



XIAMEN TAX CASE: 5 YEAR LONG INVESTIGATION BEARS FRUIT FOR SAT

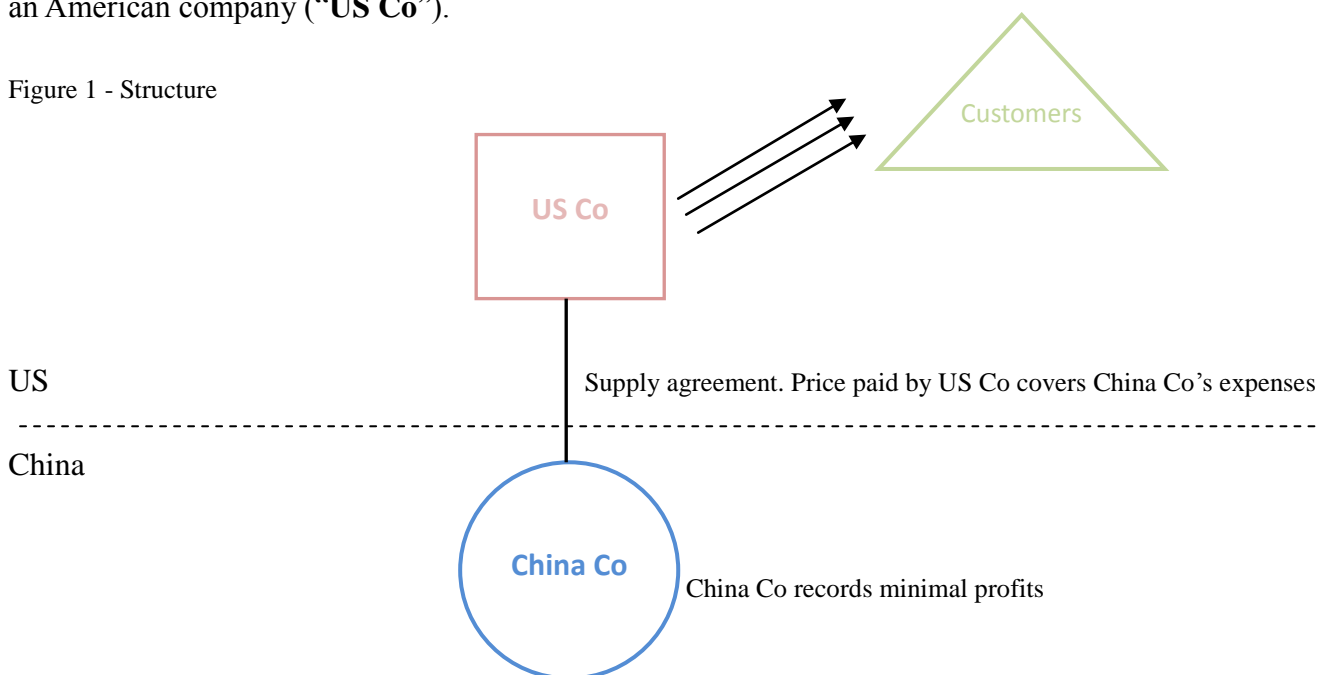
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In a five year investigation into a Xiamen company in relation to tax avoidance, the State Administration of Taxation (the “SAT”) has for the first time successfully used information exchange with counterpart tax authorities (the report does not indicate which country provided the information) for the purpose of investigating related party transactions. In this case the information exchange was used to confirm whether the parties were actually “related” for the purpose of China’s tax law and therefore whether the transfer pricing provisions were applicable.

The name of the company has not been revealed by the tax authorities. However, the structure utilised was a very common one. A foreign invested enterprise (“China Co”) was set up in Xiamen almost 20 years ago for the purpose producing leather and polyurethane (a rubber like material) shoes. The enterprise was basically established as an original equipment manufacturer (OEM) and did not retail the shoes it produced. Overtime the business developed a stable level of production and profitability. However, China Co’s reported profits remained low. This was despite the fact that the scale of the operations expanded from an initial 4 production lines to 14 production lines, that annual production capacity increased from 4 million pairs of shoes to 10 million pairs and that the capital of the company was increased from \$400,000 to \$9,000,000.

The tax authorities looked cynically on such low profits and in 2004 began investigations into the company’s affairs. Through these investigations it became clear that China Co had one principal client, an American company (“US Co”).

Figure 1 - Structure



China Co also had a poor tax record generally, having previously been subject to tax adjustments. Further, at some stage, the ownership of the equity in China Co was transferred to a nominated



individual. The SAT formed the view that this was done to avoid an appearance of a related party transaction, but had no evidence to prove this. It was incumbent upon the SAT (in order to invoke the transfer pricing rules) to establish that China Co and US Co were related parties. In response to the tax authorities enquiries, China Co argued that there was neither an investment relationship (US Co was not a shareholder in China Co) nor any common senior management between the two companies. Accordingly, China Co argued that this was an ordinary commercial relationship. Despite the obvious concerns arising out of the inherent nature that the business was run, the authorities had difficulties in acquiring sufficient evidence to establish a related party nexus.

In around 2007-2008, the authorities determined to proceed with an information exchange with their counterparts in a relevant country in relation to the companies. This information exchange included information in relation to US Co's bank accounts. The information provided established a critical clue – that the controller of US Co's bank account was the individual shareholder of China Co. This therefore established a requisite related party nexus.

It should be noted that the current transfer pricing rules provide that parties will be related where one party largely controls the purchase and sales activities of the other party. Its likely that proving that US Co controlled China Co would no longer be necessary. The fact that China Co's whole business was, in essence, for the purpose of supply China Co would likely be sufficient.

This case demonstrates the SAT's current attitude towards related party transactions and the problems with structures that were adopted in an earlier tax environment. The structure used in case is not dissimilar to many structures that have been adopted by foreign invested companies in China in the past. It is safe to assume that these structures will be heavily targeted by the SAT over the next 12 months. Cooperation by tax authorities on information exchange will continue to occur and attention needs to be paid to this by companies doing business across jurisdictions.

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