China alert

Tax and regulatory developments

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TAX

Risks in the new transfer pricing reporting system

In Brief

- Details on how to comply with the new disclosure requirement on contemporaneous documentation are expected to be released before the end of the year.
- In the meantime, multinationals should pay careful attention to the other new annual filing requirements for related-party transactions.
- For the 2008 tax filing, related-party disclosures will include information such as the transfer pricing methodologies deployed and whether corresponding contemporaneous documentation has been prepared.
- This *China Alert* answers common client questions regarding transfer pricing reporting regulations, including anticipated implications of the new regulations.

Relevant regulation discussed in this issue:

Corporate Income Tax Law of the People's Republic of China (CIT Law), promulgated by the National People's Congress on 16 March 2007, effective from 1 January 2008

The Implementation Rules to the Corporate Income Tax Law of the People's Republic of China (Implementation Rules), issued by the State Council on 6 December 2007, effective from 1 January 2008

Are there formal transfer pricing documentation rules in China?

Yes, these rules were brought into effect by Article 43 of the CIT Law and clarified by Article 114 of the Implementation Rules. They include both an annual filing requirement and a contemporaneous documentation requirement. While we expect a new set of regulations to exempt companies with less than RMB 100 million in annual related-party transactions from the contemporaneous documentation requirements, current regulations require all companies to prepare both contemporaneous documentation and annual filing forms.

Why should taxpayers be concerned?

The biggest risk for taxpayers is that by not preparing such filings in advance, they may inadvertently increase the likelihood of a transfer pricing audit and corresponding adjustments. Self-adjustment is only available before the closing of annual accounts; after that point, positions will be effectively locked in place.

What are the minimum requirements for transfer pricing documentation?

Although the final details have yet to be released, taxpayers will need to identify major inter-company transactions for each legal entity in China that must file a separate tax return. An economic analysis must be performed to test the arm's-length nature of each transaction or type of transaction. A functional and risk analysis and an industry analysis

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should also be used to justify the arm's-length nature of the transfer pricing methodology.

What will be the effect of the current economic crisis?

The effect will be two-fold. First, stress on the financial markets will probably result in greater scrutiny from the tax authorities, who will need to ensure greater compliance to protect tax revenue bases. Secondly, transfer pricing policies may not withstand market shocks. Sudden declines in market prices or volumes may lead to sharp drops in operating profitability if the transfer pricing policy is not robust.

Will there be stiff penalties for non-compliance?

The main penalty will be an increase in the interest on any adjustments by five percentage points. However, there may be personal as well as corporate liabilities associated with misstatements in the disclosure forms. Non-compliance also increases the risk of a transfer pricing audit and related adjustments.

What should taxpayers do now to be prepared?

Multinationals should review their transfer pricing risks and exposures before the annual account closing, in order to fulfill their legal requirements and avoid the risks described above. In addition, multinational groups in China with significant related-party transactions and significant transfer pricing exposures should consider preparing their contemporaneous documentation as soon as possible. However, we only recommend that clients prepare documentation when they believe their transfer pricing position is defensible and complies with relevant regulations.

How can KPMG help?

With a team of over 200 full time transfer pricing professionals in Greater China, KPMG helps companies review their transfer pricing profiles and assists in preparing or reviewing disclosure forms to ensure they are appropriately completed and consistent with transfer pricing positions. Most importantly, when transfer pricing issues are identified, we can help clients devise practical and proactive solutions. Our dedicated team of professionals, backed by the global network of KPMG member firms, can examine taxpayers' specific issues as they relate to customs, foreign exchange, remittance, turnover tax and prospective versus retroactive adjustments.

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