Insights:
Transfer Pricing

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Intercompany payments between multinational corporations and their affiliated companies in China

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The "cash trap" problem

For multinational corporations operating in China, the repatriation of cash from their subsidiary operations in that country has always been an important and challenging issue. A phenomenon known as the "cash trap" is perceived by multinational corporations to exist regarding their operations in China. The cash trap means that, while the multinational corporation's affiliate or subsidiary operations in China may be profitable, there are no legal and effective means of getting out some of the cash representing those profits, so that in a sense a portion of the profits (the cash) is effectively trapped in the country.

The cash trap phenomenon exists because of the way the different layers of Chinese regulations—foreign exchange regulations, PRC Company Law on foreign-invested enterprises, tax law regulations, and, last but not least, China's transfer pricing rules—are applied and interact with one another in the context of multinational corporations operating in China.

Because China still officially considers itself a developing economy, it maintains a strictly regulated system of foreign exchange controls. Funds flowing into and out of China are tightly regulated so that, for certain intercompany transactions between affiliated companies, the incorrect handling of the registration and approval procedure can result in situations where the intended transaction (such as the remittance of a loan or if services or royalties failed to meet the foreign exchange regulatory requirements and become illegal or worse) simply cannot be successfully made.

For foreign-invested enterprises in China, the PRC Company requires that 10% of its annual after-tax profits be placed into a legal reserve. Payments to the legal reserve fund can only stop once the legal reserve fund has reached 50% of the foreign-invested enterprise's registered capital. Therefore, simply under this PRC Company rule, profits of up to half the amount of the registered capital cannot be distributed as dividends and end up trapped in China. Having satisfied the legal reserve requirement does not mean a foreign-invested enterprise can distribute current year profits. It can only distribute to its foreign investors dividends out of its accumulated profits, which means that it must have, on a historical basis, had more profits than losses previously accumulated. This means that at a point that a foreign-invested enterprise wishes to pay out dividends, it is not sufficient that it is profitable for the current year but that its prior accumulated losses must be more than offset by its profits in other years.

Another issue has to do with the computation of profits under financial accounting standards. China's accounting standard, like those of most other countries, considers depreciation and amortization as expenses that decrease an enterprise's operational profits. For foreign-invested enterprises with a relatively large amount of fixed assets or amortizable intangibles on its books, depreciation and amortization deductions can significantly decrease its profits. This also means that the amount that can be classified as profits, and therefore distributable as dividends, are reduced by the non-cash expense deductions such as depreciation and amortization. Why is this a problem? After all, China's accounting standard is the same as everyone else's in this regard. The problem is that while in other countries without a restrictive foreign currency system that allow the reduction and outward remittance of capital (which is essentially what it is, due to the cash left by the non-cash expenses of depreciation and amortization), it is virtually impossible for a foreign-invested enterprise to reduce and remit its capital to its foreign investors.

Therefore, as a practical matter, only 90% of a foreign-invested enterprise's after-tax profits can be remitted on an annual basis, assuming that it does not have any accumulated losses.

Because of this perceived cash trap in China, many multinational corporations have adopted certain policies that are not expressly announced in most cases and are implicit in the way they conduct their transactions with their subsidiary and affiliated companies in the country. These multinational corporations: (1) minimize their capital injection into China unless there are clear business objectives that require it; (2) through intercompany payments, as part of their transfer pricing strategy, minimize their profits (that is, keep profits low) in China in a legitimate manner and therefore reduce their exposure to the cash trap risk.

This article analyzes the regulatory, tax, and transfer pricing issues on the major types of intercompany payments that multinational corporations may have with their subsidiary and affiliated companies operating in China. Through case studies derived from actual examples of multinational corporations operating in China, it illustrates practical problems and suggests possible solutions.

In structuring intercompany charges with an affiliated company in China, the multinational corporations should try to address the following major objectives and issues:

- The China affiliate can claim a deduction against its enterprise income tax (EIT) assuming it is an expense item such as service fees, royalties, licensing fees, or interest.
- The non-Chinese recipient is not subject to excessive tax in China; part of this may be to avoid being classified as having a permanent establishment in China.
- The China tax paid can, if possible, be credited against the non-Chinese recipient's home country tax.
- Payment can be remitted by the payor out of China through the banking system, clearing the hurdles of foreign exchange controls as administered by the State Administration of Foreign Exchange as well as other regulatory requirements.

Income tax deductibility

Service fee charges paid to overseas parent or affiliate company

It has been a long-established practice of the Chinese tax authorities that management fees being charged by the parent company of a Chinese affiliate are not deductible for corporate income tax purposes under the EIT. This position was confirmed in a circular issued after the new EIT law took effect in 2008.[1]

As the Chinese tax regulations do not define the meaning of management fees, it is not uncommon for local tax bureaus, as an initial position, to simply disallow a service fee deduction so as not to have to get involved with the more complicated task of addressing the reasonableness of the service fee as to whether it meets the arm's length standard from a transfer pricing perspective. It is therefore crucial to have an appropriate agreement in place that provides a detailed description of the services performed, where the services were being rendered, and the basis for computing the service fee amounts. One example might be a time-based service fee, with the number of hours and the personnel involved in performing the services, or a cost plus formula, with the amount of costs incurred and a "% markup" added on.

It is a popular practice for many companies to use the "cost markup" method to arrive at an intercompany service charge when it comes to services provided between companies in China and their affiliates overseas. Due to the lack of guidance in Chinese transfer pricing regulations on services, both the taxpayers and Chinese tax authorities have in the past relied on Guoshuifa [2002] No. 128.[2] Guoshuifa No. 128 provides that in the case of a China holding company, a profit margin of 5% of cost can be used to determine the service fee charges against the holding company's Chinese subsidiary. Therefore, in the past, this 5% markup convention has been used by many companies, and not just China holding companies, when it comes to charging service fees.

However, in 2008, the SAT issued circular Guoshuifa No. 86[3] that provides that the service charges between a China parent company and its China subsidiary should be based on the arm's length standard and noticeably omits any reference to the 5% markup convention in Guoshuifa [2002] No. 128. This has led to speculation that perhaps the 5% markup of Guoshuifa No. 128 can no longer be relied upon as a safe harbor convention.

Interest expense payments to overseas parent or affiliate

If there is a loan outstanding between the multinational company and its Chinese affiliate, then there are two sets of Chinese regulations with which the multinational and the Chinese affiliate need to comply. First, there is the maximum debt to equity ratio imposed under the Chinese foreign exchange rules on how much debt a foreign-invested enterprise's capital structure can accommodate. These foreign exchange rules impose a minimum percentage that a foreign-invested enterprise's registered capital must be of the "total investment" of the foreign-invested enterprise. Presented below is a table showing the registered capital requirements. For example, for a foreign-invested enterprise with a total investment of, say, US$5 million, then the registered capital amount must be at least US$2.5 million. In other words, this particular foreign-invested enterprise can have a

[1] Guoshuifa [2008] No. 86, issued August 14, 2008.
[2] Guoshuifa [2002] No. 128, issued September 28, 2002, effective January 1, 2003.
[3] Guoshuifa [2008] No. 86, issued August 14, 2008.

loan from the multinational corporation parent company of a maximum of US$2.5 million (the difference between the total investment and registered capital).

Total investment	Registered capital/ total investment ratio	Registered capital as a % of total investment
Less than US$3 million	At least 7:10	70%
From US$3 million to less than US$10 million	At least 1:2	Higher of 50% or US$2.1 million
From US$10 million to less than US$30 million	At least 2:5	Higher of 40% or US$5 million
Over US$30 million	At least 1:3	Higher of 33.33% or US$12 million

Secondly, under Chinese tax law, there is a thin capitalization rule that provides that for companies that are not financial institutions, the debt to equity ratio on related party borrowings cannot normally exceed 2:1. If the related party indebtedness exceeds that ratio, then under the Chinese tax regulations, the effect is that a prorated portion of the interest accrued on the portion of the loan exceeding the 2:1 ratio will be disallowed, with the disallowed portion carried over to the next year. However, even if a taxpayer's debt to equity ratio exceeds 2:1, the taxpayer may apply for approval of the deduction of the excess portion of the interest if it can be documented that the related party loan is made at arm's length.

Taxation of the recipient of the intercompany payments

For the overseas recipient of intercompany payments made by a China subsidiary or affiliate, an assessment of the taxability of the payments received should include both income tax and turnover taxes (business tax and value added tax). Depending on the type of payment, it is possible that both income tax and turnover tax may apply.

Figure 1: Income tax and turnover tax applicability on the major types of intercompany payments

Type		Income tax (EIT)	Turnover tax
Service fee	No PE in China	No See Note (d)	Yes (business tax @ 5% or value added tax) See Note (a)
	PE in China	Yes (@ 25% of profit attributable to PE) See Note (d)	
Licensing fee/royalty		Yes (@ 10%) See Note (c)	Yes (BT @ 5% or value added tax) See Note (a)
Licensing fee that involves a transfer of technology		Yes (@ 10%) See Note (c)	No See Note (b)
Interest		Yes (@ 10%) See Note (c)	Yes (business tax @ 5%)
Dividends		Yes (@ 10%) See Note (c)	No

Notes:

(a) In certain areas such as Shanghai, a value added tax pilot program has been adopted so that the business tax is being replaced by value added tax on certain types of businesses and receipts. For example, in Shanghai, technical service fees are now subject to a value added tax of about 6.8% instead of the business tax. Beijing will likely adopt a value added tax pilot program similar to the one in Shanghai.

(b) If the license fee is paid pursuant to an arrangement that results in a technology transfer, then the business tax is exempt under current PRC tax policy.

(c) The statutory EIT withholding rate is 10%, which can be reduced to a lower rate if a tax treaty is applicable.

(d) If the service fee is attributable to a permanent establishment in China, then the EIT will be imposed at the rate of 25% on profits for the PE, determined under transfer pricing principles.

On the issue of permanent establishment, the affiliated service fee recipient abroad should be prepared to determine, via analysis and documentation, whether a permanent establishment would be created due to the provision of the services involved. If the overseas service provider is located in a country that has a tax treaty with China, then the determination should be made under the permanent establishment clause of the treaty.[4]

As a practical matter, even if it is quite clear to the overseas party that no permanent establishment exists because of the services provided, the party will need to be prepared to defend that position to the SAT tax bureaus in China. It is common practice that the local branch of the SAT tax bureau that has jurisdiction in issuing a tax clearance certificate so that the China related company can remit the service fees to the related overseas service provider may simply ask that EIT be withheld based on a presumption that a permanent establishment exists.

In fact, if an overseas service provider wishes to claim that there should be no corporate income tax imposed on the service fees because no permanent establishment exists in China because of an applicable tax treaty, the non-resident service provider will need to do certain reporting in order to claim the benefit of the permanent establishment clause of the treaty.[5]

Foreign exchange requirements

Under the foreign exchange regulations in China, the remittance of service fees in an amount of US$30,000 or more to the overseas parent company or affiliated company would require that tax clearance be first obtained, as well as other proper documentation, before the State Administration of Foreign Exchange would allow the remittance to be made. The process of obtaining tax clearance can be cumbersome and time-consuming. This is because two separate tracks of tax clearance may be necessary: (i) obtaining clearance from the State Administration of Taxation on income tax first and then (ii) obtaining clearance from the local tax bureau for turnover tax.

After successfully obtaining the tax clearance documentation, the following items need to be submitted by the payor of service fees to the State Administration of Foreign Exchange to facilitate the outward remittance:

- The original agreement or contract between the parties;
- The original invoice issued by the overseas service provider; and

[4] For example, under the China-US tax treaty, Article V addresses the definition of what constitutes a permanent establishment under the tax treaty.

[5] Guoshuifa [2009] No. 124, issued August 24, 2009, effective October 1, 2009.

- The tax payment or exemption certificate issued by the Chinese tax authorities.

For service fee payments of less than US$30,000, an exemption from the tax clearance process is provided by a 2008 SAFE circular, Huifa, No. 64.[6]

Figure 2: Scope of exemption under Huifa [2008] No. 64

Huifa [2008] No. 64	
Requirement	• Tax clearance required before making remittance
Threshold	• US$30,000 or above (not required for smaller amounts)
Coverage (examples)	• Services • Interest, guarantee fees, salary and wages, dividends • Financing lease payments, payments for the transfer of real property and shares

Other approval and registration requirements

Foreign exchange requirements are not the only hurdles that must be crossed by the overseas payment recipient and the PRC payment remitter to successfully make the outbound intercompany payment. There can be other approval and registration requirements as well. For example, if an overseas company is charging a Chinese entity royalties related to the use of technology and know-how, the underlying royalty agreement must be registered with the local branch of the Ministry of Commerce. However, if the royalties are for the use of trademarks, then either the trademark owner (in this case, the overseas company) or the Chinese affiliate company using the trademark will have to register the trademark with SAIC (State Administration of Industry or Commerce). Therefore, it is incumbent upon both parties involved to perform the necessary due diligence in each case to determine what other approval and registration may be required.

Case studies

Most multinational corporations with operations in China engage in deliberate planning to efficiently structure their intercompany payments with Chinese subsidiaries or affiliated companies. However, with the continuously shifting regulatory landscape in China, multinational corporations sometimes find themselves reacting to situations that were not anticipated during the planning process. Below are examples from actual cases of multinational corporations operating in China. In the first three examples, the multinational corporations react to situations they did not anticipate during the planning process. The fourth example shows how a multinational corporation proactively plans for the tax-efficient structuring of intellectual components in its expansion in China.

[6] Huifa [2008] No. 64, issued November 25, 2008, effective January 1, 2009.

Example 1: "G-UK" company

Facts

G company is a UK company that owns valuable technology, some of which has been patented. It has a subsidiary in China "G-China," that has manufactured the products for G-UK and then immediately sold the manufactured products to G-UK. G company is part of a large multinational group and is subject to financial reporting in the US.

In the last two years, however, G-China began selling some of G-UK's products in China. However, G-UK has not charged G-China any royalty/license fees for the sale of its products (i.e., the G-UK brands and the embedded technology, etc.).

G-China has been profitable in the last few years and has paid EIT in China at the rate of 25% on its net profit.

Problem

From a transfer pricing standpoint, G-China should have been paying royalties to G-UK when it began selling G-UK's products in China. The risk is that the UK Inland Revenue may, under UK's transfer pricing rules, impute royalty income to G-UK, and therefore G-UK will be liable for additional UK corporate income tax.

However, there is no ready mechanism in place for G-China to amend its prior years' tax returns to adjust and get a refund for those years.

Consequences

Immediate: G-UK and its parent company group is under pressure from its auditors to provide for a tax expense provision reserve for FIN 48 reporting purposes in the US.

Longer term: If G-UK is assessed additional UK corporate income tax, and if it cannot readily obtain a refund of the EIT G-China has paid in China, then it will be double-taxed on the same income for the group as a whole.

Solution

Is a competent authority proceeding, the mutual agreement procedure (MAP) a realistic possibility in this case under the UK-China tax treaty?

MAP under the UK-China tax treaty:

- Under the existing UK-China tax treaty (1984), Article 25 provides for a competent authority proceeding.
- There is a new UK-China tax treaty, signed but not yet effective. Article 25 in the new treaty has essentially the same provisions except that there is a statute of limitation relief.
- In theory, the MAP proceeding can be initiated in the UK, or possibly, in China.
- If the MAP proceeding is initiated in China, then Guoshuifa [2005] No. 115 (GSF 115 issued July 1, 2005) will govern.
- However, a competent authority proceeding is discretionary as to whether the tax authorities will agree to begin one. Also, not all competent authority proceedings result in agreement.

Example 2: “L-US” company

Facts

The L-US company is a multinational group in a very specialized software product business that is very profitable in its home country, the US. It has a subsidiary in China, the L-China company. The L-China company provides services to various customers, performing the Chinese localized version of its software services and adding components and interfaces to various major software programs. Some of its customers are affiliated companies outside of China within the L-US group.

The L-China company is required to prepare contemporaneous transfer pricing documentation because its intercompany transactions with affiliates exceed the threshold requirement (greater than RMB 40 million in fee payments) since 2008. Under its transfer pricing documentation, L-China is described as not engaged in “software development” but rather as simply engaged in certain programming functions and performing minor modifications to certain parts of the software.

In 2010, under Caishui [2010] No. 64, a company that performs outsourcing in certain types of industries/functions can obtain an exemption from its business tax on its “outsourcing business revenue.” The “software development” business is one type of qualifying industry or function eligible for a business tax exemption under Caishui [2010] No. 64. This is the only possibility for L-China if it wants to get the business tax exemption.

Problem

As the business tax rate is 5% (effectively 5.6%, if local surcharges are added) on gross revenue, the tax exemption under Caishui [2010] No. 64 can provide significant tax savings for L-China.

Can L-China maintain that it is in the “software development” business for purposes of Caishui [2010] No. 64 without changing its transfer pricing documentation’s position that it is not engaged in “software development” for EIT purposes?

Solution

With a thorough examination of its software services components, and the tweaking of its processes and reporting functions, the L-China company finds that it can qualify for the business tax exemption without jeopardizing its transfer pricing position and strategy. With the anticipated rollout of the pilot value added tax program later this, the L-China company will likely qualify for the value added tax exemption on its outsourcing revenue.

Example 3: “M” company

Facts

The M company is engaged in the design, development, and manufacturing of integrated circuits and other electronic equipment. It has a subsidiary in China, M-China, that has been in operation since 2009. M-China provides design services solely for its parent, the M company.

The M company has not paid any service fees to M-China since its inception. M-China has not shown any revenue for 2009 and 2010, and therefore operated at a loss for those two years. It is now February 2012 and the management of M company decided that it should compensate M-China for 2011 on a cost-plus basis (around cost +10%). Management is wondering whether they can put an intercompany service agreement in place and what problems, if any, should they anticipate.

Problem

As it is now February 2012, the interim accounts of M-China have already been submitted to the local tax bureau without showing any revenue for 2011. Further, if service fees should have been charged by the M company against M-China during 2011 then invoices should have been issued during the year with the requisite business tax of 5.5% collected from the customer, the M company.

If M company now pays M-China a service fee of cost +10% for the year 2011 then there can be a late penalty and interest for the earned income tax and business tax that should have been collected and paid during 2011.

Also is it possible to, on the one hand, adjust M-China’s 2011 financial statement and taxable income without having the billings/official invoices to show for it during 2011?

Solution

Official invoices showing the correct amount of business tax or value added tax should be issued as soon as possible for 2012 based on an agreement for intercompany services effective for the year 2011. A meeting should be arranged with the tax official in charge at the local tax bureau for a discussion of 2011 and prior years.

Example 4: "P" company

Facts

The P company is engaged in the sale of pet-related products to customers within continent E. It obtains almost all of its products from unrelated factories and suppliers in China. The P company has done its procurement through two representative offices it has in China. The P company owns a number of patents and trademarks it has developed for its products over the years.

P company believes that there will be a significant increase in the consumer demand for pet-related products in China and the rest of Asia in the future.

In 2012, the P company will establish a wholly foreign owned enterprise (WFOE) in China, P-China, to replace its two representative offices. It will also set up a new company in Hong Kong, P-HK. The plan is that the new wholly foreign owned enterprise will provide procurement services to the P company and P-HK and also will develop products and brands for the China market to which P-China will sell. P-HK will develop products and brands for the markets outside of China and the E continent and will be responsible for selling to customers in those areas.

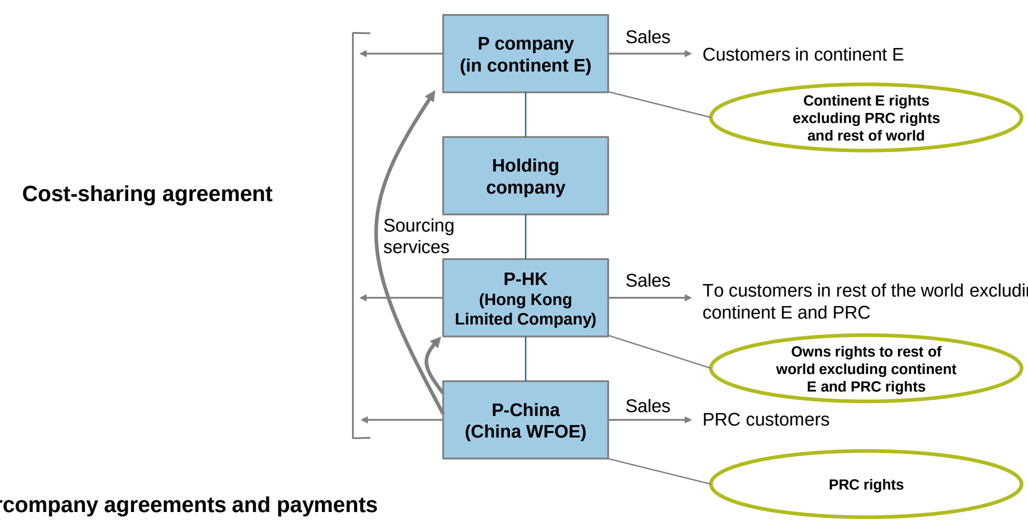
Problem

What intercompany agreements are needed among P company, P-China, and P-HK?

Solution

One solution is to develop a procurement services contract between P-China, as the service provider, and P company and P-HK as the service recipients.

Figure 3: Example 4: "P" company
Hypothetical solutions—new IP/product development/exploitation model in China



Intercompany agreements and payments

- ☐ Procurement services agreement between P-China WFOE and P company and P-HK
  - P company and P-HK to pay service fees to P-China
- ☐ Cost-sharing agreement between P company, P-China, P-HK
  - P-HK to pay P company buy-in payment
- ☐ License agreement between (a) P company and P-China and (b) P company and P-HK

Intercompany payments as part of a systematic cash repatriation strategy

In dealing with subsidiaries or affiliated companies in China, multinational corporations need to view the intercompany payments as part of its cash repatriation strategy. Figures 4 and 5 show the effects of various types of intercompany payments.

Figure 4: Analytical framework for intercompany payments I

	Strategy/technique	Regulatory	Foreign exchange	Withholding tax	Deductible
Pre-tax	Interest	Permitted	Permitted	Y	Y
	Royalties	Permitted	Permitted	Y	Y
	Service fees	Permitted	Permitted	N	Y
	Purchase of depreciable assets (e.g., intangibles asset)	Permitted	Permitted	N	Y (over time)
	Others: Swaps and other contractual arrangements	Limited	Limited	Depends	Y
Post-tax	Dividends	Permitted	Permitted	Y	N
	Purchase of non-depreciable assets (e.g., share of affiliates)	Permitted	Permitted	Depends	N
	Loans to affiliates	Not yet permitted	Not yet permitted	N	N

Figure 5: Analytical framework for intercompany payments II

	Strategy/technique	Reduces taxable profit	Cash
Pre-tax	Interest	√	√
	Royalties	√	√
	Service fees	√	√
	Purchase of depreciable assets (e.g., intangibles asset)	√	√
	Others: Swaps and other contractual arrangements	√	√
Post-tax	Dividends	X	√
	Purchase of non-depreciable assets (e.g., share of affiliates)	X	√
	Loans to affiliates	X	√

As China’s economy continues to grow and business processes there get more complicated, coupled with the tax authority’s increasing sophistication regarding international tax and transfer pricing issues, multinational corporations need to have a comprehensive and methodical system of dealing with the complex issues in effecting intercompany payments from the Chinese subsidiaries and affiliated companies. It is only through the complete mastery of the Chinese regulatory requirements, taxation, and transfer pricing rules that intercompany payments can be used as an effective component of a cash repatriation strategy.

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