What You Don't Know About Transfer Pricing Can Hurt You

Transfer Pricing compliance is a problem for foreign companies operating in China today, and most are oblivious to the risks. This was not a material risk just a few years ago, but it is now a serious exposure and one that Western companies are advised to deal with proactively. Waiting for the China Tax Bureau to challenge Transfer Pricing practices is the worst possible approach, risking significant fines. The good news is that there is a path to minimize exposure, even if past Transfer Pricing was not compliant with China regulations.

Transfer Pricing is coming under intense scrutiny in China because the China Tax authorities recognize that many foreign companies have designed Transfer Pricing practices to minimize taxable income in China. Some foreign companies incorrectly believe that because they own their China operations, they can unilaterally set prices for the sale of materials and services between their China operations and parent company. The fact is that foreign affiliates are independent legal entities that must comply with all local regulations, including rules governing the pricing of goods and services bought and sold between company affiliates.

Guiding Principle – Arm's Length Principle

This is not just a China issue. Transfer Pricing is a global issue and the taxing authorities of every country pay close attention to related party transactional pricing – Transfer Pricing – because of its potential to improperly siphon away local tax revenues. In 1961 a group of countries established an international organization – Organization for Economic Co-operation and Development (OECD). The OECD's objective is to develop guidelines for national policies (such as overall tax policy) that promote cross-border trade and economic growth. The United States is a member country of OECD. China is not a member, but China has used the OECD guidelines to develop its trade and tax policies.

The OECD's guiding principle is that all countries should frame their respective Transfer Pricing regulations based on a concept called the Arm's Length Principle ("ALP".) The ALP ensures that buyers and sellers of a product or service act independently. The ALP has two important and separate requirements:

- Any value exchange that would be priced between unrelated parties, must also be priced between related parties;
- The price between related parties for these value exchanges must be the same that would be charged between unrelated parties under like conditions.

The point of these two requirements is to reflect that each independent entity has local legal and tax obligations. If one independent company contracts with another for a product or activity, there would almost always be a price for the value exchange. The ALP says that even if companies are related, the activity must be priced as if unrelated. The greater complication is that the price must reflect the same conditions, while costs associated with unrelated party transactions are often different. For example, two legitimate reasons for different prices between related and unrelated parties would be the absence of sales/marketing costs or bad debt exposure in the related party example. There can be many other differences that can justify materially different prices that would exist between related versus unrelated parties.

The ALP is the basis for Transfer Pricing in most countries that engage in international trade. Within each country, national tax bureaus have the obligation and authority to tax the legitimate taxable profits according to their national regulations. This means that cross border related party transactions must adhere to the regulations in two countries – the exporting and importing country. For the remainder of this paper, the two countries discussed will be China and the United States.

China's Increased Scrutiny

Historically, China's underdeveloped government administrative sophistication and capacity have not enabled comprehensive application of its tax regulations. As capability and capacity are enhanced, Transfer Pricing practices of foreign companies operating in China have come under increased scrutiny to protect and correct China's tax base.

Practices that were common and accepted in the past are

coming under challenge. It is very common that companies have no formal rationale, comparable analysis, or even written policies for Transfer Pricing between their China and their U.S. entities. This lack of documentation becomes a prima fascia proof of Transfer Pricing manipulation by a company challenged. The presumption is that if there is no formal rationale, then the pricing method is arbitrary and intended to avoid proper taxation in China.

As a practical matter, China generally seems to understand that local government practices have contributed to the situation. Local authorities were not historically capable of effectively monitoring Transfer Pricing. Annual statutory audits, required of all foreign companies, seldom scrutinized related party transactions and audit “sign-offs” were interpreted as concurrence with Transfer Pricing practices. This historic lax oversight is quickly ending.

China’s regulations provide the ability to review and impose retroactive taxes and penalties on company tax calculations that are judged to be non-compliant. China tax regulations provide for a potential 10-year look-back period, with significant potential for penalties and interest. The tax bureau has the authority to make judgments and the burden of proof of compliance is on the company.

The good news: if a company implements compliant practices on a go-forward basis, the likelihood of retroactive assessments and penalties is low – but not zero.

Transfer Pricing Management Program

To be compliant, a company must develop a formal Transfer Pricing policy that adheres to the specific regulations in China (basically adherence to the ALP). Equally important, the Transfer Pricing policy must include contemporaneous documentation at the China entity that is maintained and ready to present to the Tax Bureau upon request. Transfer Pricing is dynamic and must be adjusted to the changing requirements and conditions related to the company, including changes to the company’s business model, product costs, market prices and other relevant aspects of the specific company situation.

Transfer Pricing management is far more than an accounting issue and approaching it solely from an accounting perspective will inevitably overlook important considerations and management options. Transfer Pricing has cross-functional implications that certainly affect tax and cash flow strategy. However, Transfer Pricing also has implications on product marketing/pricing, management incentive programs and basic business model structuring. Transfer Pricing needs to be approached as a cross-functional process in order to assure compliance and optimize the outcome for the company.

The development of a compliant and defensible Transfer Pricing program should be approached in a step-by-step process:

1. Define the Business Model and Business Risk

This business/risk model assessment is the first and the most important step because it sets the foundation for the rest of the process. It assures that Transfer Pricing aligns with the company’s true business model and objectives. Companies are encouraged to spend time to review all relevant business model elements.

What are the roles and business risk elements of the related parties? The considerations here include which party carries various risk elements such as market, technology, and financial. For example, if a China entity is essentially a captive internal contract manufacturer, the model should be structured so that the China company does not own technology, product designs, customer relationships; carry sales or marketing costs, or have bad debt expense exposure. In such a model, it is generally the case that lower margins are justified and earned. If, the China company engages in sales, marketing, engineering, and manufacturing with its own customers and products, higher margins are expected.

2. Inventory and Map the Related Party Transactions

Identify all related party exchanges that need to be considered. These can be product transfers, services, financial flows such as loans, technology/trademark licenses, market rights or other transfers of value. They must only be transactions that an unrelated party would freely contract. For example, some companies want to allocate a % of corporate costs to an international related party as some form of management fee. Another example is charging for services that are actually oversight of the parent company’s shareholder interests and framed as management fees. Neither of these practices are allowed by Transfer Pricing regulations because no independent company would agree to these charges in an arm’s length relationship. The test of an appropriate value exchange is to ask whether a truly independent company would contract for the product or service.

3. Determine the Transfer Pricing Methodology

China Tax regulations allow most of the OECD recognized methodologies for calculating and benchmarking Transfer Pricing. The approved methods include:

- Comparable uncontrolled price method;
- Resale price method;
- Cost-plus method;
- Transactional net margin method (TNMM);
- Profit split method; and
- Other methods consistent with the ALP.

No single method is better than the other. The attributes of each situation need to be assessed to select the best choice. A company must be prepared to justify the rationale for the methodology selected.

4. Research Comparable Metrics

Once the Transfer Pricing methodology is selected, the next step is researching market comparable data to finalize the exact Transfer Pricing metrics. The data collected will vary by and will depend on the methodology selected. The common goal, however, is to support the selected metrics used for calculation with market-based rationale to show alignment with the ALP.

5. Develop Formal Contemporaneous Transfer Pricing Documentation

The Transfer Pricing procedures, rationale and supporting data must be documented in a package that demonstrates to the satisfaction of the Tax Bureau that the Transfer Pricing approach is proper. The documentation should be ready for immediate presentation upon request by the Tax Bureau, reinforcing the fact that this process is formal, thoughtful, supported and documented. This documentation also serves as the basis for on-going management and refinement of Transfer Pricing.

If a company does not have this documentation when the Tax Bureau asks, the exposure is significant. The absence of this documentation is essentially “proof” that the process is arbitrary and puts the company immediately on the defense with a weak argument for compliance.

6. On-going (Annual) Review and Management of Transfer Pricing

Transfer Pricing is not a static process. It must be periodically monitored and refined. Market price, cost, and business models change constantly. While there is no requirement, Transfer Pricing should be updated at least annually.

Summary

Transfer Pricing is a serious issue in China that is coming under more intense scrutiny daily. As China’s regulatory oversight becomes more sophisticated and the capacity for enforcement increases, foreign companies are confronting a significant risk that might not be evident until the Tax Bureau knocks at the door and then it is too late. Companies are advised to act before they find themselves in defensive mode.