

Transfer Pricing Country Summary China

March 2018

Legislation

Existence of Transfer Pricing Laws/Guidelines

The transfer pricing legislation in China is mainly contained in the following documents issued by the China State Administration of Taxation:

- Implementation Measures of Special Tax Adjustments, Trial Implementation (Guoshuifa [2009] No. 02).
- Public Notice on Matters Regarding Refining the Filing of Related Party Transactions and Administration of Contemporaneous Transfer Pricing Documentation [2016] No. 42 ("Notice 42").
- Public Notice on Issues Concerning Improving the Administration of Advance Pricing Arrangements, SAT Bulletin [2016] No. 64. ("Notice "64").
- Public Notice on Supervisory Measures for Special Tax Investigation Adjustments and Mutual Agreement Procedures [2017] No. 6 ("Notice "6").
- Public Notice of the State Administration of Taxation on Clarifying Country-by-Country Reporting Related Issues [2017] No. 46 ("Notice 46").

Definition of Related Party

Any of the following relationships of an enterprise (one party) with other enterprises, organisations or individuals (the other party) shall constitute a "related party relationship" as stipulated in Notice 42:

1. One party directly or indirectly owns 25% or more shares of the other party; or a common third party directly or indirectly owns 25% or more of shares of both parties.
 - a. Where one party indirectly holds the other party's shares through an intermediate party, so long as it owns 25% or more shares of the intermediate party, the percentage of the other party's shares held by it is equal to the percentage of the other party's shares held by the intermediate party.
 - b. Where two or more natural persons, who are spouses, related by lineal consanguinity, siblings, or in other custodianship/family maintenance relationships, hold the shares of a same enterprise, the percentage of shares held by them shall be aggregated in the calculation to determine related party relationship.
2. One party owns shares of the other party, or a common third party owns shares of both parties, even though the percentage of shares held in either situation is less than the percentage as specified in item 1, the total debt between both parties accounts for 50% or more of either party's total paid-in capital, or 10% or more of one party's total debt is guaranteed by the other party (except for loans or guarantees from or between independent financial institutions).
3. One party owns shares of the other party, or a common third party owns shares of both parties, even though the percentage of shares held in either situation is less than the percentage as specified in item 1, the business operations of one party depend on the proprietary rights, such as patents, non-patented technological know-how, trademarks, copyrights, etc., provided by the other

party.

4. One party owns shares of the other party, or a common third party owns shares of both parties, even though the percentage of shares held in either situation is less than the percentage as specified in item 1, the business activities, such as purchases, sales, receipt of services, provision of services, etc., of one party are controlled by the other party.
 - a. The aforementioned “controlled” refers to the case where one party has the right to make decisions on the other party’s financial and operational policies and can therefore derive benefits from the other party’s operations.
5. More than half of the directors or senior management (including secretaries of the board of directors of listed companies, managers, deputy managers, financial controllers and other personnel specified in the company’s articles of association) of one party are appointed or assigned by the other party, or simultaneously serve as directors or senior management of the other party; or more than half of the directors or senior management of both parties are appointed or assigned by a common third party.
6. Two natural persons who are spouses, related by lineal consanguinity, siblings, or in other custodianship/family maintenance relationships have one of the relationships as specified in items 1 to 5 with one party and the other party respectively.
7. Two parties substantially have common interests in other ways.

Except for item 2, the aforementioned related party relationship should be recognized for the period during which it exists, in the event it changes during the filing year.

Any shareholding by the State or association through assignment of directors or senior management by the state-owned assets management authorities, and therefore qualified as the relationship as specified in Items 1 to 5, will not be deemed to constitute a “related party relationship”.

Risks Factors

A company can be audited in terms of transfer pricing if:

- It has a large number of intercompany transactions or has intercompany transaction over multiple years.
- It incurs consistent profit losses, either marginal or fluctuating.
- It has lower profit levels compared to industry average figures.
- The profit level does not match with its functional profile.
- It has transactions with affiliates registered in tax havens.
- It failed to prepare or submit Annual Related Party Transactions Reporting Forms or the transfer pricing documentation.
- The company has thin capitalization issues (Debt-to-equity ratio exceeding the stipulated

threshold).

- The company is Controlled by country with less than 12.5% tax rate.
- The company's transfer pricing arrangement does not have business purpose.
- The company's transfer pricing arrangement does not comply with the arm's length principle.

Additionally, the State Administration of Taxation (SAT) has intensified industry-focused or group enterprise-oriented national joint investigations, targeting industries with potentially high transfer pricing risk profiles, although by no means have such investigations been limited to these industries.

Compliance Responsibility

If a company fails to prepare or submit Annual Related Party Transactions Reporting Forms or the transfer pricing documentation, delivers false or deceptive information and materials, the tax authority may impose a penalty of between RMB 2,000 – RMB 10,000.

Non-compliance may also trigger special transfer pricing investigation of taxable income by the tax authorities and may result with special tax adjustments. The tax authority may charge an additional 5% interest on top of the lending rate published by the Bank of China.

In addition, the penalty interest charge is also applied on any intercompany transaction amount that is greater than the threshold for document preparation.

Advance Pricing Agreement (APA)

The requirements for APA application are stated in Notice 64. APA is available for unilateral, bilateral and multilateral type.

The process of an APA includes the following stages: Pre-file meetings, Intention discussion, Analysis and Assessment, Formal application, Negotiation and conclusion, Execution Monitoring.

Companies should pay special attention to the requirement on value chain analysis and location specific advantages for application of APA in China.

For company has related party transaction in excess of RMB 40 million for each of the past 3 years pay apply for an APA.

Where the related party transactions in prior years are the same as or similar to those covered by the APA, per the company's request, the tax administration(s) may apply the agreed pricing methodologies and calculation process specified in the APA to such related party transactions. The maximum rollback period is 10 years.

Documentation And Disclosure Requirements

Tax Return Disclosures

In case there are cross-border related party transactions taking place in the financial year, the company is required to report the relevant information in relation to the related party transactions and submit the People's Republic of China Enterprise Annual Reporting Forms (2016 version) at the annual tax returns.

Threshold of Documentation

Contemporaneous documentation may include master file, local file and special issue file.

Master file

Any company that meets one of the following criteria shall prepare a master file:

1. The enterprise that has conducted cross-border related party transactions during the tax year concerned, and the MNE group to which the ultimate holding company that consolidates the enterprise belongs, has prepared a master file.
2. The annual total amount of the enterprise's related party transactions exceeds 1 billion RMB.

Local file

Any company that meets one of the following criteria during the fiscal year shall prepare a local file:

1. The annual related party transfer of ownership of tangible assets exceeds 200 million RMB (for toll manufacturing transaction, the amount is calculated using the import/export customs declaration prices).
2. The annual related party transfer of financial assets exceeds 100 million RMB.
3. The annual related party transfer of ownership of intangibles exceeds 100 million RMB.
4. The annual total amount of other related party transactions exceeds 40 million RMB.

Special issue file

A company that enters into or implements a cost sharing agreement ("CSA") shall prepare a special issue file for the CSA.

A company with a related party debt-to-equity ratio exceeding the threshold shall prepare a special issue file on thin capitalisation to demonstrate its conformity with the arm's length principle.

Country-by-Country report

Company is the ultimate holding company of a multinational enterprise's group having total consolidated group revenue of more than 5.5 billion RMB during the fiscal year is required to submit country-by-country report.

Level of Documentation

Master file

Master file shall mainly include the following information:

1. Organizational structure
2. Description of the MNE's business;
3. Intangibles
4. Financial actives
5. Financial and tax positions.

Local file

Local file shall mainly include the following information:

1. Overview of the enterprise
2. Related party relationship
3. Related party transactions
 - a. Overview of related party transactions
 - b. Value chain analysis
 - c. Outbound investment
 - d. Related party equity transfer
 - e. Related party services
4. Comparability analysis
5. Selection and application of transfer pricing method

Special issue file

Special issue file on CSAs shall include the following information:

1. A copy of the CSA.
2. Other agreements reached by the CSA participants to facilitate the implementation of the CSA.
3. Use of outcomes of the CSA by non-participants, amount paid, form of payment, and the allocation method.
4. Information on any participants entering in or withdrawing from the CSAs.
5. Description of amendments to or termination of the CSA
6. Total cost from the CSA and its breakdown during the fiscal year concerned.
7. Cost sharing among the CSA participants during the fiscal year concerned, including the amount and form of payment.
8. A comparison of expected benefits and actual benefits from the CSA, and the balancing adjustments made.

9. Calculation of expected benefits.

Special issue file on thin capitalization shall include the following information:

1. Analysis of the enterprise's solvency and borrowing ability.
2. Analysis of the borrowing ability and financing structure of the group to which the enterprise belong.
3. A description of changes in equity investment of the enterprise, such as changes in registered capital, etc.
4. Nature and purposes of the related party debt investment, and the market conditions at the time the debt investment was obtained.
5. Currency, amount, interest rate, term and financing terms of the related party debt investment.
6. Whether an unrelated party is capable and willing to accept the aforementioned financing terms, amount and interest rate.
7. Collaterals provided by the enterprise in order to obtain the debt investment and the relevant terms.
8. Details of the guarantor and the terms of guarantee.
9. Interest rates and financing terms of similar loans occurring during the same period of time.
10. Terms of conversion of convertible bonds.
11. Other information that can demonstrate the enterprise's conformity with the arm's length principle.

Country-by-country report

Country-by-country report has the same format and required information as the BEPS Action 13 and the OECD Transfer Pricing Guidelines 2017. Country-by-country report is included in the Annual Related Party Transaction Reporting Form.

Record Keeping

Contemporaneous documentation shall be kept for 10 years from the completion date of the preparation as required by the tax administrations.

Language for Documentation

Contemporaneous documentation shall be prepared in Chinese.

Small and Medium Sized Enterprises (SMEs)

Not applicable.

Deadline to Prepare Documentation

Master file shall be completed within 12 months of the fiscal year end of the ultimate holding company of

the enterprise group

Local file and special issue file shall be completed by 30 June of the year following the year during which the related party transactions occur.

It should be noted that, Country-by-country report is included in the Annual Related Party Transaction Reporting Form, which is required to be submitted at the annual tax return.

Deadline to Submit Documentation

Contemporaneous documentation shall be submitted within 30 days after receiving a request from the tax administrations.

Statute Of Limitations

The period of 10 years statute of limitations is applied for special tax adjustments, which include transfer pricing matters.

Transfer Pricing Methods

In accordance with Notice 6, the following transfer pricing method can be accepted by tax authorities:

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- Comparable uncontrolled price method.
- Resale price method.
- Cost plus method.
- Transactional net margin method.
- Profit split method.
- Other methods consistent with the arm's length principle.

Comparables

The Chinese tax authorities have access to a few databases such as Bureau van Dijk's Osiris database and Standard and Poor's Research Insight database. Generally, the Chinese tax authorities rely on comparable data obtained from public listed companies. Secret comparables can be used by the tax authorities when no public data available.