

China's Response to BEPS Action Plan -- Brand New Requirement for Contemporaneous Documentation and Reporting of Related Party Transactions

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China transfer pricing alert

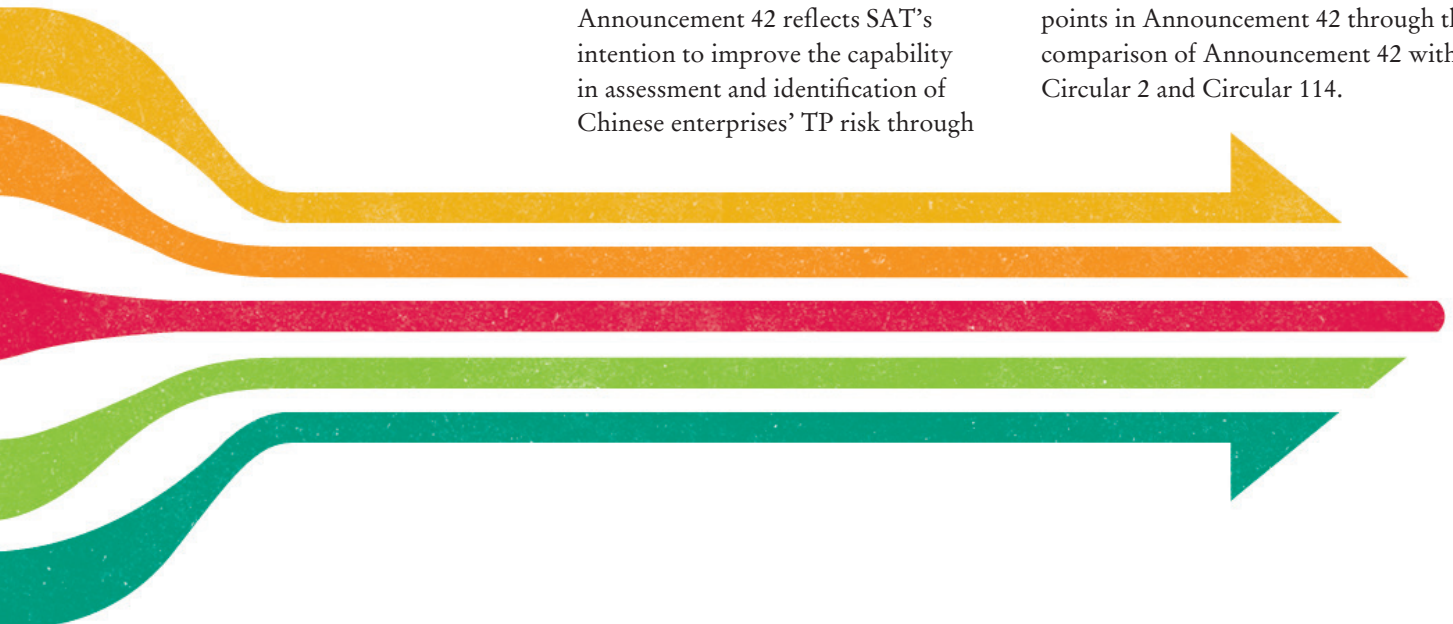
On 29 June, 2016, China State Administration of Taxation ("SAT") released Announcement of the State Administration of Taxation on Refining the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation ("Announcement 42"), as the replacement of the requirement for contemporaneous documentation

under Circular 2 and the requirement for annual reporting of related party transactions under Circular 114.

As SAT's first active response in terms of transfer pricing ("TP") ruling to Base Erosion and Profit Shift ("BEPS") Action Plan launched by Organization for Economic Co-operation and Development ("OECD"), Announcement 42 reflects SAT's intention to improve the capability in assessment and identification of Chinese enterprises' TP risk through

strengthening the management of contemporaneous documentation and annual reporting of related party transactions.

Since enterprises have years of practical experience in preparing contemporaneous documentation and annual reporting of related party transactions, we will illustrate the key points in Announcement 42 through the comparison of Announcement 42 with Circular 2 and Circular 114.



Comparison of Legal Obligation

Comparison of legal obligation for contemporaneous documentation under Circular 2 and Announcement 42

Items	Circular 2	Announcement 42	Remark and Interpretation
Legal Trigger			
Local File	The annual related party transaction amount meets any of the criteria below: <ul style="list-style-type: none"> Annual amount of related party buy-sell transactions no lower than RMB 200 million Annual amount of other types of related party transactions no lower than RMB 40 million 	The annual related party transaction amount meets any of the criteria below: <ul style="list-style-type: none"> Annual amount of tangible assets ownership transfer no lower than RMB 200 million Annual amount of financial assets transfer no lower than RMB 100 million Annual amount of intangible assets ownership transfer no lower than RMB 100 million Annual amount of other types of related party transactions no lower than RMB 40 million 	<ul style="list-style-type: none"> Adopts almost the same threshold of related party transaction amount as that of Circular 2 Adds the threshold for intercompany financial assets transfer and intangible assets ownership transfer according to the latest regulation on types of related party transaction Single-functioned enterprises with loss position still follow the Circular 363
Master File	None	Enterprises meet any of the criteria below: <ul style="list-style-type: none"> With cross-border related party transactions, and the ultimate holding company has already prepared master file Total annual amount of related party transactions no lower than RMB 1 billion 	Master file is the brand new requirement of Announcement 42 and it is applicable to large-scale enterprises
Special File	<ul style="list-style-type: none"> Cost sharing agreement Thin capitalization 	No change	<ul style="list-style-type: none"> No obvious change, Announcement 42 classifies these two items into "special files" No threshold for cost sharing agreement; enterprises exceeding the statutory debt-equity ratio is obliged to prepare the special file for thin capitalization. Thus, there exists the case that an enterprise is not obliged to prepare the master file and the local file but obliged to prepare the special file(s)
Exemption Condition			
Exemption Condition	<ul style="list-style-type: none"> Related party transactions are covered by an effective Advance Pricing Arrangement ("APA") The foreign shareholding is below 50%, and related party transactions are purely domestic 	<ul style="list-style-type: none"> Enterprises who execute an effective APA are exempted from preparation of local file and special file with regard to the effective APA. Furthermore, the related party transaction amount doesn't need to be included into the related party transaction amount calculation for local file Enterprises with purely domestic related party transactions are exempted from preparation of master file, local file and special file 	<ul style="list-style-type: none"> Announcement 42 refines the exemption conditions of APA Pure domestic related party transactions are exempted from preparation of contemporaneous documentation under Announcement 42
Time Requirement			
Deadline	<ul style="list-style-type: none"> Contemporaneous documentation should be completed by May 31 of the subsequent year 	<ul style="list-style-type: none"> Master file should be completed within 12 months since the end of the fiscal year of the group ultimate holding company Local file and special files should be completed by June 30 of the subsequent year 	Announcement 42 extends the deadline and submission period for contemporaneous documentation
Submission	<ul style="list-style-type: none"> Within 20 days upon tax authority's request 	<ul style="list-style-type: none"> Within 30 days upon tax authority's request 	



Comparison of legal obligation for reporting of related party transactions under Circular 114 and Announcement 42

Items	Circular 114	Announcement 42	Remark and Interpretation
Reporting of related party transactions	Enterprises which are taxed based on an actual profit basis	No change	
Country-by-Country report (CbC report)	None	Enterprises meet any of the following criteria: <ul style="list-style-type: none"> • Ultimate shareholder of a MNC whose consolidated revenue in the previous fiscal year exceeds RMB 5.5 billion • Designated by a MNC to submit CbC report 	<ul style="list-style-type: none"> • Announcement 42 establishes CbC report mechanism by referring to the guidelines of BEPS Action Plan • The CbC report is mainly applicable to Chinese enterprise who is the ultimate shareholder of the group. Meanwhile, the tax authorities have the right to request the enterprise to provide the CbC report under certain conditions during the special tax investigation

Comparison of Information Disclosure for Contemporaneous Documentation

Announcement 42 replaces the existing single-tier documentation in Circular 2 with a three-tiered system.

- Local File demands to disclose more comprehensive information compared with the existing contemporaneous documentation, and also provide some modification to the existing contents.
- Master File is a new requirement for Chinese entity with significant intercompany transactions (over RMB 1 billion), aiming to enable tax authorities to better understand general information of global activities of MNCs.
- Special Files on cost sharing agreement and thin capitalization have almost the same requirements as Circular 2.

Local File

Layout of Local File	Major Changes	Remark and Interpretation	
Company Overview	Organizational structure, management structure, industry description, business strategy (including value creation factors), segmental financial data (profitability of different types of business and product), business restructuring and intangible transfer	Except for organizational structure and industry description, all other items are newly required	Require a clearer description of business model; compare the profitability under different types of business and product
Related Party	Information of related parties, tax rate (including tax preference) and etc.	Newly require to disclose related parties with direct or in-direct shareholders	
Related Party Transactions	Overview of related party transactions (transaction description, transaction flow, function and risk profile, key factors to determine the pricing, transaction data)	Newly require to compare the difference with third party transactions. Particularly mention the impact of local special factors on the pricing policy, such as cost saving and market premium	More focus on the impact of intangible assets on the pricing policy
	Value chain analysis: <ul style="list-style-type: none"> • business flow, logistic flow, cash flow and financial statements of participants in the value chain • calculation and allocation of the local special factors on value contribution of enterprises • principle and result of the group profit allocation within the global value chain 	New	Pay attention to value contribution and profit allocation within global value chain (covering from design, development, sales and after-sales). The related parties with no intercompany transaction but involved in value chain should also be analyzed.
	Outbound investment (investment outline, project overview, project data)	New	It is in line with the situation that more and more enterprises are going global. It is aimed to dig out the cases where enterprises shift profit to the overseas countries or do not distribute profits through outbound investment.
	Related party equity transfer (overview, transferred equity, valuation report, etc.)	New	Directly supervise equity transfer

Layout of Local File		Major Changes	Remark and Interpretation
Related Party Transactions	Intercompany service transaction (overview, cost/expense calculation and allocation method) Differences and similarities of pricing policies and transaction results between intercompany service transaction and third party service transaction	New	Focus on service cost/expense calculation and allocation method (allocation key, calculation process and etc.). Pay attention to comparative analysis with internal comparable transactions
	Signed APA on the related party transactions involved by the entity, and tax assessment of tax authorities in other jurisdictions	New	
Comparable Analysis	Factors considered in performing the comparable analysis, function/risk/asset profile of comparables, description of comparable transactions, source of comparable information, selection criteria and rationale, adjustments made on the comparable data and the reasons for such adjustments	No change	
Selection and application of TP method	Selection of TP method on a transactional basis and on an overall basis, as well as the rationale; how the comparables support the selected TP method; application of reasonable TP method and the result of comparable analysis; determination of the arm's length nature of the covered related party transaction(s); the assumptions and judgments during the analysis process, etc.	Minor change Newly require to disclose the contribution to the overall group profit and or residual profit	In line with the idea of BEPS and SAT that the determination of whether to adopt "profit split method" or not should be based on the analysis on the actual places where function is conducted and value is created
Appendix		Remove Form of Function and Risk Analysis and Form of Financial Analysis	Form of Financial Analysis is transferred to Annual Related Party Transactions Reporting Forms. Meanwhile, enterprises are required to allocate the revenue, cost and expense between related party transactions and unrelated party transactions in the section "related party transaction data"

Master File

Layout of Master File	Contents	Remark and Interpretation
Organizational Structure	Global shareholding structure, geographical layout of all subsidiaries (including corporation, partnership, permanent establishment)	Formerly, most enterprises only disclose the information related to its operation. However, in the future, the enterprises shall reveal all the related party information in Master File.
Business Description	Business operation (including value-creation factors), major revenue contributors, intra-group services, value contribution by each entity (main function performed, risk undertaken and assets employed), business operation changes in reporting year	Tax authorities will focus more on the analysis of value contribution by each entity.
Intangible Assets	Global strategy, information of R&D entities and management entity, TP arrangement (including TP policy) related to R&D and intangible assets	Pay attention to the arrangement of intangibles and the creation, allocation and transfer of the profits associated
Financing Arrangement	Financing arrangement with related parties and with third parties, entities with centralized financing function, TP policy for related party financing arrangement	Pay attention to whether group capital flow and financing arrangement are rational; and to compare it against the third party financing arrangement
Accounting and tax position	Consolidated financial statement of MNCs, APAs, tax assessment and information of entity preparing and submitting CbC reports	Require to understand group-level financial performance and tax arrangement of profit distribution among different countries

Special File

The requirement for special file for cost sharing agreement and thin capitalization is basically the same as requirements under Circular 2.

Comparison of Disclosure Requirement of Related Party Transaction Reporting Forms

Announcement 42 introduces the formal templates and filing instruction for the Annual Related Party Transactions Reporting Forms (the "New Forms"). The New Forms require more detailed and comprehensive information disclosure requirement compared to the forms issued in Circular 114. The New Forms include the Country-by-Country reporting form (CbC Form). The number of forms has also increased from 9 to 22. The following table compares the contents of the new and original forms.

Announcement 42	Circular 114	Remark and Interpretation
Cover page Reporting Enterprise Information Form	Cover page	More detailed basic information are required to be disclosed according to Announcement 42: <ul style="list-style-type: none"> Enterprises are required to disclose the ultimate holding company so that tax authorities may investigate whether the group is set up in tax havens Enterprises are required to disclose the number of employees in different departments so that tax authorities can understand the real function and risk profile of the enterprises
Summary of Annual Related Party Transactions of Enterprises	Summary of Related Party Transactions Form	Summary of all the forms: <ul style="list-style-type: none"> Adds the disclosure of the Debt-to-Equity Ratio Refines the disclosure of cost sharing agreement Refines the new three-tiered structure of the documentation
Related Party Relationship Form	Related Party Relationships Form	Reflects the date of the changes of related party relationship
Tangible Assets Ownership Transaction Form Tangible Assets Use Right Transaction Form	Purchase and Sales Form Fixed Assets Form	<ul style="list-style-type: none"> Combines the transactions of goods and fixed assets Distinguished by ownership and right to use Requires the disclosure of the transaction details of related parties with the highest five total amount of related party transactions Removes the requirements of the disclosure of transfer pricing methods
Intangible Assets Ownership Transaction Form Intangible Assets Use Right Transaction Form	Intangible Assets Form	Similar to the disclosure requirement of Tangible Assets
Financial Asset Transaction Form	None	<ul style="list-style-type: none"> Similar to the disclosure requirement of Tangible Assets Reflects the tax authorities' attention to financial asset
Financing Form	Financing Form	<ul style="list-style-type: none"> Refines the disclosure content, e.g. expands the scope of interests Optimizes the structure of the form
Related Party Service Transaction Form	Service Transaction Form	Similar to the disclosure requirement of Tangible Assets
Equity Investment Form	None	Disclosure of equity investment
Cost Sharing Agreements Form	None	Applies to enterprises which are engaged or implementation in Cost Sharing Agreements
Outbound Payment Form	Outbound Payment Form	<ul style="list-style-type: none"> Removes the items "withholding tax paid" and "whether entitled to preferential tax treatment" Reclassifies the form
Overseas Related Party Information Form	None	The new form requires additional information of overseas related parties such as effective tax rates, reflecting the tax authorities' attention to the regulation of profit shifting
Financial Analysis Form of Annual Related Party Transactions(Standalone Information) Financial Analysis Form of Annual Related Party Transactions(Consolidated Information)	None	<ul style="list-style-type: none"> The subjects of disclosure expand to all enterprises which are taxed based on an actual profit basis Although Announcement 42 does not specify whether the financial analysis form should be disclosed in local file, taxpayers will inevitably allocate the revenue, cost and expenses between related party and unrelated party transactions during the preparation of local file.



Announcement 42	Circular 114	Remark and Interpretation
CbC Report-Country Distribution of Income, Tax, Business Activities (Chinese and English)	None	The requirements of CbC Report are basically consistent with the BEPS Action 13. Including: <ul style="list-style-type: none"> • Disclose revenue, profit before tax, the actual tax burden, registered capital, number of employees, tangible assets and etc. on an country-by-country basis • Disclose members of the group and checking the boxes of their main activities on an country-by-country basis
CbC Report-List of Multinational Group Entities (Chinese and English)		Thus, the CbC Report will help tax authorities to preliminary judge whether each entity's function matches with their share of MNE global value chain profits in different countries.
CbC Report-Additional Information Form (Chinese and English)		The implement of the CbC Report is an essential part of the cross abroad tax information exchange.

Recommendations from Grant Thornton

With the ever increasing involvement of China in the global supply chain, the country's administration on international taxation, and in particular, transfer pricing matters, keeps on stepping up in terms of both technical sophistication and practicality. The codification of Announcement 42 is the latest response of China SAT to the BEPS Action Plans, and extends the legal obligation of taxpayers on filing and documentation.

Announcement 42 will not have an imminent impact on many of the taxpayers already lodging TP documentation, in the sense that this Announcement does not alter the essence of such legal requirement. These taxpayers can swiftly adapt to and fulfill the new requirement of Local File by extending certain information to be disclosed in their existing documentation. Taxpayers with significant amount of intercompany transactions, however, shall give heed to the brand new requirement of Master File.

Announcement 42 also revamps the existing transfer pricing annual filing system, to which the Country-by-Country Reporting mechanism is newly integrated. This development will naturally engage taxpayers into more administrative efforts such as data collection, synchronization and presentation, changing the landscape of their compliance and reporting responsibilities.

Overall speaking, the extended disclosure of information brought forth by Announcement 42 will inevitably render the actual transfer pricing operation of taxpayers more transparent and accessible to tax authorities. Taxpayers are therefore advised to commit due resources into an overall risk review of its ongoing transfer pricing position. If the taxpayer can structure its transfer pricing mechanism in line with its role and position in the whole supply chain, and duly fulfill all its legal reporting duties, its transfer pricing exposure can be significantly mitigated from a PRC perspective.

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