China makes single largest cross-border-service TP adjustment

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An office of China's State Administration of Taxation (SAT) in Xiamen recently assessed two Chinese subsidiaries of an unidentified Fortune 500 company more than CNY 800 million (about $132.16 million) in taxes and interest – the country's single largest transfer pricing adjustment in the area of cross-border services to date – after a nearly four-year investigation, according to a 20 January 2014 Chinese news report.

Facts of the case

The two Chinese subsidiaries, incorporated in 1998 and 2004, respectively, had been gradually increasing revenue but significantly decreasing profits since 2008, the year in which China started to implement its uniform Enterprise Income Tax Law. The significant decrease in profits resulted mainly from CNY 3.8 billion (about $627.75 million) in expenses (for example, business proposal expenses, information technology support expenses, research and development expenses, and marketing support expenses) paid to a Singapore related party between 2008 and 2010. The SAT office initiated the transfer pricing investigation in May 2010.

The tax office discovered that the multinational corporation allocated global service costs to the Singapore entity, a global operating centre of the corporation, based on the number of employees of its corporate divisions, and the Singapore entity in turn allocated the costs to the two Chinese companies based on revenue (rather than the number of employees).

As a result, higher costs were allocated to the Chinese subsidiaries; however, they had no ownership in intangible property arising from the cross-border service activities (for example, R&D and marketing). The tax office concluded that the multinational corporation shifted Chinese profits abroad through cross-border service payments.

The multinational corporation hired two well-known global accounting firms (whose identities were undisclosed in the news report) to assist with the transfer pricing investigation. After more than 10 meetings and 200 telephone conversations, the tax office and the multinational corporation in late 2013 reached a settlement agreement for the transfer pricing adjustment. The tax office has already received a tax payment of CNY 436 million (about $72.03 million), as well as an interest payment of CNY 78 million (about $12.89 million).

Comments

China introduced a cost-sharing agreement regime in 2008 whereby an enterprise may share with related parties the costs arising from their joint development or acquisition of intangible property or from their joint provision or receipt of services. According to Chinese tax law, the cost-sharing agreement must be signed by all the related parties in accordance with the matching principle of costs and anticipated benefits and filed with the SAT within 30 days of its formation. The shared costs are non-deductible unless the cost-sharing agreement is filed.

In practice, however, it is difficult to file a cost-sharing agreement, so multinational companies generally enter into separate service agreements with their Chinese subsidiaries. The services under those agreements may also be subject to transfer pricing investigation and adjustment if they do not comply with the general transfer pricing rules in China.

It has been reported that a large transfer pricing adjustment on service fee payments was made by the state tax bureau of Xianmen city.

Facts

A Fortune 500 company set up two subsidiaries in Xiamen in 1998 and 2004 respectively. Starting from 2008, the year in which the current Enterprise Income Tax Law was introduced and the certain tax incentives for income tax under the previous tax law were abolished, the profit rates of the two companies have been declining whereas the sale proceeds were increasing. The accounting records showed that the reason for the decrease in profits was the huge amount of cross-border service fees paid by these two Chinese companies to a related company in Singapore in the period between 2008 and 2010, in total CNY 3.8 billion. According to its business structure, this Fortune 500 Company allocated the global service costs to the Singapore company which operates as a global operating centre of the company, and the Singapore company allocated in turn the costs to the two Chinese companies. The Singapore company was eligible for the exemption of enterprise income tax.

Investigation and ruling of the tax authority

The State Tax Bureau suspected that the profits have been shifted from China to Singapore and started investigation of the two Chinese companies in May 2010. During the investigation, the tax officials discovered:

- a note on a contract concluded between the headquarters of the Fortune 500 company and the related Singapore company. From the note, it could be concluded that the cost calculation in the cost allocation was based on the number of employees;

- the cost calculation in the cost allocation between the Singapore company and the two Chinese companies was based on the sale proceeds;

- the Singapore company has economic ownership of intangibles in respect of information technology system, research and development (R&D) and marketing while sharing the costs with the headquarters. However, the Chinese companies do not possess any ownership or enjoy any benefits while sharing higher costs with the Singapore company; and

- the Chinese companies paid the fees on the basis of the global costs allocated by the headquarters to the Singapore company, not the portion of the global costs to the Singapore company.

The tax authority took the view that there were inconsistence in the transfer pricing method and policy, and adjustments of expenses on the business proposal, support of information technology system, R&D and marketing support must be made.

Settlement

After four years of discussion and negotiation between tax intermediaries and the tax authorities, the companies have accepted the settlement of CYN 800 million (including interest) and the tax bureau closed the case in December 2013.

The international tax division of the State Administration of Taxation (SAT) was involved in the settlement of the case and considered it as having set an example in combating tax avoidance schemes of multinational companies.