**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 been expanded

and in particular, those involving intangibles and services. As a
umber of difficult challenges, to many of which ready answers have
delines. These include a lack of appropriate comparables,
ation specific advantages, and identification and valuation of
g Manual must address these common issues for it to be useful to

light some of the challenging issues faced by the developing
cal experience in dealing with these issues.

**eliable comparables** a **the** challenging pricing guidelines. Under this,

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 W

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

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% x 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% x 100 = 12 |
| 6 | Determine the adjusted arm's length FCMU for the Chinese taxpayer [illegible] | |

[illegible]

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

10.2.4.3. For

subsidiary

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, in

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