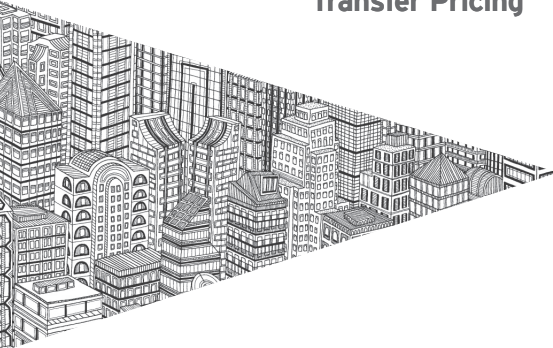


International Tax Alert

News and views from
Transfer Pricing



Mainland China's tax authorities focus on financial services transfer pricing

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The third branch of the Shanghai tax bureau has recently requested that more than 40 banks (including subsidiaries and branches) submit their transfer pricing documentation for the 2008 and 2009 financial years. The time frame of documentation submission is only 1-2 weeks rather than 20 days as specified in the transfer pricing regulations. This request appears to be one of the Mainland China's State Administration of Taxation's (SAT's) measures aiming to identify potential audit targets for further examination. In addition to requesting transfer pricing documentation, the in-charge tax bureau has requested various other documents relating to operations and payments made to accounts located in foreign jurisdictions, including the United States, Canada, Japan, South Korea and Australia.

Recap of Mainland China's transfer pricing documentation rules

In January 2009, the SAT released Guoshuifa [2009] No. 2 "the Implementation Measures for Special Tax Adjustments (Trial)" (Circular 2), which supplements the Corporate Income Tax Law and its Implementation Regulations (CITLIR) explaining how taxpayers should comply with, and how tax administrators should enforce transfer pricing regulations in Mainland China. The following summarizes the documentation requirements in circulation:

Enterprises exceeding the related party transaction thresholds¹ are required to prepare contemporaneous transfer pricing documentation by 31 May, following the fiscal year end during which the related party transactions take place. Documentation must be submitted to the tax authorities within 20 days following the request, and the documentation must be submitted to the tax authorities in Chinese.

¹ RMB 200 million for purchase and sale transactions or RMB 40 million for other transactions (such as service transactions, intangibles licensing and interest from financing transactions).

- ▶ In addition, according to Guoshuihan [2009] No. 363, loss-making, single function entities are required (regardless of whether the transactions thresholds are met) to prepare and submit to the in-charge tax authorities, transfer pricing documentation by 20 June following the fiscal year end.
- ▶ The documentation should be prepared on a yearly basis and include all information required in article 14 of Circular 2 (i.e., company analysis, industry analysis, description of transactions, economic analysis, etc.).
- ▶ If an enterprise does not comply with the documentation requirements, an additional interest rate penalty of 5% is added to the basic interest rate on owed tax resulting from a transfer pricing adjustment. Possibly more important however, is the reputational damage of a TP adjustment and a company's relationship with the tax authorities.
- ▶ In addition to the transfer pricing documentation requirements listed above, enterprises with related party transactions should prepare and submit the nine Related Party Transaction Annual Reporting Forms as part of their Corporate Income Tax annual reporting package.
- ▶ Finally, thin capitalization disclosures are also required to be reported with financing transaction disclosures. In cases where an enterprise's related-

party debt-to-equity ratio² exceeds the ratios³ outlined in the regulations, interest will not be deductible if the arm's length nature of the enterprise's capital structure cannot be supported. Where an enterprise can provide relevant information in accordance with the provisions of the CITL and CITLIR and prove that relevant transaction activities comply with the independent transaction principle, interest actually paid may be allowed to be deducted in the assessment of the relevant taxable income.

What information was requested from banks?

We understand that in addition to the submission of relevant transfer pricing documents, the third branch of the Shanghai Tax Bureau has also requested additional information from the relevant banks, including information provided under the Automatic Exchange of Information Arrangements⁴ (an exchange of tax information form) intended to provide further data related to payments made to foreign accounts.

² Calculated as the sum of the monthly average related-party debt investment in a year divided by the sum of monthly average equity investment in a year.

³ For financial service companies, the related-party debt-to-equity ratio should not exceed 5:1, and for any other enterprise, the ratio should not exceed 2:1.

⁴ Collection of outbound payment information for the purpose of the provision of tax information to the US, Canada, Japan, South Korea, and Australia is a routine exchange procedure that the SAT needs to complete each year.

Information requested includes source documents such as proof of tax payments, passport and individual income tax return information, among others. Other requests involve the investigation of financial resources, which require the submission of data including various financial ratios, adjustments for bad debt accounts and explanations regarding the nature and purpose of short term funding.

Our observation

As noted above, the tax authority will review the documentation provided before focusing on specific issues identified. In this regard, we would expect the tax authority to focus on situations where apparently similar businesses operate with different TP policies. While the differences may be entirely reasonable given the different structures of various banks' operations, this comparative assessment may provide a very simple route of challenge for the SAT.

Further, the tax authority may review situations where losses have occurred or where significant transfers of profit or losses have taken place and seek to understand why this has occurred.

What does it mean for documentation going forward and what should taxpayers be doing?

The recent request for the transfer pricing documentation of more than 40 banks clearly demonstrates the SAT's focus on financial services transfer pricing plus their desire to

ensure that Mainland China's TP regulations are being appropriately followed. Furthermore, we understand that the Jiangsu Provincial Tax Bureau will conduct an advanced TP training class for 3-months (starting from 30 May) and treasury transactions and the financial services industry have been identified as focus areas for the training.

The SAT appeared to further enforce the implementation of Circular 2 requirement to enable the

authorities to make an assessment of a taxpayer's transfer pricing arrangements. In this regard, it is critical that all documentation goes beyond the minimum disclosure stipulated in the regulations and seeks to fully explain the group's transfer pricing and why it is reasonable.

While the FY 2008 and FY 2009 documentation has been submitted, banks and other financial services

institutions should continue to review documentation and prepare supporting analyses for policies where questions are predicted. Furthermore, consideration of the types of information requested by the SAT provides a useful input into FY 2010 documentation, which should be completed by 31 May 2011.

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