INTRODUCTION

What is Transfer Pricing in China?

When a business transaction occurs between businesses that are controlled by the same entity, the price is not determined by market forces, but by the entity controlling the two businesses. This is called transfer pricing. An example is a transaction between a parent and its subsidiary, or other intra-group transactions.

These transactions can be used to shift funds - and thereby profits. Such transactions can serve as a tool for finance and tax planning.

For instance, China’s foreign currency control regulations only allow one dividend issuance to a foreign entity a year. Moving funds out of China by using inter-company transactions can then offer a solution.

In this report on Transfer Pricing, we discuss what types of transactions foreign investors can use to shifts funds in this way.

Double taxation agreements between countries play an important role in transfer pricing. These allow foreign investors considerable tax savings when using offshore holding companies – under certain conditions.

Intra-group transactions often serve a legitimate purpose, but tax authorities around the world are wary of their use in lowering corporate profits. China is no different. Like in other countries, the Chinese tax office sets standards as to what transactions are acceptable. Those that do not meet these standards are not recognized.

If done properly, transfer pricing can save a foreign investor a substantial amount on their tax bill. However, careful planning is advised: transfer pricing transactions are under special scrutiny. In case of non-compliance, the back taxes and penalties can be severe.

Dezan Shira & Associates can assist your company in planning transfer pricing transactions, and furnishing the required documentation. If you would like to learn more about transfer pricing and how we might assist you, please do not hesitate to contact us.

ALBERTO VETTORETTI
Partner
Dezan Shira & Associates
Before profits can be remitted to the parent company as dividends, the subsidiary needs to have paid corporate income tax (CIT) over those profits. However, if the parent charges the subsidiary for a good or service, this is a cost for the subsidiary. The funds are moved from the subsidiary to the parent, but are not subject to corporate income tax, since they do not belong to the subsidiary’s taxable income.

**TAX ON DIVIDEND ALONE**

CHINESE SUBSIDIARY earns 200 from sales, pays 50 as dividend, and 150 remain.

FOREIGN PARENT COMPANY earns 150 from dividend, pays 15 as withholding tax, and 135 remain.

**TAX ON DIVIDEND AND RELATED-PARTY TRANSACTION**

CHINESE SUBSIDIARY pays 100 to foreign parent company for licensing fees.

CHINESE SUBSIDIARY earns 100 from sales, pays 25 as CIT, and 75 remains.

FOREIGN PARENT COMPANY earns 75 from dividend, pays 7.5 as withholding tax, and 67.5 remains.

**HOW DOES IT WORK?**
Various types of transactions are eligible to use in related-party transactions. These can even be payments for benefits or services that the subsidiary would otherwise enjoy for free, such as use of the brand name, tax and legal advice, HR services or staff placements from abroad.

---

### Setting the price

Tax authorities only recognize transfer pricing transactions under certain conditions. One of these is that the price is set according to the arms’ length principle. This means that the price should be determined as if the parties were not part of a group, or otherwise related. The parent cannot divert funds from the subsidiary by charging an artificially high price that an unrelated market party would never pay.

### Double tax agreements

In a purely domestic situation, the source and the beneficiary of income are in the same state. However, when a company earns money from a different country, it risks being taxed twice. The country where the company is domiciled (home state), and the one where the income originated from (source state), both often hold that they have the right to tax.

Since this double taxation harms international trade, states sign double tax agreements (DTAs) to work out arrangements for these situations. For instance, having either the home state or the source state tax the income; or splitting the tax revenue.

In the above example, China as a source state taxed the dividend that was paid to the foreign parent. In the absence of a DTA, the foreign parent might be taxed by the home state as well. If China has a DTA with the parent company’s home state, the DTA would often either assign the right to tax either to the source state (in this case China), or to the home state.

The careful use of these DTAs can save the foreign investor a significant amount of money. This happens when a DTA allocates the right to tax to one of the two states, and this state’s tax rate on that type of income is lower (or doesn’t tax that type of income at all).
RISKS AND REQUIREMENTS

TRANSFER PRICING PLANNING IS ALLOWED, BUT ONLY UNDER CERTAIN CONDITIONS

PROVIDE DOCUMENTATION TO SHOW COMPLIANCE WITH ARMS’ LENGTH PRINCIPLE

» Transfer Pricing Reporting – included with annual tax filing before May 31

CONTEMPORANEOUS DOCUMENTATION IS REQUIRED FOR:

» Sales of tangible goods between related parties that exceeds RMB 200
» Value of other transfer pricing transactions that exceeds RMB 40 million
» Thinly capitalized companies claiming relatively high deductions
» When faced with allegations of tax avoidance
» Loss-making entities with limited risk or activities

IF NOT: PRICE ADJUSTMENT AND TAX REASSESSMENT

IN MORE SERIOUS CASES: FINES, PENALTIES, CRIMINAL PROSECUTION OF TAX EVASION

COMPANIES CAN BE AUDITED BY THE CHINESE TAX AUTHORITIES FOR COMPLIANCE WITH TRANSFER PRICING REGULATIONS. AT PARTICULAR RISK ARE:

» Companies showing continuous losses or low profits
» Relatively large amounts of transfer pricing transactions
» Lower profit rates than the industry average
» Transactions with parties located in known tax havens
Dezan Shira & Associates can assist preparing and systematizing all aspects of a company’s transfer pricing activities in China.

Please visit www.dezshira.com/services/treasury-administration for a comprehensive list of our professional services.