Transfer pricing considerations in the US-China trade friction

In brief
Since last year, the trade negotiations between China and the United States have been through several ups and downs. The trade friction is no longer a new concept and it has changed the business landscape for multinational companies, forcing them to develop strategies to assuage the impact of the trade friction. This issue of our Tax News Flash will discuss the transfer pricing issues which multinational companies need to consider when dealing with the new challenges brought on by the trade friction.

First Sale valuation in multi-tiered distribution structures
The First Sale rule can be applied in arrangements with related-party transactions as a tool to minimise customs value when importing goods into the United States. In short, this means that Chinese manufacturing companies which normally export products to the United States through an intermediary (such as a Hong Kong based affiliate) could use the benchmark price between the Chinese manufacturer and the affiliate company as basis for assessing customs duties in the United States, instead of the sales price between the affiliate and the US importer.

Transactions where the First Sale rule is applicable will involve multiple related parties and these transfer pricing arrangements will be relatively complex. In order to minimise transfer pricing risks in different countries and regions, companies should also consider each related party’s function and risk profile, commercial substance and profit allocation principles of these transactions, make a reasonable transfer pricing plan and take into account the commercial risks of the arrangements.

Transfer pricing implications in supply chain transformations
In view of the external uncertainties, changes to multinational companies’ trade and supply chain structures are inevitably expected to increase.

Competition between companies is ultimately a competition between value chains and constructing efficient value chains is strategically important to any company. Trade tensions may not be the only reason for transforming a company’s value chain, but it is certainly a solution to consider when looking to reduce or eliminate the effects of the trade friction.

From a transfer pricing perspective, companies need to consider a multitude of matters which will have an impact on the value chain transformation.

PwC
Firstly, the feasibility of the transformation needs to be considered by:

- Assessing the impact of transforming the Group’s overall transfer pricing policy and value chain;
- Considering transfer pricing practices and transfer pricing risks in different countries and regions.

Secondly, if the transformation is decided to be feasible, the company should plan from transfer pricing perspective, including:

- Assessing and analysing the changes in the entire trade and transaction structure;
- Assessing the function and risk positions of the intermediate manufacturing companies;
- Planning possible related-party transactions for the intermediate manufacturing companies, such as intercompany buy-sell transactions, royalty payments etc. and designing intercompany transfer pricing policies;
- Assessing and analysing changes in the local entities’ functions, potential transfers of intangible assets, profit changes caused by changes in pricing policies, tax implications etc.

Thirdly, implementation support from transfer pricing perspective will be important for the execution phase of the transformation, including financial model analysis, preparing compliance documentation etc.

Lastly, the company needs to ensure that proper documentation is prepared to support their transfer pricing position in the event of controversy.

Supply chain transformations are long-term behavioural and structural changes. Although there may be savings in tariff costs, resources will be necessary to execute the transformation and the short-term effect may, in fact, be an increase in total costs. However, in the long-run successful supply chain transformations will enable companies to position themselves more favourably in the market and gain higher profits.

**Retro-active tariff defence mechanisms**

Whether a company chooses to apply the First Sale rule or implement a more complex supply chain transformation, taking proactive measures will help to build a stronger position when faced with increased tariff costs and a loss of profit in the market. In situations where a company has been unable to take proactive measures, other solutions will be needed to adjust to tariff increases.

Companies may want to consider whether their transfer pricing policies should be adjusted to reflect the impact of newly imposed or increased tariff costs. For example, Company B is a trading subsidiary of Group A located in China. Company B purchases finished products from Company C (Group A’s manufacturing subsidiary located in U.S.) for further distribution in China market. The company’s transfer pricing model treats Company B as a limited risk distributor to a routine margin of say 3%, but Company B’s cost for acquiring goods for distribution will increase by 25% because of newly imposed duties.

Many multinational companies will ask themselves which entity should bear the increased tariff costs from a transfer pricing perspective. Where Company B performs limited functions and assumes limited risks, Company B will be unwilling to take on the cost increase, especially if the costs are deemed unconventional.

Company B will also be interested to maintain its target profit margin as set in the group’s transfer pricing policy. Whether this profit margin should still be kept can be evaluated and verified by comparable analysis. In the current business environment, we consider it is possible that the profitability of comparable companies will be affected as the end-consumers of these companies may absorb part of the additional tariff costs. However, considering that most of the tariff costs will still be borne by companies, to maintain a stable profit margin for Company B, it will be necessary to decrease Company B’s purchase price from Company C.

In many situations the price adjustment will likely not be made in time and this will eventually lead to loss in Company B. Under such circumstances, companies may consider a year-end transfer pricing adjustment in order to control the risks of distribution companies hit by tariffs and make sure that the gained profit is consistent with the functions performed and risk assumed. Obviously, this is more passive response to minimise the effects of trade friction on companies’ taxation.

In the above case, a number of other questions may come up. If a decrease in products purchase price is made between Company B and Company C, will tariffs be evaluated based on the price before or after the adjustment? How will Chinese customs authorities interpret the price reduction? It is clear that tariff increases will have a direct effect on transfer pricing arrangements between related parties. Hopefully, in addition to the above passive response through year-end transfer pricing adjustment, companies will be able to take more proactive measures to minimize the effects of trade friction on their taxation.
News Flash — Transfer Pricing

How PwC can help?

Our Transfer Pricing Services Team can provide a professional analysis according to your individual situation and provide comprehensive services together with the Worldwide Management Services Team. Please feel free to reach out to us if you require any assistance.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact PwC’s Transfer Pricing Team:

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

Silina Zhong  
+86 (21) 2323 3393  
silina.s.zhong@cn.pwc.com

Serena Shi  
+86 (21) 2323 8478  
serena.z.shi@cn.pwc.com

With close to 3,000 tax professionals and around 200 tax partners in Hong Kong, Macao, Singapore, Taiwan and 22 cities in Mainland China, PwC’s Tax and Business Service Team provides a full range of tax advisory and compliance services in the region.

Our dedicated transfer pricing professionals across Mainland China and Hong Kong have extensive experience and knowledge in helping clients to develop tax efficient structures to increase compliance with transfer pricing regulatory requirements, prepare for rapid audit responses, resolve disputes and decrease future adjustment exposure.