Hendersen Taxand

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China Anti-avoidance Enforcement in 2010

China's anti-avoidance enforcement historically was focused on transfer pricing of contract manufacturing operations, which predominantly involve tangible goods transactions. In 2010, according to a State Administration of Taxation (“SAT”) senior official, “Closer attention will be paid this year to related-party transactions such as intangible asset transfer or share transfers.

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On May 18, 2010, a famous multinational company filed and paid non-resident Enterprise Income Tax RMB 173 million to Jiangdu Municipal Jiangsu Province tax authority. It is the largest amount of tax in single case that China tax authority collect from non-resident Enterprise for indirectly transfer the equity of Chinese company. In this case, the foreign parent company transfer share of its HK subsidiary, while the HK subsidiary owns 49% of the share of a Joint Venture ("JV") in Yangzhou, Jiangsu Province. Through China tax authority research, it concludes that the HK company has no employee, no other asset, liability; no other investment; no other operation.

According to circular Guoshuihan [2009] No. 698, article 6, where the foreign investing party (who is the actual controlling party) indirectly transfer the equity of the Chinese resident enterprise by arrangement such as abuse of the organization form for an unreasonable commercial purpose to evade the taxation obligation of paying the enterprise income tax, the competent tax authorities may, upon to the State Administration of Taxation for examination, re-define the nature of such equity transfer transaction in accordance with the economic substance thereof and deny the existence of the offshore holding company used for such taxation arrangement.

Based on circular Guoshuihan [2009] No. 698, the China tax authority re-define the substance of the equity transfer transaction and deny the existence of HK company. The foreign company shall pay tax in China for transfer the share of JV in Yangzhou, Jiangsu Province.

The automobile and pharmaceutical industries will be the key sectors for transfer pricing audits in the near future.

China's tax authorities are actively involved in international collaboration regarding tax collection and management as well as international joint anti-avoidance investigations. China will soon officially become a member of the Joint International Tax Shelter Information Centre (JITSIC), and is actively involved in attending OECD experts' lectures, and participating in the drafting of Manual of Transfer Pricing in Developing Countries initiated by the United Nations.

In recent competent authority cases, the Chinese tax authorities have raised new ideas, including:

Location-savings: Multinational companies earn excess profits by setting up factories in China that have access to cheap labor and other resources. Shall Chinese subsidiaries be entitled to the whole or part of the profit?

Marketing intangible asset: A growing number of multinational companies have set up trading companies in China as their limited-risk distributors bearing simple functions and risks. Accordingly, the profits of these distributors in China are usually extremely low. The Chinese tax authorities raised that the foreign parent company overlook the contribution of the increasing demand arising from the China market and efforts made by the Chinese distributors in developing the China market.

China market premium: China's advantage and potential of purchasing power has made particular contribution to the profitability of companies operating in the China market. The Chinese tax authorities believe that China shall be entitled to tax on the excess profit derived from China market premium.

Contract R&D: Contract R&D companies set up in China by foreign multinationals do not own the intellectual property (IP) rights generated from the R&D activities, plus a modest mark-up. The tax authority may require that the Chinese companies be able to enjoy the benefits derived from the R&D activities, especially when the R&D companies were deemed to be substantially involved in the R&D decision-making process.

Hendersen comment: Multinational companies shall examine their tax arrangement and check whether they can be adapted to the development of the taxation environment in China. The above factors should be taken into consideration in the tax planning and in developing the transfer pricing policy of the Chinese subsidiaries.

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About Hendersen Taxand

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