



New development on the Chinese tax authorities' review of transfer pricing contemporaneous documentations

Outline of this issue:

- The Chinese tax authorities have started the collection and review of the 2010 transfer pricing contemporaneous documentation. KPMG provides our observation of the recent development regarding the tax authorities' review practice.

Background

China's State Administration of Taxation (SAT) issued the circular Guoshuifa [2009] No. 2 - "Implementation Measures of Special Tax Adjustments (Provisional)" (Circular 2) in early 2009, stipulating the detail requirements for the preparation of transfer pricing contemporaneous documentation (TP documentation) for the first time. Since then, the administration of TP documentation has always been a focus of the SAT. By reviewing the TP documentations collected from taxpayers, the SAT intends to establish a foundation for other types of anti-avoidance practices.

As the deadline for the preparation of 2010 TP documentation passed, the tax authorities have started the collection and review of 2010 TP documentation reports from tax payers. The following sections set out our observations on the recent developments regarding tax authorities' collection and review efforts of the TP documentation reports.

Tax authorities' recent practices on TP documentation review

- **Northern China**

The tax authorities in Northern China have been actively training their transfer pricing officials from municipal State Tax Bureaus on the requirements of TP documentation preparation, the review procedures of TP documentations, and techniques of identifying companies with unreasonable transfer pricing arrangements.

Beijing State Tax Bureau: Recently conducted an internal training session for the officials in charge of transfer pricing administration. During the session, the following key guidelines were provided regarding the review of TP documentations:

1. For those documentation reports that do not satisfy the requirements of TP documentation as stipulated in Circular 2, revisions must be performed.
2. For companies that may have potentially shifted profits to other jurisdictions, the reports should be handed over to a specialised department for further study and analysis. The specific requirements for the content of the TP documentation reports should include the following:
 - a) Tax payers should not only evaluate the operational results of the related party transactions, but also document how the global transfer pricing policies are determined by the group in their documentations.
 - b) Different types of related party transactions should be described and tested separately and evaluated individually as to whether these transactions comply with the arm's length principle.
 - c) Tax payers should use an appropriate method to allocate revenue, costs and expenses between related party transactions and third-party transactions.
 - d) Information should be disclosed regarding the tax payer's position with respect to the entire group's supply chain, as well as company's main competitors.
 - e) Tax payers should also disclose in their TP documentations any information regarding either direct or indirect equity transfers with related parties during the review period, even though Circular 2 does not specifically require such disclosures.

Tianjin State Tax Bureau: Requested that the in-charge officials focus on the following aspects when reviewing the TP documentations collected:

1. Review whether both the disclosure of information is comprehensive and the analysis is solid according to the transfer pricing regulations and rulings circulated by the SAT.
2. Continually pay close attention to loss-making companies and low-profit companies.
3. Review the TP position of taxpayers from a multiple-year perspective by referring to TP documentations and audit reports of previous years, and rely on in-charge tax official's experience in dealing with the taxpayers.
4. Consider the fact that the quality of TP documentations prepared by domestic companies are relatively low, and select and review the TP documentations of the domestic companies that have different effective income tax rates from their related parties.

State Tax Bureau of Hebei Province: Recently issued a notice mandating municipal tax bureaus to request qualifying companies to submit their TP documentation reports. According to the notice, the municipal tax authorities should review and analyse the documentation reports collected, identify those companies that may have transfer pricing issues, and report the list to the provincial-level State Tax Bureau.

State Tax Bureau of Shanxi Province: Believes that the taxpayers need to improve the quality of their TP documentation reports as most of the documentations collected failed to satisfy the requirements stipulated in the TP regulations and relevant rulings. In order to reinforce the administration efforts of TP documentations, the Shanxi State Tax Bureau may take into account both taxpayers' profitability and the quality of their documentation reports when selecting transfer pricing audit targets.

- **Central China**

Shanghai State Tax Bureau: Has made the greatest progress, compared to the last few years, in collecting and reviewing the 2010 TP documentation reports. Firstly, the Shanghai State Tax Bureau has requested that all companies subject to preparing TP documentations need to submit their documentation reports. Moreover, the Shanghai State Tax Bureau took considerable efforts to develop a consistent approach towards reviewing the TP documentation reports and have demanded greater scrutiny on the compliance of formality, as well as the quality of the content. The scrutiny could be inferred from the self-examination list designed by the fifth office of third sub-bureau of the Shanghai State Tax Bureau. The self-examination list illustrated nine key items for the companies to self-examine their TP documentation reports. These nine items can be divided into two main categories - formality and content.

The requirements on formality include whether:

1. The TP documentation is complete by means of formality, and whether the company completed all the required analyses and disclosed all the required descriptive information.
2. The company has prepared a Chinese version of the TP documentation report, with a stamp of the company or the signature of company's legal representative or the authorised personnel by the legal representative.

The requirements on the content include whether:

1. The selection of transfer pricing methods is consistent with the company's functional and risk profile and the comparable search.
2. The comparability analysis is sufficient, whether any of adjustments made are reasonable, and whether the internal comparable uncontrolled prices/transactions used are reliable.
3. The functional and risk analysis is sufficient to accurately reflect company's actual operations.
4. When a profit method is adopted, whether the report has provided a clear explanation regarding company's contribution to the overall profit of the group level.

From the above self-examination items, it is evident that the tax authorities not only pay attention to the truthfulness and completeness of the TP documentation reports themselves, but also have more requirements on the reasonableness of the analyses on the related party transactions. In addition, the self-examination items also set out detailed requirements on the documentation of some specific transfer pricing arrangements, such as related party debt-to-equity ratio exceeding the safe harbour, as well as cost sharing arrangement.

It is worth noting that some taxpayers have been requested by the Shanghai State Tax Bureau to submit their 2008 and 2009 TP documentations, after initially submitting the 2010 TP documentation reports. Most companies under such circumstances were either in a loss-making position, or had significant profit fluctuations in 2010. We suggest that companies in similar situations be more cautious in preparing their TP documentations, as the tax authorities may have already focus their attention on such companies.

It is also noted that the Shanghai State Tax Bureau is reinforcing the documentation administration efforts on companies in financial service industry, such as banks and insurance companies. For those financial institutions, the Shanghai State Tax Bureau has called for the collection of the TP documentation reports for 2008, 2009 and 2010. The State Tax Bureau has summarised the related party debt-to-equity ratios of the taxpayers and

requested companies with the ratio exceeding the safe harbour to submit documentations.

Jiaxing State Tax Bureau: Set up a database for collecting the key elements of the TP documentations, such as related party transactions, functional and risk characterisation and profitability of the company. This effort was meant to be in preparation of further statistics analysis and selecting transfer pricing target companies. We understand that these measures may be implemented by other tax bureaus within the Zhejiang Province after the current pilot exercise in Jiaxing.

Nanjing State Tax Bureau: Evaluated the quality of the TP documentation reports collected by a grading system, which was set up by reference to each of the 26 required components of a TP documentation report as specified in Article 14, Circular 2.

- **Southern China**

State Tax Bureau of Guangdong Province: Obtained the information from the Guangdong Commerce and Industry Bureaus regarding the change of share holders of companies in Guangdong Province, and circulated such information to local tax authorities for investigating the related party equity transfer transactions. Companies are required to pay relevant taxes for the capital gain calculated based upon the fair market value from the equity transfer if the transaction fails to meet the requirements for applying special tax treatment in equity transfer.

Dongguan State Tax Bureau: Recently requested all relevant companies to self-examine the preparation of their TP documentations, in accordance with the requirements of Circular 2. Companies that are in the follow-up administration period are requested to submit TP documentation reports. Some district sub-bureaus have requested all loss-making companies under their jurisdictions to submit TP documentation reports. Some of the loss-making companies were even required to make self-adjustments to the taxable income.

Shenzhen State Tax Bureau: Issued a notice requiring companies whose related party sales exceeded RMB 100 million to submit TP documentations, except for those qualified to be exempt from preparing TP documentations. The Shenzhen State Tax Bureau has mandated the district tax bureaus to collect and review the TP documentations from at least 10 percent of the total taxpayers in their jurisdictions, among which two to three targets need to be identified for further transfer pricing audit. The Shenzhen State Tax Bureau required that, if the TP documentation report lacks the information or analysis required, the company will be required to re-submit the documentation.

The Shenzhen local tax bureau has also requested the tax-payers to self-examine their TP documentations before the annual tax filing and make appropriate self-adjustments to the tax payable during annual filing.

KPMG observations

In 2010, the Chinese tax authorities expanded their work to include domestic enterprises, service industries, intangible assets transactions, equity transfer transactions and other new anti-avoidance measures. They also conducted joint investigations on certain industries and across-region investigations on certain group companies. During 2010, 178 anti-avoidance investigations were conducted nationwide and 178 cases were closed during the year. Consequently, the losses adjusted were RMB 999 million, the incremental taxable income adjustment was RMB 16.49 billion, and the tax payable adjustment was RMB 2.31 billion, representing an increase of 10 percent compared with last year.

In the past, the SAT used to focus their administration efforts on the post-transaction TP investigations. However, in recent years, the Chinese tax authorities have shifted their focus to pre-transaction TP risk management and services. This year, the SAT will further strengthen its 'three-in-one' anti-avoidance system, which integrates 'administration, service and investigation'. Under such guidelines, the TP documentation administration, as an important part of the anti-avoidance administration, is treated with the upmost priority. By self-examination of their own TP documentations and voluntary-adjustment of taxable income, not only will the tax payers enhance their consciousness for transfer pricing management, but also the tax authorities will improve their work efficiency in the anti-avoidance area. Meanwhile, the tax authorities are also encouraging taxpayers to initiate the applications for Advanced Pricing Agreements and Mutual Agreement Procedures, so as to eliminate double taxation for taxpayers. Compared to previous years, the Chinese tax authorities have conducted more in-depth and detailed review on taxpayers' TP documentations this year. A greater number of companies have been required to submit TP documentation reports for review. In some regions, all companies that are liable to TP documentation responsibility are requested to submit their documentations. It is clear that the SAT is concerned about whether taxpayers have strictly followed the requirements in preparing the TP documentation reports in order to be compliant. We can also assume that the tax authorities will demand higher quality TP documentation reports in the future. Companies that fail to prepare comprehensive TP documentations are more likely to draw attention from the tax authorities' or even become subject to a transfer pricing audit.

Furthermore, the tax authorities are setting up databases for compiling the information collected from those TP documentation reports submitted. This indicates the intention of the tax authorities' in integrating TP documentation administration with the selection of the transfer pricing audit targets. As such, we suggest that companies revisit their 2010 TP documentations and fix the issues identified during the preparation of TP documentations. If necessary, companies may take the initiative to communicate with the tax authorities to explain their transfer pricing arrangements to mitigate the potential exposures and risks of being investigated.

Financial institutions and companies that need to prepare thin capitalisation documentation reports are the new focus of tax authorities with respect to the TP documentation administration. We recommend that these companies are prepared and have relevant documentation reports ready for any possible submission requests from the tax authorities..

We also suggest that, if not readily available, companies prepare and finish their TP documentation reports as soon as possible. According to Circular 2, taxpayers should submit TP documentations within 20 days upon request. However, based on our experience, 20 days is usually far from sufficient when preparing a high-quality TP documentation report.

From what we know, in 2011, the tax authorities will adopt the 'group experts joint investigation' as the major mechanism regarding anti-avoidance investigation and negotiation. The focus of the anti-avoidance work will expand to domestic enterprises and tertiary industries such as finance and trading, with related party transactions spreading to equity transfer, intangible transfer and intercompany financing. The target region for anti-avoidance work will be extended to Central China and Southern China. In addition, the tax authorities will try and explore the anti-avoidance administration measures of cost sharing, controlled foreign company, thin capitalisation and general anti-avoidance, as well as probing and studying the transfer pricing issues regarding local enterprise sharing costs, tax planning through financing restructuring, multi-layer share holding structure and enterprises in tax havens with no commercial substance, which would augment tax payers' risk of being investigated.



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