



PKN Alert China – Chinese tax authorities stepping up anti-tax avoidance enforcement of corporate restructurings through valuation



Transfer pricing has become a key issue for multinational corporations with operations in mainland China and Hong Kong, with new requirements as well as opportunities brought in with China's new tax regime and expanded guidance in Hong Kong. PwC's transfer pricing services team can help with dispute resolution, compliance, planning, advance pricing arrangements, and other transfer pricing services.

The Chinese tax authorities have been gearing up their administration of corporate restructuring activities through regular updates of tax regulations.¹ The core focus of these tax circulars has been addressing the tax treatments, form and substance of corporate restructurings, as well as introducing anti-tax avoidance measures to combat the abusive use of corporate restructurings to achieve tax benefits.

Under the relevant regulations, determination of the “fair value” of assets may be required during a restructuring, and appropriate documentation must be produced to ensure the appropriate tax treatment, including “legitimate evidence” or a report by a legitimate qualified asset valuation party (i.e., one which is properly licensed to conduct this type of valuation in China) as well as approval documents, statements of settlement, agreements/contracts and “other information as required” by the Chinese tax authorities. However, we are not aware of any tax circulars so far which clearly lay out how to assess fair value in any type of corporate restructurings.

Recently we observed that a landmark case on valuation of capital gain in an equity transfer transaction was concluded and reported in Dalian, a city in Northeast China, where a multinational company agreed to pay corporate income tax on capital gain, amounting to RMB 11 million. According to the brief information in the report, the multinational company undertook an internal corporate restructuring by transferring shares of a number of Chinese companies between certain foreign companies within the same group “at cost”. However, the Dalian tax bureau did not agree that the transfer should be conducted at cost. Instead, they insisted that the arm’s length principle should apply even for an internal corporate restructuring transaction such as this, proposed to use the income approach to arrive at the “fair value” of the shares of the Chinese companies being transferred, and made the tax adjustment accordingly.

This is probably the first case publicly known in China where the income approach, one of the internationally-recognized valuation approaches, was employed by Chinese tax authorities to determine the capital gain realized through an equity transfer transaction.²

Meanwhile, China’s State Administration of Taxation (“SAT”), which is the tax policy-making organ at the central government level, has encouraged its subordinate bureaus at the local level to actively build up their technical competencies by applying valuation methodologies, especially when dealing with anti-tax avoidance issues related to corporate restructuring. Two training sessions were recently conducted in the Chinese cities Wuxi and Guangdong, attended by major anti-tax avoidance tax officials from across the country. Representatives from PwC were invited to these training sessions to share their views and experiences. Topics discussed during these meetings include the application of general valuation standards and approaches in intangible asset and equity transfer valuations.

¹ Such regulations include Circular Caishui [2009] No. 59 which provides tax implementation rules for corporate restructuring, Circular Guoshuihan [2009] No. 698 on tax issues for equity transfers, and Public Notice Guojiaishuiwuzongjugonggao [2010] No. 4 which provides further details on tax aspects of restructurings.

² Please refer to the website of the Dalian tax bureau <http://218.247.242.154/detail.jsp?no=67701> for details of the Dalian case.

PwC Observation

Putting aside the question of whether it is appropriate to earmark this internal corporate restructuring as a tax avoidance case or not, the Dalian case has highlighted some new footprints of the Chinese tax authorities on the front of anti-tax avoidance, in particular tax valuation for transfer pricing:

- From our recent interactions with the Chinese tax authorities and analysis of a number of cases that have been publicly announced (such as the aforementioned Dalian case), it is observed that the Chinese tax authorities are gradually shifting the focus of their transfer pricing enforcement and administration towards relatively complex transfer pricing issues, particularly in the area of corporate restructuring. We do not think it is a coincidence. The SAT has already announced in Circular Guoshuihan [2010] No. 84 that they would pay more attention to equity transfer cases (a type of corporate restructuring) to identify and counteract tax avoidance.
- In the prior cases where similar valuation exercises were required, the Chinese tax authorities generally relied on analyses provided by third party appraisers, which put the tax authorities on the back foot in discussions with the restructuring parties. According to the Dalian report, the tax bureau in the Dalian case was able to take charge of the valuation exercise by conducting its own analysis.

It is encouraging to observe from the Dalian case that the Chinese tax authorities are looking to internationally recognized valuation approaches to resolve complex transfer pricing issues, a sign that they are working to align themselves with international practices. During the training sessions, PwC representatives emphasized the importance for both taxpayers and tax authorities to understand the strengths and limitations of the cost, income and market approaches as well as the importance of stress-testing assumptions. Important concepts, such as valuation standards, the difference between equity value and enterprise value, calculation of terminal value in the income approach and reconciliation of results from different valuation approaches, were also discussed at length.

The Chinese tax authorities are willing and eager to apply globally aligned valuation techniques on corporate restructuring cases, and will likely begin to examine more numerous and more sizeable restructuring cases soon. As such, restructuring parties and taxpayers are recommended to prepare more structured valuation studies that document and test the assumptions that are used to derive results under various valuation approaches.

Please call or e-mail your regular contact within the PricewaterhouseCoopers transfer pricing network, or one of the contacts listed below, for further information or if you have any questions.

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