

Enforcement of Transfer Pricing Rules in China Increasing

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[April 2007]

A business engaged in related-party transactions, if unprepared, could face significant business interference and financial costs if selected for a transfer pricing audit in China. Chinese transfer pricing rules are embodied in the <Tax Administrative Rules on Business Transactions between Affiliated Companies> of 1998 (guo shui fa [1998] No.059), and its 2004 revision (guo shui fa [2004] No. 143) (hereafter collectively referred to as “Transfer Pricing Rules”). Last August, The Ministry of Taxation of China published an official notice (guo shui han [2006] No. 807) to uphold the effectiveness of the 1998 Rules the provisions of which are not explicitly revised by the 2004 Revision (“Notice”). More importantly, the Notice seems to be consistent with the recent escalation, as reported, of the Chinese government’s anti-tax-evasion actions and reflects the Chinese government’s increasing commitment to enforcing the Transfer Pricing Rules against companies in business transactions with related parties and affiliates. It also has been reported that a new set of rules on contemporaneous transfer pricing documentation will be published soon.

The Transfer Pricing Rules are similar, in many places, to the transfer pricing rules in the U.S. Section 482 of the U.S. Internal Revenue Code provides, “In any case of two or more organizations . . . or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary [of the Treasury] may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations . . . or businesses . . . to [clearly] reflect the income of any of such organizations . . . or businesses.” Like Internal Revenue Code Section 482, the goal of the Transfer Pricing Rules is to require the tax aspects of related party transactions to be reported on the basis of arm’s length principles to prevent taxpayers from artificially moving income to low-tax jurisdictions. The three transfer pricing methods traditionally used in the United States -- i.e., the Comparable Uncontrolled Price method, the Cost Plus method and the Resale Price method -- have become the default methods to determine appropriate transfer pricing under the Transfer Pricing Rules in China. When the default methods are found inappropriate, most of the non-traditional methods used in the United States, such as the Profit Split method and the Transactional Net Margin method, are acceptable alternatives in China.

Preparing for and avoiding a transfer pricing audit

If faced with a transfer pricing audit, auditors will ask for details of transactions with related parties. Once a business is chosen for such an audit in China, it typically will be required to provide up to three years of financial and business records of all parties involved. The audit often lasts for more than six months. Furthermore, in China, the chance of a successful appeal from a completed audit is remote.

To reduce unnecessary business interruptions and costs, it is advisable for any business involved in related-party transactions in China to be ready at the outset for a transfer pricing audit. The following points are worth keeping in mind:

- Transactions with related-parties doing business in low-tax jurisdictions (such as the British Virgin Islands, Bermuda, the Cayman Islands and Panama) have become triggers of transfer pricing audits in China. Therefore, companies should try to avoid such transactions or otherwise be ready to substantiate their validity if audited.
- A company doing business in China that is party to related-party transactions is advised to consult its legal counsel and accountant to determine if it has a transfer pricing policy in place that complies with the Transfer Pricing Rules and should maintain records of all related party transactions and any relevant information (e.g., arm's length or market pricing of products or services comparable to those in the transactions, and markups of the company's competitors and/or resellers.)
- Consider the feasibility of entering into an Advance Pricing Agreement with China's tax authorities. By entering into such an agreement and supplementing the information provided to the authorities on a regular basis, the risk of a transfer pricing audit may be greatly reduced, if not eliminated.

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