

Pricing Knowledge Network

Focusing on the impact of major intercompany pricing issues

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PKN Alert China - Chinese tax authorities leave tax-avoiding companies no way to hide

A Transfer Pricing Publication

According to a report released by *China Taxation News* (“CTN”) on 30 March 2011,¹ the Chinese tax authorities collected approximately RMB 690 million of taxes, plus late payment surcharges and penalties through Exchange of Information (“EoI”) in 2010, representing an RMB 210 million (or 44%) increase over 2009. The largest adjustment for a single case on underpaid taxes was RMB 43 million.

EoI between two jurisdictions occurs either through a Double Taxation Agreement (“DTA”) if it exists, or a Tax Information Exchange Agreement (“TIEA”), which sets out procedures for the jurisdictions to request and obtain information from each other, for jurisdictions without an existing DTA. China has TIEAs with 6 low-tax jurisdictions including the British Virgin Islands, Bahamas, the Isle of Man, Guernsey, Jersey and Bermuda; besides these 6 a TIEA has also just been signed between China and Argentina², and a few more are in the pipeline.

¹ *China Taxation News* is sponsored by China’s State Administration of Taxation. The Chinese version of the article is available on the web at

http://www.ctaxnews.com.cn/syxw/csjd/201104/t20110404_1570759.htm

² Reported in BNA International’s *Tax Treaties Analysis*, 16 December, 2010.



Applicability of EoI

According to the CTN report, the State Administration of Taxation (“SAT”) views the EoI as “an effective weapon in meeting the challenge of economic globalisation and cross-border tax avoidance”, which is becoming increasingly important for the Chinese tax authorities. Currently, the difficulties for the SAT’s international taxation administration and thus the focuses of EoI include the following areas:

1. Outbound payment of commissions, dividends and royalty fees.
2. Non-salary derived from China and provided to non-Chinese citizens.
3. Use of tax havens or low-tax jurisdictions to shift profits outside of China.

Illustrative cases

The CTN report also provides three illustrative EoI cases in terms of tax assessment, anti-evasion and abuse of DTAs:

Tax assessment: Based on information provided by an overseas tax jurisdiction through EoI, a local-level tax bureau conducted a tax assessment on a suspicious cross-border transaction and collected additional corporate income tax of RMB 7 million. That local-level tax bureau then initiated an industry-wide investigation on cross-border transactions of the same type and collected more underpaid corporate income tax totalling RMB 40 million.

Anti-evasion: Through EoI, a local-level tax bureau identified that a taxpayer made fake transactions with a company located in a low-tax jurisdiction, and inappropriately shifted profits of RMB 30 million outside of China via outbound commission payments.

Abuse of DTAs: In another case, a local-level tax bureau used EoI to successfully verify that a company incorporated in a tax haven was actually created merely as an “empty-shell” company, without substance, in order to obtain treaty benefits. As a result, that tax bureau denied the treaty benefit claimed by the “empty shell” company with respect to the capital gain and collected additional corporate income tax of RMB 9 million.

You may find more details about the typical EoI in our China Tax and Business Advisory News Flash, Issue 06, March 2010.

PwC Observations

Although the absolute amount of the adjusted taxes (plus the late payment surcharge and penalty) may not be significant compared to the overall tax revenue of China, the release of this CTN report underscores several key trends within the Chinese tax authorities. First and foremost, they are continuing to develop their international tax regime in various directions, and finding new means to combat anti-avoidance. They are also increasing their cooperation with other countries and jurisdictions, as demonstrated by the foregoing cases. As multinational groups relocate more functions into China, the tax authorities are looking closely at payments to parties outside of China to see if substantial operations exist in the overseas parties to a sufficient degree to justify the payments. Thus EoI, which focuses on the collection of

information in order to combat tax evasion and tax avoidance, can be seen as part of a larger pattern of investigating the shifting of profits out of China.

The CTN report also reveals the areas that the SAT may focus on, including confirming the authenticity of transactions related to any suspicious transaction, investigating companies in tax havens, and enhancing administration of non-tax resident enterprises. The Chinese tax authorities are also likely to continue to develop their regime further, given their citation of the progress of the OECD countries in this area, as well as their own progress in negotiating TIEAs with low tax jurisdictions. Taxpayers should note the Chinese tax authorities' activities in this area and ensure that any transactions with overseas parties located in low tax jurisdictions have valid commercial reasons and sufficient substance both in the transaction itself and in the operations of the overseas parties.

While the illustrative cases in the CTN report address foreign companies repatriating profits in an inappropriate manner, it cannot be precluded that the Chinese tax authorities may make use of EoI to enforce controlled foreign corporation ("CFC") rules and to examine domestic Chinese companies which are suspected of using overseas structures to relocate profits or funds to tax havens. Therefore, Chinese companies should also take full note of these issues.

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