

## Chinese tax authorities stress quality requirements for transfer pricing documentation

The Chinese tax authorities have had two years since the implementation of transfer pricing documentation requirements to examine taxpayers' contemporaneous documentation, and as a result have identified common issues with the documentation prepared by many taxpayers.

China's State Administration of Taxation (SAT) published the Implementation Regulations for Special Tax Adjustments (the STA regulations) as set out in notice Guoshuifa [2009] No. 2, dated 8 January 2009. The STA regulations, which took effect as of 1 January 2008, introduced contemporaneous transfer pricing documentation requirements in China for the first time. The SAT then issued a Notice on Inspection of Contemporaneous Documentation (Circular 323, Guoshuihan [2010] No. 323) in July 2010 to launch a nationwide inspection of taxpayers' contemporaneous transfer pricing documentation for years 2008 and 2009.

Based on the inspections conducted under Circular 323, local tax authorities summarized the common issues they identified, and provided their suggestions and requirements to taxpayers through seminars and notices.

### Common issues in transfer pricing documentation

Based on the result of their inspections, the tax authorities identified the following common issues in the contemporaneous transfer pricing documentation prepared by taxpayers:

- **Incomplete and imprecise disclosure** – The taxpayer's relevant shareholding or organizational structure, its related-party relationships, as well as the related-party transaction records or data are either not provided in full as part of the contemporaneous documentation or the information provided is inconsistent with the audit report.
- **Important issues avoided** – Some taxpayers' documentation offers a detailed industry analysis, but a very limited description of the taxpayer's own business operation, its position within the market or industry chain, or any forecast in this regard.
- **Inadequate function and risk analysis** – The function and risk analysis provided relies heavily on qualitative description, but lacks quantitative analysis of factual data.
- **Random selection of profit-level indicators** – The documentation provides no strong basis for the selection of the profit-level indicators applied in the comparability analysis.
- **Limited coverage of the tested party's own unrelated party transaction** – The potential comparable transactions between the tested party and the third party are scarcely considered in the comparability analysis.
- There are usually no statements regarding "the enterprises' contribution to group overall profit or residual profit," or the profitable status of every stage of the industry chain, which should be provided when selecting the profit-based methodologies as required in the STA regulations.
- Some taxpayers completed the form on Annual Financial Analysis on Related-Party Transactions for Enterprises, but included no explanation concerning the allocation basis of cost and profits between the related-party transactions and unrelated-party transactions; and
- **Improper format** – The documentation is not compiled in accordance with the framework and in the order stipulated in the STA regulations.

Some local tax authorities have set forth detailed implementation requirements on the preparation of contemporaneous documentation, some of which were not specified in the STA regulations. Those requirements include:

- Disclosure of the equity structure of all related parties within the group, including the related parties with whom no transactions were incurred during the review period;
- A description of the product feature and production process; in the case of original equipment manufacturer (OEM) products, including information of the brand under which products are manufactured and the product grades and quality;
- Disclosure of all departments within the enterprise, the scope of their duties, and an introduction of the major operations team (including key management);

- A detailed description of the pricing and calculation methods of each related-party transaction, including the pricing process and the database used, the methodologies and principles adopted, and the impact of the competitive environment within the industry, which should be prepared based on taxpayers' actual conditions, with additional explanations for any discrepancies between the actual operations results and the anticipated results when the pricing decision was made;
- Separate descriptions of the contracts that have significant influence on the operation of the enterprise (such as contracts involving large related-party commissions or technology royalties);
- Disclosure of the financial data of the related-party transactions for consecutive years (that is, in addition to the data for the review period, data from prior years are required to be disclosed for comparison purpose);
- A comparison of the functions and risks analysis for the review period and for prior years;
- Disclosure of the functions performed and the risks born by the overseas related parties, as well as detailed items and the amount of the related expense incurred annually (for instance, R&D expense, marketing expense, etc.);
- Elaboration on the similarities and differences between the tested party and the comparable companies regarding the functions and risks (including an itemized comparison of the ratio of selling expenses and general administration expenses over turnover, and the ratio of R&D expense over turnover, etc.), based on which the "Enterprise Comparability Factor Analysis Confirmation Form" must be compiled; explanations and statements as to whether the relevant information and data of the comparables are sufficient to support the selected transfer pricing methodology (and profit level indicator); analysis of any difference between the tested party and its comparable companies concerning accounting policy and related impact based on actual conditions and the selected profit level indicator;
- A demonstration of the uniqueness of any tested party special factors, with sufficient evidence, when a special factor adjustment is introduced in the comparability analysis (for example, if a low utilization rate is treated as a special factor to the tested party, a taxpayer should not only analyze the tested party's low utilization rate but also need to prove that the comparable companies did have the same low-utilization issue as the tested party did during the review period. Otherwise, the tax authorities may challenge the reasonableness for the special factor adjustments.);
- A declaration to be included in the contemporaneous documentation regarding whether or not the related-party transactions are "at arm's length"; and
- Disclosure of the tax agent's name, if applicable.

### Suggestions from tax authorities

The tax authorities encourage the management of enterprises and groups to pay more attention to the preparation of contemporaneous documentation, and provide the following suggestions regarding the issues identified:

- Enterprises should collect transaction information, including the selection of transfer pricing method and profit level indicators, as well as the relevant market information, before the related-party transaction takes place;
- Contemporaneous documentation should be prepared with the collaboration of each department within the enterprise;
- Detailed and complete information should be provided to the preparers of the contemporaneous documentation, especially the tax agents; and
- Contemporaneous documentation should be organized in strict accordance with the framework and order set forth by the STA regulations.

Some tax authorities also emphasize that the primary purpose of contemporaneous documentation is to provide a true and objective reflection of related-party transactions, rather than to provide a defense against penalties, and that contemporaneous documentation is not a post-transaction supplement or verification, but the supporting records for pricing decisions.

### Observations

It has been two tax years since the promulgation of the STA regulations. The above information indicates that the tax authorities are increasingly strengthening the supervision of related-party transactions and contemporaneous documentation preparation, and we anticipate that the tax authorities will put forward stricter requirements for 2010 documentation.

The SAT is said to be considering the introduction of relevant administrative measures, which are likely to include:

- The improvement and refinement of the Annual Related-Party Transactions Reporting Form by providing more detailed instructions;
- The issuance of regulations to provide further standardization and guidance for taxpayers to enhance the quality of contemporaneous documentation; and
- Specifying in relevant regulations that providing subpar contemporaneous documentation would be deemed equivalent to failing to prepare contemporaneous documentation, and that the tax authorities would request the resubmission of documentation.

The tax authorities are expected to continue to push forward their work on contemporaneous documentation and to use the information collected as an important tool to understand and analyze industries and enterprises, with the goal of selecting potential transfer pricing audit targets. Currently, the SAT is planning to implement an expert panel mechanism – in addition to the ongoing contemporaneous documentation inspections – and to promote industry-wide joint examination.

From the taxpayer's point of view, the importance of contemporaneous documentation is evident. Poor-quality documentation, however, will probably increase the risk of further examination by the tax authorities, or even trigger a transfer pricing audit. As mentioned before, an increasing number of tax authorities believe the purpose of preparing contemporaneous documentation is to provide an objective description of related-party transactions, rather than to substantiate compliance with the arm's length principle. Therefore, mere reliance on post-transaction contemporaneous documentation may not be sufficient for enterprises to manage transfer pricing risks. Management of multinational enterprises should begin to view their PRC transfer pricing affairs from a dynamic and forward-looking perspective, examine whether their transaction arrangements are continuously adaptable to the PRC laws and regulations regarding tax anti-avoidance and the practical requirements, and evaluate any need to make adjustments to the current pricing policy or business arrangement if necessary. Prior to any related-party transaction arrangement, taxpayers should establish a reasonable pricing policy and prepare supporting documents to manage its potential PRC TP risks. For enterprises within the scope of the tax authorities' recent industries focus (automotive, pharmaceutical, shipping, and real estate industries), we urge the management to conduct a timely evaluation of its PRC TP risks based on the actual circumstances. For circumstances where high risk or uncertainty exists, enterprises may consider application for an advance pricing arrangement to ensure adequate control of risks beforehand.

Deloitte China's transfer pricing professional service team has been closely monitoring these matters and actively communicating with the tax authorities on a regular basis, to update you on the latest news regarding the above issues. Should you need any assistance, please feel free to contact our professional service team.

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