# Raise Management Standards of Property Tax on Transnational Corporations

## ELEVER LE NIVEAU DE GESTION FISCALE A L'EGARD DES ENTREPRISES TRANSNATIONALES

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**Abstract:** As China joined WTO, more and more foreign multinational companies will enter China. They run enterprises within the territory of China. This will inevitably play an active role in promoting the economic construction of China. But we should pay attention to some foreign multinational companies in China that often reduce the incomes of Chinese branch companies by utilizing transfer prices. Thus they achieve the goal of evading payment of duty. These make the tax revenue of Chinese Government fall sharply. So it is very important to raise management level of property tax to the multinational companies. This text explains the loss caused by the foreign businessmen using improper means to transfer prices. They import raw materials at a high price and export the products at a low price. Also the corresponding measures are made out in this paper.
**Key words**: Multinational companies, Import at a high price and export at a low price, Current capital, Transfer prices

**Résumé:** Avec l'adhésion de la Chine à l'OMC, de plus en plus nombreux sont les entreprises transnationales qui s'investiraient en Chine. Cela poussera inévitablement la construction économique de la Chine. Néanmoins, nons devons noter que, actuellement, des entreprises étrangères en Chine diminuent les profits des filiales chinoise en transférant les prix et atteint ainsi leur but d'éviter la taxe. De cet effet, les recettes fiscales de la Chine diminuent considérablement. Donc, il est très important d'améliorer le viveau de gestion fiscale à l'égard des entreprises transnationales. Cet article expose d'abord le déficit provoqué par les actions malhonnêtes de commerçants étrangers qui transfèrent les prix avec des moyens illégitimes pour acheter les ressources productives à haut prix et vendre les produits à bas prix, et propose ensuite des contre-mesures.
**Mots-Clés:** entreprise transnationale, acheter cher et vendre moins cher, fonds liquides

With the continuous deepening and development of Chinese opening up, the size and quantity of foreign multinational companies investing in China is also increasing. According to the authority's statistics, the number of the foreign companies various branches set up in China has more than 5 million. Currently, there have been about 200 among the world's largest 300 transnational corporations investing in China, such as the U.S. Motorola, Coca-Cola, DuPont, IBM, P&G, German Siemens, Lufthansa, the Netherlands Philips, Matsushita of Japan, Korea's Samsung and so on. These foreign companies have played a very important role in the development of our national economy; we believe that foreign TNCs will shine in our country in the future. However, as a coin has two different aspects, when people objectively observe and think from multiple perspectives, people will discover that the surviving transfer pricing issues cannot be ignored. A large number of international transactions, which are made by TNCs subsidiaries or branches, are established in our country and a substantial part is internal trade, which provides a possible implementation of transfer pricing. The research on the TNCs import prices and export prices from 2003 to 2004 show that among the 1500

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kind of products in 2000, the import price higher than the comparable average price is nearly 500 species, of which the highest was 1,000%. Export prices lower than the average price is 450, of which the lowest price only 5% of the comparable average price. Here the issues on transnational corporations "transfer pricing" will be discussed.

Transfer pricing is the price, which is taken by TNCs family members in mutual business transactions. The sale of material between the parent company and its foreign subsidiaries, the prices of the components and the final product are transfer prices. The tax departments of every country in the world will carry out strict examination to transfer pricing because transfer pricing can transfer funds from one entity to another entity that can significantly change the tax revenue level of the local government. We can illustrate this through Table 1 data, parent company sales semi-product to foreign subsidiaries in high transfer prices and low transfer prices if the host country income tax rate is lower.

**Table 1** **units: dollars**

| | High transfer prices | | Low transfer prices | |
|---|---|---|---|---|
| | Parent company | Affiliates | Parent company | Affiliates |
| Sales price | 8000 | 10000 | 6000 | 10000 |
| Minus the cost of goods sold | 2000 | 8000 | 2000 | 6000 |
| Gross margins | 6000 | 2000 | 4000 | 4000 |
| Minus production costs | 1600 | 1000 | 1600 | 1000 |
| Pre-tax profit | 4400 | 1000 | 2400 | 3000 |
| Less income tax ( parent company 50% , affiliates 36% ) | 2200 | 360 | 1200 | 1080 |
| Net after-tax profit | 2200 | 640 | 1200 | 1920 |
| Net consolidated accounts | 2840 | | 3120 | |

Table 1 shows that the low transfer prices compared to high transfer prices have the following differences. The introductions of transfer pricing results are:

(1) The net income of transnational corporations merged accounts increases.

(2) The gross margins and pre-tax profits and profitability of the parent company declines.

(3) The gross margins and pre-tax profits affiliate increases.

(4) Both the parent company and subsidiaries host government income tax level changes. The home government income tax reduces, and the host government income tax increases.

(5) Subsidiaries importing semi-finished pay less cost, thus only fewer funds are transferred to the parent company's account.

If a high-contrast transfer prices are implemented:

(1) The net income of transnational corporations merged accounts decreases.

(2) The gross margins and pre-tax profits and profitability of the parent company improve.

(3) The gross margins and pre-tax profits affiliate decreases.

(4) Both the parent company and subsidiaries host government income tax level change. The home government income tax increases, and the host government income tax decreases.

(5) Subsidiaries importing semi-finished pay more cost, thus more funds are transferred to the parent company's account.

Currently, the issue that some foreign multinational companies in China, using transfer pricing " import at a high price and export at a low price " approach reducing or avoiding paying income tax to local governments has become a well-known secret. Many foreign multinational companies are established based on so-called "two outer" model and that model is what we have been vigorously pursuing. In these circumstances, as long as increasing the prices of raw materials and spare parts imported from foreign subsidiaries or other affiliates while downing the prices of export products to the relevant foreign member companies, they can arbitrarily make many local subsidiaries maintain less profit, or balance, or loss, thereby to reduce or avoid the amount of income tax to our local tax department. To do so, it is no doubt that they raise other relevant members company's profitability and accelerate the transfer of funds to China, so that the Chinese government revenue declines.

In fact, in order to prevent local tax reduction, most of the countries' tax authorities have developed a series of regulations to strictly regulate the transfer price levels. If enterprises cannot confirm their transfer pricing is reasonable, then the local tax department have right to calculate the amount of tax price in accordance with what they consider reasonable. For example, the United State’s relevant provisions regulate "transfer price should be equivalent to the price which is used with a completely unrelated and the nearest enterprises transactions." Although the provisions don’t solve all the practical problems, they lay a foundation for the transfer prices identification. If a kind of product or original material can be simultaneously purchased from not related and related enterprises, then they can use this external reference price as transfer pricing standards. Some enterprises take the international market-related prices as a standard for the two sides to negotiate. There are a number of subsidiaries taking the parent company’s prices when they sale the same product to related client as transfer pricing.

More difficult situation is that a product does not have external markets, such as when the product is spare parts or semi-finished, and available for further processing, or when products containing sales side patents or other ownership, that is the case. Enterprise often uses a cost-plus pricing method for their transfer prices. But how to determine the costs and addition rate is larger flexibility. The issue that particularly easily cause controversial is how to share costs, such as management fees, marketing expenses, and R&D costs. It is more difficult to confirm the transfer price at the percentage fees, management fees, or other services rationality, because in general, it is difficult to find the same external trade as a reference. In such cases, the tax authorities in some countries directly don’t ignore how the local foreign corporations declaration of income, but according to the multinational corporations which they belong to, the overall global income, according to the enterprise's assets, represents the proportion of the total assets levying the corporation income tax, levying the so-called comprehensive tax taxes. For example, if Toyota subsidiaries in California assets, sales accounted for the Toyota Motor Corporation in worldwide total asset and the value of sales 10%, then the U.S. government determines that the subsidiary income accounts for tenth of Toyota global income, and it levies income taxes according this proportion.

Chinese local taxation departments can take the following measures to the issue that transnational corporations "publicly" use transfer prices “importing at a high price and exporting at a low price ".

First, the cognition problem needs to be resolved, as people believe that the transnational corporations shift income to offshore, primarily in order to avoid tax. If our government can provide more preferential tax policies, we can resolve these transfer prices problems. In fact, it is not the case. On the one hand, the government of any state can not give foreign investment enterprises a long-term substantial tax relief policies; On the other hand, even with this policy, there are many foreign investors shift their income and taxes to the country which they would like to pay tax, from the national interests, despite the country tax rate may be high, there may be some people think that we should do all thing conducive to attract foreign capital, and therefore, if we control TNCs transfer price, it will scare away foreign investors, make them reduce or withdraw their investment in China.

Needless to say, the TNCs in many parts have the obvious features of a short-term behavior in China. They want the highest possible speed to recover investment, or even contrary to international practice and norms, they are also without scruple. This is not caused by our too strict control over their management, but it is a consequence caused by our management and control ineffectiveness. Because the management situation can easily cause foreign investors being speculative for instant success in the short-term behavior, "a single shot is fired for a place". It is very necessary that we invest a lot of human material and financial resources in infrastructure, with a view to optimize the investment environment in many regions, but not controlling transfer price is very unusual phenomenon. This clear loophole will enable investors have a feeling of insecurity and instability. Therefore, it is imperative under this situation for local taxation departments to strengthen the management on transnational corporations transfer prices.

Secondly, the introduction of three-dimensional management is necessary. First, the Customs should strengthen the management of transnational corporations’ goods, the control of goods, trade in services price situation and prevent the transfer pricing behavior. Secondly, in joint ventures, Chinese should actively safeguard its own interests, from the passive situation in the joint ventures process; fully understand the situation in the international market, to avoid causing huge losses because of the information ineffective, and taxation departments should strictly supervise the overall financial index and investment behavior of transnational corporations. If, for example, subsidiaries have consecutive losses while parent companies continuously increase investment, we should investigate the company’s operating behavior. Once transfer pricing is identified, heavy fines should be imposed on them. The relevant policies and regulations, should maintain stability and continuity. Only in this way can we constantly promote foreign investment and other acts motivation rationalization, our country can really derive maximum benefits from the investment of transnational corporations.

Thirdly, establish a network with market conditions to understand the world market situation and strengthen prices management. As we lack of understanding on the international market price changes, there is an opportunity to take advantage of transfer pricing of foreign investor, and therefore we should pay attention to the international market situation changes, the creation of specialized scientific, technological, and economic information center to collect related products and services in the international market supply and demand, including buyers and sellers, prices, technical performance indicators, technology developments, etc. to improve monitoring prevention mechanism on this basis. At the same time, we should develop standards for transnational corporations transfer prices and make sample verification, verification of the transfer to that of the individual prices is not easily verified, and we should establish appropriate pricing standards by case analysis.

Fourthly, we can make use of "comparative pricing" principal to determine the "fair price" standard. It is generally believed that the price of same merchandise sold to customers is the "fair price". Japan use prior approval procedures to determine company transaction prices which taxpayers prior to establishment of an internal transaction price policy and the account methodology apply, applying to the Japanese tax authorities, if approved, taxpayers would in future transactions under a plan approved accounting for its transactions income with associated enterprises, providing a fair price of the deal for the two sides. The so-called "comparative pricing" principle is comparing subsidiaries import price or transnational corporations export value with the "fair price". If the difference is very big, the tax department of the host country may request pay tax by the "fair price" standard.

Fifthly, we should strengthen the control and management on foreign-funded contracting work for foreign investor drilling contract loopholes. We should understand the international market and enhance bargaining power. For example, Chinese signed a joint venture or cooperation contracts, gross margins should be based on the same industry, in the light of international comparable prices, provide products for the lowest gross margins of the product in order for supervision later. In addition, it is essential to strict the import of equipment, raw materials. With the commodity inspection departments responsible for the identification of equipment and raw materials, prevent foreign buildings to provide bad and old make instead of new and good, while requesting higher price, exorbitant demands. And control products export choice of buyers, sellers by inviting pubic bidding and expanding exports channels.

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