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6.6. Transfer Prices (RC)

Introduction

The profits of Chinese entities embedded in an international group are often depending on transfer pricing: By raising or lowering the intercompany prices for purchased goods or services the profits of the local entity will get higher or lower, influencing the company income tax paid.
Transfer Prices are a quite sensitive topic and must be defined by "arm´s lengths principle", meaning that the prices are "fair" or comparable to prices between two unrelated parties.

Transfer Price Theory

Given the case there are two companies in two different countries (A, B), belonging to the same ultimate owner, the transfer price can seriously influence

- The Corporate income tax (CiT) in each country and
- The total CiT paid.

For this example, let us assume that the company in country A produces goods for the price of 25 Euro and sells them to country B for 50 Euro which means that the Cost of Goods Sold (COGS) of county A equals the purchasing price of country B. For this very simplified example, we can assume that there are no other costs involved (e.g. fixed cost, transportation cost) and that there are no other influences (e.g. Exchange Rate).
Country B would sell these goods for 100 Euro. Let us further assume that the Corporate income Tax in Country A is 10% and in Country B is 25%.
Depending on the transfer price between these two companies, company earnings are shifted between these both countries, also leading to higher or lower Company income in each country and in total.

	Szenario 1		Szenario 2		Szenario 3	
Country	**A**	**B**	**A**	**B**	**A**	**B**
Sales Price	50 €	100 €	80 €	100 €	30 €	100 €
COGS	25 €	50 €	25 €	80 €	25 €	30 €
= Margin	25 €	50 €	55 €	20 €	5 €	70 €
CIT	2,5 €	12,5 €	5,5 €	5,0 €	0,5 €	17,5 €
Total CiT	**15,0 €**		**10,5 €**		**18,0 €**	

with:
A: Production Company, selling products to the Sales company.
Corporate Income Tax = 10%
B: Sales company, selling Products from A to the Market.
Corporate Income Tax = 25%
(therefore: Cost of Goods Sold of B = Turnover of A)

Figure 8: Transfer Price Scenarios Example

To prevent an "unfair" shifting of earnings out of China, there is a strong transfer pricing control in place.

Accepted methods of transfer price comparisons

The following methods are known to be compliant with Chinese authorities and can be split into "traditional pricing methods" and "transactional profit method".
The choice which kind of method is the most appropriate one should be done by the audit company which write the transfer price study and they will consider most appropriate method especially based on the available market data.

Comparable Unrelated Method

This method directly compares a transaction with other comparable transactions between unrelated companies. While this is one of the most accurate methods, it might be hard to find comparable transactions between unrelated parties.

Resale price method

This method uses the retail price of a (re)sold article, minus the selling and other operating expenses for the selling company to calculate an appropriate profit for the sales company.
If this profit is sufficient, it is considered as an appropriate transfer price.
It is most useful for reselling of unmodified goods.

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Cost plus method

This method uses the manufacturing cost of the producing entity and adds an appropriate mark-up to make an appropriate while considering the functions performed and market conditions.
It is most useful for the transfer of tangible assets, service transactions and financing business.

Transactional net margin method

In this method, similar comparable transactions get put together and the margin (e.g. EBIT-Margin) of these transactions will be compared to independent companies in a similar business environment.
This method is most suitable for complex businesses based on tangible and intangible assets as well as services.

Transactional profit split method

In the transactional profit split method compares the share of the profit that each of the companies receive to a possible profit split of companies at arm's length principle. It also considers the functions that both companies have in the transaction and the risk they are bearing.
This method is most recommended when entities are highly integrated and the individual value creation cannot be assessed easily.

Required documentation / Contemporaneous documentation

While before transfer pricing reports had to be filed with the local authorities this changed a bit: While the reports still have to be prepared, they just have to be given to the authorities if they are requested.

Depending on tresholds, the following documents have to be prepared:

- Master file which describes the business on a global basis including
    - Organizational Structure
    - Description of the group business
    - Intangibles
    - Financial activities
    - Financial and tax positions

  It is required if the local entity gets consolidated in a group financial statement and if the annual amount of related parties transactions exceeds 1 Billion RMB in total.
  It has to be prepared within 12 months after the relevant fiscal year of the group.

- Local file which describes the relation to business transactions of the local company with related parties and includes
    - Overview of the enterprise
    - Related party relationship
    - Related party transactions
    - Comparability analysis
    - Selection and application of transfer pricing method

  The local file is required if the amount of tangible asset transactions with related parties reaches 200 Million RMB, financial and intangible assets reach 100 Million or other related party transactions reach 40 Million RMB.
  It has to be prepared until June 30th of the following year.

- Special issue file on
    - Cost sharing agreements
    - Thin capitalization

Even while the deadline for preparation might be different, contemporaneous documentation has to be presented to the tax authorities within 30 days after they have been requested, they have to be prepared in Chinese and to be retained for 10 years.

If a company has purely transactions with a domestic related company, it can choose not to prepare it.

Risk for special tax inspections

Tax authorities are advised to pay special attention e.g. if a company

- has losses, low profits for a long-term or strong fluctuation in profit

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- has lesser profits than other companies in the same industry
- the profit level is not related to the functional risks it takes and if it is not proportional to the costs allocated
- has transactions with companies in low-tax regions
- does not report intercompany transaction value or does not prepare the required documentation
- uses unreasonable tax planning methods.

In general, there will not be special investigations related to transfer pricing for domestic intercompany transactions, as long as they do not lead to a reduction on the overall tax paid within the country.

Royalties and Services

Collecting or paying royalties for transferring or using intangible assets must be reasonable and should be re-evaluated regularly.
The amount of the royalties must also be at arm´s length and it must match the real economic interest of the company.

Services that are non-beneficial for the company cannot be considered, this e.g. can include e.g. financial processes which are related to group controlling or which are relevant for the shareholder, not the local entity itself.
Some questions to ask to assess if a royalty or service fee is reasonable and under arm´s length:

- Does the company itself (and not only the shareholders, the board, etc.) have a considerable benefit of the service?
- Are the services not directly necessary for the business operations and the functions in that business?
- Does the local entity already have similar internal functions or are there third-party providers providing a similar service to the local entity?
- Is the company directly not directly involved in the business or but is it a decision by the group or the shareholder to increase group benefits?
- Did the company already pay for the relevant services e.g. by transfer pricing? (this can be the case when the cost-plus transfer pricing method is applied for determining arm´s length principle prices)
- Is there evidence that can proof that the company received the service?

If any of these questions can be answered with a “no”, it is highly doubtable that a legitimate service has been provided in the eyes of the Chinese authorities which could lead to blocks of payment, investigations or a non-acceptance of tax deductions for corporate income tax.

General recommendations

- When deciding on transfer prices, you have to ensure that each independent entity makes enough contribution margin or profit (depending on the method) to proof that your enterprise does not violate the “arm´s length principle”
- Comparably low profits or large swings in the profits can set off the authorities to analyze your transfer pricing deeper.
- If the transfer pricing is acceptable by transactional methods (which combine multiple transactions together), in general the authorities will not investigate single transactions. Since there is never a 100% certainty, it is highly recommended to stay compliant in each and every single transaction.
- Considering international transactions, two main principals are highly contradicting: While from the tax perspective the transfer price should not be unreasonably high (which would reduce the corporate income tax), from the customs perspective it should not be unreasonably low (which would reduce import duty). In critical cases, two different methods could be used to evaluate the same transaction for different stakeholders.