



JONES DAY
COMMENTARY

CHINA'S NEW TRANSFER PRICING IMPLEMENTATION RULES

On January 8, 2009, the State Administration of Taxation ("SAT") issued the Implementation Rules for Special Tax Adjustments (Trial), Guo Shui Fa (2009) No. 2 (the "Rules"). The Rules provide guidance for transfer pricing, advanced pricing arrangements, cost sharing agreements, controlled foreign corporations, thin capitalization, and general anti-tax avoidance. The special tax adjustments were provided in the new Corporate Income Tax Law and its implementation rules; both came into effect on January 1, 2008. The Rules have provided more detailed guidance on the special tax adjustments. The Rules replace several tax circulars on transfer pricing previously issued and are retroactively effective from January 1, 2008.

RELATED PARTIES DEFINED

The Rules broadly define "related parties." According to the Rules, an enterprise is a related party to another enterprise, organization, or individual if one of the following conditions is met:

- One party directly or indirectly owns at least 25 percent of equity of another party or a third party directly or indirectly owns at least 25 percent of both parties. In computing the indirect ownership, if a party owns 25 percent or more of an intermediate holding enterprise that in turn owns a subsidiary, the full percentage of ownership of the intermediate holding enterprise in the subsidiary is considered as the percentage of ownership of the party in the subsidiary. For example, assume Company A owns 25 percent of Company B and Company B owns 25 percent of Company C, Company A will be considered as owning 25 percent of Company C even though the actual indirect ownership of Company A in Company C is only 6.25 percent. Under this attribution rule, Company A and Company C are related parties.
- One party takes a loan from another party (other than an independent financial institution) in an amount equal to or more than 50 percent of the borrower's actual paid-in capital, or 10 percent or more of the total debt is guaranteed by another party (other than an independent financial institution).

- At least half of the senior management personnel (including directors and managers) or at least one senior member of the board of directors who may control the board of one party is appointed by another party, or at least half of the senior management personnel (including directors and managers) or at least one senior member of the board of directors who may control the board of both parties is appointed by the same third party.
- At least half of the senior management personnel (including directors and managers) of one party are also senior management of another party, or at least one senior member of the board of directors who may control the board of one party is also a senior member of the board of directors of another party.
- The normal operation of production or business of one party is dependent on the industrial property or proprietary technology licensed by another party.
- The sales or supplies of one party are controlled by another party.
- The provision or receipt of services is principally controlled by another party.
- One party has substantial control over the production, operation, and trading activities of another party, or both parties have other types of related beneficial interest, including one party and main shareholder of another party having common economic interest or family relations.

TYPES OF TRANSACTIONS COVERED

China transfer pricing rules cover a broad range of transactions, including:

- The purchase, sale, transfer, and use of tangible assets.
- The transfer and use of intangible assets.
- Financing activities, including loans, guarantees, and all types of interest-bearing advance payments and deferred payments.
- The provision of services.

CONTEMPORANEOUS DOCUMENTATION

The Rules provide detailed requirements for contemporaneous documentation on related party transactions. The documents required mainly include the following:

Organizational Structure. Enterprises should document the following information:

- The organizational structure and equity structure of the group.
- Any changes in related party relationships during the year.
- Information concerning related parties that transacted with the reporting enterprise, including the name of the related party, legal representative, directors and senior management personnel, the place of registration, the place of business operations, and the name, nationality, residence, and family members of related individuals. Related parties that directly have an influence on related party transaction need to be identified.
- Information concerning types of income tax, tax rates, and tax incentives applicable to each related party.

Business Operations. The Rules require the documentation of a wide range of information concerning business operations of the enterprise, including:

- A summary of the business of the enterprise, including the development of the enterprise, industry brief, business strategy, industry policies, restrictions, other main economic and legal issues that impact on the industry and business, and the relationship between the enterprise and the chain of production and business of the group.
- A description of the main business of the enterprise, the income of the main business and its percentage in the enterprise's total income, the profit of the main business and its percentage of the total profit of the enterprise.
- An analysis of the position of the enterprise within its industry and the relevant market competition.
- The internal organizational structure of the enterprise; the information concerning functions performed, risks assumed, and assets employed by the enterprise and related parties in related party transactions.
- The group's consolidated financial statements. Such information can be subsequently provided depending on the fiscal year of the group. However, the information should be provided no later than December 31 following the related party transaction year.

Information Concerning Related Party Transactions. This would include:

- The types of related party transactions, participating parties, timing, amount, settlement currency, and contractual terms.

- The transaction model and any changes during the year and the reasons for such change.
- The operational flows of related party transaction, including information flow, flow of goods, and cash flow of each step of the transaction, and the flow comparison between related party transactions and unrelated party transactions.
- The intangible assets involved in related party transactions and their impact on pricing.
- Copies of contracts for related party transactions and a description of contract implementation.
- An analysis of major economic and legal factors that affect the pricing for related party transactions.
- The allocation of revenues, costs, expenses, and profits between related party transactions and unrelated party transactions. If these cannot be directly allocated, a reasonable apportionment can be made and the percentage of apportionment and reasons should be provided.

Comparability Analysis. The following information should be provided in the compatibility analysis:

- Factors considered in the comparability analysis, including the characteristics of assets and services involved in the transaction, the functions and risks of each party to the transaction, contract terms, economic environment, and business strategies.
- The information concerning functions performed, risks assumed, and assets employed by comparable enterprises.
- The descriptions of comparable transactions including, for example, the physical characteristics, quality, and efficacy of tangible assets; the normal interest rates, amount, currency, duration, guarantees, credibility of borrower, terms of repayment, and methods of interest computation for financing activities; the nature of services; the types and forms of transaction of intangible assets, transaction method, and the right and benefits of using the intangible assets.
- The source, selection criteria, and rationale for the comparable information.
- Adjustments to comparable data and the reasons for such adjustments.

Selection and Application of Transfer Pricing Methods. The enterprise should document:

- The selection of transfer pricing method and the reasons for such selection.
- How comparable data can support the selection of transfer pricing method.
- The assumptions and judgments made in determining the price or profits of comparable unrelated party transactions.
- The determination of the price and profits of comparable unrelated party transactions using reasonable transfer pricing methods and the results of the comparability analysis and justification that such determination is in compliance with the arm's-length principle.
- Other information to support selected transfer pricing methods.

Enterprises should complete the contemporaneous documentation on or before May 31 following the year in which the related party transactions take place. The completion of contemporaneous documentation for related party transactions for 2008, however, can be postponed to December 31, 2009. The document should be prepared in Chinese. If the original information is in a foreign language, a Chinese translation should be provided. Upon the request of tax authorities, an enterprise should submit such document within 20 days. Enterprises should retain the contemporaneous documentation for 10 years from June 1 following the transaction year.

Enterprises meeting one of the following criteria are exempt from the preparation of contemporaneous documentation:

- The enterprise has a total amount of annual related party sales and purchases of RMB200 million or less and other types of related party transactions total RMB40 million or less. For this purpose, the amount of related party financing is calculated based on interest paid or received.
- The enterprise's related party transactions are covered by advance pricing arrangements.
- The enterprise has a foreign equity interest of 50 percent or less, and all related party transactions are with parties within the Chinese Mainland.

TRANSFER PRICING METHODS

The Corporate Income Tax Law and its implementation rules prescribe various methods that should be used by the Chinese tax authorities when assessing whether related

party transactions are in compliance with the arm's-length standard. These methods include:

- The Comparable Uncontrolled Price Method ("CUP").
- The Resale Price Method ("RPM").
- The Cost Plus Method ("CPLM").
- The Transactional Net Margin Method ("TNMM").
- The Profit Split Method ("PSM").
- Other methods consistent with the arm's-length principle.

The Rules provide operational details for these methods but do not give priority to any of them. The selection of a reasonable method should be based on a comparability analysis of major factors of a transaction such as the characteristics of assets and services, the function and risk of the transaction parties, contract terms, the economic environment, and business strategies. According to the Rules, these methods are usually applicable to the following types of related party transactions:

Method	Purchase, sale, or transfer of tangible assets	Use of tangible assets	Transfer or use of intangible assets	Financing	Provision of services
CUP	✓	✓	✓	✓	✓
RPM *	✓				
CPLM	✓	✓		✓	✓
TNMM	✓	✓	✓		✓
PSM	Usually applicable to highly integrated related party transactions where it is difficult to independently assess the operating results for each party.				

* Usually applicable to situations where resellers do not provide value-added processing such as change of shape, functions, structure, and trademark of goods.

TRANSFER PRICING INVESTIGATION AND ADJUSTMENT

The Rules provide the procedures and requirements of transfer pricing investigations conducted by the tax authorities. According to the Rules, the following enterprises will be the main targets of transfer pricing audits:

- Enterprises that have a large volume or many types of related party transactions.
- Enterprises that report losses, marginal profits, or fluctuating profits for extended periods.
- Enterprises whose profit margins are lower than those of other enterprises in the same industry.
- Enterprises whose profit margins are obviously inconsistent with the functions and risk taken.
- Enterprises that transact with related parties established in tax havens.
- Enterprises that fail to file or prepare required contemporaneous documentation.

- Enterprises that are otherwise obviously not in compliance with the arm's-length principle.

Under the Rules, the tax authorities may, during a transfer pricing audit, request that the audited enterprise, related parties, and other parties that are relevant to the related party transactions provide information; the tax authorities may use both public and nonpublic information when analyzing the related party transactions.

If the tax authorities make a tax adjustment as a result of a transfer pricing audit, the enterprise will be placed on the watch list for five years following the last adjustment year. During this period, the enterprise is required to submit contemporaneous documentation for each year to the tax authorities on or before June 20 after each year end. The tax authorities will assess the changes of business and related party transactions based on this document. The tax authorities may request that the enterprise make self-adjustment.

ADVANCE PRICING ARRANGEMENT (“APA”)

Taxpayers may enter into an APA with the tax authorities. An enterprise may apply for an APA if (1) its annual related party transactions total RMB40 million or more; (2) it has performed related party transaction filings in compliance with the law; and (3) it has prepared, maintained, and submitted contemporaneous documentation in accordance with the regulations. An APA consists of six steps including pre-filing meetings, a formal application, a review and evaluation, negotiations, signing of the agreement, and implementation and monitoring. An APA applies for a period of three to five years from the year in which the formal application is filed. The Rules make it clear that the negotiation of an APA should have no influence on transfer pricing audit and adjustment; however, transfer pricing policies and computation methods determined for the APA can be retroactively applied to past related party transactions identical or similar to those covered in the APA upon the approval of the tax authorities. An APA automatically expires at the end of the APA term. The enterprise may apply for renewal of an APA 90 days prior to the expiration date of the APA.

COST SHARING AGREEMENT (“CSA”)

Under the Corporate Income Tax Law and its implementation rules, an enterprise may enter into a cost sharing agreement with its related parties on the sharing of jointly incurred costs based on the arm's-length principle. The Rules provides more detailed guidance on CSAs, including the following key points:

- CSAs apply to jointly developing or acquiring intangible assets or jointly providing or accepting services.
- Parties to a CSA share costs and benefits; the cost assumed by the related party should be consistent with what unrelated parties would have paid for the benefits in comparable circumstances. Participants to a CSA are not permitted to be required to pay royalties for intangible assets developed or acquired under the CSA.
- The beneficial right of an enterprise to intangible assets or services under a CSA must be a reasonable and measurable expected benefit based on reasonable business assumptions and operational conventions.
- CSAs involving services are generally applicable to group procurement and marketing activities.

- A CSA should be filed with the SAT through local tax authorities within 30 days after the conclusion of the CSA. The tax authorities' determination as to whether a CSA is in compliance with the arm's-length principle should be reviewed and confirmed by the SAT.
- During the implementation of a CSA, if the benefits actually received by participants are not consistent with their respective share of costs, compensating adjustments should be made based on the actual situations.
- Enterprises may deduct their share of costs under a CSA in current periods. Compensating adjustments should be included in taxable income in the year in which adjustments are made. For a CSA involving intangible assets, payment for cost sharing should be treated as the acquisition of assets; the compensation on exit from or the distribution on termination of the CSA should be treated as the disposal of assets.
- Enterprises may enter into CSAs in the form of an APA.
- Enterprises should prepare and retain contemporaneous documentation with respect to the CSA during the implementation of the CSA and submit such documentation to the tax authorities on or before June 20 of the following year for each tax year.
- An enterprise is not allowed to deduct its shared costs if:
 - The CSA does not have a reasonable business purpose and economic substance;
 - The CSA does not comply with the arm's-length principle;
 - The CSA does not comply with the principle of “costs consistent with benefits”;
 - The enterprise did not file a CSA or prepare, retain, and submit contemporaneous documentation as required; or
 - The operating period of the enterprise is 20 years or less from the signing of the CSA.

CORRESPONDING ADJUSTMENTS

Where a transfer pricing adjustment is made with respect to a party to a related party transaction, a corresponding adjustment to the tax liability of another party to the transaction is allowed to avoid double taxation. If the corresponding adjustment involves a related party in a country or region with which China has a tax treaty, upon the application of the enterprises, the SAT may negotiate with the competent

authority of the treaty country in accordance with the mutual agreement procedure provided in the tax treaty. If an enterprise seeks a corresponding adjustment, it must apply in writing to the tax authority in charge. The application should include a copy of the transfer pricing adjustment notice issued to the enterprise or the related party and other relevant information. The tax authority in charge should forward the application to the SAT. The application for corresponding adjustment must be made within three years from the date of the transfer pricing adjustment notice. If the transfer pricing adjustment involves interest, rental, or royalty paid by an enterprise to its overseas related parties, the withholding tax that has been paid cannot be adjusted.

INTEREST AND PENALTIES

If an enterprise fails to file annual related party transaction schedules or retain contemporaneous documentation in accordance with the Rules, the tax authorities may impose a fine of up to RMB2,000 or, in serious circumstances, a fine of between RMB2,000 and RMB10,000. If an enterprise refuses to provide related party transaction information or provides false or incomplete information, the tax authorities may impose a fine of up to RMB10,000 or, in serious circumstances, a fine of between RMB10,000 and RMB50,000.

When the tax authorities make special tax adjustments, including transfer pricing adjustments, and assess additional tax liability on transactions occurring on or after January 1, 2008, interest will be imposed, on a daily basis, upon the underpaid taxes. The interest rate will be the RMB base rate published by the People's Bank of China in the year(s) to which the underpaid tax relates for a loan of same term as the period for which additional tax is payable, plus five

percent. If an enterprise provides contemporaneous documentation and other information in accordance with the Rules or is exempted from preparation of contemporaneous documentation under the Rules, the interest rate should be reduced to the base rate. The interest charged on the additional tax cannot be deducted in computing taxable income.

Under the Tax Collection Law, a late payment charge at a daily rate of 0.05 percent (*i.e.*, an annual rate of 18.25 percent) on the underpayment is imposed from the date that tax is due and payable. It appears that such late payment charge does not apply to transfer pricing tax adjustments before the required additional tax payment date as a result of a transfer pricing adjustment. Instead, only interest applies to those periods. However, if an enterprise fails to pay the additional tax and interest without an approved extension, the tax authorities will impose a late payment charge on the additional tax and interest from the due date.

The Tax Collection Law imposes a penalty of 50 percent to 500 percent of the tax underpaid in tax evasion cases. The tax authorities can potentially impose such penalty where taxpayers provide false information for the purpose of tax evasion.

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