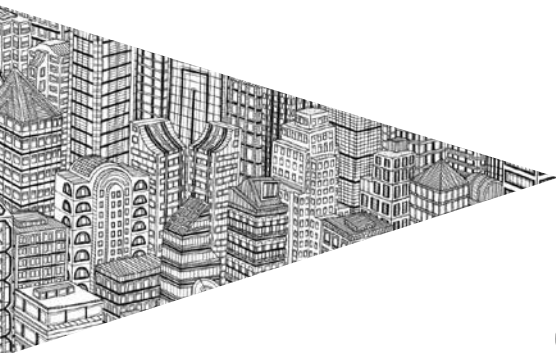


# Tax Alert

News and views from  
Transfer Pricing



## China Steps Up

### Draft Regulations Released by the SAT

When it comes to transfer pricing in China, the rules of the game have changed. Transfer pricing enforcement has clearly become a priority.

While a number of drafts of transfer pricing compliance regulations have been put forward by the SAT over the past two plus years, on 21 March 2008 the State Administration of Taxation ("SAT") selectively circulated a comprehensive final draft regulation entitled "The Regulation of Special Tax Adjustments (Trial) (discussing draft)". This draft regulation (the "Draft Regulation") is largely, but not exclusively, about transfer pricing.

It is the third piece in the progression of tax law development in China. The Draft Regulation is a Guoshuifa, which is the SAT's administrative guidance to tax auditors and taxpayers. The Draft Regulation is in accord with the relevant articles of the Corporate Income Tax Law ("CIT Law"; Zhuxiling 63 enacted by the National Peoples' Congress in March 2007) and Corporate Income Tax Law Implementation Rules ("CITLIR"; Guowuyuanling 512 promulgated by the State Council in December 2007). Both the CIT Law and CITLIR took effect on 1 January 2008. When the Draft Regulation is finalized (expectations are by mid-June, at the latest), it will also have the same effective date.

With the Draft Regulation, China will finally be on par with its major trading partners insomuch as having detailed implementing regulations is concerned.

The Draft Regulation has thirteen (13) chapters and one hundred twenty (120) articles:

1. **General Principles**  
(Articles 1 through 6)
2. **Related Party Transactions**  
(Articles 7 through 10)
3. **Contemporaneous Documentation**  
(Articles 11 through 21)
4. **Transfer Pricing Methods**  
(Articles 22 through 29)
5. **Transfer Pricing Tax Audit Investigation and Taxable Income Adjustment** (Articles 30 through 47)
6. **Advanced Pricing Agreement**  
(Article 48 through 63)
7. **Cost Sharing Arrangement**  
(Article 64 through 77)
8. **Administrative Guidance Concerning the Controlled Foreign Corporation**  
(Article 78 through 86)
9. **Administrative Guidance Regarding Thin Capitalization**  
(Article 87 through 94)
10. **General Anti-Avoidance Principles**  
(Articles 95 through 100)
11. **Transfer Pricing Adjustment, Double Taxation, and International Treaty Obligations/Negotiations**  
(Article 101 through 107)
12. **Legal Obligations, Fines, Interest & Penalties** (Articles 109 through 115)
13. **Supplementary Provisions**  
(Articles 116 through 120)

As an attachment, yet integral part of the Draft Regulations, the SAT also circulated drafts of the various forms that must be filed (if certain conditions are met) with the annual tax return. These include:

- ▶ Annual Reporting of Related Party Transactions- Related Parties
- ▶ Annual Reporting of Related Party Transactions - Transaction Summary
- ▶ Annual Reporting of Related Party Transactions - Purchasing and Sales
- ▶ Annual Reporting of Related Party Transactions - Services
- ▶ Annual Reporting of Related Party Transactions - Financing
- ▶ Annual Reporting of Related Party Transactions - Assets Transfer
- ▶ Annual Reporting of Related Party Transactions - Thin Capitalization
- ▶ Annual Reporting of Related Party Transactions - Foreign Remittance
- ▶ Annual Reporting of Overseas Investments
- ▶ Annual Reporting of Controlled Foreign Corporations

Additionally, attached to the Draft Regulation were other forms that will be used by tax inspectors at the provincial and local tax district levels when conducting a tax audit on transfer pricing as well as when communicating their findings within the tax authority and to the taxpayer.

Make no mistake about it, the Draft Regulation and supporting forms are very comprehensive and detailed. As with most guidance throughout the globe on transfer pricing, there remain open issues and a continued need for clarity, but for the most part, the Draft Regulations put forward a framework that taxpayers can understand and largely follow albeit with related administrative burden.

Immediate attention should be paid by taxpayers to Articles 13 and 14 which outline the requirements concerning the preparation and maintenance of transfer pricing documentation. Chinese taxpayers with related party transactions (as defined in Chapter 2; Articles 7 through 10) in excess of 100 million RMB must prepare full scope documentation (as defined in Article 12). Those taxpayers with related party transactions between 20 million and 100 million RMB can prepare simplified documentation (as defined in Article 13). Certain taxpayers will be exempt from preparing documentation. In Article 14, a taxpayer that satisfies any one of the following criteria is exempt from the preparation, maintenance and submission of contemporaneous documents:

1. Annual related party transaction amount is lower than RMB 20 million;
2. The taxpayer is in a period covered by an effective APA; or
3. The taxpayer is only involved in related party transactions with domestic related parties (excluding Hong Kong SAR, Macao SAR and Taiwan area).

Ernst & Young's detailed review of the Draft Regulation has revealed a number of issues that will affect all Chinese taxpayers (both domestically headquartered companies and foreign invested enterprises). We focus in this Alert on five fundamental issues which we hope will be addressed differently in the final Regulations.

## 1. 20% Ownership Threshold

**The Draft Regulation:** The Draft Regulation sets the threshold for "related party definition" at 20%, which is much lower than the stipulated ratios of other members of OECD.

**Ernst & Young:** We believe a higher ownership ratio is appropriate (e.g., 25%) and aligned with practices in other major trading countries, or to grant exceptions to taxpayers under MAP.

## 2. Criteria for APA Application

**The Draft Regulation:** According to the current draft, for those taxpayers who do not fit the profile of encouraged applicants (e.g., at least 10 years of operating history), APAs are not accessible and therefore, they should not bother applying because the SAT will not permit them into the APA program. The reason for such a request is that the SAT would like to see the applicant's history before entrusting them with the APA opportunity.

**Ernst & Young:** We believe the APA should be applied to a larger scope of taxpayers to mitigate tax uncertainty in their operations. As such, the criteria for APA application should be relaxed (e.g., 5 years of operating history). In addition, it would be helpful to have greater clarity around whether the specific taxpayer legal entity is required to have this history or whether the taxpayer group can rely on its history (i.e., the group has been operating in China for many years through other legal entities).

## 3. Contemporaneous Documentation

**The Draft Regulation:** It becomes a must for taxpayers to prepare and maintain relevant contemporaneous documentation, regarding related-party transactions for each taxable year, and submit them to the tax bureau when requested, probably within 15 days upon request. Detailed requirements on the transfer pricing documentation report are also provided and the corresponding rules on interest and penalties are also included. Based on the Draft Regulation, all documents must be in Chinese including any intercompany contracts.

**Ernst & Young:** We believe the 15-day preparation time is too limiting for taxpayers. In addition, more clarification needs to be provided on several aspects such as the provision of guidelines on the quality of documentation, the contemporaneous nature, etc.

#### 4. Transfer Pricing Adjustment Threshold

**The Draft Regulation:** According to the current draft, if the profitability of a tested party is lower than the median of the comparable range, in principle the tested party should be adjusted up to the level not lower than the median.

**Ernst & Young:** The requirements of this article are tough. In other words if a taxpayer uses the classical transfer pricing technique of an interquartile range of arm's length results and finds itself in that range, but below the median, then the Chinese tax inspector can adjust to the median or above at his discretion. The Draft Regulations therefore only recognize a range of arm's length results as a tool to find a median, not as range per se where a taxpayer can legitimately find itself below the median. We believe the threshold of the adjustment should include points other than the "median" such as the "lower-quartile" to upper quartile of an interquartile range which has clearly become international standard. Where a taxpayer has not prepared contemporaneous documentation, the SAT would appear well within reason to adjust that taxpayer to the median of a range thereby ignoring any points lower than the median (e.g., in the absence of transfer pricing documentation, then Article 42 applies).

#### 5. Information Disclosure

**The Draft Regulation:** Not only are numerous tax-return disclosure forms are requested in the draft, but also certain offshore group-level data are required.

**Ernst & Young:** Disclosure of unnecessary information will be a burden on taxpayers. Ernst & Young believes reducing the number of forms and/or enhancing one of the current forms is a more efficient approach. As for overseas group-level data, information requests ought to align fully with information sharing articles in the relevant tax treaties. For foreign invested enterprises, it will be difficult to meet requirements for notarized financial statements from related parties outside China.

It may be that the SAT will issue one more discussion draft in early May before going final.

What do taxpayers need to do now to prepare for the final regulations?

It is clear from our ongoing discussions with the SAT that there will not be any grace period for taxpayers with regard to transfer pricing and implementation of the CIT Law, CITLIR and now the underlying administrative guidance. Hence, to be in full compliance, taxpayers in China will need transfer pricing documentation in place by 31 May 2009. This means that resources, internal and external, need to be marshaled now. Our experience with multinational groups operating in China is that the operations take place through multiple legal entities with transaction flows both purely domestic and cross border.

The first step a taxpayer must do now is to determine the applicability of guidance to all of its Chinese legal entities. Which entity requires no documentation versus limited or full scope documentation.

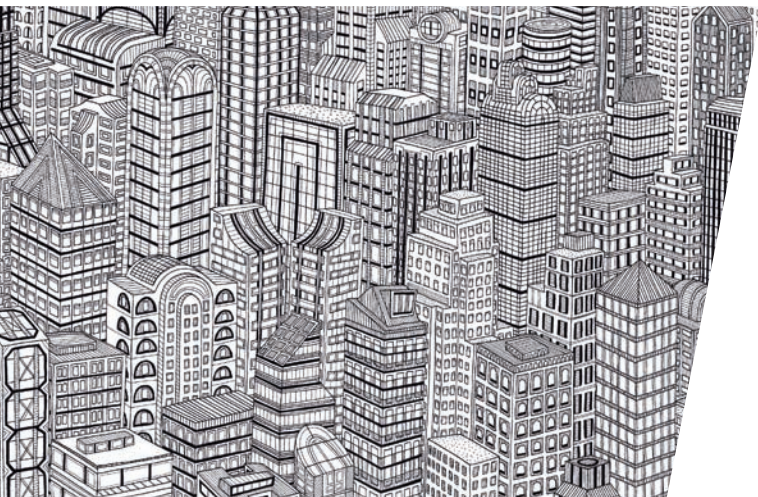
The second step is to determine whether the applicability to China and Chinese operations of components of a global transfer pricing MasterFile. Clearly, where a taxpayer can appropriately leverage documentation prepared outside China, it should to avoid expending valuable time and resources on redundant information gathering.

Third, a taxpayer needs to understand from a Chinese perspective what additional, China specific work needs to be done on an entity by entity basis.

And last, the taxpayer needs to get that work done prior from now until Spring next year.

In summary, China has stepped up and with the pending release of final regulations is now on par with global trading partners when it comes to a regulatory framework for transfer pricing. Given China's role in global trade, it is important to note that the CIT Law, CITLIR, and draft administrative guidance are, in fact, very reasoned and comprehensive. In many respects they draw upon best practice from other countries. As with most if not all tax law, there remains uncertainty, but this is a great leap forward.

Ernst & Young is in regular communication with the SAT regarding the development of the final regulations.



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