China Law Update

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Multinational Companies Could Face Stricter Transfer Pricing Investigation By Chinese Tax Authorities

In the beginning of 2009, the Chinese government set a target for annual tax growth of 8.2%. Due to the financial crisis, tax revenue has dropped 10.3% in the first quarter and 6% in the first half of the year compared with the same periods of last year. Therefore, China's State Administration of Taxation ("SAT") has started to put more emphasis on tax inspection. Tax inspection is a regular function for the SAT, and a common practice internationally. But now China is expanding its scope.

The latest tax revenue report, which was issued by Ministry of Finance on Nov. 3, 2009, indicates that although the tax revenue has dropped in the first quarter and the first half of 2009 compared with the same periods of last year, the tax revenue in the first three quarters of this year increased by 2.2% compared with the same period of last year. However, tax revenues still fall short of the target. Therefore, it is estimated that tax inspection efforts will intensify.

To avoid paying taxes, multinational companies transfer profits through transfer pricing in order to achieve "virtual loss". Their practice is becoming the focus objective of Chinese tax inspection authorities, Currently, SAT is taking a general census of the tire industry and the revenue assignments have already been made to local tax authorities.

<u>The New Rules</u>

In order to strengthen tax investigation efforts this year, the central government has issued a number of laws and regulations. For transfer pricing investigation, the most important rule is Guo Shui Fa [2009] No. 2, entitled Implementation Measures of Special Tax Adjustments (Trial) ("Circular 2").

Based on the previous relevant provisions of transfer pricing, Circular 2 specifies conditions of selecting the supervision and investigation processes.

The most remarkable provision of Circular 2 is Article 29, which states that transfer pricing investigations shall focus on the following enterprises:

1. Enterprises with a considerable amount of affiliated transactions or more kinds of affiliated transactions;
2. Enterprises with longtime losses, slight profits, or leaping profits;
3. Enterprises with profits lower than the average of the same industry;
4. Enterprises with a profit level which obviously does not match the functions performed and risk assumed by the enterprises;
5. Enterprises engaging in transactions with affiliates in a tax haven;
6. Enterprises that fail to file their affiliated transaction declarations or prepare the contemporaneous documentation as required; and
7. Enterprises that obviously violate the arm's-length principle.

With regard to transfer pricing, Circular 2 differs from the "Procedures for the Taxation Administration of Business Transactions between Affiliated Enterprises" in the following respects:

- Circular 2 expands the scope of the focus enterprises;
- Circular 2 has more stringent investigation and evidence collection standards, and the scope of data providers, whose liability is emphasized, becomes wider;
- The procedures are more clear in the transfer pricing rules;
- Circular 2 intensifies the penalties for transfer pricing investigation;
- Circular 2 extends the duration of follow-up management from three to five years.

Conclusion

In sum, there are indications that Chinese tax authorities will ramp up the transfer pricing investigation, and that the multinational companies are facing new risks. To deal with these new risks, multinational companies should pay attention to the following issues:

- Be aware of the triggers of transfer pricing investigation, which may be long-term losses or low profit;
- Take the inquiry by tax authorities seriously;
- Since the related parties are usually offshore, the burden of supplying information may pass on to the company under investigation;
- Multinational companies should develop proper negotiation strategies to take advantage of the negotiation with tax authorities.

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