TRANSFER PRICING

Transfer Pricing

A Diagrammatic and Case Study Introduction, with Special Reference to China

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PART 2:
LEGISLATION TO GOVERN TRANSFER PRICING OPERATIONS IN CHINA

FOREWORD

Transfer Pricing is a reality for any multinational. Tax authorities globally need to protect their revenue base and are therefore actively enforcing the arm's length principle to ensure they get a fair share of the profit on any transaction. Taxpayers generally are not seeking to "profit shift" and want to be compliant in addressing Transfer Pricing risks, but don't always know where to begin in understanding the issue and creating the right framework for managing it. For this reason it is no surprise that Transfer Pricing is consistently voted as the biggest challenge for tax directors globally.

The focus of this book from a practical perspective is on China. China's phenomenal growth and increasing prominence in the world economy are well known and documented. As officially the second largest, and by some estimates already the largest, economy in the world, and an economy that has enjoyed a lot of its growth due to manufacturing for an export market, Transfer Pricing is inevitably a high priority item. Coupled with this is the tendency to import or license intellectual property to address a gap in knowledge, skill, or innovation, as well as the reliance on services such as IT, marketing, or human resources provided centrally within a group. All these transactions - tangible goods, royalties/license fees and service fees - create their own unique Transfer Pricing challenges.

Another important element is the Transfer Pricing climate elsewhere in Asia and globally. Rules have been in place in the United States, Europe, Japan, and Australia for some time. However, over the last five years, the emerging Asian economies are catching up and nearly all have introduced and are enforcing Transfer Pricing rules. These include Singapore, Indonesia, Malaysia, India, Vietnam, and South Korea.

Against this backdrop, the Chinese authorities have introduced detailed and far reaching Transfer Pricing rules, with a mandatory documentation requirement, enforced through an active and rapidly expanding audit and investigation programme.

For the above reasons any multinational doing business in China and the region needs to have their head firmly around Transfer Pricing, in particular what it is, how to manage it and how to document and defend it. Once this is achieved risks can be managed more effectively and opportunities to use Transfer Pricing/supply-chain planning to reduce effective tax rates, utilize tax losses, or reduce tax compliance costs, may open up

I commend the authors of this book for making a contribution to creating a conceptual and practical framework for understanding and addressing Transfer Pricing issues in China and globally.

Steven Carey
Global Partner
Transfer Pricing Associates
Hong Kong

PREFACE

The genesis for this book is the dynamic extent and quality of company growth in China over the last forty years, creating the potential for China to become the world's largest economy. World-wide, a vast number of people in companies, especially those now engaged in company activity in their own countries with Chinese connections, or in China itself, come into contact with the subject and practice of Transfer Pricing. They include those already responsibly involved in companies, financial institutions, accountancy firms, and government organisations, and those who will replace them as time passes - not least the many young people on study courses in higher education and those who have already embarked on careers in one of those many occupations.

This book offers an introduction to Transfer Pricing with particular reference to China, for those who are looking for an overview that can be rapidly comprehended and who value diagrammatic images as a vehicle for learning. The subject is of importance both for Chinese and foreign personnel engaged in foreign company activity in China and for those who are similarly engaged in Chinese owned companies already operating abroad, or which are to be extended to foreign locations.

Part 1 of the book consists of fifty items focusing on the concepts and practices in Transfer Pricing. Each item occupies two facing pages, both carrying the appropriate item number. Each left hand page presents a diagram for which a variously introductory, descriptive, and explanatory text is on the opposite right hand page.

Part 2 focuses on the latest legislation to govern Transfer Pricing operations in China. Against this background the documentation involved for associated companies trading in China and other countries is considered.

We are grateful for the assistance of Paul Connor, a British accountant, for reading the text, and Sheila Smurthwaite for assistance with design and solving lay-out problems.

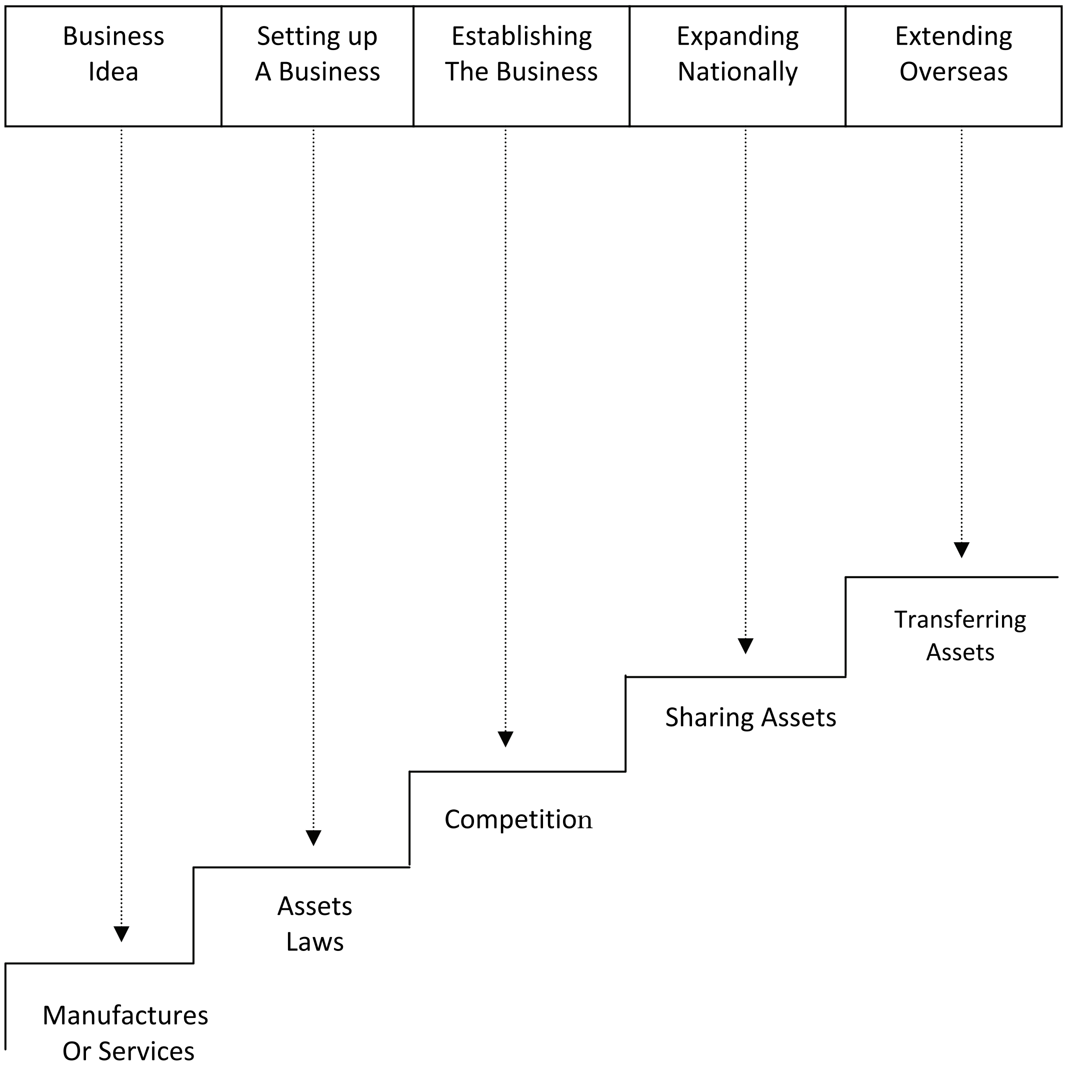
Alan Paisey, Christchurch, New Zealand and Jian Li, Shanghai, China 2011

PART 1

CONCEPTS AND PRACTICES IN TRANSFER PRICING

1

FIVE BUSINESS STEPS TO TRANSFER PRICING



1

If you are thinking of starting a business, Transfer Pricing will not be an issue for you for quite a long time to come, perhaps never. But if you are working in a large company, it may already be an important concern for the management of your company.

The diagram opposite depicts the emergence of a company from an initial idea to its foundation as a thriving concern - a process that can be fraught with difficulty, excitement, disappointment, and triumph. From an acorn, a huge oak tree will grow - given the right conditions. In the same way, a company can grow to the extent that it becomes national in nature, then finally international in nature. The 500 largest international companies of the world, most of which have current operations in China, all began with an idea and the action of an individual working alone or with an associate, and then a larger group of people.

There comes a time in the expansion of a company when it decides to establish a second branch or more branches in the same country, or finds other companies with which to establish an associated relationship for their mutual benefit.

This same strategy may then be extended to include one or more foreign countries.

Transfer Pricing possibly may not be relevant in a national setting, but once a foreign country is involved it becomes a matter of the utmost importance.

Fired with an idea for a new product or service, or the attractive modification of an existing product or service, you may decide to start a business to manufacture the article or to provide the service. Start up costs and procedures require the acquisition of assets and an understanding of, and compliance with, the laws and their derivative regulations which govern the particular form of enterprise and business activity involved. The effort to establish such a business will include a measure of competition from other businesses which detect the displacement effects that your business might have on them.

With the realization of a thriving business, the possibility of founding company branches in other locations arises, eventually nationally and then internationally. To facilitate growth in both dimensions, assets must pass between the units to found and develop them.

2

TERMS IN USE

Transfer Pricing

Transfer Pricing is the term used for
the policy and practice adopted by a company
when making an asset available to an associated company

National Applicability

It applies to transactions
between companies in the same country
particularly when the companies concerned
are located in zones which have different fiscal rates

International Applicability

The term predominantly belongs
to the vast intra-company and inter-company
transactions across the borders of different countries

An Asset

Anything of value
contributing directly or indirectly to the production
of a company's goods or services

2

Transfer Pricing as a term can be used in two senses. First, it can have a restricted use for the actual prices paid on assets transferred between associated company units. Such units might be organically part of the same company or they might be to one degree or another separately owned but in association with one another, or enjoying special relations, such as preferential trading and collaborative agreements. Assets passing between these two categories of companies are bought and sold in the same way as between totally independent companies, but are typically different. The prices asked and paid might be higher or lower than usual.

Secondly, it can have an inclusive use, and as such is the usual way in which it enters into industrial, commercial, and state currency - as an international subject for companies, governments, scholars, and authors.

Its purview takes account of the considerations bearing on

the actual pricing adopted
the methods by which they were calculated
the decision making process involved
the company policies that governed the entire action.

The inclusive use of the term applies to transactions taking place between companies within the same country and between those operating in different countries.

Given that one-third of world-wide trade consists of asset transfers between either units of the same company - intra-company transactions - or units of different companies which are in association with each other - inter-company transactions - the prices charged have a bearing on market prices generally and competitive levels. But above all they are of interest to governments for the effect they may have on the revenues they gather from different forms of taxation and duties.

It is right to think of Transfer Pricing, therefore, as an issue simultaneously for companies and for governments.

3

FISCAL LIABILITIES

Fiscal liabilities are charges levied by Government on a company operating within its jurisdiction

Of concern in the field of Transfer Pricing, these are mainly **direct taxes** on company profits and **customs duties** on imports and exports.

They can be regarded as costs in the same way as for land, labour and materials. Consequently, they become subject to the same cost reduction strategies.

Low priced transfers (underpricing)

If an asset can be transferred, by whatever means, at an artificially **low** price to a company operating in a country with **low** comparative fiscal rates, this company is enabled to have a **higher** profit margin subject to a **lower** comparative tax rate.

High priced transfers (overpricing)

If an asset can be transferred, by whatever means, at an artificially **high** price to a company operating in a country with **high** comparative fiscal rates, this company is enabled to have a **lower** profit margin subject to a **higher** comparative tax rate.

Underpricing and Overpricing

Depending on the Industrial, commercial and organizational context in which a company is operating, underpricing or overpricing can apply to its purchases but also to its sales. For an example, a Subsidiary company in China may buy an underpriced purchase which increases its profit that is subject to lower fiscal rates. It may also buy the purchase at an overpriced rate, which squeezes its profit margin, thus reducing its fiscal liability. Similarly, it may sell products or services by undercharging or overcharging with reverse effects.

3

The central concern of a company is survival. In general, it must minimize its costs and maximize its profits. The existence of numerous units of a company nationally and internationally stems from this consideration. The distribution of its production functions among its many units and the interchange of assets between them are governed by the same consideration.

An opportunity for a company to cut its costs arises when the fiscal rates vary between different countries. By the adroit use of the prices for assets sold and bought among associated companies, the full fiscal liabilities that would occur if the prices charged were identical with those applying between independent companies, can be avoided.

On the face of it, such manoeuvres are legal, but governments are as anxious to maximize their own revenues as much as companies are determined to maximize their incomes.

Transfer Pricing, therefore, becomes an issue when a company flouts a government's expectations by overpricing and underpricing assets transferred to and from another country.

This can apply within the same country if different jurisdictional sub-units in it have different fiscal rates. A prime example is the differential in tax rates between China's mainland Provinces and Hong Kong.

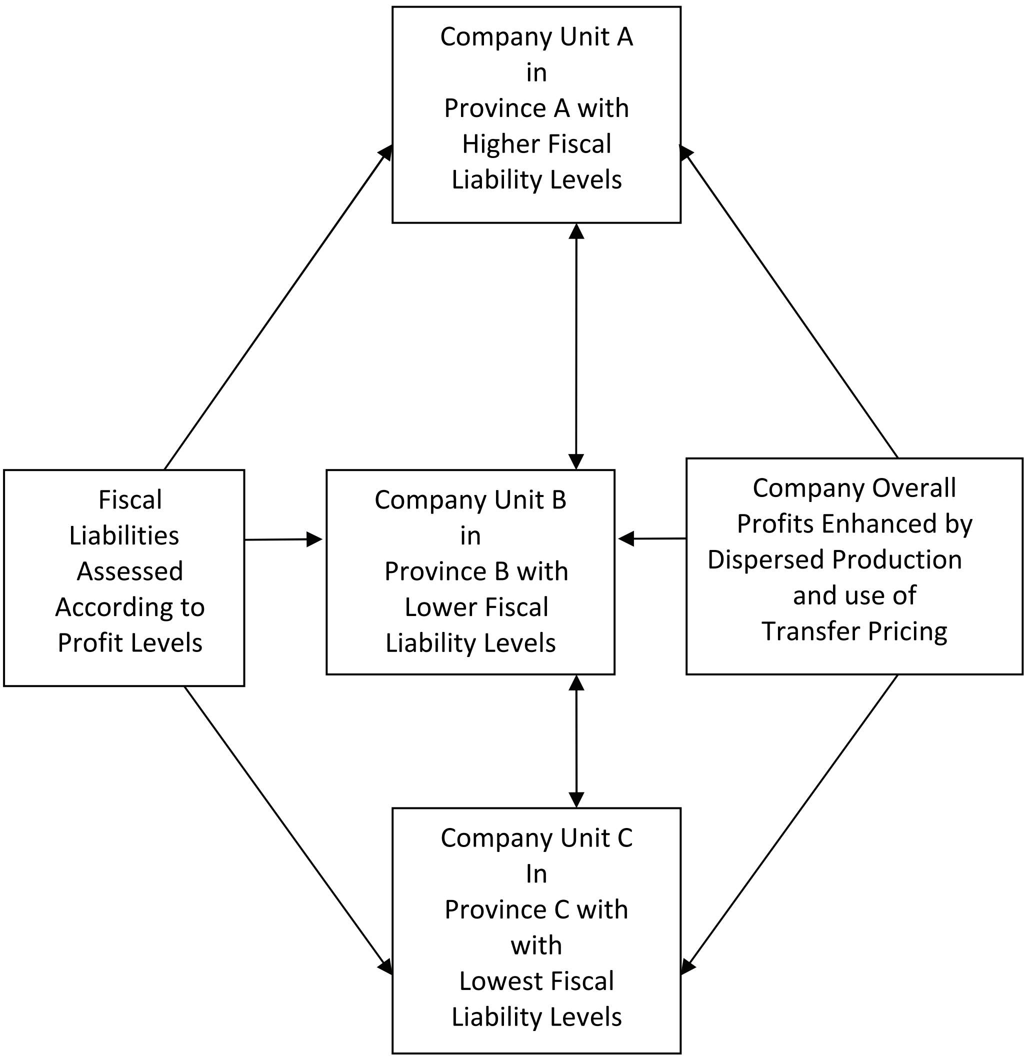
But overwhelmingly, Transfer Pricing as a problem for governments and as an ongoing - and sometimes vexed - issue for companies, exists on the international scene.

The Fiscal Authorities concerned with the collection of fiscal revenues in general, and from Transfer Pricing in particular, in some of the leading economies of the world include:

China – State Administration of Taxation
United States – Internal Revenue Service
Japan – National Tax Administration
United Kingdom – HM Revenue and Customs
Germany – Federal Ministry of Finance
France – National Tax Administration
Italy – Ministry of Finance

4

TRANSFER PRICING USED IN THE SAME COUNTRY TO TAKE ADVANTAGE OF DIFFERENT PROVINCIAL FISCAL RATES



4

In this example, a company consists of three units A, B, and C, each located in a different province of the same country. There can be many economic reasons for dispersing company units in this way. They include

land costs
local government tax rates
transportation costs
availability of labour
access to markets,
ports and motorways
availability of resources and services

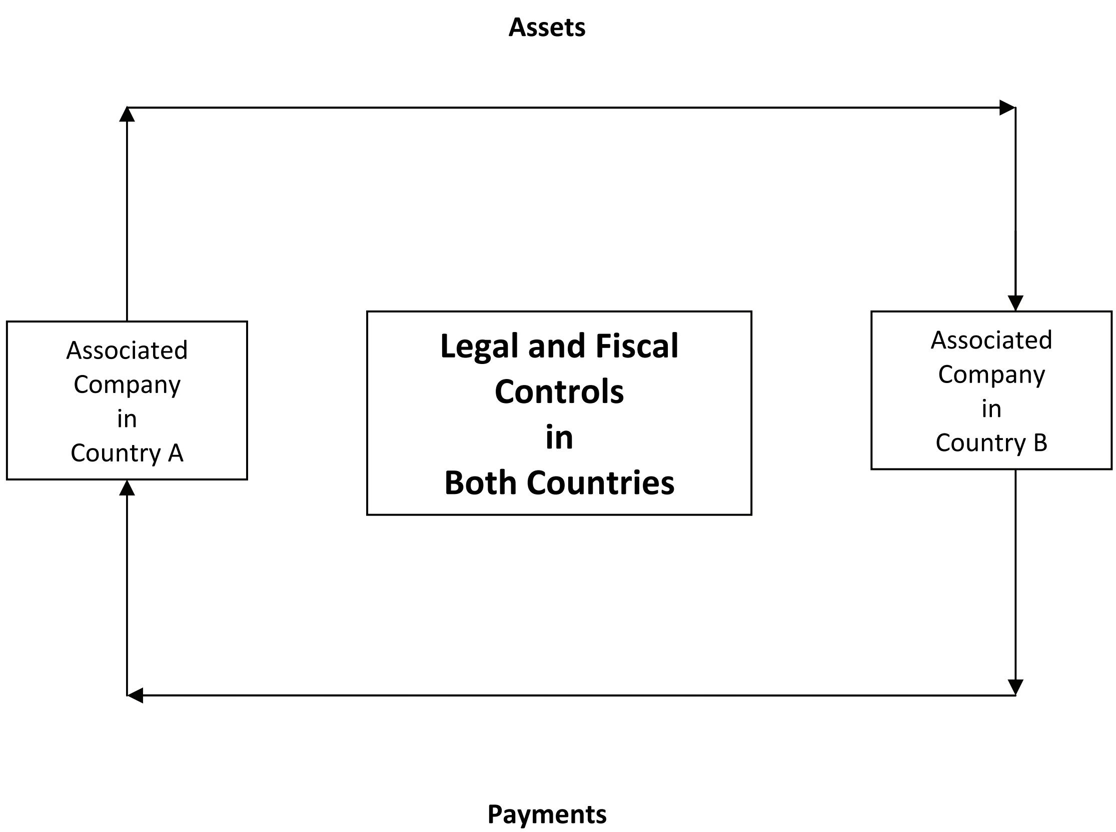
Such a dispersal of company units may be motivated in part at least by the desire to take advantage of any differences in fiscal rates between the various provinces of the country concerned, in the absence of ubiquitous national standard rates - as in the case of tax breaks. When differential rates within a national economy exist, a company's units can transfer assets to each other at prices which minimize the company's overall fiscal liabilities. In this case, Company Unit A in a province with high fiscal rates supplies materials to Company Unit B for processing. These are then passed to Company Unit C for finishing. The fiscal rates are progressively lower in the provinces where B and C are located. The prices charged on the goods transferred from A to B and from B to C are progressively underpriced, relative to the prevailing prices that would be charged for the same transactions between independent companies. With valued added to it, the product of C can then be sold back to A at a price in excess of that which would apply to the same transaction between two independent companies. In this way, a fiscal liability reduction has been obtained by three methods:

1. At B because it pays less for the transferred assets than normally, deriving a higher than normal profit which is subject to lower fiscal rates
2. At C because it too pays less than normally, deriving a higher than normal profit which is subject to even lower fiscal rates
3. At A because the product has been sold back to it at a higher price than normally which squeezes its profit margin subject to high fiscal rates and therefore reduces its liability.

Overall, the company, consisting of three units, records a higher profit by the use of Transfer Pricing than would have been the case if either it had been legally required to price its intra-company transactions at the same levels as for identical transactions between independent companies, or if a single rate of fiscal liabilities had existed.

5

TRANSFER PRICING USED INTERNATIONALLY TO TAKE ADVANTAGE OF DIFFERENT NATIONAL FISCAL RATES



5

A company that can use differential fiscal liability rates within the same country to its advantage by the use of Transfer Pricing, can exploit the variations in fiscal rates that exist internationally in the same way.

Nation states impose different levels of fiscal liability from each other on foreign companies operating within their borders. They may be deliberately differentiated to encourage foreign companies to locate within their national borders. If political sub-units are established within national borders, such as provinces, they might have the option of imposing fiscal liability rates which vary and include special inducements for companies to locate specifically in their respective provinces.

It is at the international level that Transfer Pricing has emerged as a prominent feature of company and government attention, potentially providing the one with large gains and the other with large losses.

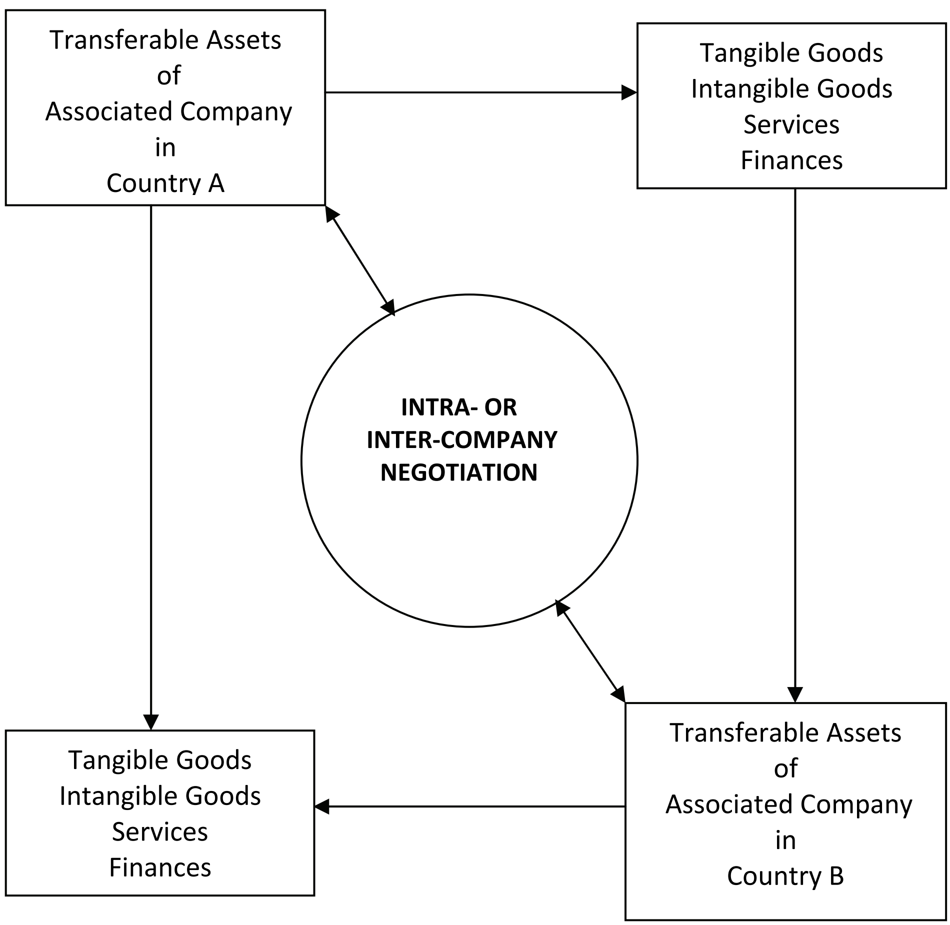
Since the practice of avoiding full fiscal liabilities has become so substantial, governments have progressively introduced legislation and detailed regulations in an effort to control the use of Transfer Pricing as a means for avoiding a company's full fiscal liabilities.

Consequently, an asset transferred from a company in Country A to a subsidiary or associated company in Country B is legally expected to carry an open market price. The differences in fiscal rates which exist between the two countries, however, enable the companies concerned to overcharge or undercharge each other by agreement for their mutual benefit, as a means to avoid the full fiscal liabilities that would normally accrue from charging the full market rates as applied to identical transactions between independent companies.

In the case of China, with the release of the new Enterprise Income Tax Law (EIT Law), the corporate income tax rate for domestic and foreign investment enterprise has been unified at 25% since 1 January 2008. This represents a jump of 10 percentage points for some foreign investment companies which previously could avail themselves of a 15% rate if they were based in special economic zones, such as Shenzhen and Shanghai's PuDong district. However, under the new EIT Law, high-technology companies will still enjoy a preferential tax policy. The key issue of domestic Transfer Pricing in China now is that companies may set up a business unit as a high-technology enterprise then shift profits to that unit to take advantage of a reduced 15% corporate tax rate applicable to the high-technology company.

6

THE INTERNATIONAL ASSET TRANSFER NETWORK



6

The all-consuming pre-occupation of the vast panoply of industrial and commercial companies that constitute the world economy is to survive, while fulfilling a distinctive contribution to support the world's population. With the growth of that population to unprecedented levels has come the kaleidoscopic proliferation of distinguishable specialisms in company products.

Companies offering a bewildering array of **services** between them have supplemented the ever increasing range of companies producing **goods**. Companies of both kinds have become multinational by opening a branch, or subsidiary, or by contracting an associated status relationship with a previously independent company, in a foreign country. Potentially, they are all able to take advantage of inter-country differentials in fiscal rates by transferring assets between themselves at prices that can be set at levels to avoid their full legal fiscal liabilities.

To achieve this - and whatever a particular company's product - all of them in one degree or another, on varying levels of magnitude, and with different frequencies, can transfer assets consisting of tangible goods, intangible goods, services rendered, and financial commitments.

Whilst the objective is the overall benefit accruing to a company from the use of Transfer Pricing in terms of full fiscal liabilities avoided, many considerations must be borne in mind by those who have the responsibility of deciding the actual price to be set on a transferred asset, and who oversee the process by which such a price is determined. Nuances in the interests of each participating company come into play. Not least, the prices agreed might have a bearing on the subsequent company performance evaluations of personnel involved.

The transfer of both intra-company and inter-company assets can be potentially subject to extensive and protracted negotiations, all with a view to the adjudication of the various and often competing interests at stake within companies, as well as to the means and terms by which the transfer of such assets can be accomplished with impunity.