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China Tax for **Healthcare & Life Sciences Industry**

Transfer pricing focus for value chain management in pharmaceutical and medical device companies

Introduction

The fast-paced development of the healthcare & life sciences industry in China has prompted multinational corporations (MNCs) to re-evaluate the effectiveness and current/future capabilities of their local business models. In the last issue, we provided an overview of research and development (R&D) activities that affect MNCs from the perspective of both Chinese corporate tax and customs. In this issue, we will focus on the transfer pricing considerations for these Chinese healthcare & life sciences MNCs, as increased public awareness and debates about this industry have resulted in tax authorities aggressively scrutinising the transfer pricing arrangements of pharmaceutical and medical device companies in recent months.

General overview of transfer pricing in China

The State Administration of Taxation (SAT) has listed pharmaceutical and medical device industries as explicit targets for potential audit scrutiny. In addition, all levels of the Chinese tax authority are focusing on increasing the sophistication of their internal resources and are aggressively pursuing transfer pricing adjustments, making China transfer pricing a key focus area regarding potential exposure in an MNC's value chain. The SAT uses a 'three-dimensional effort' for transfer pricing, comprising administration/management (review of contemporaneous filings and initiations of informal 'self-adjustments'), service (participation in advance pricing agreements [APAs] and mutual agreement procedures [MAP]), and investigation (pursuit of formal audits).

Trends in technical transfer pricing issues raised by the SAT

1. Location-specific advantages

In late 2012, the SAT published the China Country Practice chapter ("China Chapter") in the UN's Practical Manual on Transfer Pricing for Developing Countries. One focus of the China Chapter is to provide insight into identifying and analysing location-specific advantages (LSAs) which arise from factors such as government industry policies, demographic and cultural influences, or other incentives. The direct citations of LSA arguments in the China Chapter and another of the SAT's publications, the China APA Annual Report, emphasise the need for taxpayers to try to identify and account for LSAs in their transfer pricing arrangements in China.

As mentioned in Issue 1, the government's commitment to sweeping healthcare reform, along with the aging population and growing urbanisation trends, create unique market opportunities for pharmaceutical and medical device companies, which tax authorities may argue represent significant LSAs. However, the National Development and Reform Commission (NDRC) creates barriers to entry and reduces competition by imposing implicit quotas on the number of market participants, possibly generating price premiums for Chinese MNCs. Moreover, Chinese tax authorities may rationalise the higher levels of profit at 'routine' or limited risk entities by applying such LSA concepts as cost savings that are created by relatively lower labour/resource costs or market premiums due to the excessive demand in China relative to other markets. The realistic implication of LSAs on pharmaceutical companies operating in China is that the tax authorities expect higher profit levels.

2. Intangibles

In 2009, the SAT issued Shuizonghan [2013] No. 139, which outlines that pharmaceutical companies will be considered transfer pricing audit targets, and further emphasises the increased scrutiny regarding transactions involving the valuation of intangible property (IP). Chinese tax authorities are likely to assert that these Chinese entities create significant local market intangibles for which they need to be compensated due to factors such as: 1) pharmaceutical and

medical device companies often develop unique/valuable relationships with doctors, hospitals and drug distribution companies based on their continuous interactions and cultural/linguistic understanding of the market; and 2) the Chinese Government has advocated further development and innovation in the industry, which would potentially give rise to residual profits for the Chinese entities (rather than solely a more traditional routine return). This issue will be further discussed in this report using a few cases we have recently observed.

3. Transactions with tax havens

We have commonly seen Chinese (distribution) affiliates transacting with a trading company or regional hub located in a tax-friendly jurisdiction, particularly for pharmaceutical MNCs operating in China. In tandem with the recent focus on the base erosion and profit shifting (BEPS) initiative by the G20 and the Organisation for Economic Co-operation and Development (OECD), China has placed greater emphasis on scrutinising transfer pricing structures where profitability is seen as having shifted to tax havens. Transacting with related parties in such countries or locations will raise the detection risk associated with a company's transfer pricing position.

Furthermore, tax authorities now demand more transparency regarding the structure of entire value chains – in China, it is common for authorities to request supply chain profitability when performing transfer pricing audits or APA due diligence. Therefore, MNCs in the healthcare & life sciences industry should perform a risk assessment of their current transfer pricing structure as it relates to China, and re-evaluate any higher-risk positions that may attract the attention of the relevant authorities.

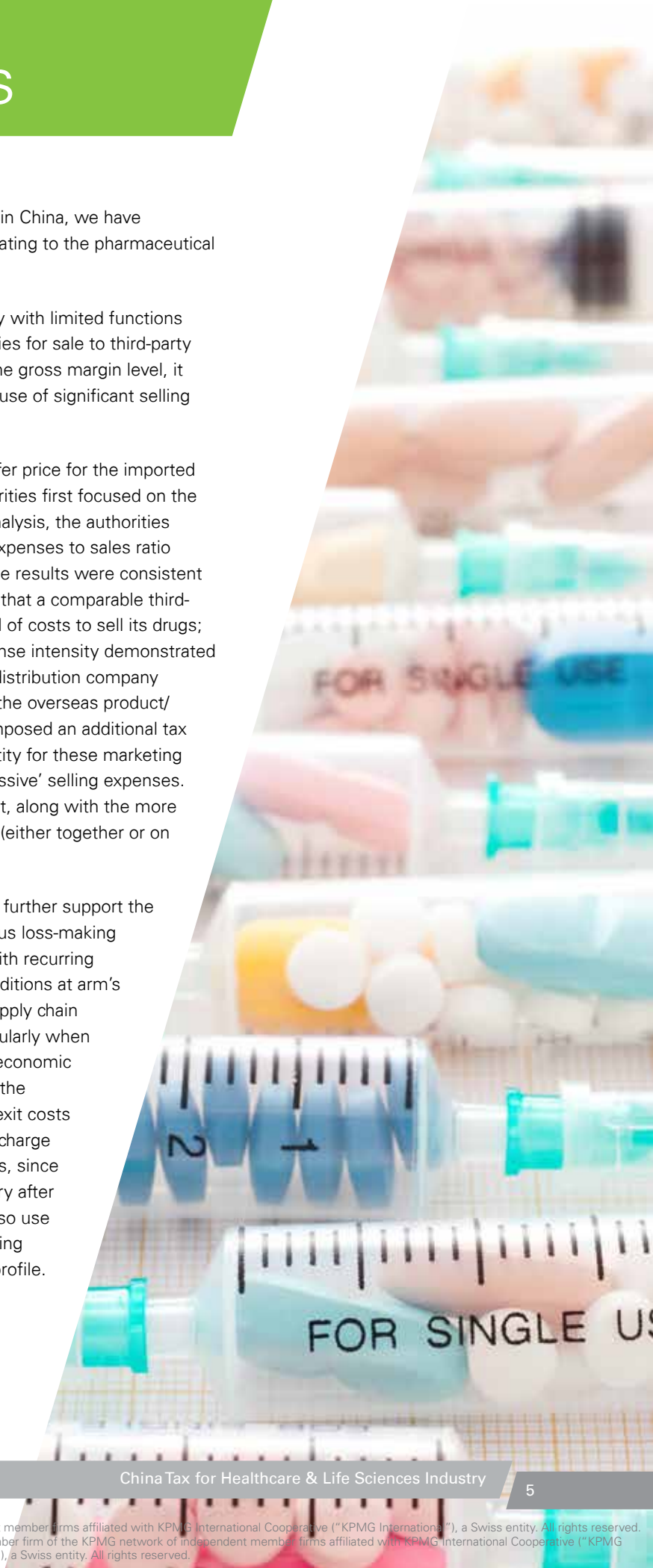
Our recent observations

Although transfer pricing audit cases are not published in China, we have observed the following relevant cases in the market relating to the pharmaceutical industry.

In one instance, a routine Chinese distribution company with limited functions and risks imported drugs from its overseas related parties for sale to third-party distributors. Although this company was profitable at the gross margin level, it was not able to achieve a positive operating profit because of significant selling expenditures.

Instead of the more traditional argument that the transfer price for the imported goods was too high, in this case the Chinese tax authorities first focused on the company's excessive selling expenses. As part of its analysis, the authorities benchmarked the Chinese distribution entity's selling expenses to sales ratio against similar third-party distributors to determine if the results were consistent with the arm's length principle. The authorities claimed that a comparable third-party distributor would not incur the tested party's level of costs to sell its drugs; therefore, the Chinese distribution entity's selling expense intensity demonstrated that either the drugs were not marketable, or that the distribution company incurred branding expenses which should be borne by the overseas product/brand owner. As a result, the Chinese tax authorities imposed an additional tax adjustment to compensate the Chinese distribution entity for these marketing activities, calculated by applying a mark-up to the 'excessive' selling expenses. Therefore, MNCs can now expect to face this argument, along with the more conventional assertion that the import price is too high (either together or on a standalone basis).

We have observed that the Chinese tax authorities can further support the economic basis for an adjustment analysis on continuous loss-making companies by arguing that an independent company with recurring losses would not continue to operate under similar conditions at arm's length. Therefore, Chinese entities in a multinational supply chain can be expected to have their losses scrutinised, particularly when their counterparty is profitable and there is no rational economic argument supporting their loss positions. In particular, the presence of limited fixed assets translates to lowered exit costs for distributors, providing further grounds for a service charge (or other types of compensation) for their operating loss, since third parties could easily be expected to exit the industry after continuous losses. The Chinese tax authorities could also use the same logic to challenge loss-making/low profit-making manufacturers, depending on their functional and risk profile.



Competing interests of different authorities

MNCs operating in the healthcare & life sciences industry in China are further constrained by the strictly controlled regulatory environment when establishing their transfer pricing arrangements. As we discussed in the first issue, the NDRC regulates drug and medical device prices, and governs the margins earned by pharmaceutical companies in China, with the goal of easing the financial burden on patients by keeping prices low. Therefore, the NDRC may deem those Chinese enterprises that earn higher profits as being in violation of certain regulatory requirements, as the NDRC imposes maximum allowable mark-ups at both the wholesale and retail levels. As a national agent, the NDRC can effectively monitor drug and medical device prices (the import price for imported goods; the ex-factory price for locally manufactured goods), and require pharmaceutical companies to make price reductions when appropriate, resulting in an expected shrinkage in profitability across the Chinese supply chain. As mentioned in Issue 1, this has the potential of running counter to the expectations of the SAT and local tax authorities, and also provides for increased exposure at the China Customs office if the import price is reduced.

Our recommendations

Various authorities in China are keeping a close eye on pharmaceutical companies, each from different (and sometimes contradictory) perspectives. To determine a supportable and defendable transfer pricing position, we would recommend that MNCs work with a cross-functional team of service providers to create a multifaceted solution which minimises the potential exposure across the various tax and non-tax issues. Based on the functional profile of the Chinese affiliates, it is important to establish a transfer pricing structure that is supportable in terms of economic rationale and that can realistically be carried out without incremental burdens on the business.

Careful planning and ongoing evaluation of a company's transfer pricing arrangement are both integral steps, especially for pharmaceutical and medical device companies which have been in the spotlight. Documentation is crucial and a two-layer/multi-layer approach would be helpful:

- Operationally, MNCs should put internal manuals in place that clearly define the roles and responsibilities of key personnel in order to provide a more robust picture of the functions performed and risks assumed by Chinese entities. This will not only serve as internal guidance for the functional departments, but will also help defend the functional profile of the Chinese entities when they are being scrutinised by the Chinese tax authorities.

- In terms of compliance, pharmaceutical companies should monitor and justify the reasonableness of their profit levels appropriately, including contextualising the profit levels with regard to China-specific factors.

- Last but not least, the nature of the expenditures, such as selling expenses, has to be analysed, especially when the Chinese entities cannot achieve positive operating results. In such circumstances, the Chinese entities may need to consider alternatives, such as charging out certain costs to the overseas brand/product owner, to mitigate the Chinese transfer pricing risks.

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