wang@cn.ey.com

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