

Determining Uncertain Tax Positions in China*

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Introduction

By now many multinational companies have begun the process of addressing how Financial Accounting Standards Board Interpretation No. 48 ("FIN 48") will apply to their global business. The challenge in understanding the FIN 48 implications for tax planning and local country compliance issues in foreign jurisdictions will be significant. FIN 48 requires companies to ascertain, evaluate, and conclude on discrete tax risks. Companies must not only account for the interest and penalties on these conclusions, but must also adhere to a new disclosure regime.

Companies may not have the wherewithal to fully appreciate the implications of their tax posture due to many factors, including lack of knowledge, time constraints, resource constraints, quality of the past compliance filings, and insufficient mechanisms to gather data. Many issues, including documentation, transfer pricing, arbitrary enforcement and inconsistent interpretation by regulators, are common in many jurisdictions, although each jurisdiction may have its own particular twist.

For companies operating in China, the tax planning environment creates another level of complex Uncertain Tax Positions ("UTPs") analysis. This complexity arises because many companies have negotiated at the provincial and local levels to reduce the national statutory rate, plus there are numerous local incentive regimes. This article provides the author's perspective on UTPs in China and suggests some areas that companies currently or potentially operating in China should consider.

Background

In the past, a diversity of practices has existed when accounting for income tax uncertainties in China. As a result, there may have been cases whereby companies in China did not record reserves until faced with tax audits and assessment by the Chinese tax authorities. In contrast, the FIN 48 model now requires an upfront analysis to both recognize and measure the benefit for a company's tax positions. This change is particularly significant given the complex nature of China's tax system. Examples of this complex nature include: the gap between the tax law enacted at the national level (State Administration of Tax or SAT) and the tax law interpreted at the local or enforcement level; the zeal with which local governments grant benefits which they may not in fact have the proper authority to grant; and the existence of precedents and practice that are understood locally but not necessarily documented in a manner consistent with Western norms. Thus, many of the common tax planning strategies used in China could be prudent, carefully negotiated, and supportable, yet still rely on positions that are potentially uncertain as defined by FIN 48.

The new FIN 48 model will require judgments about recording tax benefits from strategies or transactions in China that previously might have been deferred until addressed by the Chinese tax authorities. Furthermore, China tax matters may not have been in scope due to the immateriality of the China operation when compared to the global business. However, as the China operations of many companies continue to grow, the China affiliates will require more attention in order to be compliant with the requirements of Sarbanes-Oxley, including the external auditor review. Thus, companies may simultaneously be faced with both FIN 48 and scoping issues when dealing with China tax matters.

This article illustrates some typical fact patterns that could lead to UTPs. It is not intended to provide an exhaustive list of all UTPs that may exist in China. Each company must develop a course of action to determine its own UTPs. The analysis required to meet the recognition criteria as well as to measure the benefit will be challenging due to the limited number of relevant court findings and the general nature of settling issues at the exam level.

Tax holidays, reduced rates, and incentive regimes

As a matter of economic policy, China has a broad array of regimes for foreign investors. The provinces vigorously compete to attract capital investment for employment and growth. Moreover, certain types of investments attract additional incentives (generally in the form of local subsidies). However, these negotiated incentive agreements with the provincial and city governments may fall outside of their authority as granted. In addition, the tax authorities at both the local level and the state level are not compelled to accept agreements negotiated by the governments. Thus, these negotiations often involve the relevant tax authorities to ensure an appropriate level of acceptance. Furthermore, even if the local tax authorities initially accept the tax filings supporting the incentives claims, the future is far from certain simply because these granted incentives fall outside the tax legislation.

In China, tax subsidies may take one of the following forms: 1) direct grants of cash from the provincial treasury, or 2) refunds of taxes paid in a subsequent year. An evaluation of the treatment of these payments should include whether there is any associated Chinese tax liability present, whether the company can establish a receivable without a reserve on an expected refund, and whether the authority exists for the company to receive such amounts in the first place.

The amount of the tax rate reductions via tax subsidies can be significant. The headline rate for China income tax is 33% (30% at the country level plus 3% at the local level).

Chinese tax laws provide various income tax incentives including: two years of full exemption, an additional three years of exemption at 50% of the regional tax rate, income tax refund for profit reinvestment, various incentives for the purchase of Chinese-manufactured production equipment, incentives for research and software development-type activities, incentives for high-tech activities, and incentives for export regimes. Incentives offered by local government to attract foreign investments may take the form of extended tax holidays, reduction of headline rates or refunds on a certain percentage of income tax paid.

The reduction from the headline rate is a permanent item under GAAP. Thus, the incentives not only save cash taxes but also reduce the earnings tax charge. Companies may therefore want to evaluate all material permanent tax savings when implementing FIN 48. As a practical matter, the amount of the historic, current, and future savings may increase the scrutiny on tax positions taken by the company. Furthermore, the associated analysis of the tax positions could reach conclusions ranging from highly certain to uncertain.

Factors affecting the analysis of the tax positions could include:

1. the possibility that the local authorities were not within their authority to grant the incentives
2. whether the Company is fully complying with all the terms specified in the agreement, and
3. the Company's experience in resolving differences at the examination level.

In many instances, companies are claiming that activities qualify for an incentive when, in fact, the activities may be questionable or may not qualify. Nevertheless, the tax authority may still allow the benefit. Examples of some these activities include:

1. trading activities that exceed a specified mix when combined with manufacturing
2. conducting activities outside of an agreed economic zone
3. conducting activities beyond the agreed scope of legal activities
4. misrepresenting the nature/scale of operations in order to qualify for certain incentives
5. claiming incentive benefits for export contract/toll manufacturing on activities that exceed the agreed maximums of the product flow's dollar value, and
6. applying a head office (low) tax rate to income arising in branch locations which should be taxed at the branch location's income tax rate.

The recognition threshold of FIN 48 requires a "more likely than not" conclusion based solely on the technical merits of the position. Even though companies are claiming benefits that pass the tax authority examination level, companies should still evaluate the technical merits for activities that might exceed the parameters of the incentive agreement. FIN 48 does permit consideration, for recognition purposes, of widely-understood administrative practices. However, such practices are viewed rather narrowly and must be carefully assessed in this context.

The need for constant reassessment of tax positions will pose a significant challenge for companies. In many instances, companies might have only limited information to support their assertions and judgments. Companies should therefore consider establishing processes for the timely documentation of 1) ongoing examinations and discussions with taxing authorities, 2) the assessment of the current environment within significant tax jurisdictions, and 3) the underlying judgments and estimates.

Permanent establishments

One of the most difficult analyses under FIN 48 is that a risk for a purported non-taxable activity will be treated as a Permanent Establishment ("PE"). Again, the recognition requirement is a "more likely than not" position, based solely on the technical merits of the position and assuming full knowledge by the tax authority. Failure to meet the recognition requirement may force taxpayers to indefinitely accrue penalties and interest on tax risks that grow every year but do not expire. Many of the typical PE-type issues exist within China, including those for activities conducted beyond the scope granted to

representative offices for sales and services functions, etc. Thus, companies should carefully evaluate their exposure to PE risks. Two China-specific structures that have PE implications are briefly discussed below.

1. Export processing structures. Foreign companies often conduct export toll manufacturing in China via for example, a Hong Kong (HK) principal. The HK principal commonly performs various activities within China that could, from the technical perspective, result in a PE. Thus, companies with this structure should review the FIN 48 impact on their operational model and address not only the China tax implications, but also the potential for double taxation that may arise from the other jurisdiction.
2. China Business Trust. One structure that has been used for China tax planning, The "China Business Trust," requires that companies pay particular attention to the PE risk both for the China Trust entity and the entity being used as the Principal. Further discussion of the China Business Trust is beyond the scope of this article.

Transfer pricing

The China environment for transfer pricing is very fluid. Many companies have difficult transfer pricing issues in China due to the complexity of their operating models. Furthermore, each Chinese entity is a separate taxpayer without the benefit of consolidation. Many multinationals manage their Chinese taxable profits via planning strategies that, while consistent with their worldwide tax planning, may not work within the Chinese tax framework. Additionally, the Chinese taxing authority is trying to keep up with the challenge of adopting rules and enforcement policies consistent with more global standards. Thus, the dynamic environment challenges even the most diligent tax planner. Examples of transfer pricing issues within China include:

1. The use of export toll manufacturing operations within Southern China, where the operations face the dilemma of declared customs values for their imported raw materials, which differ from the actual transaction value.
2. Export contract manufacturing, where the cost-plus margin is a common issue for tax authorities to examine and challenge. Thus taxpayers must not only provide adequate supporting documentation, but must also defend the method used to determine the mark-up rate used. The taxing authorities are using more sophisticated arguments which could lead to disallowing, adjusting, or including certain costs (e.g., deemed depreciation on the free usage of assets), thereby increasing companies' China tax liabilities.
3. The deduction of intercompany charges, which is frequently challenged and which is not only documentation-driven, but may also require upfront discussions with authorities to ensure deductibility. Again, China does not provide for the filing of group or consolidated returns. Thus, adjustments made by a taxing authority to one China entity may not be automatically recognized as an offset for another China entity, even though the transaction is between two China entities.

In sum, transfer pricing compliance will prove difficult for many companies, due to the complexity and the uncertainty inherent in the multiple judgments that are required.

Documentation issues for events such as asset disposals and bad debts

Like many other jurisdictions, China has a host of document-intensive requirements. Asset disposals and bad debts are particular areas of examination scrutiny. The tax rules clearly allow for the deductibility of loss on asset disposals and the write-off of bad debts. However, in practice, unless care is taken to gather and present the support in the form required, the tax inspector may disallow the items, creating a permanent adjustment. Therefore, companies should determine what types of items are documentation driven and what procedures are necessary to meet the specific requirements of the tax inspector. These issues are further impacted by changes in personnel, changes in the business model, etc. Thus, monitoring the change aspect for internal control purposes is essential.

Super research & development

China has various non-cash permanent items such as an extra deduction for research activities (equal to an extra 50% of the economic outlay). This item is subject to interpretation and therefore, uncertainty. Companies should evaluate all of their permanent items and their positions to optimize their filing posture.

Impact on non-income taxes

Many of the issues analyzed under FIN 48 could also have non-income tax impacts. For example, transfer pricing transactions could trigger VAT; possible differences between China rates versus other country rates could create payroll withholding exposures; inward processing regimes could have duty issues; and PEs could incur a China Business tax (similar to a sales tax on revenues). These non-income taxes are separately covered by FAS 5 and should be considered in the context of the control environment as well.

Interest and penalties

China has a straightforward interest charge environment. For tax issues that require a FIN 48 liability this process should be mechanical. However, the penalty aspect may be more intricate. The statutory penalties range from 50% to 500% of the tax due in certain cases. However, most tax disputes can be settled for payments of tax and interest only. Thus, companies should determine whether to take a mechanical approach to penalties or conclude that the "unwritten" practice is an "administrative practice", as defined by FIN 48. Whether or not this practice would be considered an "administrative practice" under FIN 48 is currently not clear. As additional guidance in this area unfolds, companies should factor new information into their assessments, since the penalty rates for the FIN 48 liability can quickly become material, particularly when a PE issue never closes.

Statute of limitations

China generally has a three-year statute of limitations. However, this is extended to five years if an underpayment exceeds RMB 100,000 (about \$12,500 at recent exchange rates). These limitation periods assume that the information was properly reported such that the tax inspector had full awareness of any issues. For transfer pricing adjustments, the statute is 10 years. For tax evasion the statute remains open indefinitely. Thus, companies should determine the appropriate period for consideration of past years. This analysis may also be impacted by the local practice of the jurisdiction in which the issue resides.

Conclusion

China will present challenges to companies subject to FIN 48. The technical expertise required to make the judgment calls under FIN 48 most likely exists in corporate headquarters and not within the local financial staff. Yet the facts and circumstances may best be known by local financial staff and not by headquarters personnel. Thus companies should quickly educate their local personnel on FIN 48, and ensure that their central tax function understands the facts at the local level. For many companies, the impact of their China operations has grown more quickly than their internal control systems. FIN 48 will require immediate attention to fully understand tax positions claimed. Finally, this new regime will require up front analysis as well as ongoing monitoring.

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