

China tax law commentary

中国税务评论



In this Update

-Summary of implications arising from the recently released Implementation Measures for Special Tax Adjustments

Happy New Year! The New Year has started how 2008 ended, with a flurry of important tax developments that may have significant implications for U.S. MNCs. On January 8, 2009, the State Administration for Taxation (SAT) released the long-awaited Implementation Measures for Special Tax Adjustments (the Implementation Measures), which have retroactive effect from 1 January 2008 and set forth detailed rules regarding transfer pricing, advanced pricing agreements (APA), cost sharing agreements (CSA), thin capitalization, controlled foreign companies and general anti-avoidance. Below is a summary of the rules regarding transfer pricing and how these rules may impact U.S. MNCs, including the penalties imposed for non-compliance.

Transfer Pricing Implications

1. Who do the rules apply to?

The Implementation Measures have defined related parties and clarified which enterprises are required to prepare contemporaneous documentation.

The definition of a related party, which will determine whether a taxpayer needs to comply with the Implementation Measures, includes a quantitative test and certain scenarios under which taxpayers exercise effective control over another. In general, two parties will be related where one of the following scenarios applies:

Upcoming Webcasts

Transfer Pricing in China: An Overview of the Newly Released Implementation Rules for Special Tax Adjustments (9 PM EST, February 5, 2009) [Click here](#)

China Tax & Regulatory Update (11:00 AM EST, February 12, 2009, Lili Zheng, Sarah Chin, Jeff Xu) [Click here](#)

China Cross-Border Investment – Quarterly Round-up (11:00 AM EST, March 12, 2009, Wendy Cai, Mike

Barbalas)
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- One party directly or indirectly holds a total of 25 percent or more of another party's shares.
- A third party holds, directly or indirectly, 25 percent or more of the shares of both parties.
- An entity has significant control over another entity (e.g., personnel, operations, or finance).

Where one party holds an interest through an intermediary holding entity, its indirect interest of the lower tier company will be deemed the same as the intermediary's interest if the shareholding in the intermediary entity is 25 percent or more.

This definition may therefore subject two entities to the transfer pricing rules where there is no legal ownership (under the control test) or where there is a relatively minor indirect shareholding (under the look-through test).

2. Contemporaneous documentation and exceptions

The Enterprise Income Tax Law ("EIT Law") requires that contemporaneous documentation be prepared to support an enterprise's position that its transactions with related parties are priced at arm's-length rates. The Implementation Measures stipulate what should be included in this documentation, including an organizational structure of the group the taxpayer is related to, a summary of business operations, details of an enterprise's related-party transactions, a comparability analysis, and rationale for selection of transfer pricing methods used.

Contemporaneous documentation needs to be prepared for the fiscal year, by 31 May¹ of the following year. However, the deadline for the preparation of contemporaneous documentation for 2008 has been extended to December 31, 2009. Entities that meet one of the following exceptions will not be required to prepare contemporaneous documentation:

- The annual amount of related-party purchases and sales is less than RMB 200 million AND the annual amount of other related-party transactions is lower than RMB 40 million (exclude any amounts covered under a APA or CSA).
- Entities who have an advance pricing agreement for all of their related party transactions.
- Entities that do not have significant foreign ownership and do not have any cross-border related-party transactions.

It is important to note that even if a company meets one of the exceptions and is not required to prepare contemporaneous documentation, it is still required to meet the arm's-length principle with respect to its pricing of related-party transactions. Accordingly, it is important for all companies to be able to support their related group pricing and, at a very minimum, have a basic level of supporting documentation available (e.g., benchmarking study).

3. What are the penalties for noncompliance?

Where taxpayers do not meet the required standard, either by not providing documentation or providing false or incomplete documentation, the tax bureau may impose a penalty of up to RMB 50,000. In addition, SAT has the right to assess the enterprise's related group pricing in accordance with "reasonable" deemed methods. This could give rise to additional income tax and interest on unpaid income tax.

For transfer pricing adjustments imposed by SAT, a nondeductible interest surcharge of 5 percent will be levied. This interest is in addition to the additional tax and interest levied on the unpaid tax but can be waived if the taxpayer produces the contemporaneous documentation.

4. The use of an interquartile range

The Implementation Measures state that related group profits found to fall below the median of an interquartile range of comparable profit results should in principle be reassessed to the median value or above. Therefore, taxpayers should be aware that transfer pricing policies that incorporate prices near the bottom end of a comparable profit range will likely not be accepted by SAT in an audit situation. Instead, taxpayers should consider adjusting their intercompany pricing to reflect the median or higher value of its comparable profits analysis.

What Should U.S. MNCs Do?

The release of the Implementation Rules signals a major development in Chinese transfer pricing and demonstrates the authorities' determination to tighten up transfer pricing compliance enforcement. To this end, we recommend that taxpayers carefully assess how the new rules will impact their businesses.

Please mark your calendar to join us for an informative [Asia Pacific webcast on February 5, 2009](#), where China experts will break down these rules in laymen's terms for our audience. For other China tax developments, including new anti-avoidance rules, new VAT rules, and tax filing requirement changes, etc., please join us for our quarterly [China Tax and Regulatory Update webcast on February 12, 2009](#).

For a more detailed technical analysis on the Implementation Measures, Frequently Asked Questions, and a copy of the actual law, please refer to the following links:

- [The New Chinese Special Tax Adjustments Rules: What are the implications?](#)
- [New Transfer Pricing Requirements in China: Frequently Asked Questions](#)
- [Implementation Regulations for Special Tax Adjustments \(Trial\)](#)

We will continue to monitor developments in the Chinese tax law and bring changes to your attention in a timely manner. Please feel free to contact our regional team members, who are listed below, should you have any questions.



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Footnote:

1 For the 2008 fiscal year (year ended December 31, 2008) the deadline is extended to January 31, 2009.



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