

## Corporate Tax - China

### Information Exchange: A Warning to Foreign-Invested Enterprises?

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As part of a five-year investigation into a Xiamen company in relation to tax avoidance, the State Administration of Taxation undertook its first successful exchange of information with a counterpart tax authority for the purpose of investigating related-party transactions. The authorities have not identified the country that provided the information, but have stated that the information exchange was used to confirm whether the parties in question were related under Chinese tax law and therefore whether its provisions on transfer pricing applied.

The name of the company has not been revealed; however, the structure that it used is common in China. A foreign-invested enterprise was established in Xiamen almost 20 years ago to manufacture shoes. The enterprise was established essentially as an original equipment manufacturer and did not retail the shoes that it produced. The business's production and profitability stabilized, but its reported profits remained low, even though the four initial production lines expanded to 14, annual production capacity more than doubled to 10 million pairs of shoes and the company capital was increased from \$400,000 to \$9 million.

Suspicious of the low profits, the authorities began investigating the company's affairs in 2004. It became clear that the foreign-invested enterprise had one principal client, a US company. The foreign-invested enterprise had a poor tax record generally, having previously been subject to tax adjustments. Furthermore, at some stage the ownership of the equity in the foreign-invested enterprise had been transferred to a nominated individual. The authorities suspected that the equity had been transferred to avoid the appearance of a related-party transaction, but they had no evidence. In order to invoke the transfer pricing rules, the authorities had to establish that the foreign-invested enterprise and the US company were related parties.

In response to the authorities' enquiries, the foreign-invested enterprise argued that there was neither an investment relationship (as the US company was not a shareholder) nor a common senior management between the two companies. Accordingly, it argued that the two companies had an ordinary commercial relationship. Despite the obvious concerns arising from the nature of the business, the authorities could not acquire sufficient evidence to establish a related-party nexus.

At some point in 2007 or 2008 the authorities decided to proceed with an exchange of information about the companies with their counterparts in another country. This exchange included information in relation to the US company's bank accounts that provided a vital clue: the controller of the US company's bank account was the individual shareholder of the foreign-invested enterprise. This fact established the requisite related-party nexus, as transfer pricing rules provide that two parties are related if one party largely controls the purchase and sales activities of the other. The discovery meant that it was probably no longer necessary to prove that the US company controlled the foreign-invested enterprise, as the fact that the foreign-invested enterprise's business was essentially for the supply of the US company would likely be sufficient.

This case demonstrates the authorities' attitude to related-party transactions and the problems with structures that were adopted under an earlier fiscal policy. The many foreign-invested companies in China that have adopted similar structures are likely to be targeted in the next 12 months. Moreover, this success may well encourage the authorities to undertake further information exchanges. Companies doing business across jurisdictions should follow these developments closely.

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