China - The New Corporate Income Tax Law and its Effect on Transfer Pricing
and in particular the issue of documentation requirements

Master's thesis within International taxation
Author: Ida Hansen
Viktoria Lin
Tutor: Hubert Hamaekers
Jönköping January 2008
Special thanks…

We would like to thank Professor Hubert Hamaekers, Mika Myllynen at PricewaterhouseCoopers in Stockholm, Sweden, and Jeff Yuan and Joy Yao at PricewaterhouseCoopers in Shanghai, China, for all their help throughout the semester.

Gratefully yours
Ida & Viktoria

Jönköping, January 17 2008

Ida Hansen
Ida.j.hansen@gmail.com

Viktoria Lin
Viktoria_lin84@hotmail.com
Abstract

China has had a remarkable development since the late 1970s, when the Chinese government started opening up its internal market for the outside world. The Chinese legislation and the legal system itself have been developing rapidly to adapt to the new economic environment, however not without complications. Many uncertainties still remain.

Under the old income tax regime, corporations on the Chinese market were taxed under two different systems, one for domestic enterprises and one for foreign invested enterprises and foreign enterprises. With the new Corporate Income Tax Law, these two systems were merged and new concepts introduced. The new income tax law includes important articles that affect the transfer pricing regime in China. The OECD’s transfer pricing regulations have served as a model when China first started to regulate their transfer pricing, there are consequently similarities between the two.

Multinational corporations consider the issue of transfer pricing as the most important issue in their international taxation. It is important both from the aspect of being the most effective way to maximize the world profit of the corporation and also in the aspect that an adjustment due to inaccuracies in the corporation’s transfer prices can be expensive. The Chinese transfer pricing system is considered to be young in comparison with other jurisdictions, for example the United States. The Chinese government and its tax authorities have in recent years put a lot of effort in improving the transfer pricing system and its execution. Due to the amount of loss in tax revenue that is believed to be due to transfer pricing measures, the issue is considered to be of utmost importance.

The requirement on transfer pricing documentation has been an important issue for MNCs on the Chinese market, especially now when there is an interest levy on adjustments made through an audit. Since the current regulation on documentation is still quite vague, it constitutes an uncertainty for both taxpayers and tax authorities. However, an issuing of a clearer regulation on documentation requirements have long been anticipated but not yet released, although clarifying measures have been taken through the Corporate Income Tax Law and newly issued circulars during 2007.
### Content

#### Abbreviation List

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Page</th>
</tr>
</thead>
</table>

#### 1 Introduction

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1 Background</td>
<td>7</td>
</tr>
<tr>
<td>1.2 Purpose</td>
<td>8</td>
</tr>
<tr>
<td>1.3 Method</td>
<td>8</td>
</tr>
<tr>
<td>1.4 Delimitation</td>
<td>9</td>
</tr>
<tr>
<td>1.5 Outline</td>
<td>9</td>
</tr>
</tbody>
</table>

#### 2 China after 1979

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1 The 'open door policy'</td>
<td>11</td>
</tr>
<tr>
<td>2.2 Foreign investment in China</td>
<td>12</td>
</tr>
<tr>
<td>2.3 After China's accession to the WTO</td>
<td>13</td>
</tr>
</tbody>
</table>

#### 3 Legal and Administrative Framework of China

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1 State Organs</td>
<td>15</td>
</tr>
<tr>
<td>3.1.1 The legislative body</td>
<td>15</td>
</tr>
<tr>
<td>3.1.2 The Supreme Court</td>
<td>16</td>
</tr>
<tr>
<td>3.2 The different types of laws</td>
<td>17</td>
</tr>
<tr>
<td>3.3 Language and interpretation of laws</td>
<td>17</td>
</tr>
<tr>
<td>3.4 State Administration of Taxation</td>
<td>18</td>
</tr>
<tr>
<td>3.4.1 Implementation of tax law</td>
<td>19</td>
</tr>
<tr>
<td>3.4.2 The Role of Rulings</td>
<td>19</td>
</tr>
</tbody>
</table>

#### 4 Corporate income taxation

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1 Introduction</td>
<td>21</td>
</tr>
<tr>
<td>4.2 Taxation under the Corporate Income Tax Law</td>
<td>22</td>
</tr>
<tr>
<td>4.2.1 Enterprise</td>
<td>22</td>
</tr>
<tr>
<td>4.2.2 Tax resident</td>
<td>22</td>
</tr>
<tr>
<td>4.2.3 Tax rate</td>
<td>23</td>
</tr>
</tbody>
</table>

#### 5 The legal framework of transfer pricing in China

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1 Introduction</td>
<td>25</td>
</tr>
<tr>
<td>5.2 Statutory rules</td>
<td>25</td>
</tr>
<tr>
<td>5.2.1 The arm’s length principle</td>
<td>25</td>
</tr>
<tr>
<td>5.2.2 Applicable methods</td>
<td>26</td>
</tr>
<tr>
<td>5.2.3 Related party</td>
<td>27</td>
</tr>
<tr>
<td>5.2.4 Cost sharing agreement</td>
<td>27</td>
</tr>
<tr>
<td>5.2.5 Advance pricing agreement</td>
<td>28</td>
</tr>
<tr>
<td>5.2.6 Special interest rate</td>
<td>30</td>
</tr>
<tr>
<td>5.3 Other regulations</td>
<td>31</td>
</tr>
</tbody>
</table>

#### 6 Documentation and audits

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.1 Introduction</td>
<td>33</td>
</tr>
<tr>
<td>6.2 Annual documentation requirements</td>
<td>33</td>
</tr>
<tr>
<td>6.3 Documentation requirement upon investigation</td>
<td>34</td>
</tr>
<tr>
<td>6.3.1 Functional Analysis</td>
<td>34</td>
</tr>
<tr>
<td>6.3.2 Transfer pricing audits</td>
<td>36</td>
</tr>
<tr>
<td>6.3.2.1 Selection of taxpayers</td>
<td>36</td>
</tr>
<tr>
<td>6.3.2.2 Audit procedure</td>
<td>37</td>
</tr>
</tbody>
</table>
6.3.2.3 Transfer pricing adjustments .............................................................. 38
6.3.2.4 Tax dispute resolution methods ............................................................ 40
6.3.2.5 Penalties ......................................................................................... 42

7 International documentation requirements ....................... 43
  7.1 OECD Transfer Pricing Guidelines ......................................................... 43
  7.2 EU TPD ......................................................................................... 45
  7.3 PATA Documentation Package ............................................................ 46

8 Analysis ......................................................................................... 48
  8.1 Legal Uncertainty ................................................................................... 48
     8.1.1 The legislative power ...................................................................... 48
     8.1.2 About the courts ............................................................................. 49
  8.2 The new Corporate Income Tax Law .................................................... 50
     8.2.1 Taxable person .............................................................................. 50
     8.2.2 New tax rate .................................................................................. 51
     8.2.3 Attitude change ............................................................................. 51
     8.2.4 Preferential treatments ................................................................ 51
  8.3 Tax audits ............................................................................................ 52
  8.4 Documentation .................................................................................... 52
     8.4.1 Annual documentation requirements ............................................ 52
     8.4.2 Documentation upon investigation ................................................ 53
     8.4.3 The anticipated circular on documentation requirements ............... 53

Annex 1 ................................................................................................. 62
# Abbreviation List

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALTRC</td>
<td>Administrative Law of the People’s Republic of China on the Tax Revenue Collection</td>
</tr>
<tr>
<td>APA</td>
<td>Advanced Pricing Arrangement</td>
</tr>
<tr>
<td>CFC</td>
<td>Controlled Foreign Corporation</td>
</tr>
<tr>
<td>CIT</td>
<td>Corporate Income Tax Law of the People’s Republic of China</td>
</tr>
<tr>
<td>Constitution</td>
<td>Constitution of PRC</td>
</tr>
<tr>
<td>CPM</td>
<td>Cost Plus Method</td>
</tr>
<tr>
<td>CSA</td>
<td>Cost Sharing Arrangement</td>
</tr>
<tr>
<td>CUP</td>
<td>Comparable Uncontrolled Price Method</td>
</tr>
<tr>
<td>DE</td>
<td>Domestic Enterprise</td>
</tr>
<tr>
<td>DIR of the ALTRC</td>
<td>Implementation rules of the Administrative Law of the People’s Republic of China on the Tax Revenue Collection</td>
</tr>
<tr>
<td>DIR of the CIT</td>
<td>The Implementation Regulations of the Corporate Income Tax Law of the People’s Republic of China</td>
</tr>
<tr>
<td>EU TPD</td>
<td>European Union Transfer Pricing Documentation</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>FE</td>
<td>Foreign Enterprises</td>
</tr>
<tr>
<td>FIE Implementing Rules</td>
<td>Detailed Rules and Regulations on the implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises</td>
</tr>
<tr>
<td>FIE</td>
<td>Foreign Investment Enterprises</td>
</tr>
<tr>
<td>MNC</td>
<td>Multinational Corporation</td>
</tr>
<tr>
<td>Non-TRE</td>
<td>Non-Resident Enterprises</td>
</tr>
<tr>
<td>NPC</td>
<td>National People’s Congress</td>
</tr>
<tr>
<td>OECD Guidelines</td>
<td>OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------------------------------------</td>
</tr>
<tr>
<td>PATA</td>
<td>The Pacific Association of Tax Administrators</td>
</tr>
<tr>
<td>PSM</td>
<td>Profit Split Method</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>Research and Development</td>
</tr>
<tr>
<td>RPM</td>
<td>Resale Price Method</td>
</tr>
<tr>
<td>SAT</td>
<td>State Administration of Taxation</td>
</tr>
<tr>
<td>TNMM</td>
<td>Transactional Net Margin Method</td>
</tr>
<tr>
<td>TRE</td>
<td>Tax Resident Enterprise</td>
</tr>
<tr>
<td>US</td>
<td>United States</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization</td>
</tr>
</tbody>
</table>
1 Introduction

1.1 Background

The foreign direct investment (FDI) in China has increased since the doors to China’s internal market were opened up to foreign investors in the late 1970s. During the last decade or so, China has been the leading receiver of FDI amongst the developing countries and after the accession to the World Trade Organisation (WTO) in 2001, the amount of FDI entering into China has increased even more. In the year 2002, the amount of FDI entering China exceeded that which was received by the United States that year, hence making China the largest recipient of FDI in the world.  

China’s continued efforts on abolishing restrictions for foreign invested enterprises (FIEs) and foreign enterprises (FEs) together with its accession to the WTO will most likely result in attracting even more FDI into China from the United States and the European Union.  

International taxation and in specific transfer pricing issues are of outmost importance for multinational corporations (MNCs). Transfer pricing can be used as a mean to minimize the worldwide income for associated enterprises. For governments, rules on transfer pricing is a way to make the related companies set their prices on internal transactions as if there were between unrelated parties, thereby ascertain that enterprises does not extract all profit into another country. According to the WTO’s estimation, the intercompany transactions among MNCs sums up to about one-third of the total world trade. That the issue of transfer pricing is an important issue for both enterprises and governments is obvious.  

In the late 1990s, up to 70 % of all FIEs in China reported losses and a majority of that is believed to be due to transfer pricing measures made by the company in order to extort income out of China. It is not only the loss of tax revenue that constitutes a problem, it also affect the balance of foreign exchange income and expenditure. Moreover, it creates a wrongful image of the Chinese market, which can have an impact on investment.  

China is aware of the problem of transfer pricing and have in recent years put a lot of effort in resolving the issue. However, having their first legislation on transfer prising issued in 1991 and 1992, China is still in an early stage of its transfer pricing system. Several problems can occur for both MNCs trying to follow the transfer pricing rules in order to avoid adjustments and for the tax authorities when trying to ensure that the regulations are being followed.  

---

2 Ibid. p. 11.
3 Ibid. p. 69.
5 Ibid. p. 47.
6 Ibid. p. 69.
In regards of documentation requirements in transfer pricing, such can sometimes compose a demanding task for MNCs when the requirement are as rigours as is the case in the United States (US). However, regulations on proper documentation can be positive not only for the government or for the tax authorities in question but also for the concerned enterprises. Transfer pricing adjustments are expensive for MNCs, there can be issues with both double taxation and penalties, not to mention the fact that it can be very time consuming. If enterprises have clear regulations on documentation to follow, the risk of adjustment decrease and facilitate procedures such as advanced pricing arrangements (APA) and transfer pricing audits.

The Chinese market and legislation in most areas is experiencing an often rapid development, and the area of transfer pricing and documentation are no exceptions. The regulations concerning documentation requirement are constantly developing, only during 2007 several circulars affecting the issue of documentation have been issued by the State Administration of Taxation (SAT). Moreover, the upcoming new Corporate Income Tax Law, effective from January 1 2008, which will have major legal and economic consequences, will consequently also affect the transfer pricing area and the current legal framework on documentation.

1.2 Purpose

The purpose of this thesis is firstly examining what problems can arise due to complications with being active on the Chinese market, in particular in terms of legal uncertainty, which consequently also affect enterprise’s transfer pricing concerns. The main focus is however on the new corporate income tax law and its consequences in some transfer pricing issues, with emphasis on documentation requirement.

1.3 Method

The juridical method that this thesis is based on is the both the traditional legal method and the comparative method, although the traditional legal method are not fully applicable due to the complexity of the Chinese legal system.

In the thesis, Chinese basic laws and administrative regulations, mainly those in form of circulars released from the SAT, are examined whilst regarding the judicial hierarchy among them. Chinese legislation is originally issued in the Chinese language, although in this thesis English versions are used. When available, officially translated versions are used and when not attainable, unofficial versions translated by e.g. practitioners such as the PricewaterhouseCoopers are used instead. Regardless of whether the English version is officially translated or not, the version in Chinese is considered the most accurate one.

In addition to legislation, literature relevant to the topic is used to complement the understanding of the legal system and its regulations. Furthermore, databases such as the IBFD and OECD, containing i.e. legislation, publications and articles on relevant subjects are reviewed as well.

---

The Chinese regulations on documentation requirements are discussed in comparison with the framework of other international guidelines and regulations in the area, mainly in order to discuss possible benefits of having detailed transfer pricing documentation requirements, i.e. what possible advantages and disadvantages such regulation could have.

1.4 Delimitation

Since the focus of this thesis is on transfer pricing in China, and especially the documentation requirement, other regulations concerning China’s transfer pricing regime is only briefly presented and only when considered necessary for the selected purpose. The new Corporate Tax Law as well as the Income Tax Law for Enterprises with foreign investment and Foreign Enterprises is also only reviewed in those parts that are linked to transfer pricing. Some parts of the corporate taxation system are reviewed even though not having any direct connection with transfer pricing since it nonetheless affects the issue.

Regarding the documentation requirements, only existing rules and regulation is examined, therefore the draft of the new regulation which is anticipated during 2008 on documentation requirement is not addressed in this thesis. Although the anticipated regulation exists as draft, the draft will most likely differ from what is later issued, and the draft is therefore delimited from the thesis since there are such uncertainties regarding what it will entail.

The issue of double taxation, though closely linked with the issue of transfer pricing, will not be addressed in detail.

The thesis focus in the taxation of multinational corporations, operating in China, the thesis does not put focus on the taxation of domestic enterprises in China.

In regards of the comparison with other international standards on transfer pricing documentation, these are not examined in detail.

When speaking of China, Macau and Hong Kong are excluded. Macau and Hong Kong are special administrative regions of the People's Republic of China and have their own legal systems.

1.5 Outline

In order to facilitate the understanding of the various difficulties, which can affect a foreign enterprise or a foreign investor operating in China, the thesis firstly provides the reader with a general background to China’s economic development and legal framework.

After a brief assess of the development since the reform in the late 1970s up till the accession to the WTO in the second chapter, follows a introduction to the legal system in general and the corporate income taxation system in particular in chapter three and four. A general introduction to the development of the Chinese market and how the legal system is constructed is necessary to be able to understand the difficulties with conducting transfer pricing within China. Problems arising from other parts of the legal system than the transfer pricing legislation still affect multinational corporations in their transfer pricing decisions.

In the fifth chapter the legal framework of transfer pricing in China is introduced. The transfer pricing audits and the documentation requirements are being as-
essed in the sixth chapter, and are followed by a general overview on international work on documentation in chapter seven.

In the eighth and final chapter, the analysis including our final thoughts in the matter are presented.
2 China after 1979

2.1 The ‘open door policy’

During the middle of the 1960s, China experienced the so-called Cultural Revolution and the political disturbance the following years put China’s development in regards of legislations and economic development on hold. However, in the late 1970s, the new political leadership started to develop the country in several areas and the modernization included an economic reform. The Chinese government adopted the ‘Open Door Policy’ which made the internal market accessible for the outside world. Prior to this point there was no legislation governing foreign investment in China. The foreign trade in China had up to this point been centrally controlled and all imports and exports were controlled by the Ministry of Foreign Trade. In order to attract outside investors, the Chinese government was required to create basic legislation to protect such investments. In 1979, China therefore passed its first, of many to come, law on FDI. Special economic zones were also created, which offered for example special tax treatment to foreign investors. Alongside this, several open coastal cities and other special areas were designated to attract foreign investment.

These measures were the take-off point for a massive flow of FDI coming into China. China has experienced a remarkable annual GDP growth during the last two decades. Although there are discussions on the exact annual growth, it is according to the International Monetary Fund about four times the average growth of the G-7 countries. Both the increasing amount of FDI and the increasing complexity of the transactions relating to it, has forced China to build up

10 Ibid.
13 Wang, Chinese Commercial Law, p. 83.
14 Shenzhen, Zhuhai, Shantou and Xiamen.
15 Lo and Tian, Law and Investment in China: the legal and business environments after China’s WTO accession, p. 3.
16 Wang, Chinese Commercial Law, p. 83.
17 Gross Domestic Product.
18 9.3 % according to Lo and Tian, Law and Investment in China: the legal and business environments after China’s WTO accession, p. 4; more than 8 % according to Chan and Lo, International Transfer Pricing in China, p. 25.
19 Canada, France, Germany, Great Britain, Italy, Japan and the United States.
a legal system in order to protect and govern foreign invested companies. What started with the first law in 1979 has since then evolved to a massive amount of legislations related to foreign trade. Although there are no certain statistic on exactly how many regional and national legislations have been passed on the subject, it had been claimed that the National People’s Congress (NPC) and its Standing committee have passed over 300 laws and decision, alongside with the State Council’s enactments of around 750 administrative laws and regulations and as many as 53,000 local decrees made by the local People’s Congresses. All this in the period of 20 years (1979-1999).

### 2.2 Foreign investment in China

The countries from which most of the FDI comes from is Hong Kong, the US, Japan and Taiwan. The majority, almost half, of the total FDI in China comes from Hong Kong. There are several reasons behind these overwhelming investments from Hong Kong. For one, several MNCs have formed joint ventures with Hong Kong firms when they intend to invest in China. Many Taiwanese companies invest in China via Hong Kong and even some investment from mainland China itself goes through Hong Kong in attempt to benefit from certain regulations applying to FIEs. Furthermore, taxpayers in Hong Kong are not being taxed for income derived from outside of Hong Kong. Between the Eastern, Western and Central region in China, the Eastern region received the largest part of the total foreign direct investment. China’s continued efforts on abolishing restrictions for foreign enterprises together with its accession to the WTO will most likely result in attracting even more foreign direct investment into China from the US and the European Union. In 2004, it was estimated that some 400,000 FIEs were operating in China, although not all of these were properly registered. Although the Chinese market has increased in size and importance, the number of foreign companies in China that reported losses also increased during the 1990s. In the last five years of the millennium, as many as 60-70 % of the foreign companies in China reported losses. According to the Chinese government, a majority of the reported losses were due to misuse of transfer pricing. The fact that so many of the companies report losses even though there might not be an actual loss can have several negative consequences for China. Not only does it deprive the country from tax

---


25 Li and Paisey, *Transfer Pricing Audits in China*, p. 11

26 Ibid.

revenue but has other negative impacts as well, such as give false image of the Chinese market and investment climate.\textsuperscript{28}

With the exclusion of Hong Kong, China’s income tax is generally lower compared to that of the other major trading partners. However, the import tariffs in China are as a rule higher. When looking at the income tax and the import tariffs, they create an incentive for foreign investors to move their profit into China. Nevertheless, the foreign exchange control risk has the opposite effect, namely to tempt investors to shift the profit out of China instead.\textsuperscript{29}

\subsection*{2.3 After China’s accession to the WTO}

After 15 years of negotiation, China became a member of the WTO in December 2001.\textsuperscript{30} Even though the Chinese government has already made numerous efforts in order to attract foreign investors and protect their rights when they operate on the Chinese market, the accession to the WTO is still considered a great step in the direction of furthering the foreign investment in China. China’s commitments in relation to the membership are set out in more than 800 pages of legal documents.\textsuperscript{31} Nonetheless, China has been criticised for its implemented commitments, among other the implementation itself has been accused of being rather random.\textsuperscript{32}

Since China’s accession to the WTO, there is no longer only a limited number of Chinese companies, and under certain restrictions to some foreign invested companies, that can export and import products.\textsuperscript{33} Except for some explicit products,\textsuperscript{34} all FIEs have the right to import and export products in and out of China.\textsuperscript{35}

Measures that discriminate foreign companies, such as for example taxes and dual pricing systems, are to be abolished by the Chinese government as a compliance with the WTO accession. Furthermore, China has, as the other WTO member countries, committed to reduce border measures such as import tariffs and quotas.\textsuperscript{36}

One of the major impacts of China’s accession to the WTO is the new corporate income tax law, which will take effect from January 1 2008. The legislation is a unification of the two previous enterprise income tax laws applying respectively

\textsuperscript{28} Ibid. p. 27.
\textsuperscript{29} Chan and Lo, \textit{International Transfer Pricing in China: Post WTO}, p. 27.
\textsuperscript{31} Ibid. p. 53.
\textsuperscript{32} Ibid. p. 54.
\textsuperscript{33} Ibid. p. 53.
\textsuperscript{34} Such as oil, sugar, tobacco and cotton when it comes to import. Tea, rice, cotton and silk are some examples when talking about the right to export products.
\textsuperscript{35} Reuvid and Young, \textit{Doing Business with China}, p. 53.
\textsuperscript{36} Ibid. p. 54.
to domestic and foreign enterprises. The new legislation is further discussed under chapter 4.
3  Legal and Administrative Framework of China

3.1  State Organs

China is a civil law country. The laws, which are codified in statutory instruments, are deriving from different levels of government, from national to local, and with hierarchical basis of authority.

3.1.1  The legislative body

The National People's Congress (the NPC) and its Standing Committee have the supreme legislative power according to the Constitution of the People's Republic of China (the Constitution). The NPC also has the final authority to make and interpret legislation, but in practice much of the power has been passed down to the State Council. The State Council, which is the Central People's Government of the People's Republic of China, is the executive body of the highest organ of state power; it is the highest organ of state administration. The administrative regulations made by the State Council rank directly under those ratified by the NPC. With these regulations come supplementing instructions, orders and rules issued by the appropriate subordinate ministries under the State Council. The State Administration of Taxation (SAT) is the major ministry responsible for tax matters.

People's congresses in provincial capital municipalities, centrally administered municipalities, large cities that are approved by the State Council and in Special economic zones are empowered to make local rules and regulations, as long as they do not contravene with the Constitution or the law made by the NPC or the administrative regulations made by the State Council. Since the central government has experienced problems with provinces that have approved tax incentives for foreign investors that varied widely from national legislation, declarations have been issued stating that lower-level governments are forbidden to offer more generous incentives than those authorized under national law. These kinds

64 Article 99 of the Constitution of the People's Republic of China (Also see Deloitte Touche Tohmatsu, China Master Tax Guide 2005, p. 6).
of problem might be due to the fact that the different types of laws and regulations are not defined anywhere.\textsuperscript{45}

3.1.2 The Supreme Court

The judicial organ of the state is the People’s Courts.\textsuperscript{46} The Supreme People’s Court and the local People’s Courts are established at different levels.\textsuperscript{47} The People’s Courts are to exercise its judicial power independently and not to subject any interference by administrative organs, public organizations or individuals.\textsuperscript{48} The highest judicial organ is the Supreme People’s Court and its function is to supervise the administration of justice by the local People’s Courts and the Special People’s Courts. People’s Courts at higher level supervises the administration of justice by those at lower levels.\textsuperscript{49}

The quality of judges in some parts of the country can still be questioned and the corruption among judges is still a persistent concern. Before 1995, judges were not required to hold a college degree and it was not until 2002 when applicants for judgeships were required to take the national bar examination\textsuperscript{50} It is the local governments that select and pays the judges’ salaries. This relationship has a tendency to lead to pressure on the courts to favor locals in litigations involving foreign parties and parties from other regions of China.\textsuperscript{51}

The courts cannot independently interpret any laws and the judicial decisions made by the courts are not part of legislation in China since they do not have any common law tradition.\textsuperscript{52} Rather than being superior, the courts are parallel to other units of the Chinese bureaucracy. Lower level courts often request instructions from higher courts even though the case is still pending, which to some extent nullifying the appellate procedure.\textsuperscript{53} Partly due to low educational levels of many judges and partly to the general lack of transparency of the government, it is not usual that judicial opinions are made available to the public. The opinions that were used to be issued by the Chinese courts have been short and formalistic and usually without detailed legal reasoning, without explanation or analysis.\textsuperscript{54}

\textsuperscript{45} Lubman, \textit{Looking for Law in China}, Columbia Journal of Asian Law Vol. 20 Fall 2006 No.1, Columbia, p. 28.

\textsuperscript{46} Article 123 of the Constitution of the People’s Republic of China.

\textsuperscript{47} Article 124 of the Constitution of the People’s Republic of China.

\textsuperscript{48} Article 126 of the Constitution of the People’s Republic of China.

\textsuperscript{49} Article 127 of the Constitution of the People’s Republic of China.

\textsuperscript{50} Lubman, \textit{Looking for Law in China}, p. 29.

\textsuperscript{51} Ibid. p. 30.

\textsuperscript{52} Li, \textit{Development and Tax Policy}: Case Study of China, p. 39.

\textsuperscript{53} Lubman, \textit{Looking for Law in China}, pp. 29-30.

\textsuperscript{54} Ibid. p. 30.
3.2 The different types of laws

Laws promulgated by the NPC are mainly categorized as either basic laws or resolutions. Administrative regulations issued by the State Council are designated as regulations, provisions or measures.\(^5\)

During the drafting of the laws, they are relatively clear in wording and address many critical issues, but this kind of characteristic is not included in the laws that have been promulgated. The drafters sometimes make the language of the law so simple that the intent of the law is unclear when the law passed.\(^5\) This means that interpretations will be needed and that the administrators can vary the meaning of the legislation depending on the circumstances, attempting to make the system more effective. Another reason for the wording to be vague is that sometimes the drafters have not reached a consensus on the provision.\(^7\)

In addition to those basic laws and resolutions by the NPC and administrative regulations by the State Council\(^8\), other administrative documents are issued to State agencies. These give instructions or provide clarification regarding specific laws or legal reforms and include decrees, directives, notices and circulars. Many of these documents are classified as internal and in order to understand how they affect and alter the published laws and regulations, foreigners must rely on the opinion of professional advisors, or on unofficial summaries of the documents provided by Chinese business partners.\(^9\)

There are also three types of local regulations. There are regulations required to implement the laws of the Central Government in accordance with special local conditions, supplementary regulations and regulations dealing with strictly local issues. There are many local regulations and accordingly they have a great impact on China’s legal system. Since they are of local nature, consequently they can lead to different results depending on jurisdiction.\(^6\)

3.3 Language and interpretation of laws

The laws in China are written in Chinese, and it is also the original Chinese version that is the most authoritative one when there is a translated version. Government agencies and the judiciary conduct the formal interpretation of laws\(^6\):

- **Legislative interpretation** – the Constitution, laws enacted by the NPC and laws enacted by the Standing Committee of the NPC which needs to be


\(6\) Lubman, *Looking for Law in China*, pp. 36-37.


\(8\) Article 89 of the Constitution of the People’s Republic of China.

further clarified or supplemented are interpreted by the Standing Committee of the NPC.\(^{62}\)

- **Administrative or executive interpretation** – when questions relating to the application of administrative regulations arise, it is the State Council that does the interpretation. The interpretation has the same effect as the interpreted regulation itself. Ministries under the State Council interpret the rules they have made and the interpretation has the same effect as the rules in question.

- **Local interpretation** – interpretations of rules made by the standing committees of provincial people’s congresses are made by themselves. Local rules and regulations are interpreted by the respective provincial governments and their departments. Their interpretation has the same effect as the rules or regulations in question, but it is only binding in the jurisdiction concerned.

- **Judicial interpretation** – in theory, the Supreme People’s Court and the Supreme People’s Procuratorate can only make binding interpretations of laws within the context of trial and procuratorial work. In practice, the Supreme People’s Court’s power to interpret national legislation has expanded. However, the Court is restricted to interpreting laws promulgated by the NPC and its Standing Committee, except the Constitution. They are not empowered to interpret administrative regulations, government rules or local rules and regulations.

### 3.4 State Administration of Taxation

National tax legislations and policies are developed and interpreted jointly by the SAT and the Ministry of Finance.\(^{63}\) Both of them have to report directly to the State Council.\(^{64}\) The local tax bureaus established at provincial and municipal levels are under the supervision of the SAT, which are also responsible for formulating and coordinating tax policies.\(^{65}\)

The State Council has delegated the responsibility for the collection and administration of taxes that generate revenue for the Central Government or revenue shared between the central and local governments to the SAT. The day-to-day administration of state tax matters is put on the local tax bureaus. All the local taxes are handled by bureaus of local tax in the respective locations. Taxes that only generate revenue for local governments are collected by the respective local tax bureau. Specialized departments under the State tax bureaus and local tax bureaus can be found in most locations, and they are responsible for handling matters relating to tax collection and enforcement of foreign individuals, foreign enterprises and foreign investment enterprises.\(^{66}\)

---

\(^{62}\) Article 67 of the Constitution of the People’s Republic of China.


\(^{64}\) Ibid. p. 30.


\(^{66}\) Ibid.
3.4.1 Implementation of tax law

The tax legislation in China includes tax laws, administrative regulations and administrative rules issued by the SAT. The broad principles of the respective taxes are set out in basic tax laws while the detailed provisions, concerning the scope of the tax, person liable, calculation of tax charge, etcetera, are contained in the implementing regulations. The rulings that the SAT and Ministry of Finance issues clarifies specific questions raised by local tax authorities, taxpayers or the courts. These rulings are not to be seen as law. The State Council has delegated power to the SAT and Ministry of Finance to interpret tax law. Their rulings are only binding for the tax authority and should regarding taxpayers provide guidance. When the courts need to settle a tax dispute they will usually apply the rulings as long as they are not in conflict with the basic tax laws and implementing regulations.

3.4.2 The Role of Rulings

Tax policies in China are changing frequently and the lack of judicial supervision of tax administration makes the rulings made by the SAT of great importance for both the taxpayers as well as for the tax authorities. In specific tax matters the SAT is entitled to issue several of rulings, but the NPC will in some cases issue tax laws. Rulings issued by the SAT are subordinate to regulations and rulings made by the Ministry of Finance and the State Council. Rules and practices made by the SAT are subordinate to the regulations made by the State Council, in the case that they are conflicting. When the State Council and Ministry of Finance occasionally make rules on taxation, most of these rulings are issued and interpreted by SAT.

Rulings made by the SAT are handed out to the local tax bureaus. In addition to the time it takes for the SAT to get their rulings disseminated to the local tax bureaus, it often takes several weeks before the rulings have been reviewed and understood by the local bureaus and passed on to the taxpayers.

If there is a ruling by the SAT that is unfavorable for the taxpayer during the tax planning stage, the taxpayer will not have the standing to challenge the ruling until the time when the taxes are actually imposed. In theory, a taxpayer can only bring suit against tax bureaus when the taxes are actually imposed on them. However, even if the taxpayers win the case, the court cannot be asked to nullify the contested ruling since only the SAT can decide whether to keep or revoke a ruling. The court’s decision will only be effective for the taxpayer in the certain case, other taxpayers that have the same or similar situation will still have to follow the issued ruling. What taxpayers can do is to try and lobby for the SAT to either change their position or issue a new ruling.

70 Ibid.
71 Ibid, CHN 9-120 p. 22, 102 (also see *Tax Compliance in Greater China*, CCH Hong Kong Limited 2007, p. 303).
4 Corporate income taxation

4.1 Introduction

After January 1 2008, a new corporate income tax law will take effect, replacing the system applying to domestic enterprises and the system applying to FEs and FIEs. The two taxation systems which are in effect at the moment consist of many individual laws, regulations, rules etcetera. Efforts have been made to unify the two systems, but until the year 2008 the corporate income tax is levied and administered under separate laws for FIEs and FEs, and DEs. The domestic income tax system and the one covering FIEs and FEs will now be unified to one corporate system as a result of China’s accession to the WTO. Consequently, the new Corporate Income Tax Law of the People’s Republic of China (the CIT) will merge and replace the FIE Income Tax Law and the income tax law for DEs.

The Chinese tax system has never before been changed in any greater way than this, the CIT introduce several changes affecting China’s significance to the global market and the business strategies to numerous amount of MNCs. Under the previous system, FIEs and FEs had a more favorable tax treatment than DEs, there were preferential tax rates, tax deductions and tax holidays. The CIT will result in a significantly higher tax burden for MNCs since many of the preferential tax rates and holidays are eliminated. The key feature of the new legislation is to create a taxation system that is equal to both FIEs and DEs, and due to that, preferential tax treatments for FIEs and FEs are reduced. The CIT states some specific preferential tax treatments whilst some of the earlier preferential treatments will be eliminated. According to the earlier tax law, manufacturing FIEs and export-oriented FIEs could take advantage of certain preferential tax treatment which will no longer be available after the CIT takes effect.

The sixth chapter of the CIT is dedicated to tax avoidance and transfer pricing concerns. Some of the rules introduced under chapter 6 are not directed towards transfer pricing. Article 45 is a controlled foreign corporation (CFC) rule, article

72 Lehman, Tax Planning & Compliance in Asia, Volume 1, CHN 3-100 p. 7, 102.
73 Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises
74 Li, Fundamental Enterprise Income Tax Reform in China: Motivations and Major Changes, p. 519.
46 is concerning thin capitalization and finally article 47 is a general anti-avoidance rule.

4.2 Taxation under the Corporate Income Tax Law

4.2.1 Enterprise

The CIT will apply to enterprises established in accordance with Chinese law or under the law of another country. In the earlier FIE Income Tax Law, FIEs included wholly foreign owned enterprises, equity joint ventures and co-operative joint ventures. For an outside investor there were these three legal forms of FDI available in China. In addition to the various forms of FIEs, foreign companies, enterprises and other economic organizations, which have income sources within China, were regarded as foreign enterprises.\(^{79}\)

This dividing of FIEs will no longer be applied in the new taxation law, due to the unification of domestic and foreign enterprises, the CIT will apply to all enterprises. According to the Implementation Regulations of the Corporate Income Tax Law (DIR of the CIT), an enterprise established in accordance with the law of China shall include enterprises, public institutes, social organisations and other income generating organisations.\(^ {80}\) Enterprises established according to the laws of a foreign country include enterprises and other income generating organisations.\(^ {81}\)

4.2.2 Tax resident

Two new concepts to determine the tax status of corporate income taxpayers are introduced through the CIT. Enterprises are divided into tax resident enterprises (TRE) and non-tax resident enterprises (non-TRE).\(^ {82}\) Enterprises established under Chinese law or enterprises established under foreign law but with its effective management in China are considered as TREs. Foreign enterprises without its effective management in China but with an establishment or place in China are considered as non-TREs, and additionally an enterprise without establishment in China but with income deriving from a source within the country is also considered a non-TRE.

When determining an enterprise’s status as either a TRE or a non-TRE, the CIT will not affect DEs and FIEs registered in China since they are already liable to tax in China. However, the new legislation also considers FEs that have their effective management in China as TREs.\(^ {83}\) “Effective management” refers to an establishment that exercises, in substance, overall management and control over the production and business, personnel, accounting, properties, etcetera of an


\(^{80}\) Article 3 paragraph 1 of the Implementation Regulations of the Corporate Income Tax Law of the People’s Republic of China.

\(^{81}\) Ibid. article 3 paragraph 2.

\(^{82}\) Article 2 of the Corporate Income Tax Law of the People’s Republic of China.

enterprise.\textsuperscript{84} The implementation regulations are still quite vague and it is believed that the SAT will apply this provision flexibly on different situations depending on their intentions. For example, the SAT may choose to use a softer approach toward regional headquarters of MNCs that are established in China to encourage more regional headquarters to be established in China. However, Chinese investors that set up a foreign holding company which makes investments back into China might be at more risk now than before.\textsuperscript{85}

TREs are liable for paying income tax based on both its China-sourced income and its non-China sourced income; TREs are subsequently liable for their worldwide income.\textsuperscript{86} Non-TREs on the other hand are only liable to tax for its China-sourced income, or in the case when the FE has an establishment or place in China, tax shall also be paid on income deriving outside of China if the income is effectively connected to the establishment.\textsuperscript{87} According to the DIR of the CIT, “establishment and a place” refers to such place which engage in production and business operations, for example representative office, factories etcetera.\textsuperscript{88} According the term “effectively connected the implementation rules state that it refers to when the establishment or place of a non-TRE in China owns the shareholdings or creditor's right which give rise to the income, or owns, manage or control the properties which give rise to the income.\textsuperscript{89}

According to the earlier income tax law, FIEs were required to pay income tax on income derived from sources inside and outside of China, and FE on income derived from sources within China.\textsuperscript{90}

### 4.2.3 Tax rate

The CIT will unify the two different income tax rates currently applying to DEs and FIEs and FE. According to the new legislation, both DEs and FIEs, and other FE which are considered to be TREs or has an establishment or place in China, will pay income tax at the rate of 25%.\textsuperscript{91} There are however an exception for smaller companies which will pay 20 % tax on their income.\textsuperscript{92} Non-TREs, without

\textsuperscript{84} Article 4 of the Implementation Regulations of the Corporate Income Tax Law of the People's Republic of China.


\textsuperscript{86} Article 3 paragraph 1of the Corporate Income Tax Law of the People's Republic of China.

\textsuperscript{87} Ibid. article 3 paragraphs 2 and 3.

\textsuperscript{88} Article 5 of the Implementation Regulations of the Corporate Income Tax Law of the People's Republic of China.

\textsuperscript{89} Ibid. article 8.

\textsuperscript{90} Article 3 of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises.

\textsuperscript{91} Article 4 of the Corporate Income Tax Law of the People's Republic of China.

\textsuperscript{92} Ibid. article 28.
establishment in China, will be liable for taxation on their China-sourced income at a rate of 20 %.

In the earlier taxation system for FIEs and FEIs, the tax rate on taxable income would be 30 % and the local income tax is 3 % for FIEs and FEIs with establishment in China. If FIEs or FEIs met the requirements for tax incentives, the 30 % tax rate was usually exempted or reduced. The local government usually waived the 3 % to attract and maintain foreign investment. Although, there could still be registration fees and surcharge. In the end, the effective tax rate would be between 10-15%. FEIs with no establishment in China or FEIs with establishment but where the derived income was not connected with the establishment, had to pay a withholding tax of 10 %.

---

93 Ibid. article 4.
95 Lehman, *Tax Planning & Compliance in Asia, Volume 1*, CHN 3-100 p. 7, 102.
96 Guofa (2000) No. 37. The WTH used to be 20 % according to article 19 of the FIE Income Tax Law.
5 The legal framework of transfer pricing in China

5.1 Introduction

The development of transfer pricing legislation in China is quite recent in comparison with the US and other developed countries. However, the implementation of transfer pricing regulations has been given top priority by the SAT. The Chinese transfer pricing legislation is modeled on the OECD Guidelines.\(^{99}\) The OECD Guidelines explains and provide guidance on how to apply the arm’s length principle.\(^{100}\) It also gives guidance to the tax administrations when developing the rules and procedures on documentation.\(^{101}\) China’s arm’s length principle and the different types of economic methods reflect those that are used in the OECD countries. However, this does not necessarily mean that China will accept a transfer policy that is acceptable in an OECD country.\(^{102}\) China is still not a member of the OECD although they participates in OECD work as an Observer on some OECD Committees.\(^{103}\)

5.2 Statutory rules

The first transfer pricing provisions were found in national legislation 1991 under the FIE Income Tax Law.\(^{104}\)

5.2.1 The arm’s length principle

In the new income tax law, the arm’s length principle is found in the first paragraph of article 41, and it reinforces the previous regulation on transfer pricing adjustments found in article 13 of the FIE Income Tax Law. The principle has also been incorporated in article 36 of the Administrative Law of the People’s Republic of China on the Tax Revenue Collection (ALTRC). The arm’s length principle was earlier further clarified and codified in the Detailed Rules and Regulations on Implementation of the Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment Enterprises and Foreign Enterprises (FIE Implementation Rules), articles 52 to 58.

According to the arm’s length principle, a price on a transaction between related parties should, in terms of determining the taxable income, be deemed to be the

---


\(^{103}\) Organisation for Economic Co-operation and Development, *Further reforms would boost innovation in China, says OECD*, retrieved 20 October 2007, http://www.oecd.org/document/60/0,3343,en_33873108_36016481_39160380_1_1_1_1,00.html

same price which would have been applied in a transaction between unrelated parties.  

The arm’s length principle is the standard principle that should be used by MNCs and tax administrations when determining the transfer price, according to the OECD. It is stated in the first paragraph of article 9 of the OECD Model Tax Convention, and the Chinese regulation corresponds with the article. In the OECD Guidelines, the arm’s length principle is further discussed and gives guidance on how it should be applied are provided.

5.2.2 Applicable methods

Under the FIE Income Tax Law, there were three methods for determining the arm’s length principle. Transactions should be priced at a transactional basis, using the comparable uncontrolled price method (CUP), the resale price method (RPM) or the cost plus method (CPM). If conditions and circumstances are met, a fourth alternative may be allowed, which is using one of the profit based methods instead. The three transactional based methods will be continually applicable according to the CIT. The new Chinese regulations also allows the use of other reasonable methods, and according to the DIR of the CIT, these methods are the profit split method (PSM) and the Transactional Net Margin Method (TNMM). The regulations are consequently consistent with the transactional profit methods stipulated in the OECD Guidelines. However, the new legislation does not rank which method is preferable in any given situation.

The SAT did in Circular 70 encourage the transfer pricing auditors to apply alternative transfer pricing methodologies when it was appropriate. The circular especially recommends the PSM, the TNMM, as well as other profit-based methods in addition to the three traditional methods (CUP, RPM and CPM).

Unlike the Chinese regulations, the OECD explicitly states the three transaction methods as the preferred ones. The three methods are the comparable uncontrolled price method (CUP), resale price method and cost plus method. In addition to those, the OECD also considers the two transactional profit methods, the

---

105 Li and Paisey, *Transfer Pricing Audits in China*, p. 34.


111 Ibid. p. 3.


113 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, chapter II.
TNMM and the PSM, to be valid methods for determining the transfer price according to the arm’s length principle.

5.2.3 Related party

A “related party” is defined in article 109 in the DIR of the CIT as an enterprise, an organization, or an individual that has one of the following relationships with the taxable person:

- Direct or indirect control with respect to capital, business operations, purchasing and sales etc;
- Direct or indirect common control by a third party; and
- Any other relation arising from mutual interest.

5.2.4 Cost sharing agreement

A cost sharing agreement (CSA) is an agreement between parties to share the cost and risks of the development and production of intangibles as well as the benefit in proportion to shares. Some countries will use the term “cost contribution agreement”. The two terms are similar types of arrangements, the difference being that a cost contribution agreement is broader than a CSA. There has not been any formal guidance on the issue before, but the SAT approved a R&D CSA by one multinational corporation in a private letter ruling. With the introduction of article 41 of the CIT, CSA is formally accepted. According to the CIT, CSAs can be used in two circumstances; in the joint development or transfer of intangible assets and in the provision or receipt of labor services.

The article is similar both to the OECD Guidelines and the US transfer pricing regulations. The Chinese legislation models both OECD and US framework on CSA. The article provides a framework for this type of agreement and is a way to attract in particular high/new technology enterprises since CSA is valuable to enterprises for which intellectual property plays a vital role.

Each of the participants in the agreement should share a proportionate part of the costs and risk, which should be consistent with the participant’s proportion-

114 United States Treasury Regulations, Section 1.482-7(a)(1).
117 Article 41 paragraph 2 of the Corporate Income Tax Law of the People’s Republic of China.
118 Ibid. article 41 and Coronado and Chou, Unified Enterprise Income Tax Law and Its Impact on Transfer Pricing, p. 2.
119 OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, section 8.3.
120 United States Treasury Regulations, Section 1.482-7(a)(1).
121 Yuan, China: Transfer Pricing Under the New Income Tax Law Regime, p. 3.
ate share of the expected benefits.\textsuperscript{122} The arm’s length principle consequently applies to the cost of the arrangement.\textsuperscript{123} An enterprise in a CSA shall also apply the relevant information about the arrangement with the tax authorities in accordance with the authorities’ requirement.\textsuperscript{124}

The OECD Guidelines review the concept of cost contribution agreements in Chapter VIII. The purpose of the chapter is to provide general guidance to whether the conditions in a cost contribution agreement between associated enterprises are in accordance with the arm’s length principle.\textsuperscript{125} Even though the most common cost contribution agreement is cost contribution agreement for R&D of intangible property, there can be other types of agreements as well.\textsuperscript{126} According to the OECD, the conditions of a cost contribution agreement corresponds with the arm’s length principle when a participant’s contribution is consistent with what an independent enterprise would have agreed on under comparable circumstances seeing to the benefits that can be reasonable expected to derive from the arrangement.\textsuperscript{127}

5.2.5 Advance pricing agreement

Article 42 of the new CIT concerns Advance Pricing Arrangements (APAs). An APA is an agreement where a taxpayer can, in advance of controlled transactions, determine the criteria\textsuperscript{128} to use for determining the appropriate transfer price for those transactions over a fixed period of time.\textsuperscript{129} An APA is an agreement between the taxpayer, one or more associated enterprises and one or more tax administrations.

APAs can be very useful when the more traditional mechanisms fail or are difficult to apply.\textsuperscript{130} The concept of APAs already existed in the Chinese tax legislation before the CIT.\textsuperscript{131} Regulations on APAs is found both in article 53 of the Detailed
Implementation Rules of Tax Collection and Administration Law (DIR of the ALTRC) and in Circular No 118. The concept of APAs is found in Section IV.F of the OECD Guidelines, the description of the arrangement is basically the same as the one in the Chinese regulation.

The first bilateral APA was signed between the SAT and the Japan’s National Tax Agency in April 2005 and was the starting point for MNCs to use APAs to resolve double taxation in the future. The first bilateral APA between China and the US was signed by the Commissioner of SAT the second week of January 2007. The Wal-Mart Stores Inc. case was not randomly chosen for China’s first bilateral APA with the US, it was due to the technical aspect of transfer pricing and the important issues such as intangibles and cost sharing. The SAT did express its wish for taxpayers to use bilateral APAs in order to obtain more assurance of tax compliance and to avoid double taxation. During 2007, the SAT also signed a bilateral APA with the South Korea’s National Tax Service. The CIT is expected to contribute to an increasing interest in using APAs.

Details of APAs are generally not released to the public, however, some information about the Wal-Mart case has been published. Many different issues were brought up in the application process, there was the uncertainty of how the, at that point, newly issued Circular 118 on APA would be implemented at a local level. Additionally there was the question on whether the information obtained in the APA process could be used in future audits. The Chinese regulation does provide a rule stating that the non-factual information obtained may not be used for future audits whilst the US rules clearly defines the limitations on the use of obtained information in the APA process. However, any factual information obtained is available to the tax authorities on audit under both jurisdictions. One of Wal-Mart case’s major issues were that, according to Chinese regulations, MNCs with several entities in China are not allowed to file consolidated income tax returns and this created a problem while applying for an APA. However, after demonstrating that each of the Wal-Mart entities in China was part of a unified

---


140 Internal Revenue Service, Revenue Procedure 2006-9, December 19 2005, sections 10.04 and 10.05.

enterprise that employed the same operating model, the SAT allowed the APA application to cover all entities in China and also future entities that would operate in the same way as the existing ones.\(^{142}\)

One of the reoccurring complications with transfer pricing in China that also complicates the examining of the APA application is the continuing lack of resources within the SAT. Additionally, the local provinces might be reluctant to rely on that their interests are being protected either by the SAT or by the other provincial tax authorities. In the Wal-Mart case, the issue of lacking resources was addressed by having the Shenzhen Local Tax Bureau (SLTB) assist the SAT during the examination of the application. SLTB were chosen since they had experienced staff that had worked on the first bilateral APA with Japan and they were also the tax bureau that has had the most contact with the Wal-Mart previously.\(^{143}\) Discussing the transfer pricing methodologies also turned out to be a problematic stage since the transfer pricing methods are not well defined in Chinese legislation when compared to US regulations and the OECD Guidelines. The fact that APAs have not been that commonly used in China and the limited experience with APAs, especially when it falls outside the scope of using the cost plus method\(^ {144}\), also contributed to the level of difficulty.\(^ {145}\) The SAT did however refer to the OECD Guidelines where Circular 59\(^ {146}\) did not provide enough guidance as long as not contravening with Chinese regulations. Both Wal-Mart and the SAT were unable to find any comparables on the Chinese market and as a result, the SAT accepted US comparables to be used.\(^ {147}\)

### 5.2.6 Special interest rate

The CIT enables the tax authorities to impose a special interest levy on anti-avoidance tax adjustment.\(^ {148}\) The levy is imposed both on transfer pricing adjustments and on other anti-avoidance adjustments in relation to rules on controlled foreign corporation (CFC), thin capitalization and general anti-avoidance, i.e. articles 45, 46 and 47 of the CIT. At the moment, the retribution for incompliance with tax legislation consists of surcharge and penalty. The special interest levy introduced by the CIT however differs from the current punishment measures of tax collection.\(^ {149}\)

When it comes to the special interest levy it is basically the case that it deals with tax avoidance whilst surcharge and penalty deals with tax evasion. In regards of

\(^{142}\) Ibid. p. 3.

\(^{143}\) Ibid. p. 4.

\(^{144}\) This method is most commonly used by manufacturer.


\(^{147}\) Ludeke and Mader, *The bilateral APA in China: Wal-Mart’s experience*, p. 5.


transfer pricing, the special tax levy will be imposed on the taxpayer where there has been a transfer pricing adjustment.\footnote{150}

The special interest levy is going to increase the financial cost for an enterprise in being adjusted on its transfer prices.\footnote{151} The rate will be the Renminbi loan base rate\footnote{152} applicable to the relevant period (of tax delinquency) in the tax year to which the tax payment is related increased with 5 percentage points. In the case where the taxpayer has provided relevant information according to article 43 of the CIT and the belonging implementation regulations, the interest levy will just be the RENMINBI loan base rate.\footnote{153} If the transaction between an enterprise and its related party does not comply with the arm’s length principle, or if there is an arrangement without reasonable commercial substance, the tax authorities will be able to make adjustment within 10 years from the year the transaction took place.\footnote{154}

\section{5.3 Other regulations}

Other than the codification in the CIT and the DIR of the CIT, alongside the previous statement in the FIE Income Tax Law and the FIE Implementation Rules, important circulars has been issued by the SAT to clarify taxation on related party transactions\footnote{155}:


The SAT introduced a new legislation in 1998, the Administrative Regulations on the Taxation of Business Transactions between Associated Enterprises, Circular No. 59.\footnote{156} This circular was China’s first complete legislation on the taxation of transfer pricing issues between related parties and included more detailed meth-
odologies and procedures.\textsuperscript{157} It provided different forms for the reporting, analyzing, investigating and adjusting of transfer pricing, and is designated for either tax bureaus or the taxpayers in question.\textsuperscript{158} The SAT confirmed the importance of these rules in both the ALTRC (2001) and its implementation rules (2002).\textsuperscript{159} Previous circulars issued by the SAT are still effective, but Circular No. 59 takes precedence over those rulings and serves as the key guideline. In 2004, Circular No. 143\textsuperscript{160} was issued to redefine the scope of the term associated enterprises.\textsuperscript{161}

\textsuperscript{157} Ibid (see further Chan and Lo, \textit{International Transfer Pricing in China}, p. 124).

\textsuperscript{158} Lehman, \textit{Tax Planning & Compliance in Asia, Volume 1}, CHN 15-140 p. 8-40, 203.

\textsuperscript{159} Li and Paisley, \textit{Transfer Pricing Audits in China}, p. 47.

\textsuperscript{160} Guoshuifa (2004) No. 143.

\textsuperscript{161} Lehman, \textit{Tax Planning & Compliance in Asia, Volume 1}, CHN 15-140 p. 8-40, 203.
6 Documentation and audits

6.1 Introduction

Transfer pricing is a focus area for the SAT and many developments have been made during the year 2007. There have been new circulars addressing the documentation and the importance of documentation has also been stressed by the new CIT. The long awaited China Transfer Pricing Contemporaneous Documentation Ruling is still not issued but is anticipated during 2008.

6.2 Annual documentation requirements

An enterprise is obligated to disclose its related party transactions in a form together with the annual income tax return. Under the former legislation, the FIEs and FEs were required to file the “The State Administration of Taxation Annual Return for Transactions between Foreign Investment Enterprises or Foreign Enterprises and Their Related Parties”. Depending on the character of the transaction, it will be placed in category A or B. If there has only been one type of transaction with simple content between the taxpayer and its associated enterprises the form A is to be used. If on the other hand there are multiple types of transactions and multiple content, form B is applicable. The declarations request the taxpayer to provide basic information, such as the nature and amount of intercompany transactions. Whether the ‘form’ that the first paragraph in article 43, of the CIT refers to, is comparable with the forms used under the former legislation is still unclear. It could involve further obligation for the taxpayer to provide information, for example functional analysis etcetera. However, during 2007 the SAT issued Circular No. 156 which contained an addition of seven different forms to be completed by a taxpayer that conducts intercompany transactions. The forms require a more detailed filing than before and include:

- Form A1301 (a summary of related party transactions)
- Form A1302 (buy-and-sell transactions)
- Form A1303 (service provision)
- Form A1304 (financing)

---

162 Article 43 paragraph 1 of the Corporate Income Tax Law of the People’s Republic of China.
165 Annual Return on Business Transactions between a Foreign Investment Enterprise or Foreign Enterprise and its Associated Enterprise, form A and B.
- Form A1305 (transfer of tangibles)
- Form A1306 (transfer of intangibles) and
- Form A1307 (other related party transactions)

The circular provides further guidance on what sort of documentation should be prepared by the taxpayers. The SAT did not require the seven forms to be used regarding the 2006 annual filing. However, it is expected that the SAT will use these forms together with forms A and B in the future to obtain information about enterprises’ intercompany transactions.  

6.3 Documentation requirement upon investigation

The second paragraph of article 43 provides the clearest documentation requirements this far and states that the tax authorities have the right to, during investigation of intercompany transactions, request the taxpayer and its related parties and other enterprises related to the investigation to provide relevant transfer pricing information. The DIR of the CIT provides a definition of “relevant information”:

1. Contemporaneous documentation regarding the determination standards, computation methods and explanation, etcetera of the prices and expenses relevant to the business transactions with related parties;

2. The relevant information regarding the resale (or transfer) prices or ultimate sale (or transfer) prices of properties, rights to use of the properties and labor services, etcetera involved in business transactions with related parties;

3. Information of product price, pricing methods and profit levels, etcetera comparable to the enterprise under investigation, to be submitted by other enterprises, which are relevant to the related party business investigation; and

4. Other relevant information of the related party transactions.

6.3.1 Functional Analysis

As stated in article 114(3) of the DIR of the CIT the enterprises needs to provide information about what comparables they have used when establishing their transfer prices. One authorized database with comparables is the OSIRIS. By

---


171 Contemporaneous transfer pricing documentation means that it is created at the same time as the terms are set and the transactions are carried out (Li and Paisey, *Transfer Pricing Audits in China*, p. 84).

172 Bureau Van Dijk Electronic Publishing.
conducting a functional analysis, an enterprise can understand the assets and risks undertaken by the enterprise. The analysis is also to great help during the selection and application of a particular method.\textsuperscript{174}

The SAT has previously acknowledged the importance of the functional analysis in Circular No. 118\textsuperscript{175}, and with the release of Circular No. 363\textsuperscript{176}, the SAT is encouraging the tax bureaus to put greater pressure on the functional analysis of investigated taxpayers.

Functions in a cross-border transaction can be seen as the activities performed by each associated company. The functional analysis will help to identify what contributes to the profits derived from the transaction and what each party has contributed with to the transaction. A basic functional analysis shall enable the tax auditor to identify\textsuperscript{177}:

- The degree of complexity involved in each of the identified functions performed
- The level of risk associated with the functions undertaken by the audited party (elements such as inventory, technology, obsolescence, product quality, research and development, warranty, foreign exchange and insurance)
- Comparable entities.

A functional analysis should identify the following four general categories\textsuperscript{178}:

- Manufacturing functions – such as inventory, materials purchasing, production equipment and scheduling, manufacturing and processing engineering, packing and labeling, quality control, shipping of products.
- Research and development – such as the development of intangible goods and the production and marketing of intangible goods.
- Marketing functions – marketing and product strategies, advertising and trade shows
- Administrative and selling functions – pricing policy, accounting, legal, computer processing, finance, insurance and personnel.

The enterprise should also identify its risks, including: market risks; inventory risks (including raw materials, work in progress and finished goods); defective

\textsuperscript{173} Wallis and Yuan, \textit{The Latest Update on Transfer Pricing Documentation Requirements and Transfer Pricing Audits in China}, PricewaterhouseCoopers 2007, p 15.

\textsuperscript{174} Li and Paisey, \textit{Transfer Pricing Audits in China}, p. 86.

\textsuperscript{175} Guoshuifa (2004) No. 118.

\textsuperscript{176} Guoshuihan (2007) No. 363.

\textsuperscript{177} Li and Paisey, \textit{Transfer Pricing Audits in China}, p. 86.

\textsuperscript{178} Ibid.
products and warranties, credit and bad debt risks, foreign exchange risks and environmental risks.\textsuperscript{179}

\subsection*{6.3.2 Transfer pricing audits}

MNCs apply transfer pricing as a way of obtaining the strategic objectives of the corporation. On the other side, the tax authorities conduct audits to selected groups of taxpayers in order to maximize their tax revenues and induce voluntary compliance.\textsuperscript{180} The Chinese tax authorities are required to conduct an annual tax audit on all FIEs, but this is in practice impossible to attain. Therefore, the SAT introduced a taxpayers’ rating system in 2003. Now all FIEs are put in three different classes, A-C,\textsuperscript{181} based on their compliance, tax filing compliance, books and records administration, promptness of tax payment and seriousness of any violations of tax laws and regulation. A company can be re-graded on a biannual review.\textsuperscript{182}

What the annual tax audit put most focus on is the tax treatment of specific items that has resulted in a reduction of tax liabilities. During the general audit process the auditor will examine the details reported on the tax return of the specific items and if there is special complexity to it, this will be transferred to an audit team with special training and experience.\textsuperscript{183}

\subsubsection*{6.3.2.1 Selection of taxpayers}

A minimum of 30\% of the enterprises should each year undergo an actual auditing,\textsuperscript{184} but because of shortage in manpower this is not always achieved. Yet, the number of FIEs that are being audited is increasing. The tax authorities finds the audit targets based on the enterprises’ income tax return, including transfer pricing declaration forms A and B. Article 12 of Circular 59,\textsuperscript{185} lists ten different types of potential audit targets, however, with Circular No. 70\textsuperscript{186} the SAT requires the tax authorities to specifically target FIEs with sustained losses, FIEs that increase their scale of operations continuously while consistently reporting losses or small profits, and FIEs with fluctuating patterns of profits and losses. There is a high risk that FIEs that falls within these categories will be targets for transfer pricing tax audits and should therefore be ready defend their transfer pricing policies.\textsuperscript{187}

\textsuperscript{179} Ibid. p. 87.
\textsuperscript{181} Class A- designates enterprises with good compliance history and is normally audited on a biannual basis. Class B – includes most of the enterprises, which are subject to an annual audit if sufficient resources are available. Class C – enterprises are put on a watch list as important audit targets.
\textsuperscript{182} Chan and Lo, \textit{International Transfer Pricing in China}, p. 92.
\textsuperscript{183} Ibid.
\textsuperscript{185} Guoshuifa (1998) No. 59.
\textsuperscript{186} Guoshuifa (2004) No. 70.
Moreover, the SAT has with Circular 70\textsuperscript{188} also emphasized the importance of transfer pricing audits. During 2007, the SAT in Beijing issued over 400 notices requesting detailed information on related-party transactions, but only to FIEs. It has seemed that the primary targets have been larger FIEs with significant amounts of related party transactions. An FIE that has annual sales over Renminbi 100 million and related party transactions over Renminbi 50 million per year or sales over Renminbi 50 million and related party transaction over 50% of the company’s transaction per year counts as such larger FIE. It is uncertain whether this kind of notices will be issued outside of Beijing too. The notices are in line with the new circulars issued on the transfer pricing audits.\textsuperscript{189}

### 6.3.2.2 Audit procedure

Generally, transfer pricing tax audits are carried out within three years after the beginning of the year after the relevant tax year. The different adjustments can be made retrospectively within a period of 10 years.\textsuperscript{190}

The tax authority will start the audit with obtaining a general understanding of the company’s background, including the company’s operations and tax status.\textsuperscript{191} The reviewed documents would be the enterprise’s foundation approval documents, business and tax registration certificates, investment and operational contracts, articles of association, feasibility studies, annual financial statements, its internal audit reports, account books and vouchers, commercial contracts and other relevant documents. The tax authority is also directed to analyze financial information from the taxpayer, which includes the company’s profits or losses on sales, rates of return on investments, sales revenues, levels of costs, expenses, interest rates and prices paid for the acquisition or use of tangible and intangible assets.\textsuperscript{192} When examining these financial variables the criteria of normalcy and reasonableness are applied.\textsuperscript{193} It is possible for the target company to apply for an extension of 30 days on the original 60 days to submit any required transfer pricing document.\textsuperscript{194} If necessary, a field audit will follow the office audit. Tax officials will examine the enterprise’s filed tax return, financial statement and additional tax related documents. Investigated items could be sales, purchase of materials, fixed assets and depreciations, wages, welfare expenses, land-use rights, entertainment expenses, production costs, accounts receivable and provision for bad debts and other income.\textsuperscript{195}

\textsuperscript{188} Guoshuifa (2004) No. 70.

\textsuperscript{189} Ernst & Young, \textit{Tax Authorities Request Detailed Information on Related-Party Transactions from over 400 Foreign Invested Enterprises}, Tax Alert July 2007, p. 1.

\textsuperscript{190} Chan and Lo, \textit{International Transfer Pricing in China}, p. 96.


\textsuperscript{192} Article 16 of Guoshuifa (1998) No. 59.

\textsuperscript{193} Li and Paisey, \textit{Transfer Pricing Audits in China}, p. 105.

\textsuperscript{194} Chan and Lo, \textit{International Transfer Pricing in China}, p. 96.

### 6.3.2.3 Transfer pricing adjustments

Audit adjustments for taxable income are used to correct any misstatements that they find in the tax returns, underreporting of sales revenue, overstating of cost of sales, deduction of expenses without proper supporting invoices and other errors or irregularities which are a result of non-compliance with the tax rules count as misstatements. FIEs should pay extra attention to which expenses that are deductible since this may differ from other countries.\(^{196}\)

The tax authority will adjust the taxable income for the taxpayer if they find that the taxpayer’s transfer prices have not been made according to the arm’s length principle.\(^{197}\) The tax authority will make the adjustments by reference to the profit rate levels of identical or similar enterprises, based on the enterprise’s costs and a reasonable amount of expenses and profit margin, based on a reasonable proportion out of the total profit earned by the related party group and based on other reasonable methods.\(^{198}\) When making the adjustment the tax authority make use of its internal computer database, so called secret comparables, which contains information that has been collected from customs, banks, government agencies, trade associations and the transfer pricing audits of different local tax authorities.\(^{199}\) The tax authorities can choose what method to use since there is no best method approach in China and neither the CIT nor the DIR of the CIT state any preference of the pricing methods. This creates an uncertainty for the taxpayer with the tax compliance.\(^{200}\) However, it does seem like the SAT has preferred to use the comparable profit method (shown in table below).

<table>
<thead>
<tr>
<th>Transfer pricing method</th>
<th>No. of Chinese enterprises that were adjusted by this method in 1992-1993(^{201})</th>
<th>No. of Chinese enterprises that were adjusted by this method in 2002-2003(^{202})</th>
<th>No. of APAs in the US that adopted this method in 2002-2003(^{203})</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP</td>
<td>5</td>
<td>12</td>
<td>19</td>
</tr>
<tr>
<td>RPM</td>
<td>2</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>CPM</td>
<td>26</td>
<td>22</td>
<td>7</td>
</tr>
<tr>
<td>Subtotal</td>
<td>33</td>
<td>44</td>
<td>37</td>
</tr>
</tbody>
</table>


\(^{197}\) Article 44 of the Corporate Income Tax Law of the People’s Republic of China.

\(^{198}\) Article 115 of the Implementation Regulations of the Corporate Income Tax Law of the People’s Republic of China.


\(^{203}\) Ibid.
In audits conducted during 1992-1993, the most commonly used method that eventually resulted in an adjustment was the comparable profit method which is in line with the common use of this method in the US. However, the second most commonly used method by the Chinese tax authorities is the CPM. It is far more commonly used in China than in the US. This may be due to the fact that the tax officials are more familiar with it because of the use of this method as regards to levying of taxes on certain representative offices within China. The CPM is believed to be a simple and easy method for both the tax authorities and the taxpayers when it is compared to other methods. The reduction of the use of the CPM might be due both to the adoption of alternative methods and the more detailed transfer pricing guidelines from 1998 as well as the increased experience of the tax officials. In 2002-2003 audits, the SAT used the PSM more frequently than before. The reason for this is believed to be the development of recent transfer pricing regulations that promotes the use of PSM. It has been shown that the tax authorities will use the RPM or the PSM to adjust taxable income, depending on the available relevant pricing information submitted by the taxpayer. However, it is most common that taxpayers are being adjusted by the CPM.

The tax authority will after reviewing all relevant documents discuss a proposed adjustment with the company that is being audited. If an audit target is unsatisfied with the adjustment, they should try and negotiate with the tax authority about the adjustment methods and amount. It is mainly close to impossible to achieve a successful appeal against a decision after the formal noticed of adjustment has been issued, which will be further explained in following section. The taxpayer must settle the tax payment within the time limit prescribed by the tax authorities, if not a fine at the daily rate of 0.05 % on the amount of the unpaid tax will commence on the day of default. For serious violations, the amount imposed on the taxpayer in question can be up to five times the lower fine. Also, the additional taxable income derived through adjustment should not be

---

204 Others include transactional margin method and global allocation method, etcetera.


208 Li and Paisey, Transfer Pricing Audits in China, p. 89.
subject to any preferential treatment that is applicable to the equivalent kind of income.\textsuperscript{209}

It should be noted that the amount of tax adjustments made by the SAT through audits have since 1998 only been increasing (see chart below).\textsuperscript{210}

\begin{center}
\begin{tabular}{|c|c|c|c|c|c|c|c|c|c|c|c|}
\hline
\hline
Amount (RMB in million) & 5 & 10 & 10 & 15 & 30 & 40 & 80 & 120 & 160 & 260 & 310 & 370 & 390 & 410 & 460 \\
\hline
\end{tabular}
\end{center}

6.3.2.4 Tax dispute resolution methods

Any tax dispute between a taxpayer and the tax authority can be resolved through an institutionalized or a non-institutionalized method. When taxpayers use a non-institutionalized method, negotiations start with the tax authorities with an appeal to the tax official’s superior or an expose or complain through the mass media.\textsuperscript{211} An institutionalized method refers to a procedure that has expressly been recognized and authorized by national legislation to handle disputes between taxpayers and tax officials, for example an administrative hearing, administrative reconsideration, and administrative litigation. For cases that involve tax collection decision, decision on the assessment of tax liability or the imposition of interest on late payment the taxpayers need to file an administrative reconsideration before instituting an administrative litigation proceeding. It is however, most common that a tax dispute is solved through an administrative review.\textsuperscript{212}

When a taxpayer is unsatisfied with a transfer pricing decision, the taxpayer must first pay the taxes due and late payment charges under the law and regulations.\textsuperscript{213} In practice, a tax bureau will check with a tax bureau at the next level before making a decision. Consequently, with the exemption of an appeal in the Peo-

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{209} Tax Compliance in Greater China, CCH Hong Kong Limited 2007, p. 96.
\item \textsuperscript{210} Yuan and Wallis, The Latest Update on Transfer Pricing Documentation Requirements and Transfer Pricing Audits in China, p. 14.
\item \textsuperscript{211} Chan and Lo, International Transfer Pricing in China, p. 99.
\item \textsuperscript{212} Li, Development and Tax Policy: Case Study of China, pp.39-40.
\item \textsuperscript{213} Article 40 of Guoshuifa (1998) No. 59.
\end{itemize}
\end{footnotesize}
ple’s Court, there are in practice no effective appeals against an assessment.\textsuperscript{214} If the taxpayer still disagrees with the reconsidered result, an appeal can be made to the People’s Court within 15 days after the issuance of the decision, a so called administrative litigation.\textsuperscript{215} If the tax authority that reconsidered the original decision changed the outcome, then the taxpayer should sue the tax authority that made the reconsidering. If the reconsidered decision is unchanged, it is the tax authority that made the first decision that will be a party of the suit. If the decision is still unfavorable to the taxpayer, the last opportunity they have to change the decision is to appeal to a higher level people’s court, whose decisions are final. Since there are no special courts for tax litigations, the court hearing is conducted just as other administrative litigation, i.e. in accordance with the Administrative Procedure Law of the People’s Republic of China.\textsuperscript{216}

It is rare that taxpayer go through such a litigation process in China.\textsuperscript{217} There are several reasons for this kind of reluctance. Since the law maker and the interpreter is the same in China, the courts do not have any final saying of the interpretation, both the State Council and the SAT have the power to interpret the meaning of tax legislation. In practice, the Supreme Court has never heard a tax case so there is no interpretation given by them. Therefore, it is more or less pointless for a taxpayer to challenge the SAT’s interpretation in a court. Tax experts are concentrated in within the tax administration, and presumably the tax official knowledge of the law is better than most.\textsuperscript{218} Due to the low number of tax cases, judges can hardly develop any tax expertise and when it comes to dealing with tax law interpretation, there is a lack of competence among judges.\textsuperscript{219} Further, taxpayers do not want to irritate or provoke the tax authority.\textsuperscript{220} A formal controversy against the tax authorities is potentially a high cost for the taxpayer. No matter the outcome, the taxpayer will have to deal with the same tax authority during following years, and the issue of “loss of face” can result in complications in the coming years.\textsuperscript{221} Enterprises are in general reluctant to provoke their tax authority further, since they will have to co-exist in a harmonious relation with the tax authority in the future. Especially since their misdemeanors over tax avoidance or evasion by means of transfer pricing have been exposed.\textsuperscript{222}

\textsuperscript{214} Chan and Lo, \textit{International Transfer Pricing in China}, p. 100.


\textsuperscript{216} \textit{Tax Compliance in Greater China}, p. 300.


\textsuperscript{218} Taxpayers, judges and members of the legislature.


\textsuperscript{221} Schneider, \textit{Tax Controversies and the Development of Tax Rights in China}, Centre for Commercial Law Studies, School of Law, Queen Mary, University of London 2006, p. 11.

\textsuperscript{222} Li and Paisey, \textit{Transfer Pricing Audits in China}, pp. 107-108.
6.3.2.5 Penalties

The administration of the levy and collection of enterprises income tax shall be in accordance to the CIT and the Administrative Law of the People's Republic of China.\footnote{Article 49 of the Corporate Income Tax Law of the People's Republic of China.} Taxpayers have to file its related party transactions declaration in time, otherwise penalties ranging from Renminbi 2,000-10,000 will be imposed.\footnote{Article 60 paragraph 1 of the Administrative Law of the People's Republic of China on the Tax Revenue Collection.} If the declaration is not filed according to law, for example if any altering of the content has been made, the taxpayer will be fined with a sum between Renminbi 2,000 and Renminbi 10,000. If it has been done under more serious circumstances, the fine shall be between Renminbi 10,000 and Renminbi 50,000.\footnote{Ibid. article 60 paragraph 3.}

According to China's old transfer pricing rules, no interest or penalty could be imposed on a transfer pricing adjustment. This meant that taxpayer could delay paying tax and wait for the adjustment to be made, without being imposed with any penalty or interest. However, the new CIT introduced a new interest rate that will be applicable on transfer pricing adjustments (see section 5.2.6). A transfer pricing adjustment can be made ten years back and with the more aggressive transfer pricing audits by the tax authorities, this interest equal to 18.25% per year, will have a significant impact on MNCs.\footnote{Eichelberger and Kelly, \textit{Tax Planning Strategies in Response to China's Changing Tax Landscape – Issues and Structures To Be Considered in a Post Tax Unification China}, p. 142.}

If the tax authorities decide that an adjustment should be made, the company needs to adjust its accounting books to show the prices or fees that the auditors determined should have been paid to the related party and corresponding adjustment should be made with the other party. If not, adjusted amount will be treated as a deemed dividend, and if such is paid to a foreign enterprise it will be subject to a 20% withholding tax. Depending on the definition of dividends, the withholding tax rate may be reduces under a tax treaty.\footnote{Li and Paisey, \textit{Transfer Pricing Audits in China}, p. 89.}
7 International documentation requirements

7.1 OECD Transfer Pricing Guidelines

In most OECD countries, the burden of proof lies with the tax administrations. Taxpayers are reasonably required to provide the tax administration with enough documentation so that the case can be examined properly. If the taxpayer does not provide sufficient documentation the burden of proof can shift to the taxpayer in some jurisdictions, for example in the case when the tax administration are in favor of an adjustment of the transfer price. Neither the tax administration nor the taxpayer can use the burden of proof as a justification of making unjustified or unverifiable statements on transfer pricing.\(^\text{228}\)

The taxpayer normally should consider whether its transfer pricing is according to the arm’s length principle before setting the prices. Reasonably, the taxpayer should determine whether there are comparables from uncontrolled transactions that can be used and whether the same conditions used in prior years have changed or if those conditions can be used for the current year when establishing the transfer price.\(^\text{229}\)

At the stage of filing tax return, there is no obligation to provide contemporaneous documentation of the taxpayer’s process of determining whether its transfer pricing is according to the arm’s length principle. The taxpayer should apply the “prudent business management principle”\(^\text{230}\) to prepare and or refer to written materials on how the arm’s length principle have been complied with, including information used when setting the transfer prices, different factors that have been taken into account and the selected method.\(^\text{231}\) Prior to the submitting of documentation, the taxpayer can choose where and how to store the documentation. There is no preference on language but taxpayers should translate the documentation if requested by the tax administration.\(^\text{232}\).

When deciding on transfer prices, the taxpayer might be required to produce documentation that otherwise would not be processed, including documentation from foreign associated enterprises. The tax administration should on the request of such documents, see to the cost and administrative burden for the taxpayer.\(^\text{233}\)

\(^{228}\) OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, section 5.2.

\(^{229}\) Ibid. section 5.3.

\(^{230}\) The prudent business management principle is based on economic principles and implies that the extent of the documentation should be in proportion to the value of the transaction. (Commission of the European Communities, *Commission Staff Working Document – Report on the Activities of the EU Joint Transfer Pricing Forum in the Field of Documentation Requirements SEC(2005) 1477*, p. 9).

\(^{231}\) OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, section 5.4.

\(^{232}\) Ibid. section 5.5.

\(^{233}\) Ibid. section 5.6.
It is sufficient for the taxpayer to prepare minimum documentation, as long as it provides enough information to validate the transfer prices. The tax administration should also take into consideration to what extent information was available when establishing the transfer prices.

All information provided by the taxpayer to the tax administration should be confidential. The tax administration is not to disclose any information to a third party, except in the extent needed in cases of public court proceedings or judicial decisions.

The OECD gives a non exhaustive list of what could be useful information when a taxpayer is being reviewed. The tax administration will need to know information relating to each of the associated enterprises in the controlled transaction, for example the business outline, organizational structure, ownership linkage within the corporations, sales and operating result from some years before the transaction and the taxpayer’s transactions with foreign associated enterprises. Other useful information would be information on the pricing, including the business strategies and if applicable, special circumstances. By providing information of taken policies, the taxpayer can convince the tax administration that prices set are consistent with conditions on the open market. Information about general commercial and industry conditions that might affect the taxpayer may also be relevant to provide.

For the functional analysis it can be useful to provide information about functions performed, including assets used and risks assumed. Possible risks may be changes in cost, price or stocks, risks relating to the success or failure of research and development, financial risks, risks of lending and payment terms, risks for manufacturing liabilities, business risk related to ownership of assets or facilities. If there is a need to compare profit and losses between associated enterprises, it can be relevant to provide financial information. It would be enough to

---

234 Ibid. section 5.7.
235 Ibid. section 5.9.
236 Ibid. section 5.13.
237 Ibid. section 5.16.
238 Ibid. section 5.18.
239 Definition and examples of special circumstances are given in OECD (Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, sections 5.20 and 5.21).
241 Ibid. section 5.22.
242 Includes manufacturing, assemblage, management of purchase and materials, marketing, wholesale, stock control, warranty administration, advertising and marketing activities, carriage and warehousing activities, lending and payment terms, training and personnel.
243 OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, section 5.23.
244 Ibid. section 5.24.
provide information that show the appropriateness of the transfer pricing policy. The information can also include costs borne by foreign related parties. It can also be relevant to provide financial information on manufacturing costs, cost of research and development, and/or general administrative expenses from foreign associated enterprises. By keeping documentation, the taxpayer can show the negotiating process when deciding on transfer pricing.

### 7.2 EU TPD

The European Union (the EU) has also taken an interest in strengthen the documentation requirements, mainly due to ensure effective application of transfer pricing rules and to keep the compliance costs down. It has been noticed that the difference in rules on documentation within the internal market constitute a burden when associated enterprises in different member states conducts business with each other. This can especially for small and medium-sized enterprises constitute a problem, the preparation of different sets of documentation is both costly and time-consuming. Another issue that can constitute a problem is that some member states do not follow the OECD Transfer Pricing Guidelines.

According to the Commission, a more uniform approach would contribute to a stronger position in relation to countries outside of the EU. Furthermore, it is believed that keeping of good and effective documentation benefits the taxpayers as well as the tax authorities.

The purpose of the EU Transfer Pricing Documentation (EU TPD) is to provide a basic set of information needed in the documentation of transactions between associated enterprises and to serve as a risk assessment tool for both taxpayers and for the tax administrations. The approach is a combination of a standardized approach and a centralized (integrated) approach. This would mean that a MNC has one set of standardized and consistent documentation on a company level, in other words there will be one single file (the master file supplemented by the country-specific documentation) for each member state concerned, as

---

245 Ibid. section 5.25.
246 Ibid. section 5.26.
247 Ibid. section 5.27.
249 Ibid. p. 7.
250 Ibid. p. 9.
251 Ibid. p. 22.
252 The standardized approach means that the taxpayer would prepare different documentation packages for each country but according to one set of rules. (Ibid, p. 17)
253 The centralized (integrated) approach means that the taxpayer prepare one single set of documentation that could serve as the basis when preparing local country documentation from both local and central sources. (Ibid. p. 16)
254 Article 5.2 of the European Union Transfer Pricing Documentation.
opposed to a standardized documentation for all companies in the same country regardless of which industry sector or group they belong to. The tax administration in the different member states will use the same master file, but will only review the country-specific documentation that concerns them. Many MNCs conducts business in both EU and other (OECD) countries. Therefore, the EU TPD is not to interfere with the OECD Guidelines. The content of the EU TPD is based on the OECD Guidelines and the purpose is to complement, and not to impede, with the framework of these guidelines.

A member state can choose not to fully apply the EU TPD, with other words require fewer items in the master file or country-specific documentation. On the other hand the member states should not require more information than stated in the EU TPD, although they can upon specific request ask for additional information and documents. This right is retained in some member states’ domestic laws.

The EU TPD is optional for companies to use and is not restricted to companies within the EU. A non-compliance with it should not result in any penalties for the taxpayer. Although a use of the EU TPD should be consistent throughout the EU and from year to year. The EU TPD’s will not be implemented through a Directive and it is up to member states to decide how it should be implemented on a national level. The member states will also have to implement the terms in the EU TPD according the OECD Guidelines and the purpose of the EU TPD.

7.3 PATA Documentation Package

Australia, Canada, Japan and the United States are all members of the Pacific Association of Tax Administrators (PATA). PATA has created a transfer pricing
documentation package that meets all four jurisdictions' documentation requirements. To use this documentation package is optional and does not require more than the local laws does. An MNC that complies with all the principles in the documentation package avoids being imposition by any transfer pricing penalties. However, PATA members’ tax administrations still have the right to make adjustments and to levy interest on the adjustments. The PATA Documentation Package is consistent with the OECD Guidelines.\(^\text{263}\)

The PATA Documentation Package is based on the taxpayer fulfillment of three operative principles. Firstly, MNCs needs to make reasonable efforts in conforming to the arm’s length principle when establishing the transfer prices. The definition of reasonable efforts is decided by each PATA member's tax administration. The MNC is required to make an analysis of controlled transactions, search for comparable transactions between independent enterprises dealing with the arm’s length principle, and select and apply transfer pricing methods that complies with the PATA member’s transfer pricing rules and the relevant treaty on establishing prices according to the arm’s length principle. It also has to be consistent with the OECD Guidelines.\(^\text{264}\)

Secondly, MNCs need to retain contemporaneous documentation of their endeavors of complying with the arm’s length principle. Documentation is considered to be contemporaneous as long as it exist or is brought to existence no later than the due date of a timely filed income tax return for the taxation year of the controlled transactions according to the relevant PATA member's rules. The PATA has attached an exhaustive description of what MNCs have to provide to satisfy this second operative principle.\(^\text{265}\) This is list is more specific than what the individual PATA member countries stipulate in their national legislation.\(^\text{266}\) When the tax administration in each PATA jurisdiction evaluates the provided documentation by the taxpayer it is to consider all the relevant fact and circumstances, for example, to what extent reliable data was available and analyzed in reasonable manners and the importance and complexity of the transfer pricing issues in the specific MN.\(^\text{267}\)

Thirdly, MNCs are required to produce the needed documents upon request by a PATA member tax administrator within the time limit set out.\(^\text{268}\) The tax administration may only request documentation on transactions involving the jurisdiction and that is provided by domestic laws and relevant treaty.\(^\text{269}\)

\(^{263}\) Pacific Association for Tax Administrators, *Transfer Pricing Documentation Package*, section I.

\(^{264}\) Ibid. section II.A.

\(^{265}\) Ibid. section II.B.


\(^{267}\) Pacific Association for Tax Administrators, *Transfer Pricing Documentation Package*, section II.B.

\(^{268}\) Ibid. section II.

\(^{269}\) Ibid. section II.C.
8 Analysis

8.1 Legal Uncertainty

One of the major concerns with China’s legal system is its inconsistency. Even if there has been tremendous improvements made the last 10 years there is still a long way to go before the system is completely reliable. The inconsistency seems to depend on several different issues that together create a substantial uncertainty for both individuals and enterprises.

8.1.1 The legislative power

Firstly, there is a basic problem with the legal system, which is that none of the different kinds of laws are defined anywhere. This means that the institutions in theory cannot know the scope of the issued law or regulation. The one limit that is outlined is that a lower institution’s regulation cannot contravene with a higher ranked institution’s, in other words, the regulations issued by the State Council cannot contravene with any laws by the NPC and regulations by the SAT cannot contravene with regulations made by the State Council etcetera. As soon as the NPC has enacted a legislation, the State Council drafts the implementing legislation. In practice this means that the State Council could distort or alter the intent of the legislation which it is purportedly on. The only limitation to care for is the wording of the legislation. Since they wording of the laws are generally promulgated in a very simple wording, even if they are drafted with more specific wording, the State Council have rather loose hands to interpret and make implementation that might suit other goals than the NPC’s. Based on this it is reasonable to question whether the State Council only does the administrative legislation or if they in reality takes over some of the power of the NPC to legislate, the line between the NPC and the State Council seem quite vague. The same problem can occur in a later stage as well, for example when the local institutions issues local rules to accompany the national regulations. As it is, it can be questioned why the laws are not promulgated in a more detailed way. It seems that the main reason for not doing so is that there is a wish to be able to adapt to China’s rapidly changing environment as effectively as possible. By making the laws so unclear that an interpretation is necessary to be able to use them, and since it takes less effort to change an implementation rule than the law itself, the meaning of the law can be changed easier. Due to China’s fast changing landscape, there is probably a greater need than in some other countries to update the legislation continuously but whether this way is preferable can be questioned since it also causes uncertainties and complications.

Much of the legislative power has been delegated down to provincial and lower-level governments that issue a variety of regulations and rules. This results in different implementation and application among the different localities. Local bureaucrats can act rather freely and issue regulations and rules to suit the local interests. To some extent it might seem positive to enable the local institutions to issue regulations that suit the local needs, seeing as there are great differences between the different regions. The social structure and needs in the urban areas might not be the same as in the regions that has a vast economic development. Because the differences are quite large, it can seem excessive to apply the same
regulations everywhere. What is needed in a specific area is probably better known by the habitants rather than someone living in Beijing. Local rules still have to be in line with national laws and regulations, which means in theory, that the local rules still would reflect the intent of the national legislation even if the execution might not be the same. A parallel can be drawn to the European Union (EU) where the member states would represent the different Chinese regions. All member states have their own sets of rules and are allowed to execute them in a way chosen by them, however, national legislation cannot contravene with EU law. As long as the local regulations would not contravene with national legislation in China, it suits China to have such a system.

By allowing local interpretations of national legislation the development towards a nationwide uniformity is hampered, and it allows interpretation to stray widely from the legislative intent. It is a great uncertainty for both foreigners and nationals since the local application of the rules can lead to different results. It can be questioned why the government in Beijing has allowed the problems with different application of national regulations to persist. China has a national legal system which is supposed to be nationwide, but with the local interpretation this national harmonization has gone missing.

8.1.2 About the courts

A uniform application of national legislation is also hindered by the lack of a well functioning court and appellate system. The local differences occurred by local interpretation might have caused less problems if it were accompanied by a well functioning court system. In such a system, courts would make judgment on an interpretation of the national law’s intent. By doing this, the national law’s intent would still get recognition. But in the same way as the local governments issues regulation and rules that are beneficial to the region, the local courts are impaired with local protectionism. Judges are selected and paid by local governments, which can cause the judgment to be in favor of the region, in other words foreigners and parties from elsewhere in China runs a greater risk to be unsuccessful in their case. The judges might not dare to provoke the local government since that would risk their own position and you do not bite the hand that feeds you.

Because of the non-superior status of the courts in regards to other units of the Chinese bureaucracy, it can be difficult for the courts to get assistance from other units. For example, the court might wish to freeze a party’s bank accounts, but the bank can refuse to assist or delay the action.

The judicial opinions made by the courts are not always made available to the public. The opinions that were used to be issued usually were short and formalistic and in most cases without detailed reasoning, in other words no explanation or analysis. This might have been due to the low educational level of the lawyers. As noted under section 3.1.2, it was not until 2002 when applicants to judgeship had to pass the national bar examination. This has inevitable left footprints in previous case law. This might also be one of the reasons why there has been a lack of transparency in the Chinese legal system. It does seem like the quality of the judicial opinions have shown a slight improvement recently, and more opinions are being published both in newspapers and online. This might be more useful to people with knowledge of the Chinese language, since they are almost solely published in Chinese. English versions of cases or legislations
are difficult to find. There is still a lot of the Maoist-party tradition that reflects on the legal system, China needs to develop new traditions and doctrine that can facilitate the development of consistent or predictable patterns of legal interpretation.

8.2 The new Corporate Income Tax Law

The new income tax legislation is a major event and will have great impact on all participants on the Chinese market. That the CIT will have repercussions on foreign invested companies in China and foreign companies operating in China is inevitable, and of course not only in transfer pricing issues, although the new legislation brings new concepts and changes to the Chinese transfer pricing area. Apart from the regulations directly concerning transfer pricing, several other regulations in the CIT will have an impact on MNCs’ transfer pricing decisions.

8.2.1 Taxable person

Firstly, the new definition of taxable person will divide the DEs, FIEs and FEs into TREs and non-TREs. TREs will be taxed on their world wide income and non-TREs on their China sourced income, or on income from outside China if they are effectively connected to a place or establishment in China. For FIEs registered in China, the new definition will not affect the income liable for tax in China. Before the concept of TREs and non-TREs, those companies were still considered taxable for their world-wide income, and that will not change through the CIT. For some FEs however, the concept of TRE will make them liable for not only their China sourced income, as was the case before the CIT, but for their world wide income since they will be considered as TREs. The concept of TREs includes FEs which has their effective management in China, hence making them liable for all income, not only income derived from China. For an FE operating in China, this might have significant effect,

For instance, an FE operating in China was earlier only liable for tax deriving from China. After 2008, the company can be forced to pay tax on their entire income based on the fact that the Chinese tax authorities consider the company to have its effective management in China, consequently taxpayers will now be taxed depending on their physical presence in country. The problem with the concept of effective management is that it is hard to define, even if a more specific description of the term were issued in the detailed implementation rules, it was still vague enough to be subject to the tax authorities interpretation. There is a risk that the SAT will apply a more lenient approach toward e.g. regional headquarters established in China, in order to attract even more enterprises to place their regional headquarters within China. On the other hand, companies not favored by the tax authorities might face a far greater tax burden. The number of companies placing their R&D departments in China has increased lately, the question is whether or not they face a risk to be deemed as TREs or will receive a more favorable treatment due to the fact that the Chinese government’s desire to attract such establishments to China. China has increased its effort to attract another kind of company than before, instead of preferential tax treatment towards, among other, manufactures, the CIT has replaced those with tax incentives for e.g. R&D department and high/new technology companies. However, even though some companies might be less at risk of being seen as TRE, the fact that the term effective management is subject to interpretation creates an insecurity, which could affect the business decision for an FE operating in China.
Several considerations should be made by the taxpayer due to the new definition of taxable person, the structure of the business should be constructed in way to avoid being defined as a TRE if possible. Last but not least, if a company still is considered as a TRE, liable to taxation in China on a worldwide income, the transfer pricing system of the company should be carefully reviewed since it in fact is the most effective way for a multinational enterprise to strategize their tax planning.

8.2.2 New tax rate

Another major change effecting companies in China is new tax rates introduced in the CIT. For FIEs, DEs and FE which considered as TREs, there will be a new unified corporate tax rate. According to the new legislation the tax rate applying to TREs will be 25%, excluding companies qualified as small and thin-profit companies. For FIEs which earlier had an effective tax rate between 10 to 15% this is a significant change. Non-TREs will after the CIT pay a withholding tax on their income deriving from China at a rate of 20%, earlier the rate was at 10%.

In theory the tax rate would imply that China has moved from being seen as a low taxation country in which it could be desirable to place the profit of MNCs in order to reduce the tax burden for the enterprise. However, due to the former exchange system, China has not been the obvious choice of location for ones profit. China’s dedicated efforts in their transfer pricing legislation in the last 15 year, is due to the fact that so many FIEs reported losses, which was considered to be the result of transfer pricing measures. Accordingly, the change to a higher tax rate might not have such a dramatic effect in terms of companies locating their profits out of China.

8.2.3 Attitude change

There is in general a feeling of change regarding the attitude within the Chinese government and Chinese tax authorities. A more strict approach to transfer pricing and tax avoidance can be seen in several actions taken by the authorities, just under the year 2007 the SAT issued several circulars revolving transfer pricing and now further measures are taken through the new income tax legislation. The administration regarding transfer pricing is strengthen and there is an underlying message that the tax authorities will be more observant towards transfer pricing measures and the application of the arm’s length principle. Furthermore, the implementation of the special interest levy, which will result in higher costs on adjustments, also signals a stricter position towards tax avoidance. Transfer pricing measures of MNCs have during some time been of interest for the tax authorities and the new CIT signify that this is still an issue of importance for the Chinese government hence making it still an important issue of the taxpayer.

In addition to that, the CIT also entail other anti-avoidance regulations, also signaling a more stringent approach to enterprises’ tax avoidance decision.

8.2.4 Preferential treatments

Before 2008 and the new income tax legislation, FIEs and FE has benefited from a more preferential treatment than domestic enterprises. Favorable tax rates, tax holidays and tax deductions under the former income tax regime created an attractive environment for foreign investment and enterprises. Due the fact that the objective of the CIT is to create an equal treatment for all enterprises to promote
competition and transparency among the business community, the preferential treatment for FIEs and FE will reduce through the CIT.

The CIT indicates possible tax incentives based more on certain industries such as high and new technology enterprises, hence shifting from having preferential tax treatments only for FIEs to having such for both domestic and foreign enterprises. Nonetheless, many foreign invested enterprises in the Chinese market are manufacturers or exporters, and for those companies it might be necessary to review their tax planning strategies since the earlier preferential treatment for manufacturing FIEs and export-oriented FIEs have been removed through the CIT.

8.3 Tax audits

Tax avoidance often occurs in the field of transfer pricing, therefore the tax authorities have put an extra effort in regulating the audits. As noted, the authorities cannot conduct audits on all foreign invested enterprises, partly due to the lack of competent and experienced personnel. Regardless, the Chinese tax authorities have every year increased their personnel to be able to cope with the demands. There are several indications pointing toward that China is putting more focus on the audits now and releasing circulars emphasizing the importance of audits.

Certain given characteristics attract the attention of the tax authorities. Depending on what kind of enterprise and its business, some are more at risk of being audited, but the enterprises can themselves affect the risk level. By keeping well organized documentation enterprises can decrease the risk of a possible audit having a negative outcome.

The newly introduced interest levy applicable on any transfer pricing adjustment put great pressure on the taxpayer, however the many uncertainties in the Chinese transfer pricing regulations creates difficulties regarding the taxpayer's compliance. As shown in chart (section 6.3.2.3, p. 35), the amount adjusted has been increasing and with the Circulars issued to increase transfer pricing audits it does seem like this trend of increasing adjustments will continue. What method is preferred in any given situation is not stated in the Chinese legislation. The SAT has gone from a preference for the transaction-based methods in Circular 59 to encouraging the use of profit split method and the net profit method in Circular 70. This creates a major uncertainty for the taxpayers. In a comparison with the US, the Chinese authorities have a preference for using the CPM much more than the US although the comparable profit method is used in about the same extent. There is a trend pointing towards an increasing use of the profit based methods such as TNMM and global allocation method in the same extent as the US. This might be an indication that the Chinese authorities are trying to adjust its transfer pricing regulations to international standards.

8.4 Documentation

8.4.1 Annual documentation requirements

With the detailed implementation rules of the CIT, the central government has issued the clearest documentation requirement as of yet but it is still considered unclear in comparison with other countries. Firstly, the implementation rules does not state what should be included in the first stage, filing the annual income tax return. The “form” has not been defined. Whether the form in the implemen-
8.4.2 Documentation upon investigation

With the CIT and its implementation rules comes the first requirement of contemporaneous documentation. However, the definition of contemporaneous is still unclear and there does not seem to be a penalty for not conducting contemporaneous documentation. Regardless, with this article the Chinese government is putting a greater pressure on MNCs and their transfer pricing.

If a taxpayer is targeted with a tax audit, its documentation will have to be prepared within the time limit set by the tax authority, which is usually 30 days if not extended. A general problem with the documentation is that it has to be filed in Chinese. If the company has not prepared its documentation in Chinese to begin with, this can be a tough requirement to fulfil within the time limit, especially since it is sometimes needed to retrieve information from related parties abroad.

Furthermore, China does not in general allow MNCs to file group consolidated tax returns, meaning that MNCs with multiple entities in China is likely to find it hard to comply with the documentation requirements since they covers both cross border transactions and transactions within China. The fact that China has not mentioned anything about that the need for information should be balanced by the costs and administrative burden for the taxpayer is interesting especially since it is one of the main principles of the OECD Guidelines and that the Chinese transfer pricing regulations in general have been stipulated according to the OECD.

8.4.3 The anticipated circular on documentation requirements

With the anticipated circular on documentation requirements, China will formalise the transfer pricing regulatory. The circular might provide more certainty for both the taxpayers and the tax authorities if is clarified what is required by the taxpayer and what information that the tax authorities in return can aspect to receive. Hopefully, the circular will include more detailed information about what should be provided. As mentioned, the requirement for contemporaneous documentation is for the first time mentioned in Chinese legislation through the CIT’s implementation rules, albeit not defined. Chinese taxpayers have not been required to provide contemporaneous documentation earlier and most taxpayers will probably find it burdensome to comply with, since it is both costly and time consuming (if it is not prepared beforehand). There are, of course, both advan-
tages and disadvantages with regulations that are more detailed or on a more principal level.

If the new circular will provide a clear and exhaustive list of what is needed to comply with the documentation requirements, taxpayers will have greater clarity on what is required from the tax authorities. If the taxpayer provides all the information listed, there is greater certainty in regards of not having the taxable income adjusted, and through that, the number of possible double taxation can be reduced. It will also be a certainty from the tax authorities’ point of view, since they will receive enough information to base a possible adjustment on. By receiving all the information at once can also shorten the time of the tax audit. If taxpayers need to provide more detailed information, there will be less possibility to use transfer pricing as a way to evade the profit from taxation by shifting it out of the country. A detailed list could cause an overwhelming burden for the taxpayer when complying with it, in particular for smaller enterprises and the cost for complying with the requirements can both burdensome and time consuming. On the other hand, if an exhaustive list on what is required is introduced, it can prevent the kind of flexibility that could otherwise be counted for to suit the specific case and its circumstances. With a more flexible approach, the documentation can be more effective since the taxpayers will not have to prepare and collect information that might not be necessary for the particular situation. This would, again, cause some uncertainty for the taxpayer since the tax authorities might require more information than already prepared and it can be difficult for the taxpayer to get the information ready in time.

The OECD Guidelines provides, as the name suggests, a guideline for its member states. The documentation requirements that are listed are not exhaustive, and member states choose themselves which parts to implement in their legislation. A taxpayer cannot rely on that the compliance with the OECD Guidelines ensures the compliance with the specific regulations in an OECD member state. This is contrary to the case in a PATA member state, if the taxpayer has complied with the PATA Documentation Package they can be certain to having fulfilled their obligations. The exhaustive list in the PATA Documentation Package is a minimum requirement and a taxpayer can be required to add documentation if the tax authority in any member state finds it necessary, but the taxpayer will not be fined for not having it prepared. At least the taxpayer will know beforehand what kind of documentation that will be needed, and can prepare well in advance.

In China, it might be preferable to have a more detail and clear documentation requirement because of the problems with legal uncertainty. As discussed above, since most circulars that are issued are quite loose in wording, there will be regional interpretation differences. In addition to that, the Chinese auditors are not that experienced, an exhaustive list might ease the (audit) process. To add some degree of certainty for the taxpayer, it is probably more practical to have an exhaustive list to follow even if it entails some additional cost while compiling the documentation. Especially now when there is an interest rate on the adjusted taxable income which can sum up to a great amount, the need for the taxpayer to know what is required have increased even more. On the other hand, Chinese legislator wish to keep flexibility in their regulations due to their fast changing business environment. By having an exhaustive list, the possibilities to adjust the requirements according to the circumstances are eliminated.
By having a circular that is based on documentation in two parts, like the EU TPD, there is a possibility to address/solve some issues. By having one part that consists of an exhaustive list of basic information that is needed irrespective of the circumstances, and a second part that can be adjusted according to the circular, such as the particular business, size of the enterprise etcetera, it might result in a greater certainty whilst keeping some degree of flexibility. In this way, the documentation requirement would be more proportional and less likely to be too burdensome for the taxpayer. It would also decrease the burden for the tax authority to some extent, since there would not be information to process that is not necessary for the situation in question.

As the new documentation requirements have been discussed, the SAT points towards exempting APAs from the documentation requirements. APAs have a brief history in China and the rules governing the procedure have been quite vague compared with international regulations. The SAT introduced the concept in Circular 59, and then the Circular 118 was issued and lastly, the concept of APAs is now also covered in the new CIT. APAs is considered to be both complicated and time consuming, and has likely also been seen as a rather uncertain procedure. However, it is still believed that the use of APAs among MNCs will increase since an APA can reduce the taxpayers’ documentation requirements and the probability of the taxable income being adjusted, although it should be kept in mind that even if the regulations concerning APAs have been clarified, many issues remain unclear. In the bilateral APA that the SAT conducted with Wal-Mart and the IRS, many important issues came up. The SAT accepted one application covering all of Wal-Mart’s entities in China, both those existing now and those that might appear in the future. During the negotiations, the SAT also displayed evidence of its flexibility. When the Chinese regulations lacked clarification on what transfer pricing methodology to be used, they referred to the OECD Guidelines and when no comparables in China were found, external (US) comparables were allowed. The way the SAT worked on the case displays a willingness to adopt international transfer pricing guidelines and an eagerness for taxpayer to conclude APAs. All these different factors should be incentives for taxpayers to conclude APAs.
References

Legislation

Constitution of the People’s Republic of China. (Adopted at the Fifth Session of the Fifth National People’s Congress and Promulgated for Implementation by the Proclamation of the National People’s Congress on December 4, 1982)

Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises. (Adopted at the Forth Session of the National People’s Congress and promulgated by Order No. 45 of the President of the People’s Republic of China on April 9, 1991)

Corporate Income Tax Law of the People’s Republic of China (Adopted at the Fifth Session of the 10th National People’s Congress on 16 March 2007) (Unofficial translation of the Decree prepared by Baker & McKenzie, China)

Criminal Law of the People’s Republic of China (Adopted by the Second Session of the Fifth National People’s Congress on July 1, 1979, amended by the Fifth Session of the Eighth National People’s Congress on March 14, 1997, promulgated by Order No. 83 of the President of the People’s Republic of China on March 14, 1997, and effective from October 1, 1997)

Administrative Procedure Law of the People’s Republic of China (Adopted by the Second Session of the Seventh National People’s Congress on April 4, 1989, promulgated by the Order No. 16 of the President of the People’s Republic of China on April 4, 1989, and effective on October 1, 1990).


Official Publications


Detailed Rules and Regulations on the implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises.


**International Instrument**


United States Treasury Regulations Sections 1.482-7 (a)(1).

Literature


Tax Compliance in Greater China – China, Hong Kong and Taiwan. (2007). CCH Hong Kong Limited.


Other publications


Sherwood, Stanley G. Transfer Pricing - The Great Wall of Transfer Pricing Becomes Harder to Climb: China’s Transfer Pricing Circular and June 1998 Meeting with the SAT. The Bureau of National Affairs, Inc.


**Electronic sources**


OECD. Further reforms would boost innovation in China, says OECD. Retrieved on the 20 October 2007, http://www.oecd.org/document/60/0,3343,en_33873108_36016481_39160380_1_1_1_1,00.html

**Annex 1**

The Income Tax Law for Foreign Investment Enterprises and Foreign Enterprises

Article 2. The term "enterprises with foreign investment" as is used in this Law means Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures and foreign-capital enterprises, which are established in China.

The term "foreign enterprises" as is used in this Law means foreign companies, enterprises and other economic organizations, which have set up organizations or sites dealing in production or business operations in China, and which have not set up organizations or sites but have income originating in China.

Article 3. The income originating both inside and outside China of enterprises with foreign investment with their head offices in China shall be subject to income tax. Foreign enterprises pay income tax for their income originating in China.

Article 5. The enterprise income tax charged on enterprises with foreign investment and on foreign enterprises for the income of their organizations and sites dealing in production and business operations set up in the territory of China shall be calculated based on the taxable income amount and the tax rate is 30 per cent; and the local income tax shall be calculated based on the taxable income amount and the tax rate is 3 per cent.

Article 19. In case a foreign enterprise does not have an organization or site in the territory of China but has profits, interests, rental, royalty and other income originating in China, or has an organization or a site in the territory of China but the above-said income does not have any actual connection with its organization or site, a 20 per cent income tax shall be charged on all above-said income.

In regard to the income tax charged in accordance with the provisions of the preceding paragraph, the actual beneficial owner shall be the taxpayer and the payer shall be the withholding agent. The tax payable shall be withheld from the amount paid by the payer each time. The withholding agent shall, within five days, turn over the tax amount withheld each time to the state treasury, and submit a report on the income tax withheld to the local tax authority.

The following income is exempted from, or reduced of, the income tax: 1. profits earned by a foreign investor from an enterprise with foreign investment are exempted from the income tax; 2. interest income from loans lent to the Chinese Government and state banks of China by international financial organizations is exempted from the income tax; 3. interest income from loans lent to state banks of China by foreign banks at preferential interest rates is exempted from the income tax; and 4. on the royalty received from the supply of proprietary technologies for scientific research, energy resources exploration, development of the communications industry, agricultural, forestry and animal husbandry production, and the development of important technologies, the income tax may be charged at the reduced rate of 10 per cent upon approval by the competent department of the State Council for taxation, and if the technology supplied is advanced or the terms are preferential, the income tax may be exempted from.

Where, apart from those provided by this Article, it is necessary to grant preferential treatment of income tax reduction or exemption for the profits, interests, rental, royalty and other income, the State Council shall make regulations thereon.

Detailed Implementation Rules of the Income Tax Law of Foreign Investment Enterprises and Foreign Enterprises

Article 54. If the buying and selling between an enterprise and its associated enterprise is not prices at arm's length, the tax authorities may select an appropriate method according to the following sequence to make adjustments:
(1) According to the pricing of the same or similar business activities amongst un associated enterprises;

(2) According to the profit level obtainable from resale to un associated third parties;

(3) According to the costs plus reasonable expenses and profit margin; Places where contractor projects, such as construction, installation, assembly, repair and exploration, etc. are undertaken;

(4) According to any other appropriate methods.

Corporate Income Tax Law of the People’s Republic of China

Article 2. Enterprises are divided into resident enterprises and non-resident enterprises. A “resident enterprise” as referred to in this Law is an enterprise established in China, or an enterprise that is established under the laws of a foreign country (region) but whose place of effective management is located in China.

A “non-resident enterprise” as referred to in this Law is an enterprise that is established under the laws of a foreign country (region) and whose place of effective management is not located in China but that has an establishment or place in China, or that does not have an establishment or place in China but derives income from sources within China.

Article 3. A resident enterprise shall pay enterprise income tax on both its China-sourced income and its non-China-sourced income.

A non-resident enterprise that has set up an establishment or place in China shall pay enterprise income tax on China-sourced income derived by such establishment or place and on income arising outside China that is effectively connected with such establishment or place.

A non-resident enterprise that does not have an establishment or place in China, or that has an establishment or place in China but whose income is not effectively connected with such establishment or place, shall pay enterprise income tax on its China-sourced income.

Article 4. The enterprise income tax rate is 25%.

The tax rate applicable to the income of non-resident enterprises described in the third paragraph of Article 3 of this Law is 20%.

Article 28. The tax rate applicable to small-scale, low profit enterprises that meet the prescribed conditions is reduced to 20%.

High and new technology enterprises to which the state needs to provide key support will pay enterprise income tax at the reduced rate of 15%.

Article 30. The following expenditures of an enterprise are eligible for super-deduction for purposes of calculating taxable income:

(1) research and development expenses incurred for the development of new technology, new products and new processes; and

(2) wages paid to handicapped personnel employed by the enterprise and to other personnel whose employment is encouraged by the state.

Article 41. If the business transactions between an enterprise and its related parties do not conform to the arm’s length principle and reduce the taxable revenue or income of the enterprise or the related party, the tax authorities have the authority to make adjustments based on reasonable methods.

When calculating taxable income, the costs incurred by an enterprise and its related parties in the joint development or transfer of intangible assets or in the joint provision or receipt of labour services shall be allocated according to the arm’s length principle.
Article 42. An enterprise may submit its pricing principles and calculation methods for related party business transactions to tax authorities. After consultation and confirmation, the tax authorities may conclude an advance pricing arrangement with the enterprise.

Article 43. When an enterprise files its annual enterprise income tax return with the tax authority, it shall submit, with respect to its business transactions with related parties, a form for the annual report on related party business transactions.

When the tax authorities investigate related party business transactions, the enterprise and its related parties, as well as other Enterprises related to the investigation of the related transactions, shall provide relevant information in accordance with regulations.

Article 44. If an enterprise does not provide information on its related party business transactions, or provides false or incomplete information that does not truthfully reflect its related party transactions, tax authorities shall have the power to deem the taxable income of the enterprise in accordance with law.

Article 45. If an enterprise that is established in a country (or region) where the actual tax burden is distinctly lower than the tax rate specified in the first paragraph of Article 4 of this Law and that is controlled by any resident enterprise, or by any resident enterprise and any resident in China, does not distribute any profits or distributes reduced profits where such non-distribution or reduced distribution is not a result of reasonable operational needs, the portion of such profit that should belong to the resident enterprise shall be included in such resident enterprise's revenue in the current period.

Article 46. If the ratio between debt investment and equity investment received by an enterprise from its related parties exceeds the prescribed standard, the interest payments incurred thereon shall not be deducted for the purpose of calculating taxable income.

Article 47. If an enterprise implements other plans that lack a rational business purpose and as a result reduces its taxable revenue or income, the tax authorities have the authority to make reasonable adjustments.

Article 48. When additional tax is to be levied pursuant to a tax adjustment made by the tax authorities in accordance with this Chapter, the additional tax must be paid, and interest must also be levied in accordance with regulations from the State Council.

Article 49. The administration of the levy and collection of enterprise income tax shall be carried out in accordance with this Law and the provisions of the Law of the People's Republic of China for the Administration of the Levy and Collection of Tax.

Implementation Regulation of the Corporate Income Tax Law of the People's Republic of China

Article 3. “An Enterprise which is establishes in accordance with the laws in China” as stated in Article 2 of the Corporate Income Tax Law shall include enterprises, public institutions, social organizations and other income generating organizations that are established in China in accordance with the laws and administrative regulations of China.

“An Enterprise which is established in accordance with the laws of foreign countries (regions)” as stated in Article 2 of the Corporate Income Tax Law shall include enterprises and other income generating organizations which are established in accordance with the laws of foreign countries (regions).

Article 4. “Place of effective management” as stated in Article 2 of the Corporate Income Tax Law shall refer to an establishment that exercises, in substance, overall management and control over the production and business, personnel, accounting, properties, etc. of an Enterprise.

Article 5. “An establishment and a Place” as stated in Article 2 paragraph 3 of the Corporate Income Tax Law shall refer to establishments and places in China engaging in production and business operations, including:
(5) Management organizations, business organizations, representative offices;

(6) Factories, farms, places where natural resources are exploited;

(7) Places where labour services are provided;

(8) Places where contractor projects, such as construction, installation, assembly, repair and exploration, etc. are undertaken;

(9) Other establishments or places where production and business activities are undertaken.

If a Non-Tax Resident Enterprise commissions a business agent to carry out production and business activities in the territory of China, including commissioning an enterprise or individual to regularly sign contracts, store and deliver goods etc., on its behalf, such a business agent shall be considered as the establishment or place of the Non-Tax Resident Enterprise in China.

**Article 8.** “Effectively connected” as stated in Article 3 of the Corporate Income Tax Law shall refer to the situation whereby the establishment or place of a Non-Tax Resident Enterprise in China owns the shareholdings, creditor’s rights which give rise to the income; and owns, manages, controls over the properties, etc. which give rise to the income.

**Article 109.** A “related party” as stated in Article 41 of the Corporate Income Tax Law shall refer to an enterprise, an organization or an individual that has any of the following relationships with the Enterprise:

1. Direct or indirect control with respect to capital, business operations, purchases and sales, etc.;
2. Direct or indirect common control by a third party; and
3. Any other relationships arising from mutual interest.

**Article 111.** The “appropriate methods” as stated in Article 41 of the Corporate Income Tax Law shall include following:

1. Comparable uncontrolled price method (“CUP”), which refers to the method of determining prices based on the prices between unrelated parties in identical or similar business transactions;
2. Resale price method (“RPM”), which refers to the method of determining prices based on the resale price to an unrelated party in respect of the merchandise purchased from a related party, less the gross margins generated from identical or similar business;
3. Cost plus method (“CPM”), which refers to the method of determining prices by adding reasonable expenses and profit margins to the cost;
4. Transactional net margin method (“TNMM”), which refers to the method of determining profit based on the net profit margins attained by unrelated parties from identical or similar business transactions;
5. Profit split method (“PSM”), which refers to the method of allocation of the combined profits or losses derived by the Enterprise and its related parties based on a reasonable criteria; and
6. Other methods which are consistent with the arm’s length principle.

**Article 112.** An Enterprise may share the costs jointly incurred with its related parties based on the arm’s length principle and enter into a Cost Sharing Agreement in accordance with paragraph 2 of Article 41 of the Corporate Income Tax Law.

When an Enterprise shares the cost with its related parties, it shall share the costs based on the principle of matching of costs and expected benefits, and it shall file the relevant information with the tax authorities in accordance with the requirement of the tax authorities within the period as requested by the tax authorities.
Where an Enterprise fails to comply with paragraphs (1) and (2) of this Article when sharing the costs with its related parties, the self-allocated costs are not deductible in calculating its taxable income.

Article 114. The “relevant information” stated in Article 43 of the Corporate Income Tax Law shall include following:

(1) Contemporaneous documentation regarding the determination standards, computation methods and explanation, etc. of the prices and expenses relevant to the business transactions with related parties;

(2) The relevant information regarding the resale (or transfer) prices or ultimate sale (or transfer) prices of properties, rights to use of the properties and labour services, etc. involved in business transactions with related parties;

(3) Information of product price, pricing methods and profit levels, etc. comparable to the Enterprise under investigation, to be submitted by other enterprises, which are relevant to the related party business investigation; and

(4) Other relevant information of the related party business transactions.

“Other enterprises related to the related party business investigation” as stated in Article 43 of the Corporate Income Tax Law shall refer to enterprises which are comparable to the Enterprise under investigation in terms of the substance and form of the production and business operations.

An Enterprise shall submit documentation regarding the determination standards, computation methods and explanation, etc. of the prices and expenses relevant to business transactions with related parties within the time limit stipulated by the tax authorities. Related parties of the Enterprise and other enterprises which are relevant to the related party business investigation shall provide the relevant information within the limit as agreed with the tax authorities.

Article 115. The tax authorities may use the following methods when deeming the taxable income of an Enterprise according to Article 44 of the Corporate Income Tax Law:

(1) By reference to the profit rate levels of identical or similar enterprises;

(2) Based on the Enterprise's costs plus a reasonable amount of expenses and profit margin;

(3) Based on a reasonable proportion out of the total profits earned by the related party group; and

(4) Based on other reasonable methods.

Where the Enterprise does not agree with the taxable income deemed by the tax authorities using the methods mentioned in the above paragraph, the Enterprise shall provide relevant evidence; and upon verification by the tax authorities, the deemed taxable income may be adjusted.

Article 122. “Interest Levy” as stated in Article 48 of the Corporate Income Tax Law shall be determined based on the Renminbi loan base rate applicable to the relevant period of tax delinquency as published by the People's Bank of China in the tax year to which the tax payment is related, plus 5 percentage points.

If an Enterprise provides relevant information in accordance with Article 43 of the Corporate Income Tax Law and the Implementation Regulations, Interest Levy may be only based on the Renminbi loan based rate mentioned in the above paragraph.

Article 123. Where a transaction of an Enterprise with its related party does not comply with the arm’s length principle or the Enterprise implements an arrangement without reasonable commercial purpose, the tax authorities shall have the right to make tax adjustments within 10 years starting from the tax year during which such a transaction takes place.