Transfer Pricing in China: State Administration of Taxation Addresses Challenges with OECD Guidelines

By Windson Li (DLA Piper, Beijing)

Windson Li (windson.li@dlapiper.com) heads the DLA Piper tax group in Beijing office. He is a certified PRC tax agent and PRC Lawyer. His practice is focused on PRC corporate tax consulting and on PRC transfer pricing services. He advises on a variety of China corporate tax and transfer pricing matters, including corporate tax compliance, tax incentive application, tax dispute resolution, inter-company transaction arrangements, transfer pricing structuring, documentation, and audit defense.

In the past ten years, the China State Administration of Taxation (SAT) has been following the OECD Transfer Pricing Guidelines (OECD Guidelines) to set up China transfer pricing rules and practice. The major China transfer pricing regulation, i.e., the 2009 Implementing Measures for Special Tax Adjustments, to a very large extent was consistent with the OECD Guidelines. The latest China transfer pricing documentation and practice also resembled those in OECD countries.

In October 2012, the SAT published a paper in Chapter 10 of the United Nations' Practical Manual on Transfer Pricing for Development Countries (the Paper). Titled “Bridge the Gap—Applying the Arm's Length Principle in Developing Countries,” the Paper discussed several challenging issues pertinent to development countries and position adopted by the SAT.

In the Paper, the SAT believed that there are significant gaps between the OECD Guidelines and the transfer pricing practice in China. In particular, the SAT considered it necessary to address the following subjects based on the environment in China, which are not yet addressed in the OECD Guidelines.

- Lack of reliable public comparable information for enterprises in developing countries;
- Under-evaluated Local Special Advantages (LSAs) enjoyed by enterprises in developing countries;
- Overstated foreign intangibles and under-evaluated local intangibles in developing countries; and
- Alternative methods to the traditional transactional net margin method.

Identification and Quantification of LSAs

The Paper proposed additional returns to Chinese enterprises based on LSAs. The Paper did not provide a clear definition of LSAs, but instead, presented an example to demonstrate various LSAs enjoyed by a China automobile manufacturing enterprise. The listed LSAs included location savings, market premium, and miscellaneous concepts such as the inelastic demand of the China market, customers' preference for foreign brands, duty-saving from importation of parts, and benefit of high quality and low cost domestic supplies.

The Paper also provided an example of contract R&D services to demonstrate a suggested method for quantifying return derived from location savings. This method, in brief, is to recognize the difference between the cost base of a China contract R&D service provider, and its comparables in developed countries, and then allocate an additional profit to the China contract R&D service provider by way of applying Full Cost Mark Up (FCMU) of the comparables on the cost base difference.

LSAs are still a controversial concept in the transfer pricing community. Although the SAT took a pragmatic approach towards LSAs in the Paper, it did not clearly define the boundary of LSAs. Neither did SAT discuss how to quantify other sub-concepts of LSAs, such as market premium, inelastic demand of China market, and customs preference, which apparently would be very difficult (if not totally impossible).

In spite of the incompleteness of the LSA concept and the quantification methods, the Paper nonetheless delivered a clear signal—the SAT is considering, and to some extent has determined, to push this LSA concept in China transfer pricing practice. If this concept becomes part of China practice, the open-ended LSA concept and the unprecedented quantification methods very likely will pose significant transfer pricing challenges for MNCs in China.

Challenges Against Traditional Transfer Pricing Arrangements

The Paper challenged some typical inter-company transactions structured based on OECD Guidelines, and suggested new/adjusted approaches to arrive at the arm's length return for Chinese enterprises engaged in such transactions. These approaches and examples, to a large extent, represent the SAT's thoughts on future development of China transfer pricing rules and practice.

Contract Manufacturing

Contract manufacturing service is a frequent inter-company transaction between a Multi-National Company (MNC) and its China manufacturing subsidiary. The China subsidiary purchases a majority of its material supplies from overseas affiliates, and exports the finished products also to overseas affiliates. The China subsidiary is usually characterized as a strip risk manufacturing service provider, and given a target FCMU based on the Transactional Net Margin Method (TNMM).

In the Paper, the SAT expressed concerns upon the reasonableness of the material import price between the China subsidiary and its overseas affiliates. A lower material import price may not change the profit margin of the China subsidiary, but could reduce its absolute profit. In this connection, the SAT believed that a check on the arm's length nature of the material import price should be included in transfer pricing review, and any unreasonably low material import price on the custom declaration records should be questioned.

In practice, this would require MNCs to closely monitor the material import price against available market price information. Proper and continuous documentation of uncontrolled price for similar materials in the market could become a necessary part of the China subsidiary's transfer pricing defense strategy, especially for industries subject to frequent material price fluctuation.

Toll Manufacturing

Toll manufacturing is also a popular business model for MNCs that provide products 'made-in-China'. The China toll manufacturer imports most materials and components from an overseas affiliate on consignment basis, completes the manufacturing process, and then exports the finished products to the same overseas affiliate. As the material and product title remain with the overseas affiliate, there would be no (or very limited) Cost of Goods Sold in the P&L of the China toll manufacturer. The China toll manufacturer normally would charge a service fee to the overseas affiliates based on:

- The volume of products processed; or
- The total processing cost and expenses on book, plus a mark-up.

As the Paper notes, many MNCs use either FCMU or Return On Asset (ROA) of contract manufacturers to directly benchmark the profit level of a China toll manufacturer. The SAT believed that, due to the difference between a contract manufacturer and a toll manufacturer, either FCMU or ROA would underestimate the return to the China toll manufacturer.

As an alternative, the SAT suggested the following three-step approach to arrive at the arm's length return for a China toll manufacturer:

- Step 1—recover the full cost of the manufacturing operation, by way of adding back the material costs (as available in customs system upon importation) to the toll manufacturer's costs and expenses;
- Step 2—approximate the return (such as in FCMU) for contract manufacturers engaged in similar operation by way of benchmarking;
- Step 3—arrive at the return for toll manufacturers by adjustment for facts like inventory carrying costs.

While acknowledging that the above method would depend on the availability and reliability of customs information on the material costs, the SAT also emphasized that this approach "works well" when customs information is available. Judging from the Paper, it would not be surprising if the SAT starts to implement this approach in more China localities.

Royalty

MNCs very often provide certain IP to their China subsidiaries for manufacturing, distribution and business operation. Such IP is usually in the form of manufacturing technologies, know-how, and trademarks. A fixed royalty rate would be used for expatriation of extra profit from the China subsidiaries.

In the Paper, the SAT questioned the situation where a straight-line royalty rate has been applied for years without change. The SAT believed that in current China transfer pricing practice, IP life cycle has not been given proper consideration, and it is necessary to assess the value of an IP from time to time to arrive at the proper royalty payable. Moreover, the SAT emphasized that the China subsidiaries theoretically should be entitled to additional return, if they have improved the IP, or developed new IP through their China operation.

Sales, Marketing and Distribution Services

China has become the largest consumer market for many MNCs. Many MNCs characterize their Chinese distribution subsidiaries as limited risk distributors that are entitled to low or limited profit margins. The Paper argued that such transfer pricing arrangement ignores the function intensity, market difference and market intangible associated with the Chinese distribution subsidiaries. For assessing the return for the Chinese distribution subsidiaries, the SAT believed that it would be more appropriate to include a comparability adjustment based on the cost-base difference of the comparables, and additional return should be attributable to the extra function/costs of the Chinese distribution companies.

Contract R&D Service

The SAT argued that significant LSAs are enjoyed by contract R&D service providers in China. In the example provided in the Paper, the SAT showed a median of 8 percent of the arm's length ranges established by the comparable companies, and then adjusted it up to 12 percent as recognition of the return created by LSAs.

Furthermore, the SAT highlighted the situation where some R&D entities claims to be of routine functioned and are compensated on a FCMU basis, and at the same time obtain the "high and new technology status," which enables a preferential 15 percent Enterprise Income Tax rate (as opposed to the standard rate at 25 percent). The SAT considered such dual identity declaration contradictory, and specifically stated that cost plus compensation may not be sufficient for such a company. As the SAT suggested, using a different method like profit split to arrive the arm's length return for such a contract R&D service provider would be a more appropriate to approach its arm's length return.

Others

The SAT also presented its opinions on the following issues.

Comparable Search

The SAT acknowledged the lack of publicly available data in development countries, and noted that most of the comparable sets used by MNCs usually contain companies from a more mature market. To bridge such a gap, the SAT considered geographical adjustments advisable and to some extent necessary, though the SAT did not indicate how to conduct such geographical adjustment.

Holistic View of Multiple Entities in China

An interesting idea presented by the SAT in the Paper was to take a holistic view of multiple entities in China. Because many MNCs have a group of single functioned subsidiaries in China, the SAT considered that a group view of the functions and risks of all China entities should be considered by tax authorities to assess the overall profitability return of all entities. However, again, it is unclear when, where and how this holistic approach would or could be taken.

Alternative Methods to TNMM

Another remarkable point was the SAT's recommendation of alternatives to TNMM. As the SAT believed, profit split and a global formulary approach may be more 'realistic and appropriate' than transactional or profit-based method, if the majority of a group's functions and headcounts are inside China.

Observations

Taxpayers, especially those of simple and single functions, such as contract manufacturers, toll manufacturers, and contract R&D service providers, should pay close attention to the gap between their pricing policies and the Chinese tax authorities' expectations, and follow the latest transfer pricing development in China. The SAT intends to enlarge its tax base and explore ways to increase income as being “reasonable” from the cross border transactions. It is unlikely that the SAT will pursue all the ideas presented in the Paper in the short term. However, the SAT will continue to explore transfer pricing theory and practice, and the China transfer pricing practice, even if such practices differ from the OECD Guidelines.