

Transfer Pricing Tax System and Its Development in China
State Administration of Taxation
People's Republic of China

I. Introduction

Chronologically, the development of transfer pricing (hereafter abbreviated as TP) tax system in China can be divided into four stages: prior to 1991, 1991, 1992-1993, 1998 and hereafter. Prior to 1991, TP adjustments in China were anecdotal. There was no law guiding tax officials' behavior. But more than a decade's practice though piecemeal helped to gather energy for the birth of the system. The year 1991 was the watershed. In this year *Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises* (hereafter referred to as Income Tax Law for FIEs and FEs) and *Detailed Rules for the Implementation of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises* (hereafter referred to as Detailed Rules) were released. It marked the birth of TP tax system in China. For the first time in China, there were legislations regarding TP-related tax issues. In 1992, to clarify the terms and other relevant issues in *the Income Tax Law for FIEs and FEs* and the *Detailed Rules*, a circular was released by the competent authority to explain standards for the identification of associated enterprises, yearly reporting of transactions with related parties, information to be reported and other fundamental issues. In 1993, TP-related issues were written into *the Law of the People's Republic of China Concerning Tax Collection and Administration*. These two events helped to fledge TP tax system in China. In 1998, China's TP guidelines came into being, which marked the final takeoff of the system. By now a comprehensive TP tax system has been established, but in the process of its development, China has encountered many problems that need assistance from the international field.

2. Prior to 1991 – incubation

The years before 1991 was the incubating stage for TP tax system in China.

China began opening up to the outside world in late 1970s. Foreign direct investment (hereafter referred to as FDI) and joint ventures were encouraged from the very beginning. Since then, China has witnessed a rapid development of foreign-invested enterprises (hereafter referred to as FIEs) and foreign

enterprises (hereafter referred to as FEs).¹ In 1981 and 1982, there were two important legislation events. One was *Joint Venture Income Tax Law*. The other was *Foreign Enterprise Income Tax Law*. Neither of the two however mentioned anything about TP. This is because on the one hand there were a relatively small number of foreign investors in China at that time. On the other hand few TP cases, if any, were detected, therefore attracting insufficient attention from legislators.

However, as time went on, some FIEs were found to be transferring profit to avoid tax. They enjoyed profit but reported loss². TP was found out to be the primary choice for them to avoid tax³. While the actual practice might differ from case to case, a typical case would involve a related party outside China in control of the purchase and delivery. The associated party in China would import things (such as equipment, raw material, spare parts, service and intangible assets) at a price obviously higher than the market price and export things (its products) at a price conspicuously lower than the market price.

TP cases were first detected in Special Economic Zones (hereafter referred to as SEZs). SEZs were special zones designed to attract FDI and high tech with favorable policies. Enterprises located therein enjoy much more favorable tax treatment than those in other places of China. Some tax rates in SEZs were (and are) even lower than those in Hong Kong. With such preferential tax policy, however, some FEs and FIEs still took chance to avoid tax.

¹ By the end of May 2001, more than 370,000 FIEs have been approved, among which 250,000 have started operation. The actual foreign investment has amounted to over US\$370 billion. The introduction of foreign capital and technology has greatly promoted the development of China's national economy.

² Statistics show that between 1988 and 1993, 35-40% of FIEs reported losses. Between 1994 and 1995, 50-60% reported loss. Between 1996 and 2000, 60-70% reported losses. It was true that some FIEs did lose money. Most others however were fake losers. They were avoiding tax by using schemes such as TP.

³ Other methods used by foreign investors to avoid tax include thin capitalization and taking advantage of the loopholes in tax legislation and the inefficiency in tax administration

Tax avoidance through TP had a great impact upon economic development in China. It eroded Chinese tax base and directly affected the regulating function of taxation. In addition it brought distortions to Chinese economy and had a negative effect upon the balance of payment. What was worse, the transfer of profit led to a wrong impression that foreign investors in China were losing money, which hampered enthusiasm to invest in China and as a result sabotaged China's open-up policy.

In response thereto, actions were taken. But the actions were piecemeal rather than systematic. Since there was no law guiding the actions and reactions, investigation of TP cases was fable, often leading to unproductive ending. Though piecemeal and anecdotal, more than ten years' practice had helped to accumulate energy for the final birth of TP tax system in China.

III. 1991 -- Birth

Though the work against tax avoidance through TP started rather early in SEZs and striking effect was witnessed, the formal introduction of the world-popular TP tax system did not take place until 1991, when *Income Tax Law for FIEs and FEs* was drafted (a merge of the previous *Joint-venture Enterprise Income Tax Law* and *Foreign Enterprise Income Tax Law*). For the first time in Chinese history, TP-related tax issues were guided by law, which symbolized the birth of TP tax system in China. Article 13 of the new law stipulates that

The payment or receipt of charges or fees in business transactions between an enterprise with foreign investment, or an establishment or place set up in China by a foreign enterprise to engage in production or business operations, and its associated enterprises shall be made in the same manner as the payment or receipt of charges or fees in business transactions between independent enterprises. Where the payment or receipt of charges or fees is not made in the same manner as in business transactions between independent enterprises and results in a reduction of taxable income, the tax authorities shall have the right to make reasonable adjustments.

The Detailed Rules further defines "associated enterprises" and "TP adjustment methods" as follows:

"Associated enterprises" mentioned in Article 13 of the Tax Law refer to companies, enterprises and other economic units that have any of the following relationships with other enterprises:

- (3) Relationships in respect of existing direct or indirect ownership of or control over such matters as finances, business operations, or purchases and sales;
- (4) Both are directly or indirectly owned or controlled by a third party;
- (5) Any other interest-related relationships.

----- Article 52

“Business transactions between independent enterprises” mentioned in Article 13 of the Tax Law mean business dealings carried out between unassociated and unrelated enterprises on the basis of arm’s length prices and common business practices.

Enterprises have a duty to provide to the local tax authorities relevant materials such as standard prices and charges in respect of business dealings between associated enterprises.

----- Article 53

Where prices in respect of purchases and sales transactions between an enterprise and its associated enterprises are not based on independent business dealings, adjustments may be made thereto by the local tax authorities according to the following sequence of methods of determination:

- (6) Based on prices of the same or similar business activities between independent enterprises;
- (7) Based on the level of profits obtained from resale in respect of unassociated and unrelated third party prices;
- (8) Based on costs plus reasonable expenses and profit margin;
- (9) Based on any other reasonable method.

----- Article 54

Where interest paid or received in respect of accommodating financing between an enterprise and an associated enterprise exceeds or is lower than the amount that would be agreed upon by unassociated and unrelated parties, or where the rate of interest exceeds or is lower than the normal rate of interest in respect of similar business, adjustments may be made thereto by the local tax authorities with reference to normal rates of interest.

----- Article 55

Where labor service fees paid or received in respect of the provision of labor services by an enterprise to an associated enterprise are not based on business dealings between independent enterprises, adjustments may be made thereto by the local tax authorities with reference to the normal fee standards of similar labor services.

----- Article 56

Where the valuation or the receipt or payment of usage fees in respect of such business dealings as the transfer of property or the granting of rights to the use of property between an enterprise and an associated enterprise is not based on business dealings between independent enterprises, adjustments may be made thereto by the local tax authorities with reference to the amounts that would be agreed to by unassociated and unrelated parties.

----- Article 57

Management fees paid by an enterprise to an associated enterprise shall not be deductible.

----- Article 58

With the support of above legislation, anti-TP work began to develop rapidly. Tax administrations started to set up institutions to be specifically responsible for TP tax administration. The government began to allocate resources to shoulder the function of transfer pricing investigation and adjustment. TP tax system gradually took its shape.

IV. 1992-1993 – Fledgling

Two events helped to fledge the newly born system.

In 1992, in order for *the Income Tax Law for FIEs and FEs* and its *Detailed Rules* to be implemented properly, the State Administration of Taxation of the People's Republic of China released a circular called *Tax Administration Rules for Business Transactions between Associated Enterprises*, which clarified the criteria for the identification of associated enterprises, defined the procedure for yearly reporting of business transactions with related parties and specified enterprise' responsibility to prove evidence. It helped to fledge the TP tax system newly born. The main contents can be summarized as follows.

5. Identification of associated enterprises. When Article 52 of *the Detailed Rules* says “*relationship in respect of existing direct or indirect ownership of or control over such matters as finances, business operations, or purchase and sales*”, “*both are directly or indirectly owned or controlled by a third party*” and “*any other interest-related relationships*”, it mainly refers to a foreign-invested enterprise or foreign enterprise (hereafter referred to as “the enterprise”) which has one or more of the following relationships with another entity (hereafter referred to as “another enterprise”):

- ✘ One holds directly or indirectly 25% or more of the total shares of another.
- ✘ Both are directly or indirectly held or 25% or more of their shares are held by a third party.
- ✘ Money borrowed from another enterprise amounts to 50% or more of the enterprise's capital, or up to 10% of the total debt of the enterprise is guaranteed by another enterprise.
- ✘ More than 50% of such senior officials as board members or managers are, or one long-standing board member of the enterprise is, assigned by another enterprise.
- ✘ The business operation of the enterprise is exclusively based upon royalties (including industrial property rights and technical know-how etc.) granted by another enterprise.
- ✘ The raw materials and spare parts and so on (including price and transaction terms etc.) purchased for business operation of the enterprise are supplied (or controlled) by another enterprise.
- ✘ The sale of products or goods of an enterprise (and the price and transaction terms etc.) is controlled by another enterprise.
- ✘ Other interest-related relationships such as family, relatives etc. that result in actual control of the production, operation and transaction of the enterprise.

6. An enterprise that has business transactions with related parties within a taxable year should, when filing annual tax returns, submit to the local tax authorities "Annual Report of Business Transactions with Related Parties by Foreign-invested Enterprises and Foreign Enterprises".

7. Local tax authorities have the right, when undertaking audit and investigation upon an enterprise's business transactions with related parties, to require the enterprise to provide relevant information such as prices, fees etc.

8. When requiring an enterprise to provide such information as prices, fees and so on about its transactions with related parties, the local tax authorities should notify the enterprise in a written form. The enterprise should submit the relevant information within 60 days after receipt of the notice.

9. Where prices or charges of fees in respect of transactions between an enterprise and its related parties are not based on independent business dealings, which results in a reduction of taxable income, local tax authorities have the right to draw their own conclusions and then make adjustment in correspondence. The method of adjustment is

selected according to Articles 53-57 of *the Detailed Rules*.

10. When TP adjustment is made, the local tax authorities should notify in a written form the enterprise of the amount and the nature of the adjustment.

11. In general, the TP adjustment made to an enterprise is limited to the taxable income in the tax year of audit and investigation. The audit, investigation and adjustment are usually undertaken within 3 years beginning from the following tax year. If the case has to do with the taxable income of the previous years, adjustment may be made by tracing back no longer than 10 years.

12. Where TP adjustment is made to an enterprise' taxable income but the enterprise does not make corresponding changes of its books of account, the amount exceeding the usual amount received from independent business dealings received by the related parties is deemed as dividend distribution but cannot enjoy exemption of income tax as stipulated in Article 19 of *the Income Tax Law for FIEs and FEs*. If the income received by the related parties is interest or royalty, no adjustment should be made to the tax already withheld.

13. Where an enterprise disagrees with the adjustment, it should first pay the tax within the time limit and in accordance with the requirement made by the local tax authorities, and then apply for reconsideration or litigation as stipulated in Article 26 of *the Income Tax Law for FIEs and FEs*. Meanwhile, information regarding price, fees charged and so on should be provided. If the enterprise fails, within the time limit for applying for reconsideration, to provide the information or the information is insufficient, the tax authorities may turn down the application.

14. When the adjustment has to do with tax treaties, the provisions thereof should be followed.

The circular came into effect on January 1, 1993.

In the same year, another event further helped to fledge the system. That is the release of *the Law of the People's Republic of China Concerning Tax Collection and Administration*. Article 24 of the Law stipulates that:

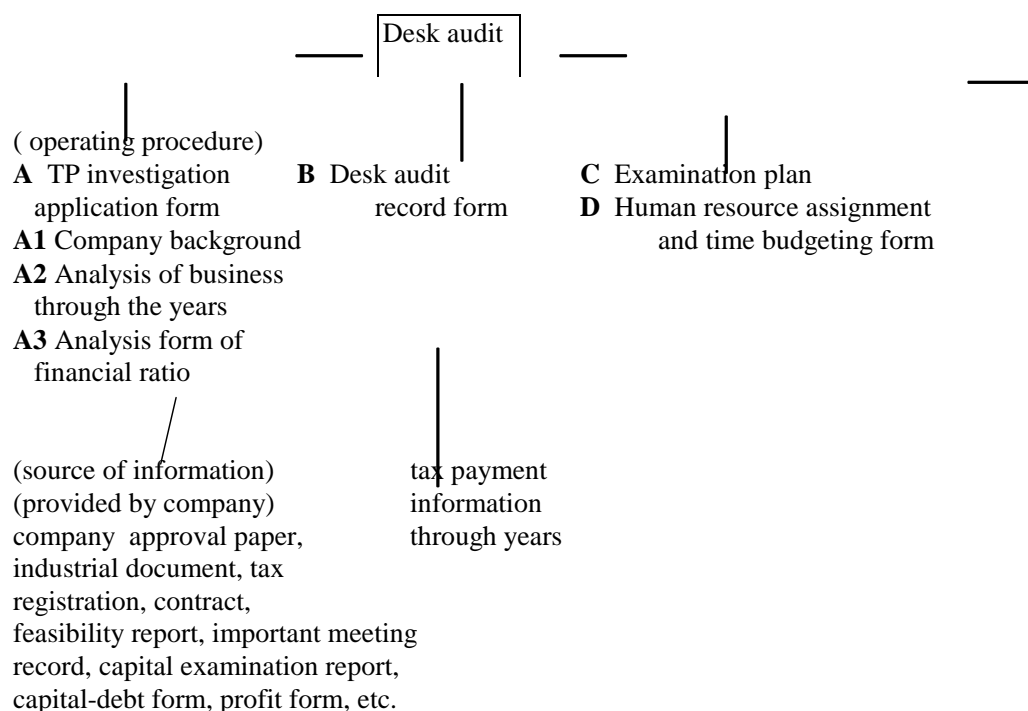
The receipt or payment of charges or fees in business transactions between an enterprise or institutions or sites engaged in production or business operations

Deciding Audit target
 established in China by a foreign enterprise, and its associated enterprises shall be made at arm's length prices. Where the receipt or payment of charges or fees is not made at arm's length prices and results in a reduction of the taxable income, the tax authorities shall have the right to make reasonable adjustments.⁴
 Making examination plan
 Time budgeting

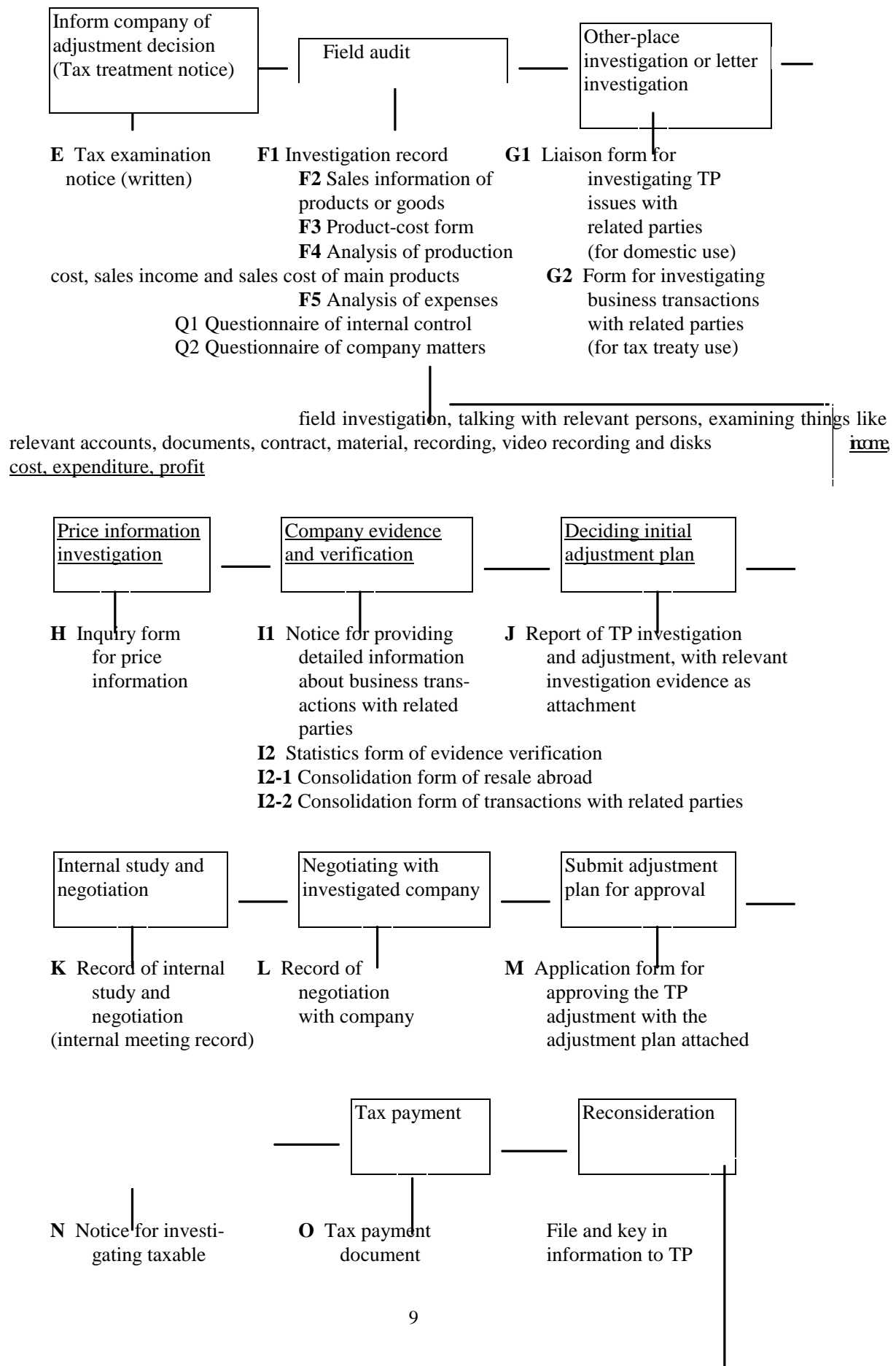
Articles 36-41 of the *Implementation Rules* (released in 1993 also) of the *Law* further clarify tax treatment of TP issues and enlarged the applicable scope to cover all enterprises. By far, TP tax system in China had become full-fledged.

V. 1998 Takeoff

Five years practice between 1993 and 1998 added sophistication to China TP tax system. But the absence of Chinese TP guidelines seriously hampered its development. In order for the system to work better, in 1998, China officially released its own TP guidelines called *Tax Administration Rules and Procedures for Transactions between Associated Enterprises*. TP working procedure was clarified and standardized as follows:



⁴ The revised version of the Law was released in 2001, in which provisions regarding TP-related tax issues remain unchanged.



income with TP issues	software system
N1 Profit form for year (x x) after adjustment	Court litigation
N2 Adjustment item form for taxable income of year (x x)	
N3 Form listing tax payment made up or refund for each tax category	

The circular contains 52 articles and 12 chapters. It is so far the most comprehensive TP guidelines in China. It follows international concept and the principles expounded in the revised *OECD Transfer Pricing Guidelines*. It standardized the procedures regarding tax audit of TP cases including selection of cases, desk audit, field audit, application of adjustment methods, evidence collection, tax collection, application for reconsideration etc.. In spite of the shortcomings contained⁵, the circular brought TP tax system in China closer in line with international practice and facilitated the final takeoff of the system.

VI. Problems

However, the system still has problems as stated in the following.

15. Lack of comparable transactions

Theoretically speaking, arm's-length principle is the best option to deal with TP issues. However, in recent discussions some people argue that it is difficult to require multinationals to strictly follow arm's-length principle. This is because multinationals are taking up an increasingly larger proportion of the total amount of international transactions. In order to maximize profit, internal division of labor among multinationals is becoming increasingly detailed. This makes it difficult to find in the international market comparables that can be applied to make comparisons with internal transactions within the same multinational group. A comparable transaction can be found, if lucky. But it often lacks comparability. This makes it hard to follow arm's-length principle.

Lack of comparable transactions also poses difficulty for the application of proper

⁵ For example, conditions and procedures for the use of Profit Method and Advance Pricing Agreement are not defined.

adjustment methods. As is known, three or four methods are popular for the adjustment to transactions of tangible property among associated enterprises. They are Comparable Uncontrolled Price, Resale Price and Cost Plus. However, in practice, like many tax authorities other methods are usually resorted to because the above three methods require comparable transactions, which are difficult to find. Other methods are a lump sum of all other unpopular methods, which lack acknowledged conditions and standards for application, because situation and legislation differ from one country to another. In such case, coordination between countries for making adjustment appears difficult if not impossible.

16. Problems in the application of Resale Price Method

In China, when investigating TP cases, Resale Price Method is often applied. Chinese tax law stipulates that the application of this method should be based on the level of profit reached after resale of goods at the unrelated third party prices. It further stipulates that the reseller cannot add value to the goods or products through changing the shape, function, structure, trademark etc.. These rules are consistent with international practice. In practice, however, the following difficulties are encountered.

- ⌘ Information is insufficient to help decide the normal profit level. For example, there is not enough information about how the related enterprise abroad purchases goods or products from related parties and then resells them to an unrelated third party. Sometimes, transactions among associated enterprises happen in many countries, which makes it difficult to split the total expenditure and decide upon the reasonable share to be allocated.
- ⌘ Intangible properties pose difficulty for the application of Resale Price Method. When the associated enterprise abroad as a purchaser resells the goods or products purchased from other associated enterprises to an unrelated third party, if the purchase and sale rights are controlled, the intangible properties used such as well-known trademarks may greatly influence the assessment of the normal profit level.
- ⌘ In cases when the associated enterprises in all the related countries purchase goods or products from related enterprises abroad and resell them to unrelated third parties, it is often not easy to get the information about the resale income.

17. The problem in the application of Cost Plus Method

Cost Plus Method is another method widely used. Chinese tax law stipulates that, when applying this method, adjustment should be made in accordance with cost plus reasonable fees and profit. In other words, the arm's-length price is decided by adding the associated enterprise's cost in selling goods or products with reasonable profit. The key point in using this method is the decision of cost-profit margin. It is however usually not easy to find a comparable cost-profit margin in the same industry because of the difference of business conditions, business activity, sales target and so on, thus leading to "negotiation" between taxpayers and the tax authorities.

18. The problem in making corresponding adjustment.

When associated enterprises in two countries conduct business transactions and the tax authorities of one country think that the price does not match the arm's-length principle and adjustment is needed, adjustment in the other country should be made in correspondence. Otherwise, international double taxation may happen. However, the tax authorities of one country cannot require the tax authorities of the other to make the corresponding adjustment, because the jurisdictions involved are independent. This problem is looming increasingly large in abiding by arm's-length principle.

China proposes that international coordination and legislation be resorted to for the solution of the problem. Currently both the UN and OECD tax model stipulate that arm's-length principle be adopted in adjusting the profit of business transactions among associated enterprises. In the tax treaties China has entered into, the above provision is also included. Actual implementation of the arm's length principle requires that agreement on the adjustment in one party be achieved so that the adjustment in correspondence can follow in the other. The agreement however is often hard to be reached because most of the time each country weighs its own interests heavily. Moreover, corresponding adjustment is not compulsory. Each jurisdiction handles it with its own law. At present the inclusion of the provisions of mutual agreement procedure in tax treaties is expected to alleviate the problem. Supposing if they are included, treaty partners only have the obligation to exchange views, not required to reach agreement. Therefore, the inclusion of the article, Mutual Agreement Procedure, does not ensure a final solution to the problem. Some countries even refuse to include the article in tax treaties, which aggravates the situation.

In order to find a better way out, some countries suggest "arbitration" and "simultaneous examination". But the procedure involved is very much complicated. Time is still needed to see whether the effect stands up to people's expectation. China thinks it advisable to include TP adjustment as a topic when negotiating tax treaties between competent authorities so as to reach a binding stipulation for actions to follow. In addition, information exchange and joint tax audit are

also recommendable ways of cross-jurisdictional tax cooperation, because they, to a large extent, avoid clash of identical interest – revenue. Up till now, there is no acknowledged rule requiring different jurisdictions to conduct joint audit upon multinationals. China thinks it practicable for different jurisdictions to pool their resources and conduct joint audit. It is a good way out not only for corresponding adjustment but also for friendly and productive international tax cooperation.

VII. Summary and conclusion

The development of TP tax system in China can be summarized as follows.

19. TP-related work in the years between late 1970s and 1991 was piecemeal and anecdotal.
20. Legislation introduced in the *Income Tax Law for FIEs and FEs* and the *Detailed Rules* released in 1991 ended the incubating stage and marked the final birth of China's TP tax system.
21. Release of a circular called *Tax Administration Rules for Business Transactions between Associated Enterprises* in 1992 fledged the system in the aspect of implementation.
22. TP-related provisions in the *Law of the P. R. China Concerning Tax Collection and Administration* and the *Implementation Rules* thereof released in 1993 further fledged the system and extended TP tax principles to domestic enterprises besides FIEs and FEs.
23. *Tax Administration Rules and Procedures for Business Transactions between Associated Enterprises* (also called China's TP Guidelines) released in 1998 standardized anti-TP working norms, principles and procedures and facilitated the final takeoff of the system.

On the whole, the system has been playing an active role in facilitating China's open-up policy, introducing FDI, improving tax system and protecting national sovereignty and interest. For example, in 1991, the total FDI actually introduced was only US\$4.366 billion. By the year 2000, however, it had amounted to US\$40.772.

In order for the system to develop in line with international practice, China is taking every effort to improve its legislation, to improve its TP-related tax administration and to train its tax officials. In the second half of the year 2001, another circular called *The Implementation Rules of Advance Pricing Arrangement for Business Transactions between Associated Enterprises* is to be released. It will be another milestone for the development of TP tax system in China.

However, China is a developing country. TP tax system is still at an elementary stage and has many problems.

24. China lacks well-trained professionals. At present there are some tax officials engaged in the undertaking of TP investigation. But they still need technical training.
25. China is short of experience in handling TP investigation. From 1991 to 2000, audit was done upon 18,000 FIEs that had business transactions with related parties, among which about 6,000 cases had been closed with rather positive effects. But the FIEs audited were only a small proportion of the FIEs. Besides, most of the enterprises audited are small in scale.
26. China also lacks experience in resolving tax disputes by means of international cooperation, for instance MAP (Mutual Agreement Procedure), bilateral APA (Advance Pricing Arrangement), corresponding adjustment etc..
27. Information Infrastructure for TP tax system in China is far from being complete. For example. China does not have an information database (for market price of the same commodities in different countries, data regarding parent company and its subsidiaries etc.), which has proved to be the major barrier for further development of the undertaking. Though a program called “TP Software System” has been under trial operation, the authenticity of the information is still to be tested and the source for information remains uncertain.
28. Inter-departmental cooperation needs to be improved.
29. Advanced TP tax techniques like risk and function analysis, comparability analysis and difference adjustment etc. need to be introduced for TP tax investigation, audit and adjustment.

This list does not exhaust all the difficulties and problems China has encountered. As time goes on many more may appear. In order to find solutions thereto and to catch up with what the developed countries have achieved, China sincerely requests help from and invites cooperation with colleagues in the international circle.

