

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

# BDO KNOWS:

## INTERNATIONAL TAXATION



### ► SUBJECT

## CHINESE TAX AUTHORITIES NOW REQUIRE TRANSFER PRICING DOCUMENTATION

### ► OVERVIEW

On January 8, 2009, the Chinese State Administration of Taxation ("SAT") released national transfer pricing documentation guidelines contained in the Implementation Rules for Special Tax Adjustments ("Guoshuifa [2009] No. 2"). These guidelines are effective retroactively, as of January 1, 2008. Since this release was issued, Chinese local tax authorities have been requesting contemporaneous documentation for related-party transactions from Chinese taxpayers.

The Notice on Strengthening Supervision and Investigation of Cross-Border Related-Party Transactions ("Guoshuihan [2009] No. 363"), issued by the SAT on July 6, 2009, seems to have furthered requests for Chinese transfer pricing documentation. The notice requires every local tax authority to strengthen its monitoring of cross-border related-party transactions. In particular, the notice encourages special investigations of multinational enterprises that transfer overseas business operating losses (including potential losses) to China or transfer Chinese profits to tax harbors. To date, tax authorities in Beijing, Kunshan, Ningbo, Shandong, Shenzhen, Tianjin, and Zhongshan have issued local notices requesting documentation.

While local requirements may vary slightly, the following general guidelines describe the requirements under the national circulars of Guoshuifa [2009] No. 2 and Guoshuihan [2009] No. 363.

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## WHAT TAXPAYERS ARE SUBJECT TO THE NEW RULES?

There are two types of Chinese taxpayers that are subject to the new contemporaneous documentation compliance requirements.

### Type 1 – Enterprises Undertaking Limited Functions and Risks

A “Type 1” enterprise is a taxpayer that meets all of the following criteria:

- It is a foreign investment enterprise, such as a wholly foreign-owned enterprise;
- It performs limited function and risk activity, for example, single-function production (toll processing or import processing), distribution, or contractual research and development; and
- It has net operating losses in the calendar year concerned.

There is no minimum threshold of annual related-party transactions for Type 1 enterprises for contemporaneous documentation purposes. This means that a Type 1 enterprise will be subject to the transfer pricing documentation regardless of the amount of its annual related-party transactions.

### Type 2 – Other Enterprises

Unlike Type 1 enterprises, there are minimum threshold requirements for a taxpayer’s related-party transactions if it is to be deemed a “Type 2” enterprise. An entity is a Type 2 enterprise and will need to prepare transfer pricing documentation if it meets one or both of the following thresholds.

Annual Related-Party Transactions	Minimum Amount
(1) Purchases and sales of goods or merchandise	CNY 200 million (about US\$ 30 million)
(2) All other related-party transactions, <i>e.g.</i> , services	CNY 40 million (about US\$ 6 million)

Note: The above threshold amounts are determined by excluding related-party transactions arising from the implementation of cost-sharing agreements and advance pricing arrangements.

## WHO MAY BE EXEMPTED FROM THE NEW DOCUMENTATION REQUIREMENTS?

All Type 1 enterprises are subject to the new documentation requirements. Type 2 entities, however, may be exempt from preparing contemporaneous documentation if at least one of the following criteria is satisfied:

- Annual related-party transactions do not exceed the minimum amounts shown in the above table;
- All related-party transactions are covered by advance pricing arrangements; or
- More than 50 percent of the Chinese enterprise’s shares are owned by domestic (Chinese) investors and its related-party transactions are with domestic parties only.

## WHEN IS THE DOCUMENTATION DUE?

A Type 1 enterprise must submit contemporaneous documentation of a loss-making year, as well as other relevant information, to the competent tax authority by June 20 following the end of that year.

A Type 2 enterprise must complete its contemporaneous documentation of a given year by May 31 following the end of that year. If submission of the documentation is requested by the competent tax authorities, a Type 2 enterprise must generally submit the documentation to the tax authorities within 20 days of the date on which the request is made. These deadlines have very limited exceptions.

## WHAT ARE THE LEGAL CONSEQUENCES?

A taxpayer that fails to prepare contemporaneous documentation in accordance with the relevant provisions of the transfer pricing rules will be at higher risk of a transfer pricing investigation in accordance with Article 29 of Guoshuifa [2009] No. 2. Also, such a taxpayer's application for an advance pricing arrangement would generally not be accepted by the tax authority, according to Article 48 of Guoshuifa [2009] No. 2. In addition, failure to submit contemporaneous documentation (or submitting false or incomplete contemporaneous documentation) can result in the following legal consequences:

- China's tax authorities may adjust the taxpayer's taxable income based on reasonable methods.
- Non-deductible interest at the rate of five percent will be imposed on any enterprise income tax adjustments made.
- The taxpayer will be subject to a penalty of up to CNY 50,000 (about US\$ 7,350).

## HOW CAN BDO HELP?

Many tax authorities worldwide view transfer pricing as a key revenue generator; the recent developments in China indicate that this is also the case in that country. As a result, Chinese taxpayers should be fully aware of the new transfer pricing environment in which they operate and should proactively review their related-party transactions and the transfer pricing policies related to these transactions.

BDO's transfer pricing experts can help Chinese enterprises in such a review. A comprehensive review should determine the relevant related-party transactions, the methodologies used in establishing the taxpayer's current transfer pricing policies, and the risks arising from the policies. Based on the results of a transfer pricing review, BDO can further assist Chinese taxpayers in preparing a local documentation package that meets the new documentation requirements and that protects against the possibility of penalties and adjustments upon a transfer pricing audit. An accurate and comprehensive documentation study is the only defense for Chinese taxpayers against a potential transfer pricing inquiry; as such, Chinese taxpayers are encouraged to develop a practical transfer pricing documentation process in order to protect themselves.

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