
SAT issues new China transfer pricing compliance requirements

July 27, 2016

In brief

On June 29, 2016, China's State Administration of Taxation (SAT) issued the *Public Notice Regarding Refining the Reporting of Related-Party Transactions and Administration of Transfer Pricing Documentation* (SAT Public Notice [2016] No. 42, hereinafter referred to as "Public Notice 42"). Public Notice 42 provides new transfer pricing compliance requirements in China, including annual reporting forms for related-party transactions (RPT Forms), Country-by-Country (CbC) Reporting, and Transfer Pricing Documentation (TPD), all of which are substantial changes to the existing rules.

Public Notice 42 replaces the provisions on related-party reporting and transfer pricing documentation in the previous Guo Shui Fa [2009] No. 2, *Implementation Measures of Special Tax Adjustment (Trial)* (hereinafter referred to as "Circular 2") and *Annual Reporting Forms for Related-Party Dealings of Enterprises of the People's Republic of China* (Guo Shui Fa [2008] No. 114).

The number of RPT Forms has increased to 22 tables (from 9 tables), including the CbC Report, while the TPD requirement has adopted a three-tiered approach, including master file, local file, and special issue file. Taxpayers still need to submit the RPT Forms with the annual income tax filing. The local file/special issue file of TPDs should be completed by June 30, 2017 for related-party transactions during the 2016 fiscal year (i.e., January 1, 2016 to December 31, 2016), while the master file should be completed within 12 months after the close of the same fiscal year of the group's ultimate holding company. Taxpayers should submit TPD within 30 days upon the tax authorities' request.

We suggest every taxpayer take the following actions as soon as possible:

- Assess and revisit their related-party transactions under the new TPD thresholds.
- Identify the gap between the existing TPD report and the new TPD requirements and start to prepare the additional documentation and disclosure to bridge the gap.
- Create and operate a consistent and coordinated approach to prepare group TPD reports.
- Collect data and conduct a trial run if necessary for the new RPT Forms.

In detail

Background

The SAT released the discussion draft of the *Implementation Measures of Special Tax Adjustment* (hereinafter referred to as "Discussion Draft")

on September 17, 2015 for public consultation¹, which was expected to be effective from January 1, 2016. While it was expected that the SAT would issue a revised and final version of the *Implementation Measures of Special Tax*

Adjustment after its release of the Discussion Draft, the SAT released a refined transfer pricing compliance requirement separately in the form of Public Notice 42.

We expect the SAT will issue revisions to the remaining parts of the Discussion Draft in the form of various Public Notices to localise the implementation of Organisation for Economic Co-operation and Development (OECD)'s Base Erosion Profit Shifting (BEPS) Action Plan in China.

With the issuance of Public Notice 42, the following regulations are annulled effective January 1, 2016:

- Chapter 2 Reporting of Related-Party Transaction, Chapter 3 Administration of Contemporaneous Documentation, Article 74 on contemporaneous documentation requirements on cost sharing agreement, and Article 89 on contemporaneous requirements on thin capitalisation of Circular 2
- Annual Reporting Forms for Related-Party Dealings of Enterprises of the People's Republic of China (Guo Shui Fa [2008] No. 114)

Actions to be taken

Compared with the previous transfer pricing compliance requirements, there are substantial changes in Public Notice 42, therefore we suggest taxpayers take the following actions immediately.

Assess and revisit the transactions

Public Notice 42 adopts a three-tiered approach for TPD, including master file, local file and special issue file, and sets different thresholds for each file and type of transaction.

If a company meets either of the following criteria, a master file should be prepared:

- A company has cross-border related-party transactions and

belongs to a group which has prepared the master file.

- The total amount of related-party transactions exceeds RMB one billion.

The thresholds for the local file are dependent on the types of related-party transactions, which are listed below.

- 200 million for tangible assets transfers (in the case of toll processes, the amount in the annual customs record for toll processing should be included).
- 100 million for financial asset transfers.
- 100 million for intangible asset transfers.
- 40 million for other related-party transactions in total.

Financial asset transfers are a new type of related-party transaction specified in Public Notice 42. Financial assets refer to account receivables, notes receivables, other account receivables, equity investments, debt investments and financial derivative assets.

There is no specific threshold criterion for the special issue file.

An enterprise will not need to prepare a local file or a special issue file for related-party transactions covered by an advanced pricing agreement (APA), and the amount of these transactions should not be included when assessing the threshold for the local file. An enterprise that only has domestic related-party transactions does not need to prepare a master file, local file or special issue file.

We expect that some taxpayers will be affected by the change of the threshold amounts and will need to expand the scope of the TPD for the 2016 fiscal

year (i.e., 2016 TPD). We suggest that taxpayers assess the related-party transactions based on the new threshold, revisit the transactions (which may not have been analysed before but are now subject to the new TPD requirements), and plan for additional resources to prepare the 2016 TPD.

Identify and bridge the gaps

We have outlined below the key differences between the master file requirements in China and those in the OECD's BEPS Action 13 Transfer Pricing Documentation and Country-by-country Reporting, as well as the differences between the local file and the previous TPD requirements.

Taxpayers are advised to identify the gaps between the new requirements and their existing TPD to start the preparation process for their 2016 TPDs.

Master file

The master file is focused on providing details of the overall operation of the Multinational Enterprises (MNE) group. The disclosure requirements are generally consistent with those recommended by BEPS Action 13. The additional information required under Public Notice 42 for the master file includes:

- Business restructuring and the transfer of functions, risks, and assets within the group.
- The functions, risks, assets, and employees of the principal research and development (R&D) facilities.
- The names and locations of the member entities for which the group is preparing and submitting the CbC Report.
- A list and a brief description of the group's existing bilateral APA(s).

The subsidiaries of MNEs, which have prepared the master file at the group level, should discuss with their group's global tax team the master file to be prepared at the group level, review the new TPD requirements in China, and address the additional information required.

We recommend any group headquartered in China, or the subsidiaries of MNEs who have not prepared the master file at the group level, to start working on the structure and framework of the master file. One of the key challenges in the master file is to identify the value driver(s) of the group and analyse the entities' principal contribution to value creation, which requires a comprehensive value chain analysis of the group.

The master file should be completed within 12 months after the fiscal year end of the group's ultimate holding company.

Local file

Compared with the previous TPD requirements, the local file requires significantly greater information disclosures and transfer pricing analyses. The new items required in the local file include:

- Key factors affecting pricing of transactions, which require enterprises to take into account the analysis of intangibles and local specific advantages (LSA); i.e. cost savings and market premium.
- Value chain analysis (VCA), including the transaction flows within the group, the latest financial report of the participating parties of the value chain, the quantifying and attribution of the LSA related to the value creation, and the principles for and results of profit allocation across the value

chain of the tested related-party transactions.

- Disclosure of outbound investment, including basic information, project background, and project data.
- Disclosure of intra-group equity transfers, which should include terms of payment, the target's geographic location, timing, methodology, cost of the transfer, income arising from the transfer, due diligence report or the asset evaluation report on the target, etc.
- More disclosure of intra-group services, which should include: the specific contents, nature, and approach of the services; the benefit brought to the service recipient; aggregation treatment for the costs and expenses of services; project, amount, allocation key, calculation process and the result, etc.; as well as comparison with service transactions with non-related parties;
- Disclosure of APA(s) signed and tax ruling(s) granted in other jurisdictions which are directly related to the tested related-party transactions.
- The enterprise's contribution to the group's overall profit and the excessive profit should be illustrated.

VCA and the illustration of value contribution will involve the most technical analyses under the new TPD requirements. They are not just intended for the immediate related-party transactions covered by the TPD, but for the overall MNE group, which will require in-depth functional analysis and economic analysis on the group's overall business. To avoid potential conflicts and inconsistency,

MNEs that are not required to prepare a master file in China still should take a consistent and coordinated approach to prepare the local files for their Chinese subsidiaries.

We expect that in a future transfer pricing audit, if the tax authorities conclude that there are no appropriate comparables available, they may use profit split or contribution analysis based on the value chain analysis to determine the transfer pricing adjustment.

Compared with the Discussion Draft, Public Notice 42 further emphasizes the analysis and consideration on LSA in the local file. Although LSA was referred to in many chapters in the Discussion Draft, it was not included as one of the requisite items for TPD. This new change requires MNEs to take LSA into account whenever they establish or review the transfer pricing arrangement.

In addition, the higher disclosure standard on intra-group services will also impact many taxpayers. It usually takes much time and effort to describe the nature and prove the benefit of intercompany services to tax authorities, especially for group-allocated service charges. In this regard, we suggest that taxpayers with group-allocated service charges start preparing the analysis.

The local file should be completed by June 30 following the year during which the related-party transactions occur; i.e. June 30, 2017 for the 2016 fiscal year.

Special issue file

The special issue file is required for taxpayers engaging in cost sharing agreements or falling under the thin capitalisation requirement.

The requirements for the above two special issue files are very similar to the contemporaneous documentation requirements for cost sharing

agreements and thin capitalisation provided in Chapter 7 Administration of Cost Sharing Agreement and Chapter 9 Administration of Thin Capitalization of Circular 2.

The additional required information under Public Notice 42 is listed as below.

Cost sharing agreement:

- The use of the results of the cost sharing agreement by non-participants, and the allocation method of the payment among the participants; and
- Calculation of the anticipated benefits, including the selection of parameters, calculation method and reason for change.

Thin capitalisation:

- Whether an independent enterprise is capable and willing to accept the financing terms, amount, and interest rate agreed between related parties.

The special issue file should be completed by June 30, following the year during which its related-party transactions occur, e.g., June 30, 2017 for fiscal 2016.

Collect the data and conduct a trial run

The new RPT Forms were released together with Public Notice 42. The new RPT Forms consist of 22 forms in total (previously 9 forms), including the CbC Reporting Forms. Taxpayers should complete the relevant forms based on their own circumstances.

The new RPT Forms should be submitted together with the annual corporate income tax filing package. Taxpayers may apply for an extension according to the provisions in the *Tax Collection and Administration Law* and its detailed implementation rules.

CbC Reporting Forms

CbC Reporting Forms are required for the Chinese resident enterprise if:

- it is the ultimate holding company of the group with consolidated revenues over RMB 5.5 billion, or
- it is nominated as the CbC Reporting Entity.

If the ultimate parent company of an MNE is a Chinese tax resident enterprise and the information may be relevant to national security, then part or all of the CbC Report can be exempted based on the relevant regulation.

The CbC Reporting Forms provided in the new RPT Forms as well as the instructions are consistent with those in BEPS Action 13.

The annual CbC Report filing requirement mainly applies to ultimate holding companies in China. However, a subsidiary of an MNE in China also may be required to submit CbC Reporting in a transfer pricing investigation, if its ultimate holding company prepares the CbC Report according to the regulations of the jurisdiction in which it resides and one of the following conditions are met:

- The MNE group has not provided the CbC Report to the tax authority of any jurisdiction;
- Although the group has submitted the CbC Report, the jurisdiction collecting the report does not have an exchange of information mechanism with China; or,
- Although the MNE group has provided the CbC Report and the jurisdiction collecting the CbC Report has an exchange of information mechanism with China, the CbC Report has not

been successfully exchanged with China.

We expect fundamental challenges for preparing CbC Reports to include:

- Reconciliation between global and local reporting, which may create potential data mismatch issues.
- Data collection and extraction, which may create additional processes and accounting tasks for tax departments.

In view of the above challenges, we suggest affected taxpayers conduct a trial run using 2015 financial data in order to develop an effective approach, identify the potential risks from the CbC Reporting data, determine the tax and operations risk profile, and build a remediation plan or at least start building the defence.

Other RPT forms

Other than the CbC Reporting Forms, taxpayers are required to provide additional disclosure under the new RPT Forms. The major additions to the increased disclosures include:

- Disclosure of internal organisational information, including names, headcount, responsibility and business processes for each department as well as the upper level department that it reports to.
- Disclosure of overseas related parties, including their business scope, effective tax rate, registered capital, total investment, preferential tax treatment, etc.
- Segmented financials based on the individual entity's financial report as well as the consolidated financial report.

The segmented financials will show the profitability of sales to related parties and non-related parties. A substantial gap in profitability

between different sales channels (i.e. related and unrelated) may increase a taxpayer's risk profile and trigger tax authorities' queries. We suggest taxpayers who have not prepared segmented financials previously should prepare a version based on their 2015 financial data, and revisit the arrangement if there is a substantial gap in profitability between different sales channels.

In addition, the higher disclosure requirement on overseas related parties will increase the compliance burden on most taxpayers. As some MNE subsidiaries transact with several overseas related parties, we suggest those taxpayers start collecting information immediately.

We expect that tax authorities will rely on the new RPT Forms to select the investigation targets by using their big data analytical technology and systems. Big data is an initiative implemented by the SAT across all levels of tax authorities with the objective of creating a systematic and efficient process to analyse the relevant tax exposure and identify potential tax investigation targets using technology.

The takeaway

The BEPS Action Plan signifies a new era in the international taxation arena. It is the first time that so many jurisdictions have had the same objective and collaborated together to identify, revise and implement the OECD recommendations on tax policies and principles into domestic tax legislation. Some examples of the recent actions taken by countries with respect to their domestic tax regimes include:

- **United States:** the IRS issued final regulations on CbC Reporting on June 29, 2016.
- **Japan:** the Japanese Cabinet approved a 2016 tax reform

proposal on December 24, 2015, which includes revised transfer pricing documentation requirements based on BEPS Action 13.

- **Korea:** Korea introduced the Combined Report of International Transactions (CRIT) on December 15, 2015 to better align the transfer pricing documentation requirements with BEPS Action 13.
- **United Kingdom (UK):** The UK published its final CbC Reporting regulations on February 26, 2016.
- **Netherlands:** The Dutch Senate approved a new law on December 22, 2015, containing detailed transfer pricing documentation requirements in line with BEPS Action 13.
- **European Union (EU):** The European Commission released a draft directive on April 12, 2016, which requires public CbC Reporting by large companies in the EU.

China has been actively participating all along in the BEPS projects. In response to the BEPS recommendations on transfer pricing, the SAT released the discussion draft of the revised transfer pricing regulation in September 2015, has now issued this final transfer pricing compliance regulation, and is revisiting other anti-avoidance measures. All these actions show China's commitment to "enhancing global taxation cooperation and attacking international tax avoidance."

The adoption of BEPS recommendations around the world will substantially change an MNE's internal governance, business operations and intangibles deployment, etc. We strongly

recommend MNEs assess their current transfer pricing structure in light of the new transfer pricing requirements for each jurisdiction and strengthen their internal controls for transfer pricing compliance.

The transfer pricing structure under the new international tax landscape should reflect the principle that profit allocation matches with value creation. The actions taken by China's tax authorities in respect of transfer pricing administration and investigation could be more frequent, stringent and complicated in the future.

Given the enhanced framework of international cooperation and information exchange mechanisms between tax jurisdictions, it is important for MNEs to take a consistent and coordinated approach in relation to group subsidiaries' transfer pricing compliance to avoid potential conflicts and inconsistencies that could arise between group entities in different jurisdictions.

While the new China transfer pricing requirements are designed to identify and prevent BEPS activities effectively, they increase the burden for compliant taxpayers. Considering the great effort it will take to comply with the new requirements and that the first-year deadlines will commence from June 30, 2017, taxpayers are advised to take action promptly to assess the impact, plan their allocation of resources and conduct necessary analyses,.

Endnote

1. For further details of the Discussion Draft of the Implementation Measures of Special Tax Adjustment, please refer to our News Flash [2015] [Issue 38](#) and [Issue 39](#).

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Transfer Pricing

Spencer Chong, *Shanghai*
+86 (21) 2323 2580
spencer.chong@cn.pwc.com

Mei Gong, *Shanghai*
+86 (21) 2323 3667
mei.gong@cn.pwc.com

Paul Tang, *Shanghai*
+86 (21) 2323 3756
paul.tang@cn.pwc.com

Winnie Di, *Beijing*
+86 (10) 6533 2805
winnie.di@cn.pwc.com

Qisheng Yu, *Beijing*
+86 (10) 6533 3117
qisheng.yu@cn.pwc.com

Tao Han, *Beijing*
+86 (10) 6533 3230
tao.han@cn.pwc.com

Kevin Tsoi, *Guangzhou*
+86 (20) 3819 2380
kevin.lk.tsoi@cn.pwc.com

Charles SC Chan, *Shenzhen*
+86 (755) 8261 8576
charles.sc.chan@cn.pwc.com

William Xu, *Chengdu*
+86 (28) 6291 2018
william.xu@cn.pwc.com

Rhett Liu, *Hong Kong*
+86 (755) 8261 8366
rhett.k.liu@cn.pwc.com

Colin Farrell, *Hong Kong*
+852 2289 3800
colin.farrell@hk.pwc.com

Cecilia Lee, *Hong Kong*
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

David McDonald, *Hong Kong*
+852 2289 3707
david.mcdonald@hk.pwc.com

Transfer Pricing Global, China and US Leaders

Isabel Verlinden, *Brussels*
Global Transfer Pricing Leader
+32 2 710 44 22
isabel.verlinden@be.pwc.com

Jeff Yuan, *Shanghai*
China Transfer Pricing Leader
+86 (21) 2323 3495
jeff.yuan@cn.pwc.com

Horacio Pena, *New York*
US Transfer Pricing Leader
+ 1 646 471 1957
horacio.pena@us.pwc.com

Stay current and connected. Our timely news insights, periodicals, thought leadership, and webcasts help you anticipate and adapt in today's evolving business environment. Subscribe or manage your subscriptions at:

pwc.com/us/subscriptions

SOLICITATION

© 2016 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 195,000 people who are committed to delivering quality in assurance, tax and advisory services. Find out more and tell us what matters to you by visiting us at www.pwc.com