



**BAKER & MCKENZIE**  
貝克·麥堅時律師事務所

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# Highlights of unified EIT, implementation rules and supplemental notices

- resident and non- resident enterprises
- tax rates and incentives
- tax incentives repealed
- transition period
- withholding tax
- limitation on expense deductions
- re-organization
- **transfer pricing**
- controlled foreign corporation
- thin capitalization
- anti-avoidance
- tax administration

# Update on China Tax Incentives

- **Software Development Enterprise**
  - A newly-established software company (established after 1 January 2008) can enjoy a 2 + 3 tax holiday
- **High New Technology Enterprise (“HNTE”)**
  - Reduced EIT rate of 15%
  - HNTEs established in Shenzhen, Zhuhai, Xiamen, Shantou, Hainan and Shanghai Pudong can enjoy a 2+3 tax holiday;
  - Core IP ownership requirement
- **Others**
  - Basic Infrastructure Projects – 3+3 holiday
  - Comprehensive Utilization of Resources – only 90% revenue taxable
  - Environmental Protection, Energy Saving and Safe Production Projects – 10% investment as EIT credits

# Withholding taxes

- under the old tax regime, the dividend withholding tax rate was zero and the withholding tax rate for interest, royalties and capital gains was 10%
- EIT introduces a potential 20% rate of withholding tax on interest, dividends, capital gains and royalties
- The actual withholding tax rate introduced was 10%
- a zero percent withholding tax rate continues to apply to dividends paid from pre 1 January 2008 profits

# China withholding tax rates with some treaty countries

Treaty Country	Royalty	Interest	Dividend	CGT Position
<b>Hong Kong</b>	7	7	5	10% if >25% of shares
<b>Barbados</b>	10	10	5	exempt
<b>Ireland</b>	6	10	5	exempt providing trading Co.
<b>Mauritius</b>	10	10	5	10% if >25% of shares
<b>Singapore</b>	6	10	5	10% if >25% of shares



# Managing China Transfer Pricing Risks

# Transfer Pricing Developments in 2007 and 2008

## **1** *Guoshuifa [2007] No. 1* - 2007 nationwide tax anti-avoidance focus

- ❖ Strengthen analysis on related-party transactions
- ❖ Expand the anti-avoidance work with regard to domestic enterprises
- ❖ Enhance anti-avoidance surveillance

## **2** *Guoshuifa [2007] No. 363*

- ❖ Underscore the role of the State Administration of Taxation (SAT) in monitoring the quality and focus of TP administration and monitoring

### Regulatory Development in 2007 & 2008

## **1** *Draft Ruling on Special Tax Adjustments*

- ❖ Provide detailed guidance on the Chapter 6 of New CIT Law
- ❖ The formal version is expected to be released in late 2008

## *Chapter Six of New CIT Law [2008]* **3**

- ❖ Disclosure and Documentation of Related-Party Transactions
- ❖ General Anti-Avoidance Rule
- ❖ Controlled Foreign Companies
- ❖ Thin Capitalization
- ❖ Interest on Tax Adjustments
- ❖ Cost Contribution Arrangements
- ❖ Advance Pricing Arrangement

**4**

# Draft ruling on special tax adjustment

- More specific and extensive disclosure requirement
- Contemporaneous documentation requirement
- New penalty regime in place for non-compliance of transfer pricing
- Enhanced transfer pricing audits
- Advance pricing arrangement available for achieving TP certainties
- Thin Capitalization
- Cost contribution arrangement first introduced in law

# New transfer pricing filing requirements

Increased annual tax filing burdens by the introduction of a number of new forms associated with related party transactions. These forms are specific to each type of transactions and applicable to **ALL TAXPAYERS**:

- Annual Reporting of Related Party Transactions
  - List of related parties
  - Transaction: services
  - Transaction summary
  - Transaction: financing
  - Transaction: purchasing and sales
  - Transaction: asset transfer
- Annual Reporting of Thin Capitalization
- Annual Reporting of Foreign Remittance
- Annual Reporting of Overseas Investments
- Annual Reporting of Controlled Foreign Corporations

# Documentation – threshold limits

- The contemporaneous documentation for 2008 should be in place by June 1, 2009
- Threshold Limits:
  - **Exemption** – Annual aggregated amount of intercompany transaction below RMB 20 million or pure intra-China intercompany transactions;
  - **Simplified Documentation** - Annual aggregated amount of intercompany transaction between RMB 20 million to RMB 100 million;
  - **Standard Documentation** - Annual aggregated amount of intercompany transaction exceeding RMB 100 million
- The documentation should be prepared in Chinese. The documentation can be kept in house but be submitted within 15 days upon request.

# Simplified documentation

- Simplified contemporaneous documentation mainly includes:
  - Organization structure
  - Pricing policy, market situation and profit allocation of involved parties
  - Functional and risk analysis
  - Description of major related-party transactions
  - Selection of transfer pricing methodology and comparable information
  - Factors affecting the arm's length prices/profits

# Standard documentation

- The standard requirement goes beyond the standard items. In addition to the standard elements in a documentation study, tax payer can be required to prepare the information including:
  - Group organizational structure
  - Business strategy and the expected profit of future years
  - Detailed functional analysis along with *Form of Functions and Risks Analysis*
  - Detailed description on intercompany transactions, including physical flow and cash flow of the supply chain; as well as allocation of revenues, expenses and profits between the related-party transactions and non related-party transactions (*Form of Financial Analysis*)
  - Description of taxpayer's contribution to overall profits or residual profits on a group level

# Example of Form of Functions and Risks Analysis

✓ **Hundreds** of entries covering all types of functions. Below uses R&D as an illustration.

Category	Item	Company A	Company B1	Company B2
1. R&D	(1) Core Technology Development			
	(2) Production and Design			
	(3) Package and Labeling			
	(4) Quality Control			
2. Production	(1) Purchase			
	(2) Production Equipment and Plan			
	(3) Quality Control			
	(4) Inventory			
	(5) Transportation			
3. Marketing	(1) Marketing Strategy			
	(2) Marketing Method			
	(3) Trade Mark and Goodwill			
4. Sales and Distribution	(1) Marketing and Distribution			
	(2) Inventory			
	(3) Transportation			
	(4) Installation and After-sales Services			
5. Management and Other Services	(1) General Management			
	(2) Pricing Policy			
	(3) Finance			
	(4) HR			
	(5) Asset Employment and Lease			

Details

Items Investigated
(I) Research and Development of Core Technology
Whether the technology is researched and developed by an affiliated enterprise
Whether a third party is entrusted to research and develop the technology
Who has the ownership of the technology
Who is entitled to share the result of research and development
Who bears the expenses of research and development
Whether the research and development lead to material result
To whom the expected earnings are distributed
Whether there is a license agreement with an affiliated party
Whether there is a license agreement with a third party
Whether there is a cost contribution agreement
Whether the enterprise has filed for a patent
Who bears the risk of research and development
Who plays a superior role in research and development
Whether the result of research and development is a unique intangible asset
Whether research and development can lead to competitive advantage

# Example of form of financial analysis

Profit and Loss	Year: XXX				
	Overseas Related Party Transactions	Domestic Related Party Transactions	Overseas Non-related Party Transactions	Domestic Non-related Party Transactions	Total
Revenue					
Cost of Service/Good Sold					
Gross Profit					
Selling Expense					
Administration Expense					
Operating Expenses					
Other Operating Profit(Loss)					
Operating Profit/(Loss) (before interest)					
Financial Income/(Expense)					
Investment Gain/(Loss)					
Non-operating Gain/(Loss)					
Profit Before Tax					

# Non compliant cost under the new penalty regime

## ✓ Compliant

- Burden of taxpayer

## X Non-Compliant

- Interest payment on owed tax liabilities as penalty
- Lending interest rate published by the People's Bank of China plus 5%\*Deemed profit approach
  - Refer to the profitability of same or similar or enterprises;
  - Adding reasonable expenses and profits to the costs of the enterprise;
  - Deeming a profit based on a reasonable percentage consolidated profit of the related group; or
  - Other reasonable methods.

**\*Note that the additional 5% can be exempted if documentation is prepared.**

# Most common audit triggers



# Special TP audit issues of China

- **Demand for overseas information** - if overseas information is needed, the tax authority can either start information exchange procedure or collect relevant information through China's overseas government organization
- **Investigation on single-functioned manufacturing entities** - enterprises engaged in processing or manufacturing under related party's orders, do not perform functions such as operation decision making, product R&D and sales, should not bear the risks and losses due to wrong decision, insufficient capacity and product obsolescence, and should maintain a certain level of profit

## Special TP audit issues of China (Cont'd)

- National audits / industry-specific audits are on the rise. Both cross-border and intra-China related party transactions (as long as different effective tax rates are involved) are under scrutiny.
- Use of secret comparables
- Arm's length profit should fall within the median to upper quartile of the interquartile range based on the new Draft Guidelines
- Additional tax exposures resulted from income tax adjustment – VAT, BT and Customs duty
- 10 years tracing back
- 5 years post-audit monitoring

# Cost Contribution Arrangement (“CCA”)

- CCA is a contractual agreement among business enterprises to share costs and risks of joint development and transfer of intangible assets, as well as joint provision and acceptance of labor services, and to determine the nature and extent of the interests of participants in those assets
- CCA is introduced in the new CIT law
  - The new draft applies to both technology CCA and service CCA.
  - Based on the new draft, group procurement and centralized marketing programs are two applied areas for service CCA
  - Approval at SAT level is required
  - A CCA can be implemented via an APA
- Based on current thinking within the SAT, CCAs, especially CCAs for services, will be practically available in the medium to long term

# Cost Sharing Arrangements

- Article 41(2) of the EIT Law gives rule for allocating costs incurred by related parties for:
  - joint development or purchase of intangible assets
  - joint provision or receipt of services
- Allocation must be based on arm's length principle: cost and anticipated benefit proportional
- Supporting documentation required
- Draft TP Guidelines – cost sharing arrangement for services must be approved by the SAT

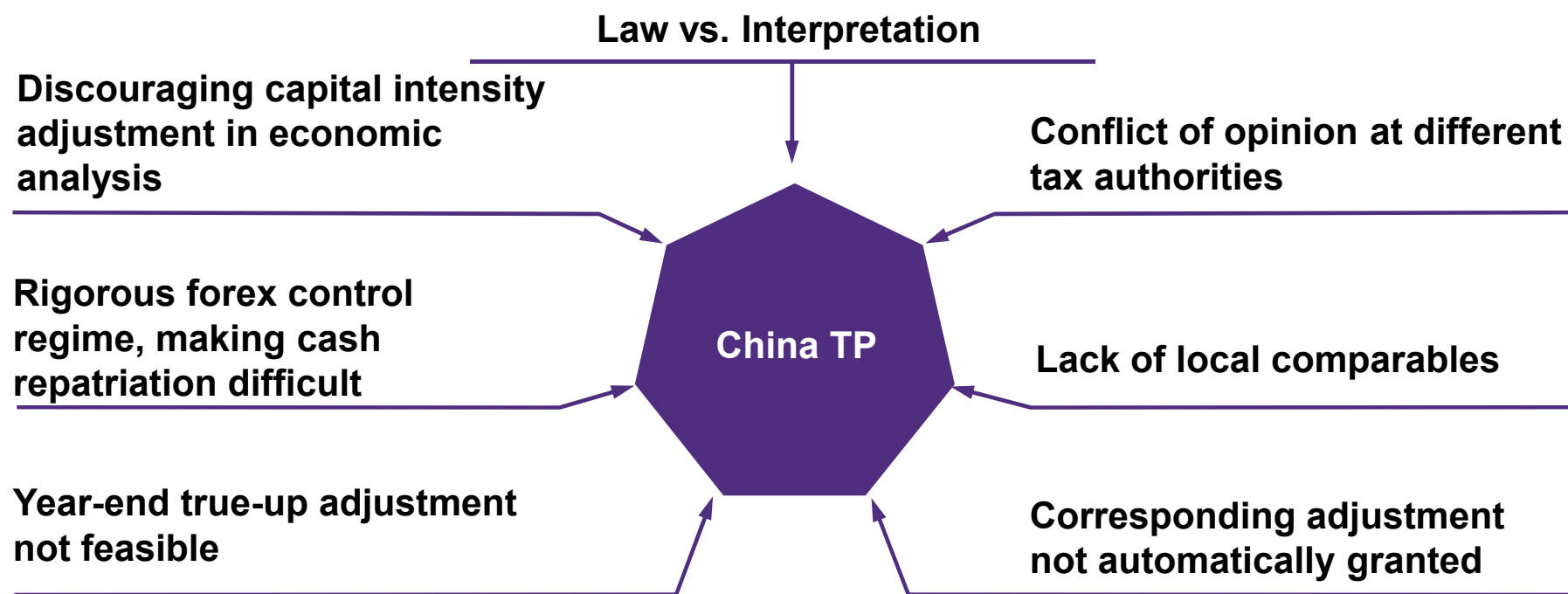
# Service Sharing Arrangement

- Guo Shui Fa [2008] No. 86 – services rendered by a parent to its subsidiaries
  - Arm's length service fee
  - Must have a reasonable mark-up

# Outstanding Questions

- Is the cost sharing concept under the EIT Law limited to deductibility of costs?
  - Profit element?
  - Difference between IP and services?
- Is there any relationship between service sharing under Notice 86 and the cost sharing for services under the EIT Law

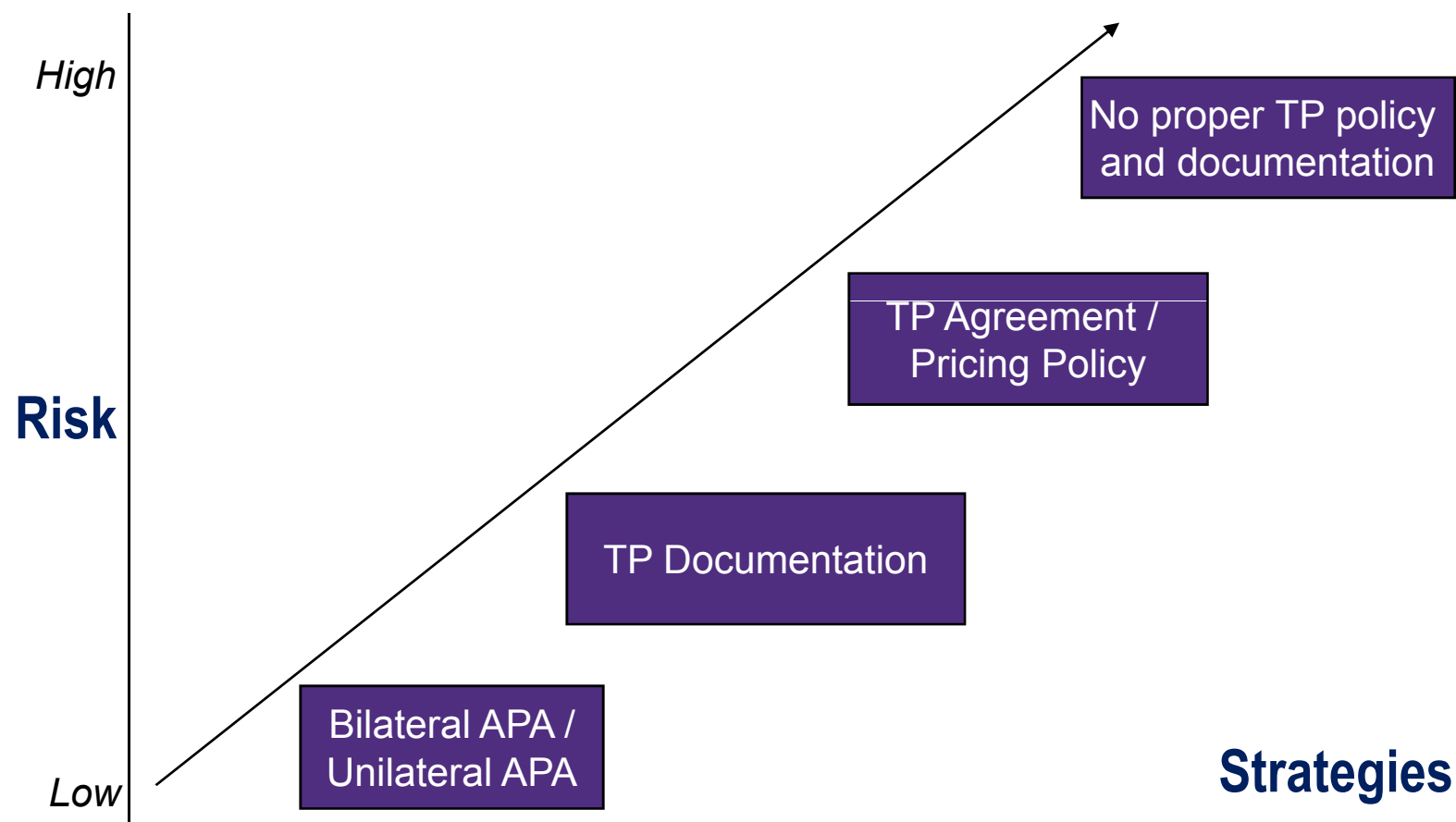
# Some peculiarities about TP in China



# Where do I start?

- **Risk assessment:** For any existing business which has never assessed its TP structure from a China perspective, do it right now
- **Planning:** Establish the right TP mechanism for any new entity / business line prior to Day One of the operation
- **Services:** Submit agreements for intercompany Service Fee prior to claiming deductions for service charges
- **Supply chain management:** Review alignment between TP structure and operation structure – tax and supply chain solutions to optimize the overall taxation
- **Documentation and audit defense:** Prepare TP contemporaneous documentation appropriately; Be fully prepared for a TP investigation / audit
- **APA:** Consider an APA for ultimate legal certainty

# Risk management strategies



# Taxability of Specific Benefits for Expatriates Working in the PRC

Base salary	Taxable, but planning
Bonus	Taxable, but planning
Fixed cash allowances	Taxable
Payment of personal income tax by the employer	Taxable
Housing allowances	Non-taxable
Meal subsidies	Non-taxable
Laundry expense reimbursements	Non-taxable
Relocation expense reimbursements	Non-taxable
Reasonable allowances for business trips	Non-taxable
Expense reimbursements for language training in the PRC	Non-taxable
Payment of children's education in the PRC	Non-taxable
Home leave reimbursements (maximum 2 trips per year)	Non-taxable

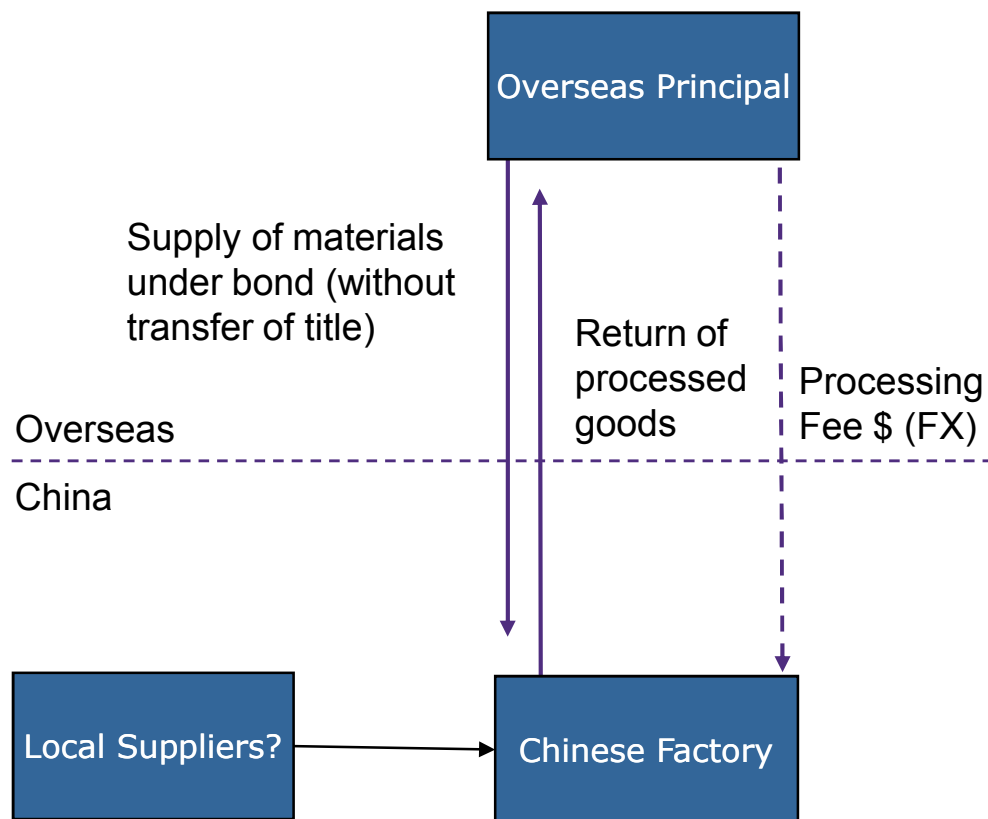
# Taxability of specific benefits for expatriates working in the PRC

- non-taxable expense reimbursements should preferably be paid directly by the employer to a third party and substantiated by valid documentation
- if the non-taxable allowance is paid to the employee (instead of to a third party), it should be a reimbursement of the relevant expenses with supporting documentation, e.g. official invoices
- the quantum of income items claimed as non-taxable should be reasonable and justifiable. This varies from location to location.

# Top 8 tax action steps under the new tax law

- **urgently assess TP risks**
- monitor expatriates and their activities in light of the new permanent establishment tests
- assess tax incentives, tax holidays etc.
- consider structure in light of new withholding implications and reorganization provisions
- assess the impact of the thin capitalization provisions
- understand VAT developments
- **assess FIN 48/FAS109 implications**
- seek professional help

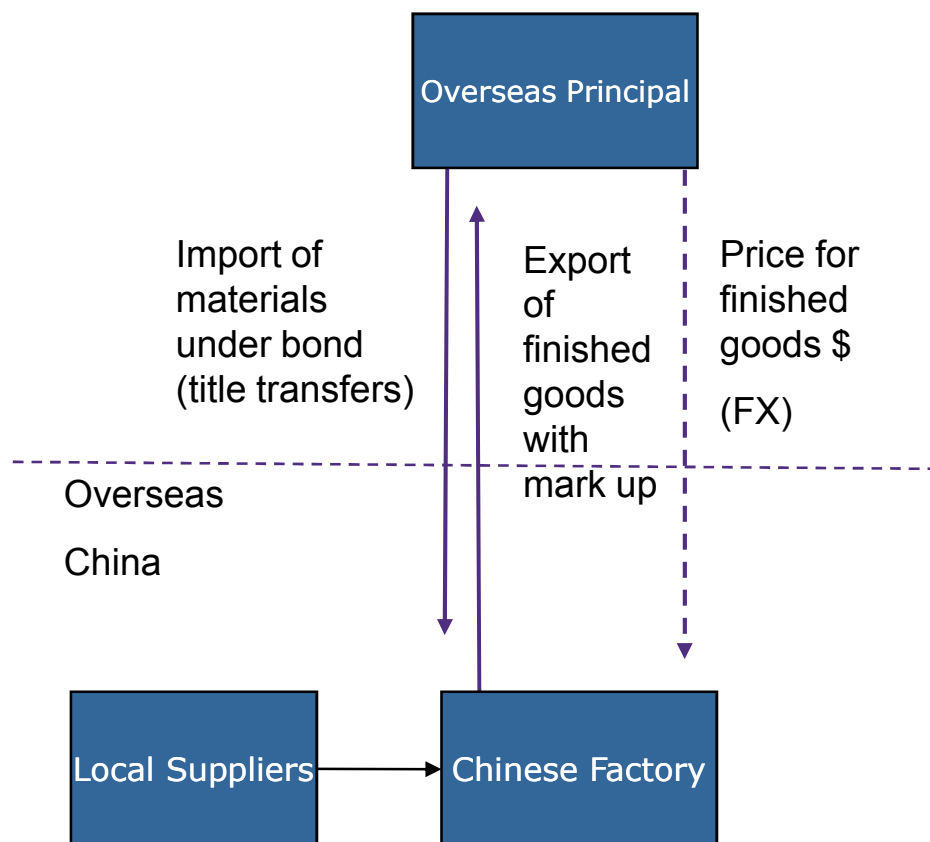
# Consignment Manufacturing (来料加工)



## Tax Implications

- Factory subject to EIT on processing fee – may be based on cost-plus (without materials)
- Materials and components imported free of customs duty and import VAT
- Finished goods exported with zero export VAT “leakage”
- VAT on processing fee received by the Chinese factory is normally exempted
- But, local supply of materials and components limited because 17% input VAT not recoverable

# Turnkey Manufacturing (进料加工)



## Tax Implications

Factory subject to EIT based on net income determined by margin on sale of finished goods

EIT burden higher than in consignment because factory bears more risk

Materials and components imported free of customs duty and import VAT

VAT is exempted on exports, but “leakage”:

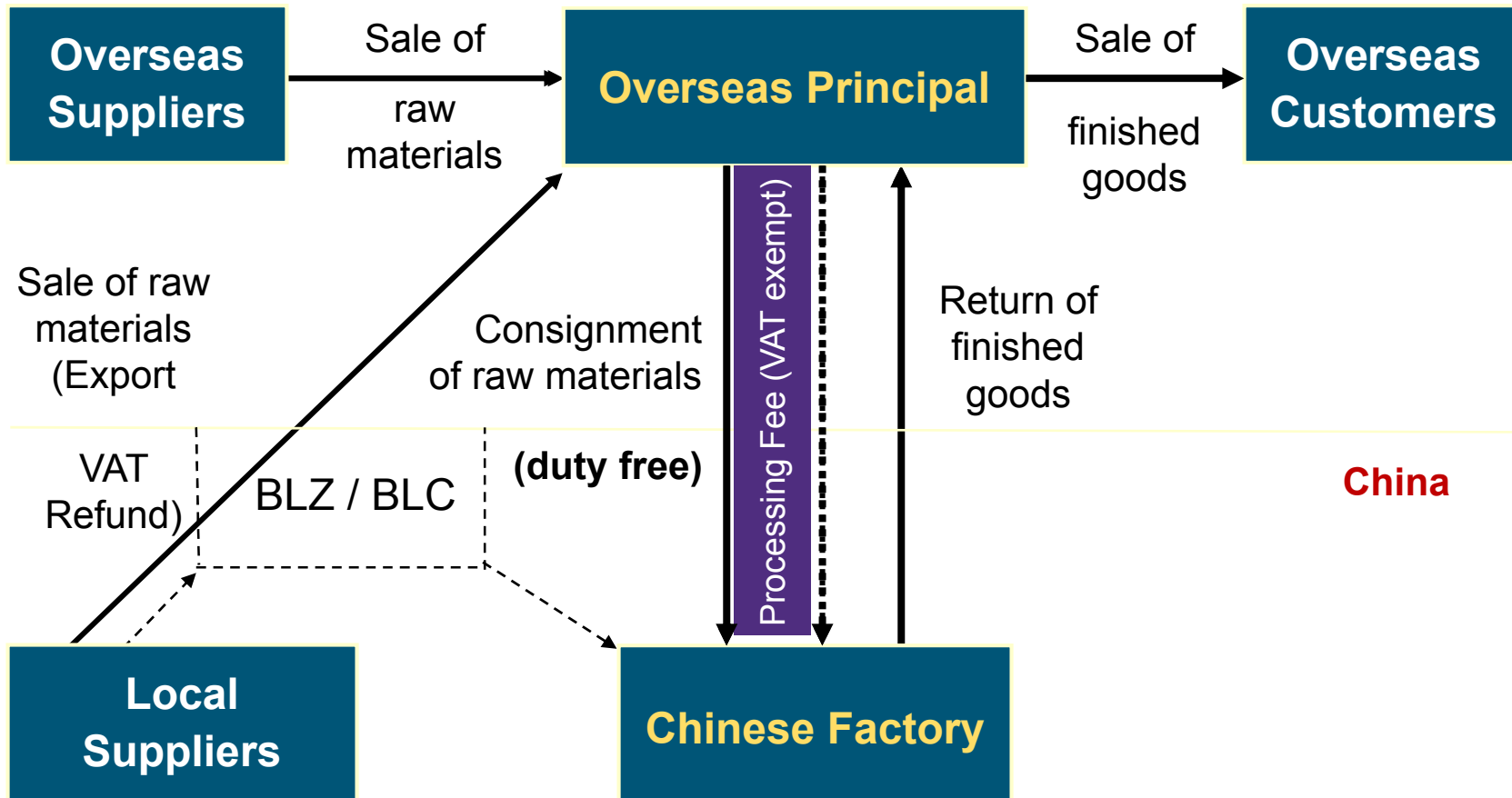
The VAT leakage depends on the EVRR

For example, where the EVRR is 13%, the VAT leakage is 4% (FOB export price); where the EVRR is 0%, the export is deemed as a domestic sale and subject to 17% but input VAT is creditable

# Potential Issues for CM Structures

- Local government reluctance to approve consignment manufacturing
- Closer scrutiny by tax authorities
- Potential PE risk for foreign principal
- Transfer pricing risks
- May need more sophisticated planning if targeting China domestic market

# Using a BLZ / BLC in a Consignment Manufacturing Arrangement



# Using a BLZ / BLC for Domestic Sales: “The Turnaround”

