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The Practical Application of China Business

Transfer Pricing in China

Second Edition

Transfer Pricing Associates

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The Practical Application of China Business

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Dezan Shira & Associates is a specialist foreign direct investment practice, providing business advisory, tax, accounting, payroll and due diligence services to multinationals investing in China, Hong Kong, India and Vietnam. Established in 1992, the firm is a leading regional practice in Asia with seventeen offices in four jurisdictions, employing over 170 business advisory and tax professionals.

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Chris Devonshire-Ellis · Andy Scott ·
Sam Woollard
Editors

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Editors
Chris Devonshire-Ellis
Andy Scott
Sam Woollard
Dezan Shira & Associates
Asia Briefing Ltd.
Unit 1618, 16/F.,
Miramar Tower,
132 Nathan Road,
Tsim Sha Tsui Kowloon, Hong Kong
People's Republic of China
e-mail: editor@asiabriefingmedia.com

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About China Briefing's Business Guides

Thank you for buying this book. China Briefing's publications are designed to fill a niche in the provision of information about business law and tax in China. When we decided, several years ago, to commence this series, we did so in the knowledge that much of such intelligence regarding China was expensive, or contradictory. Much also did not adequately address the real on-the-ground issues faced by multinational businessmen—the practical knowledge that must be part of the armory of any business dealings in emerging markets. This guide is designed to deal with this gap and is aimed at providing both the regulatory background as well as detailed information concerning China business with a firm eye on the practicalities of turning a profit and remaining in compliance on the mainland.

Accordingly, we have tried to make these guides informative, easy to read and inexpensive. To do so, we have engaged not a team of journalists or academics, but the services of respected legal and tax professionals to assist us. For this book, the text has been provided by Transfer Pricing Associates, a global firm that specializes in transfer pricing. The firm has developed a complete methodology for managing transfer pricing that uses a multidisciplinary perspective covering management control, economics, legal, tax, finance and cost accounting. We thank them for their assistance with this work.

This book was compiled and written by Steven Carey and edited by Andy Scott; with cover design by Chris Wei and layout by Chris Wei and Becky Jian.

At China Briefing, our motto is "The practical application of China business," we hope that you feel we have accomplished this within these pages.

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An Introduction to Transfer Pricing in China

Transfer pricing is a reality for any multinational company. Tax authorities need to protect their revenue base and are actively enforcing the arm's length principle for pricing of intra-group transactions.

Recent developments in China, including the release of comprehensive transfer pricing regulations in early 2009 and more rigorous enforcement in 2010, have sent a very clear signal that the mainland is no exception to this rule.

This means that detailed transfer pricing documentation is required and that companies need to disclose related party information on tax returns, as well as prepare themselves for possible audits.

If designed and implemented early in a business life, a transfer pricing system can complement and support an MNC's business model and commercial objectives, as well as optimizing its global effective tax rate.

This book explores transfer pricing, providing practical guidance on what is best practice transfer pricing design, how to document your related party transactions, how to manage overall transfer pricing risk and how to defend your position in the event of scrutiny.

1 China's Economy and Trade

China's phenomenal growth and increasing prominence in the world economy are well known and documented. As the largest developing country in the world, China has become an increasingly important part of the international economic community. Measured by total gross domestic product, China became the second largest economy in the world in 2010, behind only the US and ahead of Japan.

Foreign-invested enterprises have become the major driver behind the expansion of global trade in China. From 1990 to 1997, FIE imports constantly exceeded exports, thanks in large part to the import of capital equipment and technology. Since 1998 however, the situation has reversed and FIEs are now able to generate sufficient production, enabling China to recognize significant and growing trade

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surpluses. It was only in 2008 and 2009 and the onset of the global economic slowdown that China's trade surplus has begun to decline as a percentage of GDP.

China's major trading partners are listed in the table below.

	Exports	Imports
1	United States	Japan
2	Hong Kong	South Korea
3	Japan	Taiwan
4	South Korea	United States
5	Germany	Germany
6	Netherlands	Australia
7	United Kingdom	Malaysia
8	Singapore	Brazil
9	India	Thailand
10	Australia	Saudi Arabia

Source: PRC General Administration of Customs

2 China's Tax System

The primary tax authority in China is the State Administration of Taxation (SAT). The SAT is a ministry-level organization, which is immediately affiliated with the State Council and takes control of taxation from a strategic, regulatory and oversight perspective. Within the SAT, the International Tax Department is responsible for anti-tax evasion.

The SAT has established state tax bureaus in every province, autonomous region and special municipality. These tax bureaus are responsible for the collection and administration of taxes that generate revenue for the central government as well as taxes that generate revenue shared by the central and local governments. The local tax bureaus, on the other hand, are responsible for the collection and administration of taxes that generate revenue only for their respective local governments.

The SAT announced in July 2008 that it was engaging in a significant restructuring exercise. Under this restructuring, the Large Enterprise Tax Administration Department (LEAD) was formed to focus on large enterprises (a term not yet defined). The International Taxation Department will remain in charge of transfer pricing policy, bilateral advance pricing arrangement (BAPA) and mutual agreement procedures (MAP). The expectation is that this change will bring about higher levels of compliance from large taxpayers as well as establish stronger communication channels between large taxpayers and the SAT.

The number of staff focused on transfer pricing at the SAT level is very small—understood to be less than ten—and historically there have been inconsistencies in the interpretation and application of transfer pricing principles at the provincial, state and local levels. Through an extensive training process as well as the release of detailed circulars and guidance on transfer pricing, the SAT has been able to manage this resource constraint and ensure that transfer pricing is more systematically and consistently enforced in the future. The SAT indicated in March 2009 their intention to develop around 500 transfer pricing specialists over the next 3 years.

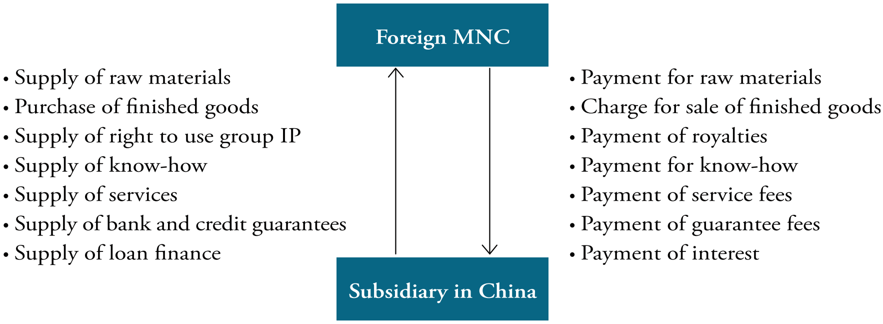
3 Transfer Pricing

Transfer pricing concerns the prices charged between associated enterprises established in different tax jurisdictions for their intercompany transactions.

Multinational enterprises are growing in number and complexity and are increasingly integrating their global operations. As a result, they transfer large quantities of goods and services among operating subsidiaries in different countries as well as engage in a range of transactions relating to services, intangible property and financing activities.

The pricing system for such transfers across borders within multinationals creates considerable managerial and tax problems due to its direct effects on the profits of both parties and the taxable revenue of all countries involved in the transactions.

The diagram figure below gives an overview of the types of activities and the corresponding inter company transactions that are defined within transfer pricing.



The Arm's Length Principle

The OECD Transfer Pricing Guidelines provide that the "arm's length principle" should be used to establish the price of transactions between associated enterprises. The guidelines require a comparison between what the taxpayer has done and what an independent party would have done under the same or similar circumstances.