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Bridging the Gap – Applying the ALP in China

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Challenges

- Lack of comparables
- Quantification and allocation of LSAs
- Identifying and pricing intangibles
- Miscellaneous
  - Single function subsidiaries
  - Contract R & D
  - ....

Lack of comparables

- Reasons
  - Limited number of public companies
  - Vertical simple-function FDI such as toll manufacturing
- Reactions
  - Adjustments to account for the differences in geographical comparability when applying TNMM
  - Different methodology (profit split replacing CUP)

LSAs

- Rational of economics: comparative advantages
- Components: cost savings + market premium
  - Cost savings: factor price + natural endowments + externality etc....
  - Market premium refers to qualities impacting the supply and demand: market size + industry policy (incentives / disincentives, market access) + consumption tendency etc....

LSAs (Cont'd)

Four-step approach

- Identify if an LSA exists.
- Determine whether the LSA generates additional profit.
- Quantify and measure the additional profits arising from the LSA.
- Determine the transfer pricing method to allocate the profits arising from the LSA.

LSAs: sample case

A Chinese taxpayer performing services for an offshore affiliate, and the full cost mark up (“FCMU”) is used as the profit level indicator for a comparable set comprising of foreign companies located in developed countries (and hence, incurring higher costs). Assuming that the Chinese taxpayer’s cost base was 100, the average cost base for the company’s service centres in developed countries was 150, and the median FCMU of the comparables was 8%.

LSAs: sample case (Cont'd)

	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	12 / 100 = 12%

Intangibles

- Overpricing
- Marketing for materializing brand name
- Know-how force attenuation VS royalty decrease
  - 3% royalty payment in 2002
  - 3% royalty payment in 2012 ?

Miscellaneous

- Sole function entities should not share losses of the group if ....
- A group with multiple single function entities in China are considered in entirety for the returns of the entities.
- Cost plus not adequate for contract R&D, profit split more appropriate.
- ....

Concluding remarks

Fair distribution of profit

Thank you