



## Transfer Pricing Monitoring in China: a Survey

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This article is quoted from March 2018 edition of International Taxation in China, a Chinese Tax Journey issued by China International Taxation Research Institute.

### Introduction

Since the issue of the *Base Erosion and Profit Shifting* (BEPS) action plans were published by the OECD, the State Administration of Taxation (SAT) has enhanced its own transfer pricing monitoring activities in China. This enquiry direct to key tax officials in effect examines the transfer pricing enforcement environment in China by collating the views of tax officials.

The results will reinforce, first, how far the development of the People's Republic of China transfer pricing rules introduced by the tax authorities have proceeded, and, second, how far the rigorous procedures for carrying out transfer pricing audits in China have become.

They ascertain that a focus on the review of intangibles and service transactions has taken precedence. Also, in transfer pricing audits, they are focused on the functional profile of Chinese entities and value creation of local intangibles contributed by Chinese subsidiaries to the overall value chain of multinational groups.

### The Survey

The survey was conducted direct to the Chinese tax authorities in December 2017. The questionnaire was sent to 125 Chinese tax officials. 100 effective returns were obtained. The survey questions put to them were composed of three sub-sections:

1. Selection of Transfer Pricing Audit Targets
2. Investigations
3. Adjustments.

Each subsection covered three or four questions. The responders were invited to express the levels of concern they had about a range of transfer pricing matters. This was achieved by weighting each of the questions according to its perceived importance for transfer pricing. The

statistical results are presented in ascending order of importance. *In effect they are ratings of factors which draw the attention of the authorities to an investigation, in an order of priority.*

1. Selection of Transfer Pricing Audit Targets

*Table 1.* Attention given according to company features

Company features	Weighting average
Enterprises with significant amounts of related party transactions or several types of related party transactions	1.253
Enterprises with long periods of losses	1.276
Enterprises with significant payments of royalties	1.276
Enterprises with significant payments of service fees	1.379
Enterprises with profit levels which do not correspond with the function performed and risk assumed	1.391
Enterprises that engaged in transactions with related parties incorporated in a tax haven	1.471
Enterprises with low or fluctuating profitability	1.517
Enterprises with profit levels lower than those of other enterprises in the same industry	1.575
Enterprises that fail to file their related party transactions disclosure forms or to prepare contemporary transfer pricing documentation	1.989

It can be seen in *Table 1* that “significant amounts or several types of related party transactions” is indicated by the respondents as being of the most concern in the selection of audit targets. “Long periods of losses” or “significant payments of royalties or service fees” are indicated as being of considerable concern by the respondent tax authorities. Variables that are of a moderate concern include “profit levels do not correspond with the functions performed and risk assumed”, “transactions with related parties incorporated in a tax haven”, “low profitability or fluctuating profitability”. The least concern in the sample includes “profit levels lower than those of other enterprises in the same industry” and “fail to file their related party disclosure forms or to prepare contemporary transfer pricing documentation”.

By reviewing the financial data in relation to related party transactions, the Chinese tax authorities evaluate and determine a company as a high risk, moderate risk, or low-risk entity. Based on this, the company that was labeled as a high-risk entity could be selected for a transfer pricing investigation. A company with the larger number of related party transactions or more types of related party transactions, the greater the impact the transfer pricing would have on its operating profits and income tax. Accordingly, the company would face greater transfer pricing risk. Therefore, the above two features are indicated as being of the most concern to the tax authorities.

“Long periods of losses” has also long been another major concern for the tax authorities. In addition, since the release of the *Public Notice Regarding Certain Corporate Income Tax Matters on Outbound Payments to Overseas Related Parties (Public Notice [2015] No. 16)*, the number of significant payments of royalties or service fees to overseas related parties have given rise to the attention of the tax authorities.

*Table 2.* Attention given according to related party transactions

Types of related party transactions	Weighting average
Transfer of intangibles	1.138
Transfer of tangibles	1.218
Service transactions	1.460
Financing transactions	1.747

Table 2 shows that “Transfer of intangibles” is indicated by the respondents as being of the most concern in the selection of audit targets. “Transfer of tangibles” is indicated as being of considerable concern by the respondent tax authorities. “Service transactions” is indicated as a moderate concern by the respondents. The least concern in the sample is “Financial transactions”.

Intercompany transactions of raw materials and finished goods are always of great concern to the Chinese tax authorities. The results show that “Transfer of intangibles” has now become the major concern in the selection of audit targets. The significance of intangibles is also greater than that of tangibles, because it reflects the extent that the audit skills and capability of the Chinese tax officials have improved greatly during the past decades.

Concerns over “Financing transaction” is lower than others. This may be due to the sophistication of international financial transactions, the knowledge of which, and skills for handling which, Chinese tax officials have yet to improve.

At present, there are very limited audit cases with respect to intercompany financing in China.

Table 3. Attention given according to identity of industry

Industry Served by the Company	Weighting average
Pharmaceutical	1.45
Consumer durables and consumer electronics	1.55
Automobile	1.65
Luxury goods	1.95
Chemicals	1.96
Machinery	2.03
Bulk agricultural products	2.42

In Table 3 “Pharmaceutical” is indicated by the respondents as being of the most concern in the selection of audit targets. “Consumer durables and consumer electronics” and “Automobile” are indicated as being of considerable concern by the respondent tax authorities. “Luxury goods”, “Chemicals” and “Machinery” are indicated as of moderate concern by the respondents. The least concern in the sample is “Bulk agricultural products”.

Pharmaceutical and automobile industries have long been targeted industries by the Chinese tax authorities. The multinational groups of the two industries are highly integrated. Transfer pricing among purchasing, research and development, production, and distribution companies within a multinational group would have a significant effect on the profit levels of these entities.

Consumer durables and consumer electronics is a highly segmented industry. Competition in this industry is very fierce. The pricing power of companies in the industry is limited. The profitability of companies in the industry is in the margin, too. The Chinese tax authorities also target companies in this industry for transfer pricing investigations.

Although gross margins are usually high for the luxury goods industry, the expensive renting fees for stores, as well as increasing employee salaries and water and electricity expenses, have greatly decreased the operating margins for companies operating in the industry. The Chinese tax authorities have been recently concerned over the transfer pricing issues in this industry.

The relatively lower concern of the bulk agricultural products industry could be due to the relatively small number of multinational companies operating in the industry in China.

*Table 4.* Attention given according to types of company

Type of company	Weighting average
Licensed manufacturer	1.44
Fully-fledged manufacturer, including high technology companies	1.46
Contract manufacturer	1.54
Full risk distributor	1.71
Limited risk distributor	1.99
Full risk purchaser	2.08
Service provider	2.12
Limited risk purchaser	2.23
Sales agent	2.29
Purchasing agent	2.45
Retailer	2.68
Financing enterprise	2.70
Tolling manufacturer	3.45

In *Table 4* it can be seen that “Licensed manufacturer”, “Fully-fledged manufacturer, including high technology companies”, and “Contract manufacturer” are indicated by the respondents as being of the most concern in the selection of audit targets. “Full risk distributor”, “Limited risk

distributor”, “Full risk purchaser” and “Service provider” are indicated as being of considerable concern by the respondent tax authorities. “Limited risk purchaser”, “Sales agent”, “Purchasing agent”, “Retailer” and “Financing enterprise” are indicated as of a moderate concern by the respondents. The least concern in the sample is “Tolling manufacturer”.

The results indicate that the manufacturing companies are the focus in transfer pricing audit selection. A licensed manufacturer would not own the proprietary technology in relation to the products it would produce. The licensor would grant the usage right of the relevant proprietary technology to the licensed manufacturer and the latter would pay royalty fees to the licensor. “Licensed manufacturer” was marked as of the most concern by the tax authorities. This may be due to significant payments of royalty fees by the licensed manufacturers to their overseas related parties.

The Chinese tax authorities have also long been concerned that the profit levels earned by some fully-fledged manufacturers (including high technology companies) are not consistent with their functional profile. So the fully-fledged manufacturer is one of the major focuses in the transfer pricing audit selection.

It is surprising that “Tolling manufacturer” was marked as the least concern. The reason may be that the amounts of related party transactions (tolling fees) with tolling manufacturers are relatively smaller than others.

## 2. Investigations

*Table 5.* Attention given according to documentary integrity

Contents of the transfer pricing documentation	Weighting average
Functional analysis	1.14
Related party transactions	1.24
Transfer pricing methodologies	1.34
Industry analysis	1.62
Comparability analysis	1.71
Company information	1.77

It can be seen that “Functional analysis” is indicated by the respondents in *Table 5* as being of the most concern in transfer pricing investigations. “Related party transactions” and “Transfer pricing methodologies” are indicated as being of considerable concern by the respondent tax authorities. “Industry analysis” is indicated as a moderate concern by the respondents. The least concern in the sample are “Comparability analysis” and “Company information”.

The characteristics of related party transactions and the results of the functional analysis effect the transfer pricing methods choices and comparability analysis. These two sections in the transfer pricing documentation were marked as the most concern of the respondents. The concern of “Comparability analysis” is low. It may be due to the fact that transfer pricing documentation in the information on comparable companies is very general. The tax authorities would follow up

any enquiry with a discussion and negotiation with the taxpayer on the selection of comparable companies.

*Table 6.* Attention given according to performance elements contributing to value chain

The significance of functions, risks, and assets in the value chain	Weighting average
Function	1.08
Risk	1.24
Assets	1.77
The significance of tangibles and intangibles in the value chain	Weighting average
Intangibles	1.10
Tangibles	1.68

In *Table 6* “Function” is indicated by the respondents as being of the most concern in transfer pricing investigations. “Risk” is indicated as being of considerable concern by the respondent tax authorities. “Assets” is indicated as a moderate concern by the respondents. The results also show that the significance of “Intangibles” is also greater than “Tangibles” in the view of the tax authorities. As a combination, the tax authorities would regard functions performed and intangibles contributed as the most significant factors in the value chain. In contrast, the rating of “Tangibles” is relatively lower in the value chain.

*Table 7.* Attention given according to types of function and risk

The significance of various functions performed in the value chain	Weighting average
Research and Development	1.12
Distribution	1.62
Manufacturing	1.63
Purchasing	1.88
Administration	1.96
The significance of various risks born in the value chain	Weighting average
Research and Development	1.22
Marketing	1.37
Manufacturing	1.63

Inventory	2.11
Credit	2.15
Foreign exchange	2.42

It can be seen in *Table 7* that “Research and Development” of the functions is indicated by the respondents as being of the most significance as a factor contributing to the value chain. “Distribution” and “Manufacturing” are indicated as being of considerable significance by the respondent tax authorities. “Purchasing” is indicated as being of moderate significance. The least significance in the sample is “Administration”. As for the risks, the results indicated that “Research and Development” risk is indicated by the respondents as being the factor of most significance for the value chain. “Marketing” risk and “Manufacturing” risk are indicated as being of considerable significance by the respondent tax authorities. “Inventory” risk and “Credit” risk are indicated as of moderate significance. The least significant in the sample is “Foreign exchange” risk.

The key for a transfer pricing investigation is to determine the functional profile of the targeted company. As shown, the weightings for the various functions by the respondents are consistent with the risks. Also, the variables being “Research and Development” function and risk, “Distribution and Marketing” function and risks, “Manufacturing” function and risk, and “Purchasing and inventory” function and risk are presented in descending order of importance. The results also indicate that in measuring the profitability of the tested entities, the tax authorities would grant the highest weighting to the “Research and Development” function and risk.

### 3. Adjustments

*Table 8.* Attention given according to method used for calculating transfer pricing

Transfer pricing methodologies	Weighting average
Transactional net margin	1.22
Profit split	2.37
Cost plus	2.63
Resale minus	3.18
Comparable uncontrolled price	3.52

It can be seen in *Table 8* that “Transactional net margin” is indicated by the respondents as being of the most concern in transfer pricing adjustments. “Profit split” and “Cost plus” are indicated as being of considerable concern for the respondent tax authorities. “Resale minus” and “Comparable Uncontrolled Price” are indicated as of moderate concern by the respondents.

The comparable uncontrolled price, cost-plus and resale minus are traditional transaction-based methods, whereas the transactional net margin and profit split are profit-based methods. The results show that the Chinese tax authorities prefer profit-based methods to transaction-based

methods. Amongst the various methods, transactional net margin was used most frequently by the tax authorities in transfer pricing adjustments. This may be due to the difficulty of comparable data collection, or reliability of comparable data under the transaction-based methods.

For example, there is a strict requirement of comparability in using the comparable uncontrolled price, since it would be very difficult to locate the third party pricing information in practice. The profit-based methods use the operating margin as a profit level indicator. Compared with the traditional transaction methods based on the pricing or gross margin, the differentials of products produced or functions performed between the related party transactions and third-party transactions are more tolerable under the profit-based methods. Therefore, profit-based methods are more frequently used by the tax authorities in transfer pricing adjustments.

*Table 9.* Attention given according to the handling of procedures

Factors affecting transfer pricing adjustments	Weighting average
Accuracy of functional analysis	1.24
Comparability of selected companies	1.43
Choice of transfer pricing methods used	1.51
Relevance of investigated company characteristics	1.75
Specific factors	1.79
Market premium	1.83
Industry analysis	1.85
Cost savings	1.93

*Table 9* shows that “Accuracy of functional analysis” is indicated by the respondents as being of the most concern. “Comparability of selected companies” and “Choice of transfer pricing methods used” are indicated as being of considerable concern by the respondent tax authorities. “Relevance of investigated company characteristics”, “Specific factors”, “Market premium” and “Industry analysis” are indicated as moderate concerns by the respondents. The least significance in the sample is “Cost savings”.

The tax authorities conduct risk assessments based on the disclosure forms and transfer pricing documentation provided by taxpayers. The results of the functional analysis would determine the transfer pricing methods chosen and comparability analysis. The tax authorities regarded this section as highly important.

Market premium and cost savings were marked as not as significant as the other items. It may be due to the difficulty in factoring these indicators into transfer pricing adjustments.

*Table 10.* Attention given according to comparability

Comparables	Weighting average
Similar markets, identical industry but slightly different products	1.85
Identical or similar products but different markets - Japan, Korea, Europe, the United States	1.97
Identical market in China with similar products but at different trading levels - distribution or retail	2.24
Identical market in China for similar industries but with different products	2.74

From *Table 10* it can be seen that comparables sharing the “Similar markets, identical industry but slightly different products” with the tested party is indicated by the respondents as being of the most concern. “Identical or similar products but different markets” is indicated as being of considerable concern by the respondent tax authorities. “Identical market in China with similar products but at different trading levels” is indicated as a moderate concern by the respondents. The least significance in the sample is “Identical market in China for similar industries but with different products”.

Comparability analysis is the key in transfer pricing investigation and adjustments. The determinants of comparability include characteristics of property and services, functional analysis, contract terms, economic environments and business strategies. The different transaction environments would cause companies to incur more or less transaction costs and expenses, which would ultimately affect the prices and profits earned.

Even if the products or services for related party transactions and unrelated party transactions are identical or similar, the different transaction markets would lead to different prices or profits between the related party and unrelated party transactions. To ensure good comparability, the markets for related party transactions and unrelated party transactions should be identical or similar.

As shown in *Table 10*, in the selection of comparables for transfer pricing adjustments, the tax authorities would be in favour of comparables located in identical or similar markets. Secondly, comparables with the identical or similar products with the tested party but located in different markets could be accepted. However, it could hardly be acceptable for companies located in the identical markets and similar industries but operating different products.

## Conclusions

As a summary, the survey results indicate the major transfer pricing concerns of the Chinese tax authorities as follows:

- The concern of transfer pricing has changed from single-functional enterprises in the past to companies operating in particular industries, such as the pharmaceutical and automotive industries, in a highly integrated group business, performing multiple functions, having large transaction amounts or several types of related party transactions.
- The concern of transfer pricing has changed from the transfer of tangibles to the transfer of intangibles.
- There is more concern about the functions and risks in relation to research and development and marketing activities.
- Concern has increased about the contribution of Chinese companies in a group value chain, with regard to its functions performed and intangibles owned.

- There is greater focus on conducting high quality transfer pricing investigations and adjustments. For example, in the selection of comparable companies, the tax authorities are not only concerned about the comparability of products, they are concerned about the comparability of the business environments between the tested party and comparable companies.