

# News Flash

## China Tax and Business Advisory

January 2009 | Issue 1



### Our Transfer Pricing Team Contacts

Spencer Chong  
Partner  
Tel: +86 (21) 2323 2580  
spencer.chong@cn.pwc.com

Winnie Di  
Partner  
Tel: +86 (10) 6533 2805  
winnie.di@cn.pwc.com

Jeff Yuan  
Partner  
Tel: +86 (21) 2323 3495  
jeff.yuan@cn.pwc.com

Cecilia Lee  
Partner  
Tel: +852 2289 5690  
cecilia.sk.lee@hk.pwc.com

We have over 170 dedicated transfer pricing professionals in China with wide knowledge in economics, accounting, law, industry expertise and project management. We strive to assist clients in developing tax efficient structures that help them increase compliance with transfer pricing regulatory requirements, prepare for rapid audit response, resolve disputes, and decrease adjustment exposure in future. To offer our clients with global support, we work closely with our global transfer pricing network of more than 100 partners and 1500 dedicated professionals in over 50 countries.

## Unveiling of Long-awaited Special Tax Adjustments Implementation Measures

China's new Corporate Income Tax Law ("CIT Law"), together with its Detailed Implementation Regulations ("DIR"), introduced a set of anti-avoidance measures in Chapter 6 – Special Tax Adjustments. It may well be the most complex chapter of the CIT Law, encompassing not only exploratory new concepts such as cost sharing, controlled foreign corporations, thin capitalisation, general anti-avoidance, but also imposing mandatory contemporaneous transfer pricing documentation requirements, that could altogether cause significant impact to taxpayers.

On 8 January 2009, the State Administration of Taxation (the "SAT") formally approved a circular entitled Guo Shui Fa [2009] No. 2 ("Circular 2"), and distributed it on 9 January 2009. Circular 2 contains the final version of the "Implementation Measures of Special Tax Adjustments (Trial)" ("the Measures"), which lay out detailed rules on administering all the aspects covered by special tax adjustments.

This final version of the Measures has been eagerly awaited by taxpayers and practitioners since the SAT issued a draft version in March 2008.

### What's inside the Measures?

The Measures contain 13 Chapters and 118 provisions covering various aspects of Chapter 6. These provisions take retrospective effect from 1 January 2008. The content is as follows:

Chapter 1: General Provisions	Chapter 8: Administration of Controlled Foreign Corporations
Chapter 2: Reporting of Related Party Transactions	Chapter 9: Administration of Thin Capitalisation
Chapter 3: Administration of Contemporaneous Documentation	Chapter 10: Administration of General Anti-Avoidance
Chapter 4: Transfer Pricing Methods	Chapter 11: Corresponding Adjustments and International Consultation
Chapter 5: Transfer Pricing Investigations and Adjustments	Chapter 12: Legal Obligations
Chapter 6: Administration of Advance Pricing Arrangements	Chapter 13: Supplementary Provisions
Chapter 7: Administration of Cost Sharing Agreements	

## What to Achieve for SAT?

With the Chinese anti-avoidance regulatory framework now geared up, companies operating or investing in China will now need to proactively look at and manage transfer pricing risks and compliance requirements, as well as more emphasizing business purposes and substance. Understanding the SAT's intentions is the first and important step.

Based on constant dialogue with the Chinese tax authorities, we understand that the Measures are meant to provide a set of administrative practice notes to ensure high standard and consistency in local tax bureaus' transfer pricing enforcement and administration efforts. The SAT has effectively, in a single document, consolidated its past experiences in investigation cases. To get it right, the SAT has also consciously corrected certain shortcomings under China's old transfer pricing regime. With respect to the new concepts introduced, we note that the Measures set out, on a high level basis, the basic framework for future policy developments.

## How to Impact Taxpayers?

To help taxpayers decipher some of the more pertinent parts of the Measures, we have summarised the content of the Measures and highlighted our key observations below.

### 1. Definition of related parties

The Measures have a very broad (inclusive) definition of related parties. Not only including the criterion on share ownership criterion (*i.e.*, more than 25 percent), but it also has a special focus on the feature of "effective control" that can arise in situations of indirect share ownership, major financiers, common management, significant suppliers and customers, etc.

<b>Key Observations:</b>	Chinese enterprises should carefully review their relationships with business partners, <i>i.e.</i> , with major suppliers, customers, and financiers, as well as the relationships of their directors and high-level management with reference to the definition of related parties included in the Measures, in order to plan their transfer pricing documentation and disclosure compliance accordingly.
--------------------------	---

### 2. Annual disclosures of related party transactions

The new Related-party Transaction Disclosure Forms ("RPT Disclosure Forms"), addressed in Article 43 of the CIT Law and Article 11 of the Measures, were released by the SAT in December 2008 under *Guo Shui Fa [2008] No. 114*. There is now a significantly heavier information disclosure burden on taxpayers, as there are now as many as 9 different forms that may need to be filed.

Form 1: Related Party Relationships	Form 6: Fixed Assets
Form 2: Summary of Related Party Transactions	Form 7: Financing
Form 3: Purchases and Sales	Form 8: Foreign Investment Status
Form 4: Labour Services	Form 9: Foreign Payments
Form 5: Intangible Assets	

It is important to note that the Measures require not only enterprises resident in China to file the required RPT Disclosure Forms, but also foreign enterprises with an establishment or place of business in China who file CIT Returns with Chinese tax authorities for their taxable income determined on actual basis.

These RPT Disclosure Forms require companies to indicate whether they have contemporaneous transfer pricing documentation ("TPD") in place to substantiate their intercompany arrangements and to provide very detailed information on each type of related party transactions (including specifying the applicable transfer pricing methods). In the first year, they need to be filed by 31 May 2009, subject to further local-level requirements, together with the 2008 Annual CIT Return.

In addition, a new voluntary “Special Tax Adjustment” option in the Annual CIT Return (or called post-transaction adjustment) allows enterprises to make upward adjustments to their taxable income to bring it to an arm’s length basis.

<b>Key Observations:</b>	<p>Much of the analytical work ultimately to be included in the TPD will form the basis for completing the RPT Disclosure Forms and determining whether any voluntary adjustments should be made on the Annual CIT Return. And such work have to be at least substantially completed by the Annual CIT Return filing, despite the extended due date for 2008 TPD (see below). In addition, assembling TPD involves significant amounts of data collection, as well as functional and economic analyses, and even Chinese translation work that could be very time consuming.</p> <p>It is therefore strongly recommended that taxpayers begin the process of assembling their TPD as soon as possible. Early planning and preparation make things easier and more complete.</p>
--------------------------	---

### 3. TPD

Enterprises doing business in China must have relevant TPD in place in order to avoid an additional “Interest Levy” of 5 percent (so-called “penalty component”) on transfer pricing adjustments if occurred. There are 26 specific items of TPD under the following five broad categories:

- Organisational structure
- Description of business operations
- Description of related party transactions
- Comparability analysis
- Selection and application of transfer pricing method

*(Note: Additional elements of TPD are required for cost sharing agreements and for enterprises with related-party debt-to-equity ratios above the prescribed threshold – to be discussed in their respective parts below.)*

Failure to submit TPD upon request may result in the Chinese tax authorities deeming the enterprise’s taxable income, and assessing a 5 percent “penalty component” (in addition to a “financial component” that is based on the normal People’s Bank of China’s lending rate) as part of the “Interest Levy”. Taxpayers may also be subject to different levels of fines/surcharges (ranging from below RMB 2,000 up to RMB 50,000) for failure to provide certain RPT Disclosure Forms and/or TPD.

Enterprises are exempt from the TPD requirements if they meet any of the following criteria:

- The annual amount of related party purchases and sales transactions of tangible goods is below RMB 200 million and the annual amount for all other types of transactions (*i.e.*, services, royalties, interest, etc.) is below RMB 40 million.
- The related party transactions are covered under an APA
- The foreign shareholding of the enterprise is below 50 percent and the enterprise has only related party transactions locally

For purposes of calculating the annual intercompany purchases and sales transaction amounts of tangible goods, the annual importation and export value as per the customs declaration records under the consignment manufacturing trade model should be included. Related party transactions covered under a cost sharing agreement or APA implemented during the tax year are also excluded from the calculation of the *de minimis* threshold amounts.

<b>Key Observations:</b>	Smaller taxpayers or those with limited related party dealings may be exempt from TPD requirements.
--------------------------	---

It is important to note that, according to the Measures, the TPD must be:

- prepared and maintained for each tax year
- completed by 31 May of the following year (i.e., 31 May 2010 for 2009 tax year) and kept for 10 years (i.e., until 31 May 2020 for 2009 tax year). The due date for the 2008 tax year will be extended to 31 December 2009 as a concession for the first year
- provided within 20 days of request by the in-charge Chinese tax bureau (or within 20 days after elimination of any force majeure)
- stamped with “official chop” and signed or sealed by the legal representative of the enterprise
- in Chinese (any source materials provided in foreign language as part of the TPD needs to be translated into Chinese)

#### 4. *Transfer pricing methods*

The Measures list six methods as the “appropriate methods” in the course of transfer pricing investigations. They are the same methods provided in the OECD’s transfer pricing guidelines:

- Comparable uncontrolled price method
- Resale price method
- Cost plus method
- Transactional net margin method
- Profit split method
- Other methods that are consistent with the arm’s length principle

The Measures now provide further guidance on the application of each of the first five transfer pricing methods. The Measures also indicate that the selection of the most appropriate transfer pricing method should take into account the following five comparability factors:

- Characteristics of the assets or services involved in the transaction
- Functions and risks of each party engaged in the transaction
- Contractual terms
- Economic circumstances
- Business strategies

According to the CIT Law, the Chinese tax authorities in charge of a transfer pricing investigation are empowered to select appropriate adjustment methods at their discretion.

<b>Key Observations:</b>	The Measures do not indicate any preference or hierarchy for selecting transfer pricing methods. Practically, this would on one hand allow more flexibility, but it would also put the onus of proof to taxpayers to justify the reasonableness of the transfer pricing method they adopt.
--------------------------	--

#### 5. *Transfer pricing investigations and adjustments*

The Measures provide guidance on the procedural aspects of Chinese transfer pricing investigations, starting from selecting targets, conducting investigation, issuing “Transfer Pricing Adjustment Notice”, collecting adjusted taxes (and interest), and performing reviews in the five-year post-audit follow-up period. These provisions are generally in line with the China’s previous transfer pricing rules (e.g., Tax Circulars *Guo Shui Fa [1998] No. 59 and [2004] No. 143, Guo Shui*

Han [2005] No. 745, Guo Shui Han [2006] 901, Guo Shui Han [2007] No. 236, Guo Shui Han [2007] No. 363) and practical enforcement.

According to the Measures, transfer pricing investigations shall focus on enterprises with the following characteristics:

- Significant amounts or numerous types of related party transactions
- Long-term losses, low profitability, or fluctuating pattern of profits/losses
- Profitability lower than those in the same industry, or with profitability that does not match their functions/risks
- Business dealings with related parties set up in a tax haven
- Absence or incomplete TPD and/or Disclosure Forms
- Obvious violation of the arm's length standard

The Measures also provide that, in principle, no transfer pricing adjustment will be made to related party transactions between domestic (Chinese) related parties that had the same effective tax burden and such transactions did not result in the reduction of the country's total tax revenues. However, TPD would still be needed for such transactions when exceeding the *de minimis* thresholds if the enterprise has majority foreign shareholding or also has cross-border related party transactions.

Other elements of this aspect of the Measures that are worth mentioning include the following:

- The Measures specifically state that both public information and non-public information (e.g., "secret comparables") may be used by the Chinese tax authorities during investigation and evaluation
- Although the Measures introduce the inter-quartile range as a method of testing profitability, they provide in the context of transfer pricing investigations that enterprises with profits below the median value will still be subject to adjustment to an amount at least equal to the median value
- Enterprises can provide documentation to the Chinese tax authorities during their desk-top review, which may help reduce the chance of further transfer pricing investigation if the enterprises have proper documentation in place to demonstrate the arm's length nature of their related party dealings
- Transfer pricing issues identified during the follow-up administration period do not necessarily result in an audit – the Chinese tax authorities shall first communicate with the enterprises in a timely manner and may request them to make a voluntary self-adjustment
- During a transfer pricing investigation, any adjustments to operating profit of the enterprise and/or comparable enterprises due to different levels of working capital employed would require approval from the SAT
- Enterprises engaged in relatively simple manufacturing activities (such as contract manufacturers and toll manufacturers) should generally maintain a certain level of profits and not sustain losses
- Enterprises are subject to a five-year post audit follow-up period (as compared to three years in previous guidance), during which they must provide annual TPD to the Chinese tax authorities before 20 June of each year following the year under the follow-up review
- Under previous guidance, transfer pricing investigations in China were required to be completed in no more than three to five years, but now the Measures are silent on any limits to the duration of the investigation

<b>Key Observations:</b>	The Measures provide the SAT with the authority to adjust the taxable income of taxpayers if their results fall below the median – even if they are within an inter-quartile range, a commonly accepted measure of an arm's length range. How the SAT will use this authority remains to be seen, but it will likely cause difficulties in devising transfer pricing policies and/or determining the amount of a voluntary adjustment.
--------------------------	--

## 6. Advance Pricing Arrangement (“APA”)

The Measures provide guidance with respect to the various requirements and procedures associated with applying for, negotiating, implementing, and renewing APA. In general, these provisions are a restatement of the previous rules on APA (*i.e.*, *Guo Shui Fa [2004] No. 118*), with several modifications and amendments. The following points are also worth noticing:

- The SAT has specified that APAs will in general be applicable to enterprises meeting the following conditions:
  - annual related party transactions of no less than RMB 40 million;
  - comply with the related party disclosure requirements; and
  - prepare, maintain, and provide TPD
- The term for an APA will cover transactions for three to five consecutive years (the previous provisions provided that APA would cover two to four years)
- Upon approval of the Chinese tax authorities, the pricing policy and calculation method adopted in the APA can be applied to the evaluation and adjustment of related party transactions in the year of application or any prior years, if the related party transactions are the same as or similar
- An APA will be respected by the relevant State Tax Bureaus and Local Tax Bureaus at all levels as long as the taxpayer abides by all the terms and requirements of the APA. This can be regarded as a positive sign from the SAT to increase certainty and creditability of APA
- Pre-filing meetings with the Chinese tax authorities can now be held anonymously
- Although the TPD requirements technically do not apply to taxpayers during the term of an APA, there are still documentation requirements specific to the implementation of APA that still need to be provided to the tax bureaus within five months of the following year
- For bi-lateral or multi-lateral APAs, taxpayers should submit their filings (including pre-filing and formal application) to both the SAT and in-charge municipal or equivalent level tax authorities simultaneously

The Measures provide that the SAT will centrally coordinate the joint negotiation and implementation of APA across the various provincial, municipal, and other local-level tax bureaus. Such joint efforts are also applied for APA involving both State Tax Bureaus and Local Tax Bureaus. As long as the enterprise complies with all the provisions and requirements of the APA, these two groups of Bureaus shall implement the APA.

The Measures state that, in the event that an APA is applied for but not ultimately reached, any non-factual information regarding the applicant that was gathered during the application and/or negotiation process cannot be used for future tax investigations.

<b>Key Observations:</b>	These Measures indicate that the SAT is getting increasingly more open to assist taxpayers with APA to reduce the uncertainty associated with transfer pricing issues.
--------------------------	--

## 7. Cost Sharing Agreements (“CSA”)

It was a breakthrough that CSA for joint development of intangibles and sharing of services were finally written into the CIT Law. Closely following the OECD’s transfer pricing guidelines, the SAT will require the following items to be contained in a CSA:

- Name of participants, their country (region) of residence, related party relationships, and the rights and obligations under the CSA
- Content and scope of intangible assets or services covered by the CSA; the specific participants performing research and development activities or service activities under the agreement, and their respective responsibilities and tasks
- Term of the agreement
- Calculation methods and assumptions relating to the anticipated benefits to the participants
- The amount, forms of payment, and valuation method of initial and subsequent cost contribution by the participants, and explanation of conforming with the arm's length principle
- Description of accounting methods adopted by participants and any changes
- Requirements on the procedure and treatment for participants entering into or withdrawing from the agreement
- Requirements on the conditions and treatment of compensating payments among participants
- Requirements on the conditions and treatment of amendments to or termination of the agreement
- Requirements on the use of the results of the CSA by non-participants

The Measures state that the costs borne by the participants to a CSA should be consistent with what an independent enterprise would bear for obtaining the anticipated benefits under comparable circumstances. Moreover, the anticipated benefits should be reasonable, quantifiable, and based on reasonable commercial assumptions and common business practices. Failure to comply with the benefit testing will be subject to adjustment by the Chinese tax authorities in the event of an audit.

Some other relevant provisions of the Measures with respect to CSA include the following:

- Service-related CSA generally should be limited to group procurement or group marketing strategies
- Buy-in and buy-out payments are required when there is a change to the participants of an existing CSA
- During the cost sharing period, if there is a mismatch between the shared costs and the actual benefits, then compensating adjustments should be made based on actual circumstances to ensure the shared costs match actual benefits
- If a CSA is not considered arm's length, or does not have a reasonable commercial purpose or economic substance, costs allocated under the agreement (as well as any appropriate compensating adjustments) will not be deductible for CIT purposes
- An enterprise may apply for an APA to cover a CSA
- Participants to intangible-related CSA should not pay royalties for intangible properties developed from the agreement
- The costs allocated under a CSA and deducted for CIT purposes by the enterprise would need to be clawed back if its operation period is less than 20 years since signing of the agreement
- In addition to the TPD requirements, the Measures also includes some specific elements of TPD that must be prepared with respect to the CSA and submitted to the Chinese tax authorities by 20 June of the following year

<b>Key Observations:</b>	There are still some questions left unanswered by the Measures, such as the Chinese Business Tax treatment for CSA, or whether the "R&D super deduction" is eligible under an intangible-related CSA, especially involving cross-border shared costs.
--------------------------	---

## 8. Controlled Foreign Corporations (“CFC”)

Article 45 of China’s CIT Law provides for the inclusion into a Chinese enterprise’s taxable income the relevant profits of CFC of that Chinese enterprise that are established in countries with effective tax burdens substantially lower than China’s.

The Measures provide guidance for calculating the amount of the deemed dividend income and any associated tax credits. Pursuant to the Measures, the deemed dividend income from a CFC attributable to its Chinese resident enterprise shareholder should be determined using the following formula:

$$\text{Income attributed to a Chinese resident enterprise shareholder in the current period} = \text{Amount of deemed dividend distribution} \times \frac{\text{Number of shareholding days}}{\text{Number of days in the CFC's tax year}} \times \text{Shareholding percentage}$$

The Measures allow for the exemption from recognition as Chinese taxable income any deemed dividend from a CFC that meets one of the following criteria:

- The CFC is established in a country with an effective tax rate that is not low, as designated by the SAT
- It has income derived mainly from active business operations
- It has annual profit less than RMB 5 million

<b>Key Observations:</b>	These CFC rules may not be a concern to most foreign-invested companies, considering that they are not inclined to use a China-based company to invest outside of China at this stage.
--------------------------	--

## 9. Thin capitalisation

The thin capitalisation rules are designed to disallow the deduction of excessive related party interest expense pertaining to the portion of related party debt-to-equity ratio exceeding a certain prescribed debt-to-equity ratio.

*Cai Shui [2008] No. 121* (“Circular 121”), jointly published by the Ministry of Finance and the SAT in October 2008, sets out the prescribed debt-to-equity ratios (2:1 for non-financial enterprises and 5:1 for enterprises in financial industry) and other associated rules. Circular 121 also emphasizes that “excessive interest” from related party financing that exceed the prescribed ratios may still be deductible if an enterprise can provide documentation to support that the intercompany financing arrangements comply with the arm’s length principle, or if the effective tax burden of the Chinese borrowing enterprise is not higher than that of the Chinese lending enterprise.

Where the debt-to-equity ratio exceeds the prescribed ratio, the portion of related party interest expense relating to the excess portion would not be deductible. Furthermore, the non-deductible outbound interest expense paid to overseas related parties would be deemed as a dividend distribution and subject to withholding tax at the higher of the withholding tax rate on interest and the withholding tax rate on dividends.

The Measures provide certain administrative guidance not addressed in Circular 121, including the following:

- Mechanics for how to calculate the debt-to-equity ratio (on a monthly weighted average basis)
- Related party interest that is not arm’s length will be subject to a transfer pricing investigation and adjustment before being evaluated for thin-capitalisation purposes

The Measures also provide guidance on specific elements of TPD in relation to thin capitalisation. In the event that the related party debt-to-equity ratio exceeds the prescribed ratio, the enterprise has to prove that the enterprise's related party financing arrangements conform to the arm's length principle if it has claimed deduction of the excessive interest expense. The relevant contents of the TPD for intercompany financing include the following:

- Analysis of the enterprise's repayment capacity and borrowing capacity
- Analysis of the group's borrowing capacity and financing structure
- Description of changes to equity investment of the enterprise, such as changes in the registered capital, etc.
- Nature and objectives of debt investment from related parties, and the market conditions at the time the debt investment was obtained
- Currency, amount, interest rate, term and financing terms of debt investment from related parties
- Collaterals provided by the enterprise and the relevant terms
- Details of the guarantor and the terms of guarantee
- Interest rate and financing terms of similar loans contemporaneous to the debt investment from related parties
- Terms of conversion of convertible bonds
- Other information that can support the conformity with the arm's length principle

<b>Key Observations:</b>	Preparation of thin-capitalisation TPD is required in order to deduct excessive interest expense. The Measures stipulate that such documentation should prove that all material aspects of the related party financing arrangements, including debt-to-equity ratio, interest payment amounts, interest rates, duration of debt, terms and conditions, etc. are arm's length.
--------------------------	---

## 10. General anti-avoidance Rules ("GAAR")

The Measures state that the Chinese tax authorities may commence a general anti-avoidance investigation on an enterprise in case of any following scenarios:

- Abuse of preferential tax treatments
- Abuse of tax treaties
- Abuse of corporate structure
- Use of tax havens for tax avoidance purposes
- Other "arrangements" that do not have a reasonable business purpose

The Measures place a special focus on the principle of substance over form, and also provide details about the various procedures for conducting a "GAAR investigation" and making a "GAAR adjustment," including the requirement that initiation of all GAAR investigations and adjustments must be submitted to the SAT for approval. The consequence could be that the Chinese tax authorities may disregard the "tax benefits" solicited from the tax avoidance arrangements. Where an enterprise that is lacking adequate business substance, especially those in tax haven countries, the Chinese tax authorities may disregard the existence of such enterprise.

Finally, the Measures state that the Chinese tax authorities may request the party who planned the tax avoidance arrangement to provide relevant information and supporting evidence in the investigation.

<b>Key Observations:</b>	The GAAR are new, vaguely drafted, and untested. Companies therefore need to exercise particular caution when formulating their global tax strategies. The first-line of defence, and also the most effective defence, will be the proof of valid business purposes for the transactions or arrangement being challenged by the Chinese tax authorities.
--------------------------	--

## 11. Corresponding Adjustments and International Negotiation

The Measures provide that corresponding adjustments should be allowed in the case of a transfer pricing adjustment to avoid double taxation in China. If the corresponding adjustment involves an overseas related party resident in a country with which China has a tax treaty, then the SAT will, upon application by the taxpayer, launch negotiations with the competent authority of the other country based on the “Mutual Agreement Procedures” article of the double tax treaty (“DTA”). The statutory limitation for the application of corresponding adjustments is three years; application after three years will not be accepted or processed. Application for the initiation of the Mutual Agreement Procedures should be submitted to both the SAT and the local-level tax bureaus simultaneously.

Nevertheless, where payment of interest, rental or royalties to overseas related parties was disallowed as the result of a transfer pricing adjustment, no refund of the excessive withholding tax payment will be made. This treatment, which may result in double or even triple taxation for multinational companies in some cases, is consistent with China’s previous transfer pricing guidance and foreign exchange controls on outbound remittances.

If the originating adjustment is imposed by the overseas tax authority, then the Chinese enterprise may submit a formal application for a corresponding adjustment to the relevant Chinese tax authority within three years of the overseas related party’s receipt of the notice of transfer pricing adjustment. The Measures also state that, where the SAT accepts an application for a bilateral or multilateral APA, the SAT will launch negotiations with the competent authority of the treaty partner based upon the relevant treaty’s Mutual Agreement Procedures article.

The Measures specifically indicate that corresponding adjustments are not available in cases of CIT assessed on deemed dividends that result from non-deductible interest expenses under the thin capitalisation rules.

<b>Key Observations:</b>	This is one of the most beneficial provisions in the Measures to taxpayers - corresponding adjustments allowed in the case of a transfer pricing adjustment to avoid double taxation in China.
--------------------------	--

## 12. Legal Liabilities

As discussed above, failure to submit TPD upon request, or submission of false or incomplete information, gives the Chinese tax authorities the power to deem the enterprise’s taxable income, and to assess a 5 percent “penalty component” (in addition to a “financial-charge component”) as part of the “Interest Levy” on any special tax adjustments made by the tax authorities. This Interest Levy is not deductible for CIT purposes. Taxpayers may also be subject to different levels of fines/surcharges, ranging from below RMB 2,000 up to RMB 50,000, for failure to provide certain RPT Disclosure forms and/or TPD.

Although enterprises with annual related party transactions below the *de minimis* thresholds for TPD requirements are not subject to the 5 percent penalty component interest, such protection does not apply for enterprises that originally fall below the threshold but the restated amount of related party transactions as a result of a transfer pricing adjustment exceeds the prescribed threshold.

<b>Key Observations:</b>	Compliance with the TPD requirements will protect taxpayers from the 5 percent penalty component of the Interest Levy. Making a voluntary upward adjustment on current year transactions in the Annual CIT Return (if appropriate) could further save taxpayers the financial-charge component of the Interest Levy as well, and could even potentially reduce exposure to transfer pricing investigations.
	Taxpayers should take a proactive approach in transfer pricing planning, documentation, and risk management.

### 13. Supplementary Provisions

As discussed above, the Measures provide an extension up to 31 December 2009 for completion of the 2008 TPD. Extensions for completion of additional TPD for CSA and thin capitalisation situations, which may require additional effort, are not specifically mentioned in the Measures. Also not specifically mentioned is how the extension to 31 December 2009 will affect the calculation of any Interest Levy for 2008.

Keep in mind, though, that the RPT Disclosure Forms for 2008 still need to be filed by 31 May 2009 (subject to further local-level requirements) and enterprises must indicate by ticking a box on the Form whether or not they have properly prepared TPD.

<b>Key Observations:</b>	The effective date of the Measures is 1 January 2008, and they will prevail in case of any inconsistencies with prior transfer pricing regulations, policies, and guidelines, some of which were specifically annulled by the Measures.
--------------------------	---

### How do Taxpayers respond to the Measures?

We acknowledge that the Measures do not provide all the answers to the uncertainties raised by the new CIT Law and its DIR. The title of the Measures is coupled with the word "Trial". We do expect that the SAT will in future improve this version of the Measures or issuing more explanation and clarification after collecting more views and gain more experience during its implementation. Notwithstanding this, the Measures unequivocally disclose clearer expectation and provide additional guidance on the direction of the Chinese tax authorities in their anti-tax avoidance administration efforts.

Taxpayers should now have a better understanding of the SAT's policy intentions and should be prepared to meet their obligations under China's new tax regime by considering appropriate tax and transfer pricing strategies. They should act ahead of the May 2009 Annual CIT Return filing deadline and the December 2009 TPD deadline. Putting in place the Chinese TPD is more than just a compliance requirement – it could also serve as an effective tax planning and risk management tool to justify the arm's length nature of related party transactions and/or the reasonableness of the commercial structures and arrangements. For high-risk taxpayers, the additional five percent penalty component of the Interest Levy can be waived if appropriate TPD has been prepared by the taxpayer and is available for submission on request by the Chinese tax authorities.

\* \* \* \* \*

PricewaterhouseCoopers will be holding webcasts and seminars (mainly) in early February 2009 (right after the Chinese New Year holidays) to share more information and insights. Please stay tuned with our notices and register for the webcast and/or seminar.

In the meantime, please call or e-mail your regular contacts within the PricewaterhouseCoopers transfer pricing network if you have any questions, or if you would like to receive either the official Chinese version of the Measures or PricewaterhouseCoopers's unofficial English translation once it is completed.

In the context of this News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is of a general nature only. It is not meant to be comprehensive and does not constitute legal or tax advice. PricewaterhouseCoopers Consultants (Shenzhen) Limited ("PwC") has no obligation to update the information as law and practice change. The application and impact of laws can vary widely based on the specific facts involved. No reader should act or refrain from acting on the basis of any material contained in this publication without obtaining advice specific to their circumstances from their usual PwC client service team or their other advisers.

To make enquiries about our China tax and business advisory services, please feel free to contact the following lead specialist partners:

---

<b>Customs &amp; International Trade</b> Damon Paling Tel: +86 (21) 2323 2877 damon.ross.paling@cn.pwc.com	<b>Transfer Pricing</b> Spencer Chong Tel: +86 (21) 2323 2580 spencer.chong@cn.pwc.com	<b>Indirect Tax</b> Alan Wu Tel: +86 (10) 6533 2889 alan.wu@cn.pwc.com
<b>Mergers &amp; Acquisitions</b> Danny Po Tel: +852 2289 3097 danny.po@hk.pwc.com	<b>China Business &amp; Investment Advisory</b> Anthea Wong Tel: +852 2289 3352 anthea.wong@hk.pwc.com	<b>Domestic Market Initiative</b> Edwin Wong Tel: +86 (10) 6533 2100 edwin.wong@cn.pwc.com
<b>Registration &amp; Corporate Compliance Services</b> Matthew Wong Tel: +86 (21) 2323 3052 matthew.mf.wong@cn.pwc.com		
<b>International Assignment Services / Human Resources Services</b>		
<b>Northern Region</b> Edmund Yang Tel: +86 (10) 6533 2812 edmund.yang@cn.pwc.com	<b>Central Region</b> Stacy Kwok Tel: +86 (21) 2323 2772 stacy.kwok@cn.pwc.com	<b>Southern Region</b> Jacky Chu Tel: +852 2289 5509 jacky.chu@hk.pwc.com

---

Our regional contacts:

---

<b>Beijing</b> Edward Shum Tel: +86 (10) 6533 2866 edward.shum@cn.pwc.com	<b>Hong Kong</b> Charles Lee Tel: +852 2289 8899 charles.lee@cn.pwc.com	<b>Shenzhen</b> Charles Lee Tel: +86 (755) 8261 8899 charles.lee@cn.pwc.com
<b>Chongqing</b> Tony Kwan Tel: +86 (23) 6393 7888 tony.kwan@cn.pwc.com	<b>Ningbo</b> Amy Cai Tel: +86 (574) 8773 6888 amy.cai@cn.pwc.com	<b>Suzhou</b> Linjun Shen Tel: +86 (512) 6273 1888 linjun.shen@cn.pwc.com
<b>Dalian</b> Edward Shum Tel: +86 (411) 8379 1888 edward.shum@cn.pwc.com	<b>Qingdao</b> Steven Wong Tel: +86 (532) 8089 1888 steven.wong@cn.pwc.com	<b>Tianjin</b> Kelvin Lee Tel: +86 (22) 2318 3088 kelvin.lee@cn.pwc.com
<b>Guangzhou</b> Charles Leung Tel: +86 (20) 3819 2128 charles.leung@hk.pwc.com	<b>Shanghai</b> Tony Kwan Tel: +86 (21) 2323 2515 tony.kwan@cn.pwc.com	<b>Xian</b> Elton Huang Tel: +86 (29) 8720 3336 elton.huang@cn.pwc.com

---

This China Tax and Business News Flash is issued by **PwC TAX Knowledge Management Centre**. We are a team of experienced professionals dedicated to monitor, study and analyse the existing and evolving policies in taxation and other business Measures in China, Hong Kong and Singapore, with the aim to support our PwC professionals in the course of their provision of quality professional services to businesses and to maintain our thought-leadership by sharing knowledge with the relevant tax and other regulatory authorities, academies, business communities, professionals, as well as any party who is interested in our professional knowledge.

For more information, please contact:

Matthew Mui  
Tel: +86 (10) 6533 3028  
matthew.mui@cn.pwc.com

Additionally, we welcome you to visit our PricewaterhouseCoopers China website at <http://www.pwccn.com> or <http://www.pwchk.com> for practical insights and professional solutions to current and emerging business issues.