

Tax Alert

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Tax Authorities Request Detailed Information on Related-Party Transactions from over 400 Foreign Invested Enterprises

The Beijing State Tax Bureau is currently issuing notices requesting detailed information on related-party transactions to over 400 foreign-invested enterprises (“FIEs”). Recipients are required to respond to the notice with the required information within 10 days of receipt of the notice or face a penalty.

The notice requires recipients to furnish the following information:

- The company’s organizational chart and ownership structure showing all related parties;
- Explanation of the transfer pricing policy and methodologies adopted by the company;
- Financial reports for the fiscal years 2004 to 2006;
- Completed “Information on Business Operations Form,” “Economic Indicators of Business Operations Analysis Form,” and “Financial Analysis on Related-Party Transactions Form” (2004 to 2006); and
- Completed “Basic Enterprise Information Form” and “Functions & Risks Analysis Form”.

The forms require FIEs to answer over 130 questions on their functions and risks and provide a detailed financial analysis including segmental financial data for related-party and non-related-party transactions for specified years. Recipients that fail to submit the required documents within the specified time must pay a fine of up to RMB 10,000, and submission of false information will be subject to a fine of up to RMB 50,000.

The notices were issued only to FIEs and it appears that the primary targets were “big” enterprises with significant related-party transactions. We understand that, the rule of thumb to select “big” FIEs is:

- The company with annual sales is over RMB 100 million and related party transaction is over RMB 50 million per year; or
- The company sales is over 50 million RMB and related party transaction is over 50% of the company's transaction per year.

The notices appear to be issued on a pilot basis and it is uncertain if such information requests will be applied outside Beijing as well.

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The notices are in line with the general import of the recently issued circulars^[1]. The tax authorities have indicated that the notice was designed to assist in selecting potential audit targets and in setting up an internal database for tax audit purposes.

While completing the forms, companies are discovering that the forms are complex and require a significant amount of time and effort from company management and personnel, especially in the absence of existing documentation. It is important that response to the notice be consistent with a company's documentation or, in the absence of documentation, internally consistent with the facts. Typically, assistance from transfer pricing specialists is sought by the companies in completing / reviewing the forms.

Given that the forms are a precursor to transfer pricing audits, the importance of the information released in the forms cannot be overstated, and the process needs to be carefully managed from inception. Therefore, it is advisable for FIEs to assess their transfer pricing exposures/risks and initiate steps to mitigate them.

Typically, the selection of an audit target is followed by further information requests including transfer pricing documentation. It is advisable for FIEs to put in place a comprehensive system of transfer pricing documentation, if one does not already exist, to effectively and efficiently manage the transfer pricing inquiry and audit risk.

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^[1] In March, the SAT issued Guoshuihan [2007] 236 ("Circular 236"), which states its position on the expected profitability of FIEs and FEs in China that undertake purely manufacturing functions for their overseas parent companies. In the same month, the SAT issued Guoshuihan [2007] 363 ("Circular 363") to unveil a new functions and risks checklist (same as issued by the Beijing tax authorities) to be adopted by the tax authorities during transfer pricing investigations.