

## **10.2. China Country Practices**

### **Bridging the gap – applying the arm’s length principle in developing countries**

#### **10.2.1. Introduction**

10.2.1. 1., The OECD transfer pricing guidelines have been the gold standard for tax administrations and taxpayers to apply the "arm's length principle" for the valuation, for tax purposes, of cross-border transactions between related parties for much of the period since the original version was first issued in 1995. As the world economy becomes increasingly globalised, transfer pricing is an issue faced not only by developed countries, but is increasingly a critical matter for developing countries. Such nations face a set of unique issues that have not been addressed, or at least not sufficiently or practically addressed by the OECD Guidelines. Therefore, while much of the OECD guidelines may still be applicable to developing countries, the UN Transfer Pricing Manual should put a special focus on offering practical solutions to issues faced by developing countries.

10.2.1.2. China started looking into transfer pricing issues since the late 1990s. While the early focus of transfer pricing investigations was mostly on tangible goods transactions, it has since been expanded into a range of other transactions, and in particular, those involving intangibles and services. As a developing country, China faces a number of difficult challenges, to many of which ready answers have not been found from the OECD guidelines. These include a lack of appropriate comparables, quantification and allocation of location specific advantages, and identification and valuation of intangibles. The UN Transfer Pricing Manual must address these common issues for it to be useful to developing countries.

10.2.1.3. This paper intends to highlight some of the challenging issues faced by the developing countries, and share China’s practical experience in dealing with these issues.

#### **10.2.2. The challenge of a lack of reliable comparables**

10.2.2.1. The “arm’s length principle” is at the core of the OECD’s transfer pricing guidelines. Under this, transactions between group companies are compared with transactions between unrelated companies under comparable circumstances. Where there are no comparable transactions, then an alternative comparison may be made with unrelated companies that perform similar functions, own similar assets and bear similar risks to the taxpayer whose related party transactions are being examined, and operate under comparable circumstances.

10.2.2.2. Therein lies one of the key challenges for a developing country – a lack of reliable, public information on comparables. For a developing country, there are usually only a small number of public companies, while information on domestic private companies is lacking or inadequate. This limits the amount of publically available information on domestic companies that can be used for transfer pricing analysis. There would be, in particular, a lack of comparables for companies who are first movers in an industry not yet fully exploited. In practice, foreign companies are often used as an alternative to domestic comparables. As a result, comparables sets are often dominated by companies in developed countries, simply because there are usually a much larger number of public companies in these countries.

10.2.2.3. While globalisation and free capital mobility are the basis for the use of foreign comparables, the existence of foreign exchange controls in many developing countries violates this pre-condition. Accordingly, significant comparability adjustments may be necessary for companies in developed countries to be used as comparables for companies in developing countries. In some cases, it may require a different methodology such as profit split as no sufficiently reliable comparability adjustment may be feasible.

10.2.2.4. One of the most common adjustments in China is accounting for differences in geographic comparability when applying profit based transfer pricing methods, such as the transactional net margin method (“TNMM”), to determine an arm’s length price. For example, when an Asia Pacific set of companies is used to benchmark the transfer prices of a Chinese taxpayer, as often being the case, it often includes companies from both developed countries (such as Japan and Korea), as well as developing countries (such as Indonesia and Vietnam). Generally speaking, the Asia Pacific set is more likely to contain companies from developed countries due to a greater amount of listed companies in those countries and hence there is a greater volume of publicly available financial information.

10.2.2.5. China takes the view that there may be instances where the differences in geographical markets are so material that it warrants comparability adjustments to bridge the differences. By making such comparability adjustments, taxpayers in developing countries can overcome the practical difficulties in applying the arm’s length principle to their transfer pricing analysis.

### **10.2.3. Location specific advantages**

10.2.3.1. The globalisation of trade and economies has given rise to concepts such as “location savings”, “market premium,” and more generally, location specific advantages (“LSAs”). The LSAs are advantages for production arising from assets, resource endowments, government industry policies and incentives, etc, which exist in specific localities. For example, household electronics manufacturers invest in China to take advantage of a large pool of well-educated low-cost labour and a well developed network of suppliers, or global automotive companies set up joint ventures (“JVs”) in China to assemble automobiles locally to be close to the market and the customers and to take advantage of lower costs. Limited guidance is available on these concepts in the OECD guidelines; it has been seen that certain issues such as location savings and market premium arise more frequently in China and other developing economies, rather than in established and developed economies (which comprise the bulk of the membership of the OECD). China outlines its solutions to reconcile the arm’s length principle with the lack of reliable comparables in developing countries in the following paragraphs.

10.2.3.2. Location savings are the net cost savings derived by a multinational company when it sets up its operations in a low cost jurisdiction. Net cost savings are commonly realised through lower expenditure on items such as raw materials, labour, rent, transportation and infrastructure even though additional expenses (“dis-savings”) may be incurred due to the relocation, such as increased training costs in return for hiring less skilled labour.

10.2.3.3. Market premium relates to the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product.

10.2.3.4. In dealings with Chinese taxpayers, the Chinese tax administration has adopted a four step approach on the issue of LSAs:

1. Identify if an LSA exists.
2. Determine whether the LSA generates additional profit.
3. Quantify and measure the additional profits arising from the LSA.
4. Determine the transfer pricing method to allocate the profits arising from the LSA

10.2.3.5. In determining LSAs and their impact on transfer pricing, both industry analysis and quantitative analysis are critical.

10.2.3.6. The automotive industry is a good example where there are many LSAs that have led to extraordinarily high profits that are rightly earned by Chinese taxpayers. The LSAs include:

- The “market-for-technology” industry policy, which requires foreign automotive manufacturers to form JVs in order to assemble automobiles in China, forcing foreign automotive manufacturers to compete for limited market access opportunities by offering favourable terms including provision of technologies at below market price;
- Chinese consumers’ general preference to foreign brands and imported products – this general preference, as opposed to loyalty to a specific brand, creates opportunities for MNEs to charge higher prices and earn additional profits on automotive products sold in China;
- Huge, inelastic demand for automotive vehicles in China due to the large population and growing wealth of the population;
- Capacity constraints on the supply of domestically assembled automotive vehicles;
- Duty savings from the lower duty rates on automotive parts (e.g. 10%) compared to imported vehicles (e.g. 25%) – when MNEs manufacture products in China as opposed to importing the products from outside of China, they are able to generate overall savings from the lower duty rates, even if the MNEs incur manufacturing costs and sell their domestically-manufactured products at a lower sales price compared to a foreign-manufactured vehicle; and
- A large supply of high quality, low costs parts manufactured by suppliers in China.

10.2.3.7. For a 50/50 JV with partners having conflicting interest in the Chinese automotive industry, the Chinese JV partner generally contributes local distribution network, intimate knowledge about the local market, and the right market access. However, it does not typically have control of the JV operation, which is usually controlled by the foreign JV partner. The foreign JV partner also controls the supply chain of the parts. To the extent there could still be potential transfer pricing issues, the primary issue involves the JV being overcharged for the parts and services that are provided by related parties. In the absence of such overcharges, the JV’s results mainly reflect an arm’s length outcome, which in turn reflect the contribution of LSAs to the JVs.

10.2.3.8. A further example can be that of a Chinese taxpayer performing contract research and development (“R&D”) services for an offshore affiliate, and the full cost mark up (“FCMU”) as the profit level indicator for a comparable set comprising of foreign companies located in developed countries (and hence, incurring higher costs). The following example outlines the steps to calculate the adjusted FCMU taking into consideration of the location savings.

10.2.3.9. It is assumed that the Chinese taxpayer's cost base was 100, the average cost base for the company's R&D centres in developed countries was 150, and the median FCMU of the comparables was 8%. The comparison of the cost base between the Chinese taxpayer and that of the foreign companies is measured on an equal platform, such as the total costs (labour, raw materials, land and rent, etc) per unit of output.

Steps	Calculations
1 Calculate the arm's length range of FCMUs based on foreign comparables, mostly in developed countries	Assume the median FCMU is 8%
2 Calculate the difference between the cost base of the Chinese taxpayer (e.g. 100) and the average cost base of the foreign companies (e.g. 150)	$150 - 100 = 50$
3 Multiply the arm's length FCMU (e.g. 8%) with the difference in the cost bases (50)	$8\% \times 50 = 4$
4 The resulting profit is the additional profit (i.e. 4) attributable to China for location savings	4
5 Determine the total arm's length profit for the Chinese taxpayer	$4 + 8\% \times 100 = 12$
6 Determine the adjusted arm's length FCMU for the Chinese taxpayer	$12 / 100 = 12\%$

10.2.3.10. The Chinese tax administration has come across many other cases of market premiums for Chinese taxpayers, particularly in the luxury goods sector.

#### 10.2.4. Intangibles

10.2.4.1. Intangibles are as major an issue for developing countries as they are for developed countries. While MNEs in developed countries often have superior technology intangibles, they need the fast growing market in the developing countries and contribution of the subsidiaries in these countries to develop the market in order to monetize the value in such intangibles. For developing countries, marketing intangibles and LSAs are often closely integrated, and due consideration is necessary to properly compensate the contribution of the subsidiaries in developing countries.

10.2.4.2. MNEs often provide intangibles to their Chinese affiliates in the initial stages of the local operation to help establish the business in China. These intangibles may take various forms, such as global brand name, technical know-how or business processes. Over time, the local Chinese affiliates acquire the skill and experience from operations in China, and may even contribute to the improvement of the MNE's original intangibles. The issue in this scenario is whether the local Chinese affiliates should

be entitled to additional profit, and if so, what is the appropriate method to calculate the additional profit?

10.2.4.3. For example, if a Chinese affiliate was charged a 3% royalty for the use of a manufacturing process when the Chinese operations were established 10 years ago in 2002, then it may not be reasonable for the Chinese affiliate to continue paying the same royalty in 2012 without revisiting whether the intangible has continued to provide the same value over time. This is particularly the case if the Chinese affiliate has improved a manufacturing process provided by its parent company, through a process of trial and error and conducting manufacturing operations over a 10 year period. We would question whether the Chinese affiliate should continue to pay a royalty to the parent company for the manufacturing process, or whether the Chinese affiliates should be entitled to a return on the intangibles that they have developed and shared with the group companies.

### **10.2.5. Practical issues and solutions**

10.2.5.1. In a globalising economy, MNEs usually set up operations in developing countries to take advantage of comparative advantages that these countries offer. For example, they set up manufacturing operations to take advantage of the abundant cheap labour or natural resources to supply products for overseas markets, R&D to take advantage of local talent for overseas principals, and distribution of imported products to the local market. These operations often take the form of contract or toll manufacturing, contract R&D, and limited risk distribution to leave little profit to the local country, despite the fact that many such comparative advantages contribute significant profits to the multinational group. The following paragraphs share some of the Chinese experience in dealing with these transfer pricing issues.

10.2.5.2. A holistic view of functions and risks may need to be taken. Many MNEs have set up multiple companies in China with each company performing only a single function, such as manufacturing, distribution, R&D, and services, and claim that each of these entities is entitled to a limited return. Others have some or all of manufacturing, distribution, R&D, and services functions in one entity, and still claim that each of these functions is entitled to only a routine return. The Chinese tax administration takes the view that when a group has multiple single function entities, they may have to be taken into consideration as a whole in order to properly determine the return the group companies should earn in China. Similarly, an entity with multiple functions may have to be reviewed in its entirety in order to properly determine its returns.

10.2.5.3. While China generally respects the limited risk characterization of sole function entities,<sup>1</sup> determining an adequate return for such entities is a challenge, as explained below. Further, China has legislated made a specific article in its transfer pricing rules to require that such entities should not bear risks or suffer from losses arising from strategic failures, capacity under utilisation, or holdup in the sales of products, etc., if they do not perform business strategy decision making, product R&D, or sales functions. Simply put, if their upside is limited, their downside should be limited too.

10.2.5.4. Contract R&D is an area where the contribution of developing countries is often underestimated. The transfer pricing method commonly used to reward R&D activities performed by a

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<sup>1</sup> E.g. toll or contract manufacturing, limited risk distribution, or limited risk service provider

subsidiary of a MNE in China is cost plus. Sometimes, it has been found that the principal entity that is claimed to be responsible for the R&D has neither the technical expertise nor the financial capacity to be responsible. In other instances, the Chinese entity has obtained “high and new technology status” in Chinese law and therefore enjoys tax incentives hand on the basis of ownership of valuable core technology. However, it also claims to be a contract R&D service provider with no valuable intangibles on the other hand. These are but a few examples where a cost plus approach would not be adequate, and a different method such as profit split would be more appropriate. It is expected that companies claiming high tech status should be performing activities that result in the creation of intellectual property of which they can claim economic or legal ownership. It is not sufficient by itself that the contract R&D entity has shifted the majority of its risks (e.g. unsuccessful research) to its entrepreneurial related party. A proper analysis of the value provided by the contract R&D entity to the overall group operations should be conducted to determine the appropriate arm’s length return for the R&D entity.

10.2.5.5. Contract manufacturing is one of the most common forms of manufacturing used by MNEs in China, particularly dealing with manufacturing products for export. In evaluating a contract manufacturer’s return, the TNMM is often used as the transfer pricing method with the FCMU being the most commonly used profit level indicator.

10.2.5.6. The arm’s length principle involves testing controlled transactions with uncontrolled transactions to determine how independent parties would have acted in broadly comparable situations. This principle becomes challenging to apply where a company relies on its related parties for both input purchase and output sales. If such a company is to be evaluated on a cost plus basis, a low intercompany purchase price results in an undervalued cost base that will ultimately under compensate the contract manufacturer. However, the reasonableness of the purchase price is often difficult to assess. A further issue therefore arises on how the reasonableness of a taxpayer’s intercompany arrangements in this situation should be evaluated.

10.2.5.7. The Chinese approach to evaluating such companies is to start with the general presumption that the related party purchase price of materials is at arm’s length, and evaluate the reasonableness of the mark up earned by the contract manufacturer on its cost base. The rationale for accepting the related party purchase price is that Customs can act as a check on the reasonableness of the import price of materials and safeguard against unreasonably low intercompany purchase prices. The next step is to proceed with the transfer pricing analysis by adopting a cost plus methodology and using the FCMU as the profit level indicator. The challenge that follows lies in the search for suitable comparable companies, as discussed earlier in this paper.

10.2.5.8. Toll manufacturing is a common form used by MNEs in developing countries, but its proper return is difficult to determine since there are only a few independent listed companies that perform such activities. Some taxpayers simply use the FCMU for contract manufacturers as the mark-up for toll manufacturers. This grossly underestimates the return to toll manufacturers. Others use return on assets as a profit level indicator based using contract manufacturers as comparables, and this may also underestimate the return, particularly for labour intensive toll manufacturers as often being the case in developing countries.

10.2.5.9. In practice, the Chinese tax administration has sought to first estimate the total cost of the toll manufacturing operation as if it were a contract manufacturer, usually by adding back costs of raw materials which we may obtain from Customs. It then estimates the appropriate returns (say, FCMU)

for contract manufacturing based on contract manufacturing comparables, and apply this to the estimated total cost to arrive at the total contract manufacturing profit, from which it then adjusts for factors such as inventory carrying costs, to arrive at the total profit for the toll manufacturer. This approach works well when reliable customs information on raw materials. If customs information on raw materials is not available or not reliable, then there are unresolved issues as to what should be an appropriate profit level indicator and how it could be derived.

10.2.5.10. Sales, marketing and distribution are another set of functions where it has been seen that MNEs often underestimate the contribution of developing countries. Chinese experience shows that many MNEs treat its Chinese distribution entities as a limited risk distributor, and use a set of simple distributors performing limited functions in a mature market such as Japan as the comparables. There are a couple of obvious deficiencies in such an approach. First, there often is a mismatch in terms of functional profile, as the Chinese entity may perform significantly more functions than these so-called comparables, which is evident as it incurs significantly more operating expenses relative to sales. Second, it does not account for differences in market differences, with China being a fast growing economy and having strong demand which requires relatively less selling effort and therefore can achieve higher efficiency and profitability. Other location specific advantages such as country premium and any marketing intangibles that are created by the Chinese entity are also commonly ignored.

10.2.5.11. In practice, the Chinese tax administration has attempted to correct such deficiencies by using a more appropriate transfer pricing method, such as profit split in the cases where we identify significant local marketing intangibles or LSAs, or performing comparability adjustments when TNMM is used. For example, if the median operating expense to sales ratio for the comparable set is only 7%, and the same ratio for the taxpayer was 40%. To the extent there is location savings, we would adjust the cost base first. The Chinese tax administration would then calculate the additional return required for the extra efforts made by the Chinese taxpayer to derive the total return for the Chinese taxpayer.

#### **10.2.6. Alternative methods to the traditional transactional net margin method**

10.2.6.1. While the TNMM may still be used when there is a lack of adequate local comparables, such as using foreign comparables with proper adjustments, as in the contract R&D example, sometimes a different method such as the profit split may be more appropriate. An example is the electronic manufacturing services (“EMS”) sector, where the entire, or nearly the whole manufacturing and assembly activities of a foreign EMS multinational group, have been outsourced to its Chinese affiliate.

10.2.6.2. The typical set up for these manufacturing and assembly operations is such that the majority of the work force and tangible assets of these foreign EMS multinational groups are located in China, including many high level operational staff. The headquarters of these EMS companies are located outside of China, with the EMS group’s revenues supported by significant manufacturing contracts with third party global consumer electronics companies. Often, in such instances, the multinational group’s transfer pricing policies have little regard for properly compensating the Chinese manufacturer. The profits of the Chinese manufacturer are stripped away as much as possible on the basis that the manufacturer is a contract manufacturer or a toll manufacturer with a very low risk profile.

10.2.6.3. Under this scenario, China takes the view that a risk-based approach may place insufficient regard for the fact that there are sizeable assets located in China (i.e. the work force and factory plants). In many cases, the majority of the headcount of the EMS group are based in China, with only a few management personnel residing outside of China. Rather than a transactional or profits-based

approach, a contribution analysis approach may be more suitable. This means that remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group. In this case, the assets and the people should largely dictate where the group's profits should stay, and a global formulary approach should be a realistic and appropriate option.

10.2.6.4. Alternatively, the Chinese tax administration may determine the property return for the headquarters, with the Chinese manufacturer earning the residual profits. Another potential alternative may be to evaluate the Chinese manufacturer on the return on its assets or capital employed, using the group's results as a comparable for the Chinese manufacturer.

### **10.2.7. Other experience and recommendations**

10.2.7.1. One of the key issues faced by developing countries is the lack of experience and knowledge on how MNEs operate and on a particular industry. Transfer pricing is commonly acknowledged as one of the most difficult international tax issues, and MNEs as well as tax administrations in developed countries have developed and dedicated substantial resources including talents to this area. The Chinese experience has been that a dedicated team, with accounting, economics, and industry background would be very critical, in order for tax administrations in developing countries to effectively administer their transfer pricing rules.

10.2.7.2 Issues such as LSAs further raises the stakes. To effectively deal with such issues, solid economic and quantitative analyses are necessary. Compared with MNEs, which have vast resources at their disposal to hire the best professionals, and with tax administrations in developed countries which also have developed a large team of economists and quantitative analysts, developing countries such as China have a clear disadvantage, which has to be fixed urgently. China currently has more than 200 officials dedicated to transfer pricing issues, and aims to increase transfer pricing resources to 500 specialists in the next two to three years. This will include a specialist panel to review substantial cases such as national transfer pricing audits. This panel review system, together with the centralised approval system on transfer pricing audit cases and national information system, will ensure that Chinese transfer pricing investigations are carried out consistently with good quality.

10.2.7.3. One way to address the disadvantages faced by developing countries in transfer pricing administration is to expand the statute of limitations. For example, the statute of limitations for corporate income tax is normally five years in China. However, the statute of limitation for transfer pricing has been extended to ten years, allowing more time for tax administration to check on taxpayers' transfer pricing issues. Another way is to set clear compliance and penalty rules, putting the burden of proof on taxpayers and encouraging taxpayers to be in compliance and make self adjustments when needed. It has been found that contemporaneous documentation requirements coupled with penalty rules have been very effective to encourage taxpayer compliance. An industry wide or a multinational group wide audit has also been a very effective and efficient way for the tax administration to make use of its limited resources to maximise its benefits.

10.2.7.4. As an emerging market economy, China's priority is to establish a robust system that is based on a balanced approach with three pillars – administration, servicing, and investigating. Administration includes having the right policies in place, including avoiding loopholes and having the right disclosure requirements. Servicing includes reducing the effort and resources businesses use to show their tax compliance, the advance pricing arrangement program, for example. For investigation, China does not always have the same technical expertise and resources that developed countries possess. Nevertheless,

transfer pricing work in China is developing quickly. The real objective in conducting audits is to raise awareness of the Chinese determination to enforce tax compliance, and the tax administration has been using an industry based approach to accomplish this. As a testament to its success, the average profit margin in one of the industries focused on has increased from less than 1% to 5.6% between 2004 and 2008.

### **10.2.8. Conclusion**

10.2.8.1. Application of the arm's length principle to the companies in developing countries poses a practical challenge. Once developing countries overcome the issues of a sound legal framework for transfer pricing, they often encounter the issue of a lack of sufficient transfer pricing specialists to carry out the analysis, and a lack of reliable comparables for the analysis itself.

10.2.8.2. China, as a developing country, has unique economic and geographic factors which contribute to the profitability of Chinese taxpayers and their foreign parent companies. These factors include but are not limited to readily available migrant labour, low labour and infrastructure costs, first mover advantages in certain industries, foreign exchange controls, growing population and consumer demand for foreign and luxury products. Other developing countries have their own unique features that are similarly require special attention from a transfer pricing perspective.

10.2.8.3. In China's experience, MNEs have often implemented group transfer pricing policies that are sensitive to the developed countries' transfer pricing regulations and nuances, but neglect to consider whether the arm's length principle has been applied properly for the company in the developing country.

10.2.8.4. China has overcome this challenge by using some practical solutions that are sensitive to unique economic and geographic factors for companies operating in China. These solutions include concepts such as location savings, market premium and alternative methods of analysis besides the traditional transactional and profit based methods.

10.2.8.5. The Chinese tax administration has shared its insights on applying the arm's length principle for developing countries, and welcomes other perspectives on these issues.