Considerations for year-end transfer pricing adjustments in China

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In brief

What happened?

Multinational enterprises (MNEs) with operations in China may encounter unique challenges with respect to implementing and maintaining transfer pricing policies in that country. Commonly, MNEs structure their China subsidiaries to undertake routine functions and bear limited risks from a transfer pricing (TP) perspective, such that these entities maintain a routine return in China. This business model, while fit for purpose in many circumstances, may become challenging in times of economic slowdown or uncertainty.

Observation: MNEs still are experiencing the impact of economic slowdown in China, with lower-than-expected revenue growth, increased raw material and labor costs, and higher levels of marketing and operating expenses. Facing difficulties in forecasting market trends combined with a lack of efficient mechanisms to make real-time price adjustments, MNEs may not be able to effectively implement their transfer pricing policies.

Why is it relevant?

Transfer pricing has been a key focus area for Chinese tax authorities. In the event that a Chinese subsidiary of a MNE group does not meet its target profit level, the entity may be selected as a subject of transfer pricing audit and could face potential tax adjustments and penalties. In such cases, many MNEs wish to make a transfer pricing adjustment (TPA) so that their Chinese subsidiary achieves the forecasted target profit.

Unlike some jurisdictions, China has strict foreign exchange control on cross-border transactions. The in-charge foreign exchange authority, the State Administration of Foreign Exchange (SAFE), monitors the cash in-flows and out-flows of each transaction. Due to this strict foreign currency control, it may be difficult for companies to implement and settle a direct TPA.

What to consider?

Companies that may require a TPA should explore the feasibility as soon as possible in order to be in a better position for successful implementation before year-end financial account closing.

In detail

Year-end transfer pricing adjustments in practice

In practice, year-end TPAs may not be easy to implement, since they not only involve corporate income tax issues, but also may affect the company's indirect taxes, tariffs, foreign exchange receipts and payments, and accounting entries, among others. MNEs also should adhere to the substantive and procedural requirements of regulatory authorities (e.g., tax authorities, SAFE), and communicate with them prior to making the adjustment.

In accordance with the compliance requirements of tax authorities and foreign exchange management authorities, TPAs that are implemented in China may take the form of a price adjustment, self-adjustment of tax returns, service fees adjustment, or year-end transfer pricing special adjustment. The following table summarizes these adjustments and their key pros and cons.

Adjustment method	Overview	Pros	Cons
Price adjustment	In the remaining time of the year, increase or decrease the price of transactions not yet conducted according to the desired implementation result	Avoid amendment of historic data and re-evaluation of the impact of accounting and tax treatments	Frequent fluctuation of cross-border transaction prices may draw the attention of the customs authority The lagging nature of pricing adjustment in the remaining time may result in a very limited effect on the P&L of the current year
Self-adjustment of tax returns	In the annual corporate tax return filing, make an upward taxable income adjustment and surrender additional income tax payment for the year in accordance with provisions on special tax adjustments	Adjustment is reflected on the company's income tax return only, unilaterally reduces transfer pricing risk, and no need to consider accounting treatments, customs, foreign exchange, and other factors	Transaction counterparty is unable to make corresponding income tax deduction adjustments, causing burden of double taxation at group level
Adjustment through service fee	Obtain profit compensation through collection of a service fee	Able to achieve efficient receipt of payment under the remittance item of service fee	The service transaction may lack substance; as a result, the service fee expense of its transaction counterparty may not be deductible for tax purposes The profit compensation collected by China domestic companies under the item of service fee will create indirect tax (e.g., VAT) obligations
Year-end transfer pricing special adjustment	Make specific TPAs to the prices of transactions already conducted by issuing debit or credit vouchers	Accurately reflect the correction of discrepancy between pricing policies and implementation result	Difficulties exists in implementing foreign exchange receipts and payments in practice

Among the year-end adjustment methods listed in the table above, the year-end transfer pricing special adjustment is the most common method used by MNEs in the international transfer pricing practice. Under a transfer pricing special adjustment, companies can rectify the deviation between the pricing policy of the transaction conducted and its implementation result. Since the debit or credit vouchers issued are for the adjustments of existing transactions, a profit compensation still may be achieved through the original form of the existing transaction without creating a new one.

However, in view of China transfer pricing practices — given the lack of explicit policy guidance established by the foreign exchange administration in China regarding the handling of such foreign exchange receipts and payments — companies were unable to implement this method even if TPAs were made from an accounting perspective.

In 2021, in light of issuance of updated policies by the SAFE for handling profit compensation for foreign exchange receipts and payments for MNEs, domestic companies now may be able to reassess the feasibility of making year-end adjustments. According to Question 1, which addresses how banks handle profit compensation for foreign exchange receipts and payments of multinational companies under special tax adjustments in the *Q&A on Policies for Foreign Exchange Management of Service Trade* ("the Q&A on Policies") issued by the SAFE on January 19, 2021, when handling the foreign exchange receipts and payments for enterprises, banks must review the authenticity and rationality of transactions and the consistency between transactions and foreign exchange receipts and payments in an appropriate manner under the principles of "Know Your Customer, Know Your Business, Customer Due Diligence." Materials required from companies include written documents issued by tax or customs authorities, profit adjustment agreement, and invoices, among others.

Observation: The issuance of the Q&A on Policies in 2021 can be considered a response from the foreign exchange administration to the needs of China domestic companies to handle profit compensation receipts and payments, and is a positive sign that the foreign exchange administration is considering more efficient business practices.

The takeaway

Companies should assess as soon as possible whether the implementation result of transfer pricing policies for the current year requires a year-end adjustment — particularly companies with current forecasted profits that may fail to achieve the target profit level — and analyze the appropriate year-end adjustment method and evaluate the amount of the year-end adjustments. When assessing the proposed year-end adjustment method, in addition to considerations from a transfer pricing perspective, companies also may need to communicate with multiple concerned parties on the feasibility of a year-end adjustment, including but limited to:

- Before year-end account closing, companies that require a year-end adjustment must calculate the amount to be adjusted under the appropriate method based on the most appropriate transfer pricing method so that the correct adjustment amount is invoiced and recorded.
- Apart from including an explanation of the year-end adjustments in the contemporaneous documentation (if applicable), particularly for profit-downward adjustments, taxpayers should seek to engage with the tax authorities on the adjustment plan to be completed before tax return filing at the end of May next year.
- Since the SAFE and Customs maintain certain flexibility with respect to retroactive adjustment, discussions should be held with the relevant authorities as early as possible — depending on the actual circumstances of the company — so that the company can seek to make TPAs in a compliant and timely manner.

See also

- TP Talks: The time is now: year-end TP adjustments in China

Let's talk

For a deeper discussion of how this development might affect your business, please contact:

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