

Tax alert

News and views from
Transfer Pricing

22 March 2011

China Transfer Pricing Headlines

New Development of Administrative Systems for Special Tax Adjustment

On 23 February 2010 China's State Administration of Taxation (SAT) released Guoshuihan [2010] No. 84, entitled "Notice of Briefing on Anti-tax Avoidance Work in 2009" (Circular 84). According to Circular 84, one of the targets of the 2010 anti-tax avoidance work would be to establish a work system for special tax adjustment. Ernst & Young has been communicating with the tax authorities on this topic and obtained the following information to share with our clients.

Overview

We understand that the International Taxation Department of the SAT is now in the process of developing internal administrative systems relevant for special tax adjustment (Systems). The SAT also intends to collect feedback on the Systems from state and local tax bureaus at provincial level throughout China on said Systems.

Further to Guoshuifa [2009] No. 2: Implementation Measures for Special Tax Adjustments (the "Measures"), we understand the Systems intend to enhance the coordination and implementation of special tax adjustments including administration of Advance Pricing Arrangement, Mutual Agreement procedure (MAP), as well as a joint review procedure for significant special tax adjustment investigation.

We summarize below our understanding of the SAT's intended Systems design to help taxpayers understand the SAT's recent focus and future trends in the area of special tax adjustments. The discussions below are based on our communications with tax authorities regarding the two proposed Systems. Please note that final design of the Systems is subject to the SAT's decision.

Reinforcement of the leadership of the SAT and nationwide consistency

We understand that the SAT intends to strengthen the review of the special tax adjustment results of audit cases that are deemed "significant". Specifically, the SAT intends to establish a joint review procedure to involve appointed national specialists to evaluate the preliminary adjustment results of significant cases.

The International Taxation Department of the SAT will identify and appoint anti avoidance specialists from national bureaus for the preliminary review, and the International Taxation Department of the SAT will review and approve the final adjustment based on the opinion of the specialists team.

We understand that the SAT intends to issue guidance on the definition of "significant" cases to include cases initiated by the SAT leadership; major nationwide joint investigation cases for certain industries or MNC groups; cross-region unilateral APA cases; bilateral APA or multi-lateral APA cases; and other special tax adjustment cases determined by the International Taxation Department of the SAT.

We understand the scope of significant special tax adjustment cases will include all the major cases that can be used as examples in future special tax adjustment administration. It also appears to us that the International Taxation Department of the SAT is authorized to select any cases for joint review at its discretion. We believe that this proposed joint review system will improve the consistency of special tax adjustment results nationwide.

In connection with the MAP for double taxation relief under tax treaties, we understand that the MAP applications are likely to be submitted directly to the International Taxation Department of the SAT.

The local tax authorities would be principally responsible for actively assisting the International Taxation Department of SAT in the process of international negotiation. We also understand that the SAT may involve local tax authorities to participate in the actual negotiation of certain cases.

Information-sharing and inter-departmental cooperation

The SAT continues to promote information-sharing and cooperation among tax bureaus and within various departments of the same bureau. We understand that the SAT would like to encourage information sharing among tax bureaus when cases are transferred between special tax adjustment departments and other departments; when state tax bureaus and local tax bureaus carry out tax investigations involving multiple tax types; and when relevant provincial level state and local tax bureaus jointly audit select industries and group companies.

We understand that the SAT highlights the need to reinforce cooperation between state and local tax bureaus in special tax adjustment work. For example, if an investigation initiated by a state tax bureau involves any type of tax administration that falls within the scope of the local tax bureau, the state tax bureau at the provincial level should initiate a joint investigation request with a local tax bureau at the same level. This means that certain types of tax not often seen in special tax adjustments in the past, such as business tax and land value-added tax, will likely to be reviewed in a transfer pricing investigation and thus increase the potential financial exposure for taxpayers from a transfer pricing investigation.

In addition, the SAT highly encourages information-sharing between regions. For example, during a transfer pricing investigation, the in-charge tax bureau can send inquiries to tax bureaus in other regions to obtain information on product price or supply chain profitability.

We understand that the SAT will coordinate nationwide information-collection on comparable companies when necessary.

Information collection in special tax adjustment investigation

Based on our understanding of the Systems design, for special tax adjustments where the taxpayer under investigation uses an electronic information system for management and accounting purposes, the SAT would require that the in-charge tax bureau make sure that the data submitted to tax bureaus be identical to the original. Tax authorities can ask taxpayers to give access to its electronic information system or provide a digital copy of the original data. If the taxpayer refuses to comply, the tax authority can use appropriate technical approaches to access the electronic information system directly to retrieve any electronic data from the system for investigation. Under certain circumstances, it is foreseeable for the tax bureau to obtain relevant business and financial information from the taxpayer without the taxpayer's consent. We understand that taxpayers will likely to face more stringent review of facts and data in future transfer pricing audits.

Follow-through administration of special tax adjustments

According to the Measures, after the imposition of a transfer pricing adjustment the tax authority will continue to monitor the taxpayer for five years from the year after the most recent for which the taxable income was adjusted.

It is our understanding that, during the five-year follow-through period, the tax authority will focus on the changes in the taxpayer's business and related-party transactions after the adjustment. If the taxpayer has similar issues as before, it is likely to be requested to make a self-adjustment.

If the taxpayer refuses to make the said adjustment, or the adjustment is not appropriate, the tax authority may refer to the adjustment principles and methods used in the previous adjustment result to develop an appropriate adjustment during the follow-through period. For companies with significant changes in their related-party transactions and obvious special tax adjustment issues, the in-charge tax bureaus can initiate a new investigation.

Taxpayers within the follow-through period should monitor their transfer pricing cautiously, paying special attention to whether prices or profit margins are within the range identified in the adjustment, to avoid a newly initiated transfer pricing investigation, which may bring any unfavorable adjustment result as well as consume the company's managerial and financial resources.

Negotiation and implementation of APA

APAs have become the preferred choice for increasing multinational corporations to achieve transfer pricing certainty in China. Issued on 30 December 2010 by the SAT, the China Advance Pricing Arrangement Annual Report (2009) summarizes recent developments in APAs in China and indicates the SAT's wish to promote the use of APAs. However, we understand that the SAT has a large case load. While companies consider APA an effective tool to manage TP risks, they should be aware that they are dealing with limited resources at the SAT level and management should set appropriate expectation when managing the APA time line. As the SAT accumulates practical experience through handling APA cases and taxpayers prefer to utilize APAs in managing China transfer pricing risks, the SAT continues to fine tune the application and acceptance procedures.

As the SAT accumulates practical experience through handling APA cases and taxpayers prefer to utilize APAs in managing China transfer pricing risks, the SAT continues fine tune the application and acceptance procedures. The SAT intends to clarify through the Systems the responsibility of different levels of tax bureaus during an APA negotiation. In-charge tax bureaus are responsible for the negotiation of unilateral APAs and will submit the APA draft and review report for SAT's review, whereas the SAT will organize for bilateral and multilateral APAs, unilateral APAs involving more than two provincial tax bureaus, and unilateral APAs involving both state and local tax bureaus.

We understand that the SAT would like to reiterate the appropriate timing for a taxpayer to officially submit its APA application materials. We understand that a taxpayer should only officially submit its APA application materials after the in-charge tax bureaus and the taxpayer have reached a consensus from the pre-filing meeting. It would seem to mean that the pre-filing meeting is an extremely important step within the application of APA and that the applicants should carefully prepare relevant documents for the meeting in order to be approved to proceed with the formal negotiation.

The SAT requires the in-charge tax bureau regularly (i.e., every half year) review the implementation of the APA. We understand that if the company's actual operating result is below the range of the prices or profit level anticipated in the APA, the in-charge tax bureau will make special tax adjustments upon approval from the SAT.

Further, if the anticipated prices or profit level are determined using an interquartile range, the adjusted result should not, in principle, be lower than the median of the range.

Development of professional special tax adjustment teams

To continue building special tax adjustment capabilities across tax authorities, the SAT intends to require tax bureaus at all levels to establish dedicated special tax adjustment work force and to provide training for special tax adjustment professionals; strengthen the review of related-party transaction filings; and review contemporaneous documentation. The SAT intends to require an evaluation of the special tax adjustment work in the annual performance appraisal of tax bureaus at all levels.

The development of special tax adjustment teams in the tax bureaus may represent both risk and opportunity for taxpayers. On one hand, companies' tax arrangements may be reviewed more stringently and frequently; on the other hand, more resources may become available to taxpayers to better meet taxpayers' needs in proactive tax risk management (such as APAs).

Conclusion

Through what we understand to be the SAT's latest initiatives in standardizing the procedures for special tax adjustments, it would seem that the SAT is resolved to improve the quality of special tax adjustment enforcement and to promote national consistency. It is recommended that companies review carefully any uncertainties in their tax arrangements and, if necessary, seek assistance from professionals to mitigate any potential tax risks.

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FEA no.03000994

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