Transfer Pricing: UN Practical Manual – China

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TRANSFER PRICING: UN PRACTICAL MANUAL - CHINA

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Any contemporary Chinese transfer pricing assessment needs to consider the United Nation (UN) Practical Manual on Transfer Pricing for Developing Countries released in May 2013. In particular, Chapter 10 discusses Country Practices and presents China’s most up to date transfer pricing policy statement.

A cautionary note is in order. The detailed position in Chapter 10 has not yet been articulated in a new Circular. Nevertheless, there are risks in ignoring this very public State Administration of Taxation (SAT) statement on this matter.

China is not an Organization for Economic Cooperation and Development (OECD) member nor has it formally adopted the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Chapter 10 makes it very clear that China is charting a different transfer pricing course in at least nine important areas. China believes that:

1. significant comparability adjustments are needed when comparable sets are drawn from developed countries such as Japan, Korea, Australia, and New Zealand;
2. the transactional net margin (TNMM) is considered overused and inaccurate;
3. location savings must be reflected in the costs included in a cost-plus mark-up for research and development conducted in China;

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2 The authors of the China Chapter are: Tizhong Liao, Deputy Director of the International Taxation Department of the State Administration of Taxation (People’s Republic of China) and Wang Xiaoyue, Director of Anti-Avoidance Division of the International Taxation Department of the State Administration of Taxation. Sebastian Gonnett, Location Specific Advantages – China, TRANSFER PRICING INTERNATIONAL JOURNAL (October 14, 2011) 261 indicates:

Not all the new principles under the China Chapter of the UN Manual have been put into practice yet. Perhaps, the purpose of the China Chapter of the UN Manual is to seek endorsement from the United Nations for the positions it outlines. However, the State Administration of Taxation has expressed officially that it will incorporate these positions into law in 2013. And some tax officials are already adopting certain of these positions, like the market premium, during audits.

3 Organization of Economic Cooperation and Development, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995) & (2010) available at: [http://www.oecd.org/dataoecd/23/12/45763692.pdf](http://www.oecd.org/dataoecd/23/12/45763692.pdf). Prior to 2009 Chinese regulations listed acceptable transfer pricing methods without guidance on how to apply them. The general appeal at that time was to the “international standards” that were referenced, which was understood by most practitioners to provide the linkage that was wanted to the OECD Guidelines. Circular 2 (in 2009) provided detailed guidance on acceptable Chinese transfer pricing methods, as well as the factor analysis that needed to be applied in this analysis. The details in Circular 2 are generally consistent with the OECD Guidelines. This makes the discussion in the UN Practical Manual a departure from had been assumed to be the Chinese norm.

4 The authors of the China Chapter are: Tizhong Liao, Deputy Director of the International Taxation Department of the State Administration of Taxation (People’s Republic of China) and Wang Xiaoyue, Director of Anti-Avoidance Division of the Inter- national Taxation Department of the State Administration of Taxation.
4. toll manufacturers will be converted into contract manufacturers with tightened rules (i.e. adding back cost of materials rejecting return-on-assets analysis);
5. limited risk distributor status is denied for brand building distributors (those that have significant advertising, marketing, and promotion activities);
6. market premiums must be reflected in Chinese profits;
7. tax haven based intellectual property ownership can be “looked through” or denied (Art. 94, Circular 2);
8. cost-plus methodology is rejected when a Chinese related party qualifies as an intangible developer under “high and new technology status” (HNTS);
9. royalty adjustments over time are necessary;

The Chinese approach to transfer pricing or at least the approach presented in the Practical Manual uses familiar OECD terminology but it places a very different emphasis on some basic concepts in the OECD Guidelines. Chapter 10’s overall intent is to shift income back into China in direct contrast to the result under standard OECD practice.

The Brazilian transfer pricing regime outlined in the Practical Manual can be compared with the Chinese approach yet the differences between the two regimes are easy to spot. Brazil stresses the methods’ simplicity, safe harbors, and fixed margins. The Brazilian\(^5\) based resale price method encourages exports and stimulates foreign direct investment in domestic manufacturing\(^6\). The Chinese emphasis is different because China has a strong export profile and expects the climate for foreign direct investment to continue to be robust.

Economic projections bear this out on both the demand and the supply side. Chinese consumption (demand) is expected to be very strong, well into the 21\(^{st}\) century. China’s economy is estimated to become twice as big as that of the United States and according to a leading Chinese economist larger than both the United States and the European Union combined by 2030. Other economists are more guarded, and the consensus is that China’s GDP will be equal to the United States by 2020 and double the United States by 2050\(^7\).

The Chinese supply side is also strong, fueled by low cost labor and lower costs for doing business. For example, Sebastian Gonnett indicates\(^8\) that hourly compensation costs in China averages $2.36/hour compared with $33.53/hour in the US and $37.46/hour in the EU-15 countries. In fact, India is the only BRIC (Brazil, Russia, India, and China) market with a lower average hourly rate. For example, Brazilian labor

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\(^5\) The resale price methods are: \textit{Preço de revenda menos lucro} (PRL) – for imports; \textit{Preço de Venda por Atacado no País de Destino, Diminuído do Lucro} (PVA) – for wholesale exports; \textit{Preço de Venda a Varejo no País de Destino, Diminuído do Lucro} (PVV) – for retail exports.

\(^6\) Richard T. Ainsworth, \textit{Transfer Pricing: UN Guidelines – Brazil}, TAX NOTES INTERNATIONAL (forthcoming)

\(^7\) Shanwu Yuan, Jinghua Liu, & Glenn DeSouza, \textit{Changing Transfer Pricing Landscape: “Like It or Not,”} INTERNATIONAL TRANSFER PRICING JOURNAL (July/August 2013) 259.

\(^8\) Sebastian Gonnett, \textit{Location Specific Advantages – China}, TRANSFER PRICING INTERNATIONAL JOURNAL (October 14, 2011).
costs are roughly four times higher than Chinese at $8.32/hour. In addition, even though measured in hours, the average annual tax compliance cost in China is 398 hours or roughly twice that in the US at 187 hours and the EU-15 at 170 hours it is quite small in relation to the Brazilian cost at 2,600 hours.

Perhaps the most compelling figures come from comparing population and market size, as measured by the World Economic Forum’s Market Size Index. The Index runs from 1 to 7 (the higher number indicating the larger market). On the Population & Market Size Index the US measures 6.9, while China measures 6.7. The US population (309 million people) is much smaller than the Chinese (2.4 billion people), but their relative market sizes are similar. This makes the following market observation critical. The Chinese middle class is expected to expand to 50% of the population in the next two decades, and this will drive a huge increase in Chinese consumption. China will be at the top of the Index.

In contrast, the Brazilian population is 197 million and its market size is at 5.6. Thus, even though Brazil has more market growth potential than China, its population base is much smaller. This translates into lower overall commercial growth expectations. China’s growth will be many multiples higher than Brazil’s.

Thus, the Chinese market economics strengthens the SAT’s hand and encourages more forceful transfer pricing policies. This is the case even though these policies diverge from OECD norms. Collectively, China, unlike Brazil is not concerned that aggressive transfer pricing enforcement will negatively impact its economic growth.

This paper considers the nine major areas where the Chinese position in the UN Practical Manual differs from positions in the OECD Guidelines. Because the Chinese section in the Practical Manual is only concerned with the methods used to determine an arm’s length price and not the related party definition, this paper will only address the methods.

\[9\] Id., at Figure 2 (referencing data sources at Bloomberg Law Services and the Conference Board Total Economy Database).
\[10\] Id., at Table 2 (referencing data from the World Bank).
\[12\] All transfer pricing is really about only two issues: (1) are the parties related, and (2) can the arm’s length price for transactions between these related parties be determine by one or more of certain specified methods. The Chinese rules on related parties are different from the OECD’s definitions, and they include:

- **25% shares ownership** – One party directly or indirectly holds a total of 25 percent or more of another party’s shares; or a third party holds, directly or indirectly, 25 percent or more of the shares of both parties. Where an entity owns more than 25 percent of an intermediary entity, its indirect ownership of the lower tier entity will be deemed to be the same as the intermediary’s direct ownership of the lower tier entity;
- **Debt held** – Debts owed by one enterprise to another enterprise (other than an independent financial institution) reach 50 percent of the enterprise’s capital, or 10 percent or more of the total debts owed by one enterprise is guaranteed by another enterprise (other than an independent financial institution);
- **Senior management** – More than half of one party’s senior management personnel (including the members of the board of directors and managers), or at least one member of the board of directors
This discussion is divided into the three themes that are woven throughout the Chinese contribution to the UN Practical Manual. The themes interlock and encompass the nine major Chinese/OECD variances. The themes flow into one another and are not always easy to replicate as stand-alone propositions. Collectively, they are the “difficult challenges” for which the Chinese believe that “ready answers have not been found in the OECD Guidelines”\(^{13}\). The themes are: (A) reliable comparables; (B) quantifying and allocating location specific advantages; and (C) identifying and valuing intangibles.

**A. Reliable Comparables**

Unlike Brazil,\(^ {14}\) China recognizes that identifying comparable transactions is central to the transfer pricing analysis.\(^ {15}\) It also accepts that when there are no comparable transactions, alternative comparisons can be made with unrelated companies that perform similar functions, own similar assets, bear similar risks, and operate under comparable circumstances\(^ {16}\) provided adjustments are made to facilitate comparison.

The Chinese position is that a “key challenge” for a developing country is the lack of reliable public information on comparables. As a result, “in practice,” foreign companies routinely use comparable sets that are “dominated by companies in developed countries, simply because there are usually a much larger number of public companies in

who is able to exert control over the board of directors is appointed by another party; or two parties with more than half of their senior management personnel (including the members of the board of directors and managers), or at least one senior member of the boards of directors who is able to exert control over the board of directors is appointed by the same third party;

- **Senior Management** – More than half of one party’s senior management personnel (including the members of the board of directors and managers) concurrently hold senior management positions (including the members of the board of directors and managers) of another party, or at least one senior member of the board of directors who is able to exert control over the board of directors concurrently is a senior member of the board of directors of another party;

- **Intangible assets controlled** – One enterprise’s normal production and operation activities are dependent on intangibles licensed from another enterprise (including industrial property rights or patented technology);

- **Purchase/Sales controlled** – Purchases or sales by one enterprise are under the control of another enterprise;

- **Services** - One enterprise’s provision or receipt of services is primarily determined by another enterprise; and

- **Actual control** – One enterprise has actual control over the other enterprise’s production, operation, and trading activities through relationships associated with other interests (including family relationships).

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13 UN, *Practical Manual* at ¶ 10.3.1.2.
14 Brazil uses annual averages, and prescribes fixed margins by statute rather than using comparable transactions to determine gross margins and mark-ups. As Tatiana Falcao indicates: The Brazilian transfer pricing system is unique in that Brazil has developed an objective method that allows the taxpayer to mathematically determine and prove its pricing benchmark without having to go through a search for comparables.

16 UN, *Practical Manual* at ¶ 10.3.2.1. OECD, *Guidelines* (2010) at ¶ 1.35 & 1.36 (discussing “appropriate adjustment to establish arm’s length conditions (or a range thereof)”).
these countries."\(^{17}\). Using these companies is not a problem for Chinese tax authorities but rather the problem is using them without applying appropriate adjustments. The Chinese position is that when making these developed/developing country comparisons “significant comparability adjustments” are necessary.

The next point is critical. What happens if acceptable adjustments cannot be made? Transfer pricing systems have answered this question in two ways:

- If sufficiently acceptable comparables cannot be found, even after adjustments have been made, then statistical methods can be used to smooth out the database and derive a reasonable result, and
- If sufficiently acceptable comparables cannot be found, even after adjustments have been made, then there are no comparables. The arm’s length result must therefore be determined with a method that does not rely on comparables and the only method in that case is a profit-split.

US tax regulation champion the first position by allowing inexact comparables since 1994.\(^{18}\). Statistical methods like an inter-quartile range are accepted as mechanisms that improve accuracy. In 1995 the OECD Guidelines rejected this approach. The OECD’s position was that inexact comparables that could not be effectively adjusted were simply not comparable and there was nothing else that could be done.\(^{19}\) Yet, in July 2010 the OECD changed its position so the OECD is now more closely aligned with the US.\(^{20}\)

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\(^{17}\) UN, PRACTICAL MANUAL at ¶ 10.3.2.2.

\(^{18}\) Treas. Reg. §1.482-1(e)(2)(iii)(B).

If there are no uncontrolled comparables described in paragraph (e)(2)(iii)(A) of this section, the arm’s length range is derived from the results of all the uncontrolled comparables, selected pursuant to paragraph (e)(2)(ii) of this section, that achieve a similar level of comparability and reliability. In such cases the reliability of the analysis must be increased, where it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables so selected. The reliability of the analysis is increased when statistical methods are used to establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure. (emphasis added)

\(^{19}\) OECD (1995) Guidelines ¶1.15 & 1.16.

In all cases adjustments must be made to account for differences between the controlled and uncontrolled situations that would significantly affect the price charged or return required by independent enterprises. Therefore, in no event can unadjusted industry average returns themselves establish arm’s length conditions. (emphasis added)


Where there are differences between the situations being compared that could materially affect the comparison, comparability adjustments must be made, where possible, to improve the reliability of the comparison. Therefore, in no event can unadjusted industry average returns themselves establish arm’s length conditions. (emphasis added)
What is the Chinese position? China follows the 1995 OECD position. China prefers a profit split when comparables cannot be adequately adjusted. In the UN Practical Manual China states that, "In some cases, it may require a different methodology such as profit split as no sufficiently reliable comparability adjustment may be feasible"\(^{21}\). China is not alone in this regard. New Zealand’s Inland Revenue holds much the same opinion.

The best comparables are those that exhibit key economic characteristics closest to the targeted company or transaction. Our policy guidelines require the consistent use of one or more reliable comparables. "Industry data dumps" are not acceptable, even if additional statistical analysis is provided using various measures of central tendency (such as inter-quartile ranges, medians and averages). Statistical tools may to some extent enhance the reliability of data carefully selected, but cannot enhance inappropriately selected comparables. Regression analysis too, is only as good as the robustness of the model employed, the underlying assumptions and the data input\(^{22}\).

As a consequence, the Chinese position in the UN Practical Manual puts exceptional pressure on a MNEs transfer pricing analysis. It is very likely that the comparable profits (CPM)\(^{23}\) transfer pricing methodology will be adopted on the transactions’ US side (for example) with a well-marked interquartile range spread over a three year data period. The Chinese side for this same transaction may need to be a profit-split\(^{24}\) so the tax outcomes for the same transaction may in fact differ.

Two issues are related under this heading. China objects to both using unrestrained developed country comparables and to excessively using the transactional net margin (TNMM) or in US terms the comparable profits (CPM) methods. These issues will be considered separately for this paper although in the UN Practical Manual they are frequently considered close together. For example, the China Chapter states:

One of the most common adjustments in China [presumably referencing an adjustment made by the SAT] is accounting for differences in geographic comparability when applying profit-based transfer pricing

\(^{21}\)UN, PRACTICAL MANUAL at ¶ 10.3.2.3 (emphasis added).
\(^{22}\)New Zealand Inland Revenue, TRANSFER PRICING PRACTICE ISSUES, Comparables (December 1, 2010).
\(^{23}\)Treas. Reg. §1.482-5(e).
\(^{24}\)Consider Treas. Reg. §1.482-5(e)(Ex. 4) which uses a CPM to determines royalty amounts paid by a wholly owned US manufacturing subsidiary in Foreign jurisdiction H, and where no comparable data is found with any firms in foreign jurisdiction H, but where manufacturing entities in two other foreign jurisdictions M and N are used in a CPM that uses three years of data to arrive at a statistical range. See also Treas. Reg. §1.482-8(b)(Ex. 9) which compares the use of a CPM and a profit split in a fact pattern where there are comparable foreign manufacturing firms in the same foreign jurisdiction, but consider the possible alternate outcome if these comparables were not available, or were found in a different jurisdiction.
methods such as the Transactional Net Margin Method (TNMM), to determine an arm’s length price\(^{25}\).

\((1)\) Developed country comparables

China argues that geographic adjustments are almost always needed when MNEs propose using developed country comparables to determine a developing country arm’s length price. Baker and McKenzie observes that this argument is based on countries like Japan or Korea having low risk and low inflation rates and thus have lower overall profit\(^{26}\).

The target for Chinese criticism is likely an example like that in Treasury Regulation §1.482-5(e) Example 4 where a US high tech widgets developer manufactures them through a wholly owned foreign subsidiary, earning a 5% royalty for its manufacturing efforts. The finished product is then sold back to another US marketing subsidiary at an arm’s length price. As a result, the transfer pricing question focuses on the royalty.

If we assume that the manufacturer is located in China and the other two countries involved are Japan and Korea, then the example is precisely on point with the Chinese argument in the UN Practical Manual. Treasury Regulation §1.482-5(e) Example 4 at (iii) could be re-drafted as follows:

Uncontrolled taxpayers performing similar functions cannot be found in country H [China]. It is determined that data available in countries M [Japan] and N [Korea] provides the best match of companies in a similar market performing similar functions and bearing similar risks. Such data is sufficiently complete to identify many of the material differences between ManuCo and the uncontrolled comparables, and to make adjustments to account for such differences. However, data is not sufficiently complete so that it is likely that no material differences remain. In particular, the differences in geographic markets might have materially affected the results of the various companies\(^{27}\).

Even though material differences remain and even though these differences appear to be attributable to differences in the geographic market, example 4 shows how the US will proceed even with inexact comparables. Because the goods sold back to the US Sub (MarkCo) are found to be arm’s length, the example assumes that the entire reason for differences between the tested party (ManuCo) in foreign jurisdiction H and the inexact comparables in foreign jurisdictions M and N is the royalty paid to the US Parent\(^{28}\).

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25 UN, PRACTICAL MANUAL at ¶ 10.3.2.4.
27 Treas. Reg. §1.482-5(e)(Ex. 4) at (iii) (emphasis added).
28 This is the same situation presented in two Australian cases where the transactional net margin method was rejected by the court. In Roche Products Ltd. v. Federal Commissioner of Taxation (2008) AATA 639 at ¶185, Judge Downes observes:
The example shows that there are excess profits in foreign jurisdiction H [China] and then concludes that these profits should be transferred back to the US Parent through a royalty adjustment. The comparable profits method increases the royalty by the excess three-year average profit [$21,500] over the forecasted 1996 profit based on the selected PLI [Operating profit / Operating Assets]. The PLI was derived from analyzing the financial data from the inexact comparables.

A $21,500 royalty adjustment is made because the median operating profit should be $3,750 based on applying the PLI while the actual operating profit in 1996 is $25,250. Figure 1 presents Treas. Reg. §1.482-5(e) Example 4 in diagram form.

One of the problems of profit based methodology is that, when applied to transfer pricing, it inevitably attributes any loss to the pricing. Where operating expenses are higher these may place some of the emphasis of the cause of the loss on the wrong area. After all, it is certainly true that there are companies, which make losses for reasons other than the prices for which they acquire their stock. The Australian operations of multinational companies are not necessarily excluded from this.

This is the precise turning point in another Australian case, where Judge Middleton similarly decided against the Commissioner referencing the Roche decision, SNF (Australia) Pty. Ltd. v. Commissioner of Taxation 2010 FCA 635 at ¶131. See also: Michael Butler & Jessica Pengelly, Federal Court Rejects Commissioner’s Attempt to Use Transactional Net Margin Method, INTERNATIONAL TRANSFER PRICING JOURNAL 43, 45-46 (January/February 2011).
This example presents the Chinese case. China would prefer a different outcome than the US regulations provide. The fact that many but not all material differences are identified in this example suggests to a Chinese reader that a TNMM (or CPM) should not be performed until those remaining material adjustments can be made. By identifying Jurisdictions H, M, and N as China, Japan and Korea the Chinese concern in the Practical Manual becomes clear.

The material differences in the example are differences in the geographic markets, but now these different geographic markets can be seen as the Chinese see them. These are differences between developed and developing countries.

China contends that the fundamental reason for unresolved material differences has to do with the lower risks to doing business and the lower inflation rates in developed countries. As a result, a royalty rate based on developed country markets is not comparable to what should be paid by a Chinese firm. The Chinese royalty should be considerably lower. In other words, at arm’s length a Chinese firm would demand higher profits (through lower royalty payments), and if adjustments cannot be made to reflect this, then a profit-split should be adopted.

(2) Transactional net margin method (TNMM/CPM) Overuse

Baker & McKenzie indicate that the TNMM or the comparable profits method (CPM) is used in over 95% of all transfer pricing documentation prepared to date\(^29\). This figure may be on the high side because other evidence suggests that the number is closer to 50% for all company documentation in certain jurisdictions\(^30\). While there is nothing wrong if the TNMM is applied accurately, the Chinese position is that this is generally not the case so TNMMs should be used sparingly and instead a profit-split should frequently be preferred.

When TNMMs are applied to a Chinese company, China insists that adjustments are needed to both PLI valuations and to measure the domestic cost base. Two fact patterns present these objections:

- developed country comparable adjustments – data drawn from developed country comparables needs to be adjusted for geographic differences before it is used to calculate the PLI that will measure the profitability of Chinese firms; and
- cost base adjustments – special adjustments are needed to account for location specific advantages when a full cost mark-up (FCMU) is applied to a Chinese cost base.

The first pattern was considered above while the second is considered below. Both objections are variations on an overriding Chinese theme in the UN Practical


\(^30\) India: CBDT Resisting TNMM, Pushing CUP Method, Demanding Affiliates’ Data, Practitioner Says, 13 TAX MANAGEMENT TRANSFER PRICING REPORT 627 (Oct. 13, 2004) (citing officials from the Central Board of Direct Taxes that the TNMM was the most popular pricing method among Indian taxpayers, approximating 50%, even though the CBDT prefers the CUP method).
Manual, the OECD’s transfer pricing rules need to be applied more carefully to developing countries. The most common context where cost base adjustments are needed is in contract manufacturing.

Contract manufacturing is one of the most common forms of manufacturing used by MNEs in China, particularly dealing with manufacturing products for export. In evaluating a contract manufacturer's return, the TNMM is often used as the transfer pricing method with the FCMU being the most commonly used profit level indicator.31

The US argues against this position in the location savings example at Treasury Regulation §1.482-1(d)(4)(ii)(B). Here location savings from contract manufacturing (garment sewing) in one low cost jurisdiction are transferred back to the parent company because other buyers can secure similar low cost manufacturing services in a second and a third jurisdiction.

A further example, Treasury Regulation §1.482-9(f)(3) Example 1 reinforces the US opinion. Here related parties (parent and subsidiary) manufacture in different jurisdictions. Additionally, the parent provides advertising services for the subsidiary. A CPM is proposed because “… no data is available for comparable independent manufacturing firms that render advertising services to third parties … [but] … financial data are available, however, for ten independent firms that render similar advertising services as their principal business activity.”32

The PLI is operating profits in relation to total services cost or in China section of the UN Practical Manual terms, a TNMM with a full cost mark-up. A cost-plus methodology is rejected because it is not possible to “…determine whether these comparable companies report costs for financial accounting purposes in the same manner as the tested party…”33. The striking part of this example is that all ten comparable companies are in a third jurisdiction.

The question presented concerns the arm’s length price for the advertising services the parent’s employees rendered from parent company offices. Figure 2 diagrams this example:

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31 UN, PRACTICAL MANUAL at ¶ 10.3.5.5.
32 Treas. Reg. §1.482-9(f)(3)(Ex.1)(ii)
33 Treas. Reg. §1.482-9(f)(3)(Ex.1)(iii)
If we add specificity to Treasury Regulation §1.482-9(f)(3) Example 1 we can make it more realistic and relevant to this discussion. Suppose Country T is China and Country Y is the US. Suppose further that Company B is the parent and Company A is the subsidiary. We can then say that Company B in the US has set up a manufacturing subsidiary in China to manufacture and sell one product line out of many manufactured in the US.

In this context it would seem reasonable that the US parent would seek the Chinese subsidiary’s assistance to help advertise all its products in the Chinese market. Although it may have other advertising outlets in the US and elsewhere, the Chinese market is considered culturally and linguistically unique (emphasis added). We could further suppose that there is a long-term plan to transfer more manufacturing to China if the Chinese market develops and proves receptive to all Company B’s products.

In this context, it would seem reasonable that public data on other local Chinese manufacturers that advertise for their foreign parents would be hard to find. It might also be hard to find public data on independent advertising firms in China. Where then do the regulations’ authors believe the ten independent advertising firms are located? The answer is most likely they are located in developed countries. If they are from Japan and Korea, then from a Chinese perspective Treasury Regulation §1.482-9(f)(3) Example 1 replicates the problem from Treasury Regulation §1.482-5(e) Example 4.

Treasury Regulation §1.482-9(f)(3) Example 1, however, presents an additional issue for China. This is a FCMU hypothetical and the cost base does not “… take into
consideration the location savings. Treasury Regulation §1.482-1(d)(4)(ii)(B) makes it clear that the US will not attribute location savings to a service provider where similar services at the same cost can be obtained elsewhere, albeit in developing countries.

As a result, the Chinese position is that a TNMM will routinely undervalue returns if the PLI is largely derived from developed countries and the cost base is kept low because there are similar cost structures in other developing countries. Furthermore, if foreign providers cannot provide quality advertising services in China because China is a unique market, there may be additional (intangible) “advantages” in having a subsidiary assist with Chinese advertising. Figure 3 presents the modified Treasury Regulation §1.482-9(f)(3) Example 1:

**Figure 3: Treas. Reg. §1.482-9(f)(3)(Ex. 1) – as modified**

![Diagram showing the situation of adversting services for A & B w/out intangibles in China, USA, and Japan/Korea.](image)

1. **B. Location Specific Advantages (LSAs)**

   The Chinese position on location specific advantages (LSAs) is integral to the Chinese position on TNMM’s excessive use and using developed country comparables. Location specific advantages (LSAs) are found on the supply and demand side for many

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34 UN, PRACTICAL MANUAL at ¶ 10.3.3.8.

35 This intangible element was specifically removed from Treas. Reg. §1.482-9(f)(3)(Ex.1), but it seems likely that factor would be present in a real world fact pattern.
commercial relationships. They are commonly called “location savings” on the supply side while referred to as “market premiums” on the demand side.

China makes a holistic argument for LSAs rather than a narrow argument for location savings simply derived from low wages or inexpensive factory inputs. Three LSA elements are considered:

- **LSAs are identified and computed on a net basis.** Cost savings, revenue increases, and additional expenses (dis-savings) need to be balanced.
- **LSAs need to be captured in economic profits.** If LSAs are not passed on to consumers in lower prices, then they are included in the Chinese profit profile. Market power to capture profits is critical.
- **LSAs are allocated among related parties in the commercial chain.** Because LSAs exist due to market power, determining relative bargaining position is critical to determining which party possesses the intangibles that enable market power to be exercised.

While the China Chapter in the UN *Practical Manual* considers four LSA permutations in some detail, there are many more applications. The next four sections consider R&D, toll manufacturers, brand-building distributors, and Chinese market premiums.

**(1) Cost-plus R&D markups**

In this segment the China Chapter provides a numeric example the shows exactly what is involved. An offshore affiliate secures contract R&D services from a Chinese related party at a 50% cost differential. What would have cost 150 to perform overseas can be done in China for 100. Rather than simply adding 50 to the Chinese cost base, the China Chapter converts the cost differential into an adjustment to the FCMU derived from a foreign developed country TNMM comparable. The result is rather than an 8% FCMU on the adjusted cost base, the arm’s length result is determined with a 12% FCMU on the actual cost base.

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36 UN, *Practical Manual* at ¶ 10.3.3.2. Location savings are the net cost savings derived by a multinational company when it sets up its operations in a low cost jurisdiction. Net cost savings are commonly realized through lower expenditure on items such as raw materials, labor, rent, transportation and infrastructure even though additional expenses ("dis-savings") may be incurred due to the relocation, such as increased training costs in return for hiring less skilled labor.

37 UN, *Practical Manual* at ¶ 10.3.3.2. Market premium relates to the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product.

38 UN, *Practical Manual* at ¶ 10.3.3.6. In the automotive industry China identifies a “market-for-technology” industry policy that requires joint ventures for auto assembly in China, Chinese consumer preference for imported brands, inelastic demand for vehicles in China, supply-side capacity constraints on domestically supplied vehicles, duty savings on imported parts (10% rather than 25%), and a large supply of high quality, low cost parts manufactured in China.
China’s situation is in stark contrast to the US when it faced a very similar fact pattern in *Westreco v. Commissioner.* Westreco provided contract research services for its foreign parent Nestec and defended its pricing with four comparable US companies that provided research and engineering consulting services as their core business function. Because good US comparables were found the case was resolved rather easily and so would most Chinese cases if there were a sufficiently robust Chinese comparables set. China’s argument in the UN *Practical Manual* is that the OECD needs to extend its analytical materials so that developing countries lacking public databases can reach reasonable arm’s length results.

(2) *Toll manufacturers converted to contract manufacturers*

MNEs set up manufacturing subsidiaries that adopt contracting structures to manage their tax profiles are called limited risk structures. Both toll and contract manufacturing arrangements are used, but there are differences between them.

- *Toll or consignment manufacturing* is an arrangement whereby the manufacturing entity is paid a fee for services, normally determined on a cost-plus basis. The applicable costs are labor and other direct costs involved in providing the service but not the raw materials used to make the finished product. The cost of goods and risk of loss for both materials and work-in-process never transfers to the toll manufacturer.

- *Contract or turnkey manufacturing* is an arrangement whereby the manufacturing entity is paid a fee for finished goods. The manufacturer purchases raw materials, frequently at a principal’s negotiated price with approved third-party suppliers. The manufacturer incurs inventory costs and risk of loss. The client sells raw materials to the manufacturer and completed goods are subsequently sold back to them. A manufacturing services fee is incorporated into the cost of the finished goods. The fee is commonly calculated in the same manner as the toll manufacturing charge on a cost-plus basis.

While toll manufacturing is a common MNE structure in developing countries, it causes problems for tax authorities because there are very few direct toll manufacturing comparables and almost none have publicly available data. As a result the Chinese observe that there are problems with getting an accurate PLI:

Some taxpayers simply use the FCMU for contract manufacturers as the mark-up for toll manufacturers. This grossly underestimates the return to toll manufacturers. Others use return on assets as a profit level indicator, using contract manufacturers as comparables, and this may also underestimate the return, particularly for toll manufacturers that are highly labor intensive, as is often the case in developing countries.

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39 *Westreco*, T.C. Memo 1992-561
40 The companies are Arthur D. Little, Inc.; Artisan Industries, Inc.; Gulf Machinery Company, Inc.; and Knechtel Research Sciences, Inc. (*Id.,* at *18*).
41 UN, *PRACTICAL MANUAL* at ¶¶ 10.3.2.1 & 10.3.2.2.
42 UN, *PRACTICAL MANUAL* at ¶ 10.3.5.8.
The Chinese solution appears to be taken directly out of US case law, specifically *Compaq Computer Corporation v. Commissioner*. Much like the taxpayer in *Compaq* convinced the court that it could adjust a US-based consignment manufacturing structure to match a turnkey manufacturing structure in Singapore, the Chinese SAT has stated that it will convert toll or consignment manufacturers to contract or turnkey manufacturers whenever it finds them. It will then apply a contract manufacturer’s PLI to the adjusted tax base.

*Compaq* is an important case because the Tax Court accepts the taxpayer’s comparables (in this case a CUP) even though the adjustments made are double the amount of the underlying transactions themselves. The IRS argued that the adjustments were too extreme, stating that Compaq’s comparables were “… not based on actual transactions and, therefore, [did] not satisfy the applicable regulations”. Ultimately, the IRS lost the argument, because the proposed comparables were accurately adjusted.

Compaq manufactured central processing units (CPU’s) for its personal computers (PC’s) at its Houston, Texas, Compaq Asia (Pte) Ltd. Singapore, and Compaq Computer Manufacturing Ltd. Scotland facilities. Among the materials required to manufacture CPU’s were printed circuit assemblies (PCA’s), the electronic circuitry inside a CPU that allows the PC to operate.

Compaq acquired PCA’s from three sources. Compaq (1) US manufactured some PCA’s in Houston, (2) purchased PCA’s from Compaq Asia, its wholly owned turnkey subsidiary in Singapore on a turnkey basis, and (3) purchased PCA’s on consignment from several unrelated subcontractors located primarily in the US. Compaq Asia provided half of Compaq’s PCA’s and the transfer pricing question concerned the appropriate price that Compaq should pay for them.

The adjustment started with the consignment prices Compaq paid to unrelated subcontractors which compensated them for labor, overhead, and a profit component for both. Because the subcontractors were primarily US-based, this adjustment captured all Compaq Asia’s labor and overhead savings along with standard materials costs plus a materials mark-up. Using Compaq’s US standard materials costs, labor, and overhead allowed Compaq Asia to retain all its’ Singapore location savings. This is precisely the result the SAT wants in China:

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44 There are additional problems with the PLI itself if it has been derived from developed country comparables, but that issue is not directly addressed in the *Practical Manual* in this section.

45 Between 1990 and 1993 Compaq purchased 3.6 million PCA’s from 14 unrelated subcontractors at an aggregate price of $197,535,045 on a consignment basis. Adjustments of $399,576,598 were needed to convert these transactions to turnkey equivalents.


47 The basic adjustment essentially eliminated most of the $232 million proposed deficiency.
In practice, the Chinese tax administration has sought to first estimate the total cost of the toll manufacturing operation as if it were a contract manufacturer, usually by adding back the costs of raw materials, which may be obtained from the customs administration. It then estimates the appropriate returns (say, FCMU) for contract manufacturing based on contract manufacturing comparables, and applies 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. 48

In Compaq the taxpayer set before the court two adjustment classes. These are probably the same adjustment types that China anticipates performing on audit. First, because Compaq Asia was a turnkey operation a basic adjustment converted the third-party PCA transaction consignment 49 pricing structures to turnkey 50 equivalents. Secondly, seven additional adjustments were made to account for minor differences in property or circumstances.

(3) Limited risk distributors and brand-building activities

It is not uncommon to find related distributors engaged in exceptional (extra-contractual) brand-building activities. This is not just a Chinese or developing country problem. The US has identified the same issue in both distributors and manufacturers.

Large markets like the US and strongly growing markets exacerbate this problem. When a MNE has a subsidiary in a market that shows great promise, perhaps a market like China or India with an expanding and affluent middle class, it does not matter if the subsidiary is primarily a distributor or a manufacturer. In either case the MNE is tempted to use its subsidiary’s local expertise for brand building. It is difficult to find a better brand-builder than someone with product-specific knowledge and deep experience with the local market.

This is the precise issue considered in Treasury Regulation §1.482-1(d)(3)(ii)(C) Example 3 51. In that example, a foreign wristwatch producer (FP) that is the global registered trademark holder establishes a US distributor (US Sub). The distributor pays a fixed price per wristwatch, and without separate compensation undertakes joint

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48 UN, PRACTICAL MANUAL at ¶ 10.3.5.9.
49 Compaq consigned raw materials and components to subcontractors, and the consignment price paid by Compaq compensated the unrelated subcontractors for their labor and overhead costs plus a profit on the labor and the overhead.
50 In the turnkey transactions the unrelated subcontractors purchased materials and components from suppliers on the Compaq authorize vendor list (AVL) paying the same prices as Compaq. The turnkey price paid by Compaq compensated unrelated subcontractors for materials, labor, and overhead as well as a profit mark-up on each.
51 Treas. Reg. §1.482-1(d)(3)(ii)(C)(Ex. 4) & (Ex. 5) present a similar fact pattern as Treas. Reg. §1.482-1(d)(3)(ii)(C)(Ex. 3). The difference being that in (Ex. 4) and (Ex. 5) a formal contract modification occurs in year 7, and the question is whether or not the modification is sufficient. In (Ex. 3) there is no prior modification. The entire provision needs to be added, and the question is what should this provision be.
marketing activities to establish FP’s trademark in the US. Unrelated foreign trademarked wristwatches producers and their authorized United States distributors undertake similar joint marketing activities in independent arrangements.

In years 1 through 6, however, US Sub does more. The example describes the US Sub engaging in “…incremental marketing activities in addition to the activities similar to those observed in the independent distribution transactions in the United States market …[and for these incremental services it is also]…not directly or indirectly compensate⁵².

In year 7, the FP’s wristwatches generate a premium return in the US in comparison to wristwatches marketed by independent distributors. The example therefore suggests, although there is no express statement to this effect that the premium return is due to the US Sub’s incremental marketing activities. The transfer pricing issue is narrowed to year 7 where substantially all the trademark’s premium return in the US is attributed back to FP “…through an increase in the price paid per watch, or by some other means”⁵³.

Treasury Regulation §1.482-1(d)(3)(ii)(C) Example 3 is narrowly focused on the contract between FP and US Sub because the contract is missing something. The IRS has the authority to impute terms when the parties’ course of conduct differs from economic substance. The suggestion is that once the contract is modified to align with the parties conduct, then the tax adjustment will not be hard to determine. In the US it is relatively easy to find marketing agencies providing comparable services and publishing pricing data. The return to the incremental marketing activities may be easy to calculate. In the example it was stated that it was easy to find data on independent distributors engaging in joint marketing activities.

The example suggests three contract modifications: a services agreement and two intangible licensing agreements. They are (see figure 4):

• imputing a separate services agreement that affords US Sub contingent-payment compensation for its incremental marketing activities in years 1 through 6 which benefited FP by contributing to the FP’s trademark value;⁵⁴
• imputing a long-term, exclusive agreement to exploit trademark in the United States that allows US Sub to benefit from the incremental marketing activities it performed; and
• requiring FP to compensate US Sub for terminating US Sub's imputed long-term, exclusive agreement to exploit the YY trademark in the United States.

⁵² Treas. Reg. §1.482-1(d)(3)(ii)(C)(Ex. 3) at (i).
⁵⁴ See for example, Ciba-Geigy Corp. v. Commissioner, 85 TC 172 (1985) (Ciba-Geigy, Ltd., a Swiss corporation (Geigy-Basle), had established a U.S. subsidiary in 1908 to market and sell agricultural, chemical, and pharmaceutical products in the United States (Ciba-U.S.). In 1951, Geigy-Basle initiated a research project to develop new defoliants and herbicides. Geigy-Basle filed patent applications in more than thirty-two localities, including the United States. Ciba-U.S. performed the work necessary to obtain U.S. registration. The IRS asserted the development of a US intangible, but the court imputed a services agreement.)
The Chinese reaction to the MNE’s sales, marketing, and distribution functions is the same as Treasury Regulation §1.482-1(d)(3)(ii)(C) Example 3. China sees many “limited risk distributors” in China where the MNE determines pricing by using “simple distributor” comparables from mature markets.\(^{55}\) This is a variation of the developed country comparables issue discussed above.\(^{56}\)

China is prepared to reject these “so-called comparables”\(^{57}\) based on functional differences and market differences evidencing that the fast-growing Chinese market is not comparable to a mature market in a developed country. Based on this observation, Japan-based comparables are specifically rejected. The litmus is comparing “median operating expense to sales”\(^{58}\).

The Chinese SAT indicates two approaches: (1) rejecting the TNMM and applying a profit-split method if “… significant local marketing intangibles or LSAs” are identified; or (2) accepting the TNMM methodology but insisting on both a base adjustment for location savings consistent with *Compaq’s* allocation to its Singapore subsidiary,\(^{59}\) and a re-determining the FCMU ratio in line with the R&D discussion.\(^{60}\)

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\(^{55}\) UN, *PRACTICAL MANUAL* at ¶ 10.3.5.10.

\(^{56}\) See text *supra* at n. 26 through n. 29.

\(^{57}\) UN, *PRACTICAL MANUAL* at ¶ 10.3.5.10.

\(^{58}\) UN, *PRACTICAL MANUAL* at ¶¶ 10.3.5.10 & 11.

\(^{59}\) See text *supra* at n. 41 through n. 50.

\(^{60}\) See text *supra* at n. 29 through n. 35.
Theoretically, China agrees with Treasury Regulation §1.482-1(d)(3)(ii)(C) Example 3 on how to solve this problem through either a services cost-plus approach or an intangibles-based profit-split. Practically, China is at a disadvantage because it lacks good domestic comparables.

(4) Market premiums reflected in Chinese profits

Market premiums are Location Specific Advantages (LSAs) on the demand side. They are critical to understanding transfer pricing policy in China, India, and South Africa. On the supply side the obvious LSAs are low wages and inexpensive raw materials. They fall neatly into the expression “location savings.” China would prefer to treat these LSAs in the same manner as they were treated in Compaq. In other words, they belong to China despite suggestions in Treasury Regulation §1.482-1(d)(4)(ii)(B) that they should be realized outside of China.

For LSAs on the demand side China makes a different argument. The scope of this argument is not observed, much less replicated in any US regulations. China understands the expression “market premiums” to include both: (1) the market itself that pays a premium because of its size, scope and character and (2) product-based premiums that are returned based on special characteristics of the product. The US understanding is that element (2) is a market premium. There is no reference to market premiums as described in (1) anywhere in the regulations.

There are a number of examples in the regulations setting out the US concern with a product that has special attributes and that will return a premium price. For example:

• Treasury Regulation §1.482-7(e)(2)(ii)(E) Example 6 concerning a premium price reasonably anticipated from marketing a new pellet form fertilizer;
• Treasury Regulation §1.482-4(f)(2) Example 1 and Treasury Regulation §1.482-4(c)(4) Example 4 concerning a premium price expected from marketing a new headache medication (No split) that is superior to all other medications available in the market;
• Treasury Regulation §1.482-1(d)(3)(ii) Examples 3 through 6 concerning the premium price generated from marketing trademarked wristwatches; and

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62 UN, Practical Manual at ¶ 10.5.4.3.
63 UN, Practical Manual at ¶ 10.3.3.2.
64 See supra at note 32 and following.
65 As a result the Chinese observe:

... it has been seen that certain issues such as location savings and market premium arise more frequently in China and other developing economies, rather than in established and developed economies (which comprise the bulk of the membership of the OECD).

UN, Practical Manual at ¶ 10.3.3.1.
• The un-numbered example in Treasury Regulation §1.482-1(d)(4)(ii)(B) concerning the premium price received from selling high fashion clothing manufactured sewn in a developing country.

China’s perspective is different. The Practical Manual isolates the automobile industry. China indicates that it has uncovered many other market premium examples in other industries, but it is selecting this industry for the Practical Manual discussion66. China notes:

• Global automotive companies set up joint ventures (JVs) in China to assemble automobiles locally to be close to the market and the customers;67
• Chinese consumers have a general preference for foreign brands and imported products, as opposed to specific brand loyalty and this creates opportunities for MNEs to charge higher prices and earn additional profits on automotive products sold in China68 and
• Huge, inelastic demand for automotive vehicles in China due to the large population and its growing wealth.69

Without question China would prefer a Compaq solution where the entire premium is allocated to China in all of these instances. These “… LSAs have led to extraordinarily high profits that are rightly earned by Chinese taxpayers”70.

C. Valuing & Allocating Intangibles

The Chinese position on intangibles in the Practical Manual echoes developing country positions because both developed and developing countries seek ways to tax MNE’s income when it is improperly shifted to tax havens. China has taken a strong position. It is willing to “look through” tax havens. It will require domestic consistency in tax reporting if MNE’s apply for High and New Technology Status (HNTS).

The Practical Manual appears to be less harsh than previous Chinese positions. The Practical Manual follows a value chain analysis that frequently leads to a profit split. This analysis may be more popular in the EU than in the US. It is arguably consistent with an OECD understanding of a commensurate with income (CWI) adjustment for royalty payments.

(I) Tax haven entity IP ownership

China takes a strong position against MNEs that arranging their operations so that IP is held in tax havens. In 2009 the shift of income to tax havens was addressed in Circular 2 (the Enterprise Income Tax regulations). Circular 2 allowed the authorities to ignore the location of the IP, and treat the Chinese entity as if no royalty was due.

66 UN, Practical Manual at ¶ 10.3.3.4: Market premium relates to the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product.
67 UN, Practical Manual at ¶ 10.3.3.1.
68 UN, Practical Manual at ¶ 10.3.3.6.
69 UN, Practical Manual at ¶ 10.3.3.6.
70 UN, Practical Manual at ¶ 10.3.3.6.
The Practical Manual takes a more moderate approach. The contract R&D discussion functions as a template for the broader discussion on how China will respond when related party payments for IP are made to a tax haven resident. This is a value chain analysis.

A value chain approach involves determining and MNE’s industry value drivers or critical success factors \(^{71}\) as opposed to focusing on the controlled and uncontrolled transactions’ assets, risks, and the economically significant activities \(^{72}\). Income and related fees under a value chain analysis are determined through a fact-specific formula that apportions based on the MNE’s internal data \(^{73}\). In other words, it is a profit split at the MNE level. It rejects a cost-plus or TNMM/CPM approach to profit shifting \(^{74}\). The entity owning the IP is less important than the development location of the IP.

Under Circular 2 the SAT will eliminate payments made for IP. The Chinese entity is deemed to be the IP’s “holder” with royalties due to it based on related party IP usage. Circular 2 states:

The tax authority may, from the taxation perspective, deny the existence of enterprises without economic substance, particularly those which have been established in tax havens and enable their related parties or non-related parties to avoid taxation. \(^{75}\)

The Practical Manual is different. Under the Practical Manual the approach is to determine the contract R&D entity’s value that it provides to overall group operations. Compensation for this value contribution is not determined under the cost-plus or TNMM/CPM methods but rather under a profit split approach. The objective is to measure the Chinese R&D’s value as a contribution to the MNE’s overall profitability. The Practical Manual states:

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71 The initial studies in this area were by Pim Fris. See: Pim Fris, Dealing with Arm’s Length and Comparability in the Years 2000, 10 INTERNATIONAL TRANSFER PRICING JOURNAL 6 (2003) (but also arguing that human resources and knowledge management are the most important intangible resources of a MNE). Pim Fris & Sebastian Gonnet, ReAL Transfer Pricing: A New Paradigm for Transfer Pricing in Europe? TAX PLANNING INTERNATIONAL TRANSFER PRICING (June 1, 2006).

72 OECD, Guidelines (2010) ¶ 1.20

73 This approach differs from the traditional functional analysis approach at its extreme, which leads to an effort to seek remuneration for each function separately. Deloris Wright, an economist for the Australian Tax Office in Roche Products PTY Limited v. Commissioner of Taxation, [2008] AATA 261 (April 2, 2008) at ¶¶ 117-123.


75 Circular Guoshuifa [2009] No. 2 (Circular 2), The Implementation Measures of Special Taxation Adjustments, at Article 94. These are the basic regulations issued by the STA after the adoption of the Corporate Income Tax Law, both of which were effective as of January 1m 2008. See generally: Cheng Chi, Leonard Zhang, Gibson Ng & Kevin Zhu, China – Issue 1: General Transfer Pricing Framework, BNA Transfer Pricing Forum (March 2013).
Contract R&D is an area where the contribution of developing countries is often underestimated. The transfer pricing method commonly used to reward R&D activities performed by a subsidiary of a MNE in China is the Cost Plus Method. Sometimes, it has been found that the principal entity that is claimed to be responsible for the R&D has neither the technical expertise nor the financial capacity to be responsible. In other instances, the Chinese entity has obtained “high and new technology status” in Chinese law and therefore enjoys tax incentives on the basis of ownership of valuable core technology on the one hand. However, it also claims to be a contract R&D service provider with no valuable intangibles on the other hand. These are only a few examples where a cost plus approach would not be adequate, and a different method such as Profit Split Method would be more appropriate. It is expected that companies claiming high tech status should be performing activities that result in the creation of intellectual property of which they can claim economic or legal ownership. It is not sufficient by itself that the contract R&D entity has shifted the majority of its risks (e.g. unsuccessful research) to its entrepreneurial related party. A proper analysis of the value provided by the contract R&D entity to the overall group operations should be conducted to determine the appropriate arm’s length return for the R&D entity.⁷⁶

Consider the following example drawn from Treasury Regulation §1.482-7(j)(1)(ii) Example 2. The example highlights both the Chinese problem with the US approach to this issue and how US-Chinese differences may end up producing conflicting assessments.

In this example US Parent (USP) has two foreign subsidiaries (FS and R&D). Both USP and FS manufacture and sell products and both will exploit the R&D subsidiary’s newly developed IP. The R&D subsidiary has no exploitation rights.

The Regulation example explains that all three entities (USP, FS, and R&D) enter into a cost sharing agreement (CSA) to develop manufacturing intangibles for a new product line. The example’s purpose is to explain that even though R&D does the research necessary for intangible development, because it cannot exploit the intangible it cannot be a controlled participant (CP) in the CSA. R&D derives no reasonably anticipated benefits (RAB) from exploiting cost shared intangibles. As a result, R&D is deemed to be providing a service. Payment for the service is most likely determined on a cost-plus basis, TNMM/CPM, and shared 33.3% and 66.6% with USP and FS respectively based on their RAB. See Figure 5.

⁷⁶ UN, PRACTICAL MANUAL at ¶ 10.3.5.4 (emphasis added).
If the Practical Manual’s China section was presented with the same fact pattern, the US assessment would be replaced with a value chain analysis. The essential problem for the Chinese is that there is a three-way organic relationship among USP, FS, and R&D with each entity contributing to a single commercial outcome (selling “product A” globally). As a result, a contribution analysis is preferable to a highly segmented transactional analysis. To see how the re-configuration plays out, it helps to provide specific jurisdictions in the example.

Assume that USP is a US entity, FS is an Indian subsidiary, and R&D is a Chinese entity. For the Chinese, the 33.3% / 66.6% RAB division between USP and FS is not as important as Product A’s global sales and its financial (profitability) projections. The most critical issue is determining which entity is performing risk-averse routine functions and which is performing high value non-routine tasks.

If the manufacturing and sales functions of USP and FS are mostly routine and if R&D’s activities are mostly non-routine, then applying a residual profit split would compensate the non-routine functions at a nominal (cost-plus) rate with residual profits allocated to the R&D subsidiary. See Figure 6.
Applying a value chain approach to Example 2 of Treasury Regulation §1.482-7(j)(1)(ii) would maximize China’s return at the expense of the US and India. It considers the MNE as a whole, making allocations according to the value contributed to the entire enterprise. In Brem and Tucha’s analysis a CSA is a governance pattern (a term Brem and Tucha use to describe an MNE’s internal organization structure that is crafted to profit maximize). Governance patterns should not be ignored, and the profits they realize should not be limited by RAB requirements. They explain:

We expect the next generation transfer pricing approach will – may have to – make use of patterns of governance to characterize and to value the functional contributions to the overall value chain. These governance patterns are likely to serve for the design and/or establishment of arm’s length behavior inside the MNE. Given the governance pattern of (related-party) transactions, value chain analysis with risk-averse markups on routine functions and residual profit split remuneration for non-routine functions is likely to replace today’s bilateral transfer pricing approach.\(^\text{77}\)

The CSA examples in the US Treasury Regulations are a very good place to look for US-China differences. The CSA’s basic premise is that multiple related entities enter into an agreement to develop intangible property for the entire MNE’s benefit rather than a limited subset of entities within the entire enterprise.\(^\text{78}\) The real intent of the CSA is not to maximize profit in isolation. It is to maximize profits of the whole.


\(^{78}\) In no example are we told that the entities presented are the entire MNE. The question of whether we are looking at part or all of a MNE is irrelevant in the US regulations. An organic approach to transfer pricing
For example, in Treasury Regulation §1.482-7(g)(6)(vi) Example 1, a CSA is formed to develop very small data storage devices (nanodisks). A profit split is used to determine the USP’s intangible contributions value to the foreign subsidiary’s profits resulting from its research team and in-process software contribution. Of course there is no conflict here if the foreign subsidiary is based in China because they are the only MNE entities.

The next example, Treasury Regulation §1.482-7(g)(6)(vi) Example 2 involves dual intangible contributions to developing a diesel-electric hybrid engine. Here the US parent develops the engine technology and the foreign subsidiary develops the battery technology. Once again a profit split is recommended.

If this example was drafted by the SAT, and if the subsidiary developing the battery technology was Chinese, there would be no disagreement between US and Chinese authorities on how to determine the transfer price. However, this will only be true if no other entities within the larger MNE are involved with the diesel-hybrid engine. If there were additional related parties involved, then the US focus on binary (parent/subsidiary) relationships will give a different answer than the Chinese. China casts a wider net, and determines returns based on value-contributions to the whole business structure engage in diesel-hybrid engines.

The same analysis applies to Treasury Regulation §1.482-7(i)(6)(vii) Example 1 where the US approach is to apply a profit split when a CSA is engaged in the development of new cell phone technology.

In Treasury Regulation §1.482-7(i)(6)(vii) Example 3, US parent (USP) and three separate foreign subsidiaries (FS1, FS2, and FS3) resident in three separate foreign jurisdictions enter into a CSA. The mission is to develop version 2.0 of software that USP developed originally.

In this case the regulations treat each USP-FS relationship separately. This is inconsistent with the fact that the whole software development relationship is an organic relationship among four related parties. If FS3 is a Chinese subsidiary, FS2 is Japanese and FS3 is French, then the Chinese view would be that the Chinese contribution to developing the newer software should be measured together with FS1, FS2, and USP’s contribution. An aggregate allocation would be derived.

The profit-splits applied in Treasury Regulation §1.482-7(i)(6)(vii) Example 3 are binary, not aggregate. This is problematical. The Chinese contribution to the MNE is probably not binary, and the return that the Chinese entity deserves should be based on the value it contributes to the whole enterprise.\footnote{Lee Sheppard reported on an August 27, 2013 OECD meeting at the Center for Tax Policy and Administration that the Chinese position was explained:}
(2) Cost-plus method rejected for High and New Technology Enterprise status (HNT)

Chinese commercial incentives for High and New Technology Enterprises include numerous special deductions and preferential tax rates for R&D activity. These incentives impact the corporate income tax (CIT) via super deductions for R&D expenses and reduced documentation requirements along with value added tax (VAT) exemptions. The HNT incentive program frequently requires the development of locally owned intellectual property (IP). Provincial tax authorities grant HNT status. It is valid for three years and renewable at the tax authorities’ discretion. The CIT is reduced by this regime from 25% to 15%.80

On January 13, 2013 the Ministry of Science and Technology, Ministry of Finance and the STA released a Notice of Inspections on High and New Technology Enterprises Recognition and Administration81. The Notice indicates that the three ministries would launch joint inspections. According to the National Audit Office Audit Results Announcement [2009] No. 9 and Audit Results Announcement [2011] No. 34, 102 high-tech enterprises in total were disqualified as HNT with tax deficiencies exceeding 6.296 billion RMB during 2009 and 2010. Reportedly an addition 1,000 HNT licenses have been cancelled in 2012.

The HNT issue is the flip-side of the IP-in-tax-havens issue considered previously. The Practical Manual’s concern in this instance is with inconsistent reporting. The Practical Manual presents this issue as a warning to other developing countries that provide similar high-technology incentives. The Practical Manual states:

In other instances, the Chinese entity has obtained “high and new technology status” in Chinese law and therefore enjoys tax incentives on the basis of ownership of valuable core technology on the one hand. However, it also claims to be a contract R&D service provider with no valuable intangibles on the other hand. These are only a few examples where a cost plus approach would not be adequate, and a different method such as Profit Split Method would be more appropriate. It is expected that companies claiming high tech status should be performing activities that result in the creation of intellectual property of which they can claim economic or legal ownership.82

"Why are Chinese subsidiaries always routine? This question is always on my mind," said Wang Xiaoyue, director of the anti-avoidance division of the International Taxation Department in China's State Administration of Taxation. She advocated a holistic view of the value creation chain in a multinational operation.


80 By the end of 2012 there were over 60,000 HNTEs with tax relief exceeding 600 billion RMB. Hwuason Lawyers, Interpretations on New Policy for High-tech Enterprises: Circular Guo Ke Fa Huo [2012] No. 1220 (January 29, 2013) at ¶¶ I(A) & (B)
81 Circular Guo Ke Fa Huo No. 1220 [2012]
82 UN, PRACTICAL MANUAL at ¶ 10.3.5.4 (emphasis added).
This is another instance where the *Practical Manual* advocates value chain analysis and directs other developing countries to reject TNMMs, particularly those that have FCMU PLIs.

(3) Royalty adjustments over time

The Chinese contribution to the *Practical Manual* adopts a limited commensurate with income (CWI) rule. CWI stands for the principle that income derived from an intangible (a royalty) should reflect the profits actually being earned through using the intangible. CWI means that an initial royalty agreement should be adjustable on a periodic basis to reflect actual returns. This is necessary because (a) contingent rather than fixed royalty relationships are the modern norm, and (b) from a value chain perspective, MNEs treat IP in a shared (dynamic) manner, not a static (or possessory) manner.

The *Practical Manual* contains only a brief example. It states that royalty amounts should be *revisited* so that a new measure of an intangible’s value can be taken. Two aspects are considered. The first is the need to reduce royalty payments over reasonable time periods when foreign parties are licensing IP to Chinese firms. The second is the need to recognize that foreign licensing relationships frequently lead to developing *Chinese IP* as the Chinese firm begins to work with and adapt the foreign IP to local needs. This means that an additional royalty stream is created, one that *runs back to the Chinese firm*. Foreign related parties will then compensate a Chinese entity as benefits from the adaptation are realized. The *Practical Manual* states:

For example, if a Chinese affiliate was charged a 3 per cent royalty for the use of a manufacturing process when the Chinese operations were established ten years ago in 2002, then it may not be reasonable for the Chinese affiliate to continue paying the same royalty in 2012 without *revisiting* whether the intangible has continued to provide the same value over time. This is particularly the case if the Chinese affiliate has improved upon the manufacturing process provided by its parent company, through a process of trial and error and conducting manufacturing operations over a ten-year period. We would question whether the Chinese affiliate should continue to pay a royalty to the parent company for the manufacturing process, or whether the *Chinese affiliates should be entitled to a return on the intangibles that they have developed and shared with the group companies*.\(^{83}\)

CWI is a US construction\(^ {84}\). It is not adopted or codified anywhere else, other than in Germany. CWI may be authorized under the Canadian Income Tax Act subsection 247(2)(b) but this is not definitive. Based on the 33 branch reports to the 2007

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\(^{83}\) UN, *PRACTICAL MANUAL* at ¶ 10.3.4.3 (emphasis added).

\(^{84}\) Commensurate with income was added to §482 in 1986.
IFA Congress, only the Netherlands and Japan believe that they have the authority to apply a CWI standard.\footnote{Jens Wittendorff, _Transfer Pricing and the Arm’s Length Principle in International Law_ (2010) at 692-93. The essential problem with CWI (from an OECD perspective) is that Article 9(1) of the OECD Model Tax treaty is an _ex ante_ (before the event) arm’s length test. A transfer price needs to be determined based on the information available _at the time of the controlled transaction_. [Guidelines at ¶¶ 1.11, 1.30, 1.66, 2.11, 3.12, & 3.14.] Hindsight is not allowed. [Guidelines at ¶¶ 1.51, 3.14, 5.20, 6.32, 8.20, Annex to Ch. VI at ¶4, Annex to Ch. IV at ¶¶ 49 & 52.] Some practitioners see CWI as an _ex post_ application. This is what accounts for the limited adoption of CWI among OECD countries.}

Things have begun to change. In 1988 three examples were added to the OECD _Guidelines_ Chapter VI Annex. They illustrate a “way around” the “problem” that the OECD has with CWI. The answer is in payments clauses. By inserting a conditional payment clause in a contract based on what parties _would have agreed to_ at arm’s length under the same circumstances the OECD gets around an otherwise “fixed royalty agreement.” The Chinese position in the _Practical Manual_ agrees with this approach.

A more direct OECD statement on CWI appears to be under consideration. The OECD’s Base Erosion and Profit Shifting action plan (BEPS) appears to be considering a fuller CWI position.\footnote{R.T. French _v._ Commissioner, 60 TC 836 (1973) (concerning a US manufacturer of food products that had licenses an instant mashed potato formula from a foreign corporation that was not a related to at the time. The royalty was 3% of net sales. Unrelated parties paid 5%. After a restructuring French became a related party with the licensor, and the IRS sought an adjustment. The court did not revise the royalty, as it was arm’s length at creation, even though now it was between related parties.)}

Case law does not support the theory underlying CWI. Prior to 1986, the year that CWI was added to the Internal Revenue Code, only _R. T. French_ considered the CWI issue.\footnote{Xilinx _v._ Commissioner, 125 TC 37 (2005); 567 F.3d 482 (2009); 598 F.3d 1191 (2010) (Xilinx was in the business of researching, developing, manufacturing, marketing, and selling programmable logic devices, integrated circuits devices, and other development software systems. Xilinx and a subsidiary XI entered into an agreement providing that all technology developed by either party would be jointly owned. There was a cost allocation in the Xilinx Stock Option plan, and the Commissioner wanted to adjust it (making that the stock option costs a shared cost between Xilinx and XI). The IRS argued that the} After 1986, only the _Xilinx_ case has considered it.\footnote{Global Tax Reform: OECD Efforts on BEPS and Transparency, BNA Tax and Accounting: Bloomberg BNA (September 26, 2013): The proposal in the BEPS Action Plan to develop "special measures within and beyond" the arm's-length standard in broadly applicable circumstances (Items 8-10) is a direct admission that the OECD is looking, at least in part, outside the arm's-length standard to change current transfer pricing outcomes. Such special measures would effectively override the results of a core transfer pricing analysis, even an analysis compliant with the new people functions test. Regardless, what are these special measures? Will such measures apply only to income subject to limited or no taxation, the stated focus of the BEPS project? More specifically, is the OECD talking about a global commensurate-with-income (CWI) test applicable to intangible and possibly other transactions …} In both cases the court did not view CWI favorably.

\footnote{Craig A. Sharon, _Questions and Concerns About the OECD’s Changing View of the Arm’s-Length Standard_, BNA Tax and Accounting: Bloomberg BNA (September 26, 2013): The proposal in the BEPS Action Plan to develop "special measures within and beyond" the arm's-length standard in broadly applicable circumstances (Items 8-10) is a direct admission that the OECD is looking, at least in part, outside the arm's-length standard to change current transfer pricing outcomes. Such special measures would effectively override the results of a core transfer pricing analysis, even an analysis compliant with the new people functions test. Regardless, what are these special measures? Will such measures apply only to income subject to limited or no taxation, the stated focus of the BEPS project? More specifically, is the OECD talking about a global commensurate-with-income (CWI) test applicable to intangible and possibly other transactions … OECD, _Action Plan on Base Erosion and Profit Shifting_ (2013) at items 8 -10; Brett Weaver, Sean Foley & Andrew Hickman, _Global Tax Reform: OECD Efforts on BEPS and Transparency_, 141 TAX NOTES 318 (October 21, 2013).}
The Chinese position in the *Practical Manual* goes further. Rather than engaging in the *ex ante/ ex post* argument developed in the Annex of the OECD Guidelines, China emphasizes a *dynamic or developing IP* approach. The Chinese argument is – there are very few static, one-on-one IP relationships among entities of an MNE. An MNE’s IP is almost always multi-entity development project and the rights are shared widely within the MNE.

To paraphrase the *Practical Manual*, China believes that a new intangible is created *if a Chinese affiliate improves upon its parent company’s manufacturing process, even if it is only through a trial and error process*. Linear IP exchanges therefore quickly become multi-directional. In other words, an initial IP exchange from a foreign parent to a Chinese subsidiary can be expected to produce a derivative exchange that runs back to the MNE. The MNE expects this development, and plans for it.

Not surprisingly, this countervailing IP argument finds support in the US regulations. The regulations, however, present this problem in static (linear) manner. The Chinese view disrupts static analysis. Consider, for example, Treasury Regulation §1.482-1(d)(3)(ii)(C) Example 6 and Treasury Regulation §1.482-9(g)(2) Example 1 below.

(1) *In Treasury Regulation §1.482-1(d)(3)(ii)(C) Example 6*, company X is a MNE member in the pharmaceutical sector that undertakes R&D in years 1 through 4. It results in the development of a compound that is more effective than existing medications in treating certain conditions. In year 4 another company (Y) is acquired, and immediately thereafter:

Company X *makes available* to Company Y a large amount of technical data concerning the new compound, which Company Y uses to register patent rights with respect to the compound in several jurisdictions, making Company Y the legal owner of such patents. Company Y then enters into licensing agreements with group members that afford Company Y 100% of the premium return attributable to use of the intangible property by its subsidiaries.\(^{89}\)

Example 6 does not specify whether or not Company Y is US or foreign. This is probably intentional. Company X is a US entity. A royalty is imputed from Y to X for the IP. Figure 7 diagrams the regulation.

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\(^{89}\) Treas. Reg. §1.482-1(d)(3)(ii)(C)(Ex. 6) at (ii) (emphasis added).
A small modification to example 6 allows it to be used to illustrate Chinese concerns. Assume that the MNE has four entities: X, X1, X2, and X3. Assume further that X is Chinese while X1, X2, and X3 are US entities. Then assume that X manufactures pharmaceuticals for the Chinese market based on the IP secured from its US Parent (X1) and that the Chinese affiliate (X) has developed through its own trial, error, and experimentation with Chinese traditional medicines. This is the key discovery (among many) that allows this compound to be a more effective medication than others in the market. This R&D discovery occurs in years 1 through 4.

Continuing with example 6 we have Y acquired in year 4, but assume that Y is located in a tax haven jurisdiction. If X makes available to Y significant technical data concerning the manufacturing these new pharmaceuticals, and if Y uses this data to register patent rights in Japan, the UK, Canada, and South Africa, then we have replicated the example 6 fact pattern in a manner that highlights China’s concerns. China would be losing royalties for Chinese developed IP. This concern is in addition to the US concern that it is losing the income on the initial IP transfer. See Figure 8.
In this modified example 6 the IP that is *made available* to Y is more than X1’s base IP. X’s R&D enhancement (for which X deserved a royalty) is also transferred. In effect the aggregate IP development efforts of the MNE has flowed through the entire value chain. It culminated with Y’s patent registrations.

By making the fact pattern dynamic, rather than linear, it becomes apparent that the only method that will allocate revenue properly over time is a residual profit split. This is exactly what the Chinese contribution to the *Practical Manual* is suggesting.

(2) *In Treasury Regulation §1.482-9(g)(2) Example 1*, Company A in Country X auctions spare parts with an interactive database. Company A’s employees manage the database on servers located in Country X. Company A developed the software and licenses it to its wholly owned subsidiary Company B located in Country Y. Company Y replicates Company A’s business with spare part auctions in Country Y.

Subsequently, Company B designed specialized communications software that it uses to connect its data center in Country Y with Company A’s data center in Country X. Company B’s communications network also allows uncontrolled companies to access Company A’s interactive database and purchase spare parts directly from Company A. Company B performs marketing and advertising services to promote Company A’s database. Company B finds buyers and finds listings for Company A.

The regulatory analysis indicates that there are dual valuable intangibles, and there are “… no market comparables for the transactions between Company A and
Company B to reliably evaluate them. Thus, a residual profit split is applied. Allocations are first to routine contributions such as general sales, marketing, and administrative functions with residual profits allocated based on the non-routine contributions relative value. See figure 9 below.

Figure 9: Treas. Reg. §1.482-9(g)(2)(Ex. 1)

Dual valuable intangibles:
A develops online auction site;
B develops specialized communications network.

China’s commentary in the Practical Manual suggests that a dynamic, rather than a static analysis is preferable. Example 1 can be modified slightly to illustrate the Chinese approach.

Assume that Country X is the US and Country Y is China. The first thing we see is that A and B are independently engaged in online sales auctions using software developed by Company A. A royalty payment from Company B flows back to Company A. The reason for dual web sites is that Company B is a fully Chinese auction site that targets customers locally. Company A’s site is in English and targets the US market. See figure 10 below.

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90 Treas. Reg. §1.482-9(g)(2)(Ex. 1) at (ii).
The next step is to add in Company B’s software that links Company B and its third-party customers with Company A’s data center. In the Practical Manual China is concerned that Chinese software development is not identified and the countervailing royalty from Company A back to Company B is not recognized. This is place where the Chinese issue first comes to light, but it may not be where it began.

The Chinese approach is to strongly push for profit splits very early in the analysis. China does not want to wait until a relationship is fully matured. This approach is a nod in the direction of an understanding that early on in the process both A and B understood that linking software would need to be developed by one or the other. A profit split is preferred. See figure 11 below.

The only real difference here between the US and Chinese approach is that the US regulation jumps immediately to the end step, identifies the dual intangibles, and applies a residual profit-split. The US and China are commonly concerned. The US omits any
discussion of the transitional events, and this is where China sees trouble beginning. As a result, China almost always begins with a profit split where the US comes to it later.

CONCLUSION

The Chinese contribution to the UN Practical Manual is significant, both for foreign businesses engaged in Chinese activities and for MNEs in general. It may well be that the Chinese approach to transfer pricing will change the way cross-border problems are analyzed globally. China’s influence at the OECD may soon rival that of the US. The major UN/OECD issues involve:

1. Significant comparability adjustments are needed when comparable sets are drawn from developed countries such as Japan, Korea, Australia and New Zealand;
2. The transactional net margin (TNMM) method is considered overused and inaccurate;
3. Location savings should be reflected in costs subject to a cost-plus mark-up for research and development conducted in China;
4. Toll manufacturers will be converted into contract manufacturers with tightened rules such as cost of materials add-back; rejection of return-on-assets analysis;
5. Limited risk distributor status is denied for brand building distributors (those that have significant advertising, marketing, and promotion activities);
6. Market premiums are to be reflected in Chinese profits;
7. Tax haven based ownership of IP can be “looked through” or denied;
8. A cost-plus methodology is rejected whenever a Chinese related party qualifies as an intangible developer under “high and new technology status” (HNTS) and profit splits should be contemplated; and
9. Royalty adjustments need to be made over time in a commensurate with income manner (CWI).

Each of these issues is addressed, although somewhat cryptically in the Practical Manual, and it will be important to see the details in an official Circular. That development is expected shortly.