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15 FAQs on Transfer Pricing Documentation (TPD)

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In brief

» The year of 2014 has just ended. It is time to prepare annual Corporate Income Tax (CIT) filing, in which the disclosure of related party transactions is an essential part.

» Given the inconsistent monitoring and varying interpretation by local tax authorities, many companies may puzzle about how to deal with TPD preparation.

» WTS China has prepared 15 FAQs for your better understanding and preparation of TPD.

15 FAQs on TPD

1. Is our company required to file TPD when preparing 2014 annual CIT filing?

Companies should check whether their related-party transactions have met TPD threshold. TPD can be exempted if companies can meet one of the following criteria:-

(1) Annual related-party purchase and sale amount is under RMB 200 million; and other related-party transaction amount is under RMB40 million;

(2) Related-party transactions fall into the scope of Advanced Pricing Arrangements (APAs);

(3) Foreign-owned shares of the company account for less than 50%; and related-party transactions are conducted only with domestic related parties.

The Chinese subsidiaries of multi-national enterprises (MNEs) with limited functions and risks (e.g. processing trade, distribution or contract R&D) but incurring losses are also required to file TPD, no matter whether or not the threshold is met.

The abovementioned 2014 TPD thresholds cover the period from 1 January 2014 to 31 December 2014.

2. **Should TPD be submitted to tax authorities along with annual CIT returns?**

Not necessary. However, companies shall disclose whether they have met TPD threshold in the annual CIT filing forms. Companies should submit their TPD within 20 days upon the request by the tax authorities. In general, TPD submission comes after the annual CIT filing.

3. Are any changes in the new annual CIT returns relevant to TPD preparation?

The number of forms in new annual CIT returns are increased from 16 to 41 forms. The additional forms require the disclosure of more related-party transactions. It is important for companies to ensure that their related-party transactions disclosed in the annual CIT returns are consistent with those disclosed in TPD.

4. What contents should be included in TPD?

TPD has to cover five parts, namely organization structures, business overview, related-party transaction analysis, comparable analysis and selection of transfer pricing methods.

5. What are related-party transactions?

Related-party transactions refer to transactions between a company and its related parties. “Related parties” are defined quite broadly, which do not simply mean companies with equity relationships. To summarize, related parties can be defined as companies with equity, debt and controlling relationships:-

(1) Equity relationship
- One party directly or indirectly holds an aggregate of 25% or more of the shares in another party, or 25% or more of the shares of both parties are directly or indirectly held by a third party.

(2) Debt relationship
- Loans between two parties (excluding independent financial institutions) account for 50% or more of either party’s paid-in capital, or 10% or more of either party’s total loans are guaranteed by the other party (excluding independent financial institutions).

(3) Controlling relationship

- More than half of one party's senior management or at least one senior board member who has controlling power over the board is appointed by the other party; or more than half of both parties' senior management or at least one senior board member of each of both parties who has the controlling power over the board is appointed by a third party.
- More than half of one party's senior management are also senior management of the other party, or at least one senior board member of either party who has the controlling power over the board is also a senior board member of the other party.
- One party's production and business operations can only be carried out normally with rights to industrial property, proprietary technology & etc. provided by the other party.
- One party's purchase and sales activities are largely controlled by the other party.
- The services that either party receives or offers are largely controlled by the other party.
- Other relationships, such as one party's actual control of the other party's production, operations or transactions, or both parties' interest being connected (e.g. relationships of family members and relatives).

6. What are the acceptable transfer pricing methods?

Transfer pricing methods are used to evaluate reasonableness of related-party transactions. Transfer pricing methods can be divided into two categories, namely the price method (comparable uncontrolled price method, resale price method, cost plus method) and the profit method (transactional net margin method and profit split method). By using the price method, the prices of related-party transactions are compared with those of the third party transactions. By using the profit method, the operating profits of related-party transactions are compared with those of the third party transactions.

7. Is it a must to compare related-party transactions with third-party transactions to prove the reasonableness of the pricing?

Yes. The pricing of third party transactions usually reflects a fair market value. Whether the related-party transactions are priced on an arm's length basis can be tested by comparing them with third-party transactions.

8. Is it a must to engage a third-party professional organization to issue a TPD?

It is not a must. However, companies must ensure the reliability of data sources, the appropriateness of methodology and the reasonableness of selected comparable samples when preparing TPD on its own. The State Administration of Taxation (SAT) requires local tax authorities to use the database of BvD or Standard & Poors in TP audits. In addition, TPD prepared by local companies should be consistent with the TP master file of their overseas headquarters. Therefore, it is recommended that companies seek assistance from professional organizations for preparing TPD to avoid technical mistakes, if companies lack relevant TP experience.

9. How will the reasonableness of related-party transactions be tested in case no third-party transaction sample with the same goods or services is available?

In general, third-party transactions with similar goods and services in the same industry are also acceptable to tax authorities.

10. Is there any requirement on the quantity of third-party comparable samples when doing the comparison?

Although it is not stipulated in tax regulations, in practice, tax authorities will generally accept a sample size of approximately 6 to 10 third-party comparable samples.

11. What are the consequences if TPD is not properly prepared and submitted?

If a company fails to prepare a TPD, it is in violation of tax laws. Moreover, the company can be listed as TP audit target by tax authorities. Once being audited, tax authorities can check the company's accounting records for the past ten years or even a longer period and adjust the company's profit for inappropriate related-party transactions. The company will be subject to supplemental taxes, interest and 5% penalty on the interest.

12. What kind of companies are likely to be targeted for TP audit by tax authorities?

In general, tax authorities tend to choose the following companies for TP audit:-

- Companies with a large volume of or with a large variety of related-party transactions;
- Companies with accumulated losses, low or fluctuating profit;
- Companies' profit is lower than the industry average, or the profit level does not match its functions and risks;
- Companies dealing with related parties located in tax havens;
- Companies failing to declare related-party transactions or failing to prepare TPD;
- Companies' transactions are obviously inconsistent with the arm's length principle.

13. Is a TPD useful for companies under the TPD thresholds?

Even under the TPD thresholds, companies with a large amount of related-party transactions are still recommended to prepare TPD. On one hand, TPD can be used as a good pricing guideline for related-party transactions to ensure TP compliance; on the other hand, should a company encounter a TP audit, it can provide TPD as a supporting document on a timely basis to defend itself against challenges by tax authorities.

14. If our company detects any potential underpayment of taxes after preparing TPD, can we make self-adjustment and make up for taxes voluntarily？ Will tax authorities impose a penalty?

By preparing TPD, if a company detects underpayment of taxes in the current year due to inappropriate related party transactions, the company can make TP self-adjustment and make up for the underpaid taxes in its annual CIT filing. In this case, no interest or penalty will be imposed. According to a recent tax notice (i.e. SAT Announcement on Issues Relating to Monitoring and Management of Special Tax Adjustments), companies making TP self-adjustment on their profits for the previous years and voluntarily make up for underpaid taxes will be given a waiver on the 5% penalty interest charge, based on the approval by the tax authorities.

15. What is the impact of BEPS (Base Erosion and Profit Shifting) action plan on TPD preparation?

It is stated in the deliverable of BEPS action plan that a consistent TPD administration system should be developed by all countries. In addition, it is recommended that the headquarters of MNEs should prepare a TP master file with the information of major related-party transactions among group members, a local TPD and a country-by-country related-party transaction report. Therefore, special attention should be paid by the Chinese subsidiaries of MNEs when preparing TPD. The information and analysis in TPD prepared by the Chinese subsidiaries should be consistent with the one disclosed in the master file and the country-by-country report by the overseas headquarters. Otherwise, it could lead to potential TP audit or investigation by tax authorities.

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