Baker & McKenzie

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Session 6: Three Topical Transfer Pricing Issues

Speakers:
Peter Tan, Singapore
Thomas Brennan, Australia
Glenn DeSouza, China
Mike Nixon, Singapore
Sam Sim, IBM
Adnan Begic, Michelin

Three Topical Transfer Pricing Issues

- Movement away from the arm's length standard and the focus on economic ownership
- Adoption of ex post or "look back" valuation methodologies by tax authorities
- Implementation of master file/local file/CbC reporting
  - different reporting requirements?
  - implementation dates

Three Topical Transfer Pricing Issues

Movement away from the arm's length standard and the focus on economic ownership

- Arm's length standard
  - The international standard agreed upon by OECD members to determine transfer prices for tax purposes
- Arm's length range
  - Range of acceptable figures using transfer pricing methods

Three Topical Transfer Pricing Issues

Arm's length principle *(OECD Transfer Pricing Guidelines)*

> Where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.."
>
> *(Article 9 of the OECD Model Tax Convention)*

Three Topical Transfer Pricing Issues

Arm's length range

A range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm's length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods

OECD Transfer Pricing Guidelines

Three Topical Transfer Pricing Issues

Transfer methods

- Traditional transaction methods
  - Comparable uncontrolled price
  - Resale price
  - Cost plus
- Transactional profits methods
  - Transactional net margin
  - Profit split

Three Topical Transfer Pricing Issues

Movement away from the arm’s length standard and the focus on economic ownership

- legal ownership v economic ownership
- DEMPE
- draft guidelines on profit split
- location savings
- market premium

Three Topical Transfer Pricing Issues

Adoption of ex post or “look back” valuation methodologies by tax authorities

- When would valuation be typically required?
- Why would there be a look back
- Would a look back be fair?
- When would tax administrations challenge a valuation?

Three Topical Transfer Pricing Issues

- Implementation of master file/local file/CbC reporting
  - Different reporting requirements?
  - Implementation dates

Quick guide to Bulletin 42

What Happened to Circular 2X

- China became the first national try to fully implement BEPS when on 17 September 2015, China's State Administration of Taxation ("SAT") released a discussion draft of the Implementation Measures of Special Tax Adjustment ("Circular 2X") for public consultation.
- On 29 June, 2016, instead of finalizing the Circular 2X, SAT released a refined transfer pricing compliance requirement separately in the form of Bulletin [2016] No. 42.
- It is expected that SAT will issue the remaining parts of the Circular 2X in the form of various Public Notices in the future.

Key Takeaways from Bulletin 42

Issue	New Elements	Article in Bulletin 42
Threshold	Under Circular 2, the thresholds are (i) when the annual amount of tangible transactions is over 200 million yuan, or (ii) the amount of other related party transactions is over RMB 40 million. Minimal changes here. Bulletin 42 adds just two new criteria: (i) when transactions involving financial assets are over 100 million yuan, or (ii) when transactions of intangible assets exceed 100 million yuan.	13
Report Structure	Circular 2 required only a local file and a thin capitalization file. Bulletin 42 has a three-tier framework (master file, local file and special files for thin capitalization and cost-sharing agreements)	10
Deadline for Preparation	Under Circular 2, the deadline preparing the local file is May 31 of the following year. Under Bulletin 42, the deadline is June 30.	19
Deadline for Submission	Under Circular 2, the deadline for submission is 20 days of a request from the tax authority. Under Bulletin 42, the deadline is 30 days from a request.	19
Value Chain	Value chain should include: i. the business and capital flow at each link along the transaction; ii. the financial statements of the participants at each link; and iii. the group's profit allocation principles and results in its global value chain.	14
Market Premium and Location Specific Factors	These items from China's chapter of the UN transfer pricing manual have been introduced into the standard local file package.	14
Contribution to Group Profit	It is now mandatory to explain the tested party's contribution to the group's overall profit or residual profit, irrespective of the selected method.	14

Guide to the Master File

- Threshold: According to Article 11 of Bulletin 42, the master file must be prepared by a Chinese enterprise if either of the following conditions are met:
  - “the enterprise has overseas related-party transactions during the fiscal year and the ultimate holding enterprise has already prepared master file; or
  - the total amount of related-party transactions of the enterprise exceeds RMB 1 billion ($150 million).”

Guide to the Master File (cont'd)

– Format: The master file as specified by Bulletin 42 matches the OECD format, so if a company has already prepared a master file in its home country, this requirement would impose very little burden except that it would need to be translated into Chinese. The master file matches the very detailed five layers of OECD format.

Guide to the Master File (cont'd)

– U.S. Considerations: The home country may not require a master file. This may well be the situation for U.S. multinationals; the IRS currently doesn't require this file, possibly because it sees it as a burden on U.S. companies that doesn't serve the government's interests.
– Timing: A master file shall be completed within 12 months of the fiscal year end of the ultimate holding company of the enterprise group.

Guide to the Local File

– The taxpayer will need to prepare a local file for each enterprise in China that exceeds the threshold. The required documentation is comprehensive, with five main parts and 26 sub-parts. The required documents are:
  - Overview of local enterprise
  - Related-party relationships
  - Related-party transactions
    1. attributes of intercompany transactions (market premium, location specific advantages)
    2. analysis of value chain
  - Comparability analysis

Guide to the Local File (cont'd)

- Selection and application of transfer pricing method
  ii. selection of transfer pricing method and the underlying reason, and explanation on the enterprise's contribution to the group's overall profit or residual profit

– The local file and special issue file shall be completed by 30 June of the year following the year during which the related party transactions occur.

New Disclosure Forms (22 Forms)

Line	Form No.	Form Name
1	G000000	Filing Entity's Information Form
2	G100000	Summary of Related Party Transactions
3	G101000	Related Party Relationships Form
4	G102000	Tangible Assets Ownership Transaction Form
5	G103000	Intangible Assets Ownership Transaction Form
6	G104000	Tangible Assets Use Right Transaction Form
7	G105000	Intangible Assets Use Right Transaction Form
8	G106000	Financial Assets Transaction Form
9	G107000	Financing Form
10	G108000	Related Party Service Form
11	G109000	Equity Investment Form
12	G110000	Cost Sharing Agreement Form
13	G111000	Outbound Payment Form
14	G112000	Overseas Related Party Information Form
15	G113010	Annual Related Party Transaction Financial Analysis (Standalone Financial Statement)
16	G113020	Annual Related Party Transaction Financial Analysis (Consolidated Financial Statement)
17	G114010	Country-by-Country Report - Income, tax and business activities by tax jurisdiction
18	G114011	Country-by-Country Report - Income, tax and business activities by tax jurisdiction (English)
19	G114020	Country-by-Country Report - List of all entities of the multi-national enterprise group
20	G114021	Country-by-Country Report - List of all entities of the multi-national enterprise group (English)
21	G114030	Country-by-Country Report - Additional Information Form
22	G114031	Country-by-Country Report - Additional Information Form (English)

New Disclosure Forms – Form 14

G112000

Overseas Related Party Information Form

Number: 01

Name of Taxpayer		Registered Address	Country (Region)										
Taxpayer's Registration Number		Business Address	Country (Region)										
Business Scope													
Type of Applicable Income Tax		Actual Tax Liability		Registered Capital	Currency		Amount		Total Investment Amount	Currency		Amount	
Applicable Income Tax Benefit(s)													
Industry		Starting Date of Tax Year		Ending Date of Tax Year									
Independent Legal Entity	Yes□ No□	Legal Representative or Principal		Independent Accounting	Yes□ No□	Prepare Standalone Financial Statement	Yes□ No□						
Listed Company	Yes□ No□	Ticker Symbol		Stock Exchange		Accounting Ledger Currency							

Country-by-Country Report

- This section of Bulletin 42 is mostly directed at Chinese multinationals, but an interesting issue is whether the SAT can get the country-by-country report of the multinational from the subsidiary.
- According to Article 8, the tax authorities may request an enterprise under audit to submit a country-by- country report if:
  - The multinational group to which the audited enterprise belongs is required to prepare a country-by- country report under any jurisdiction’s law; and
  - The tax authorities cannot obtain that report through an information exchange program.

SAT Value Chain Analysis - Manufacturing

Facts:

- 60% of the global production is in China
- Global revenue is USD 5 billion and global profit equals to USD 400 million
- China entity has COGS of USD 800 million and a profit margin of 3%

SAT Method:

Step 1: Assert that the global profit comes from manufacturing, R&D and sales & marketing

Step 2: Assume that manufacturing contributes 30% of the global profit

Step 3: Calculate the global profit of manufacturing as equals to USD 120 million (400 million*30%=120 million)

Step 4: Allocate 60% of the global manufacturing profit to China since it accounts for 60% of the manufacturing output based on some metrics such as COGS. The allocated profit to China is USD 72 million (120 million*60%=72 million)

Step 5: Divide the allocated profit by the China COGS to get the Full Cost Mark up ("FCMU") for China which is 9% (72 million/800 million=9%)

Step 6: Identify comparables who can support a high profit rate

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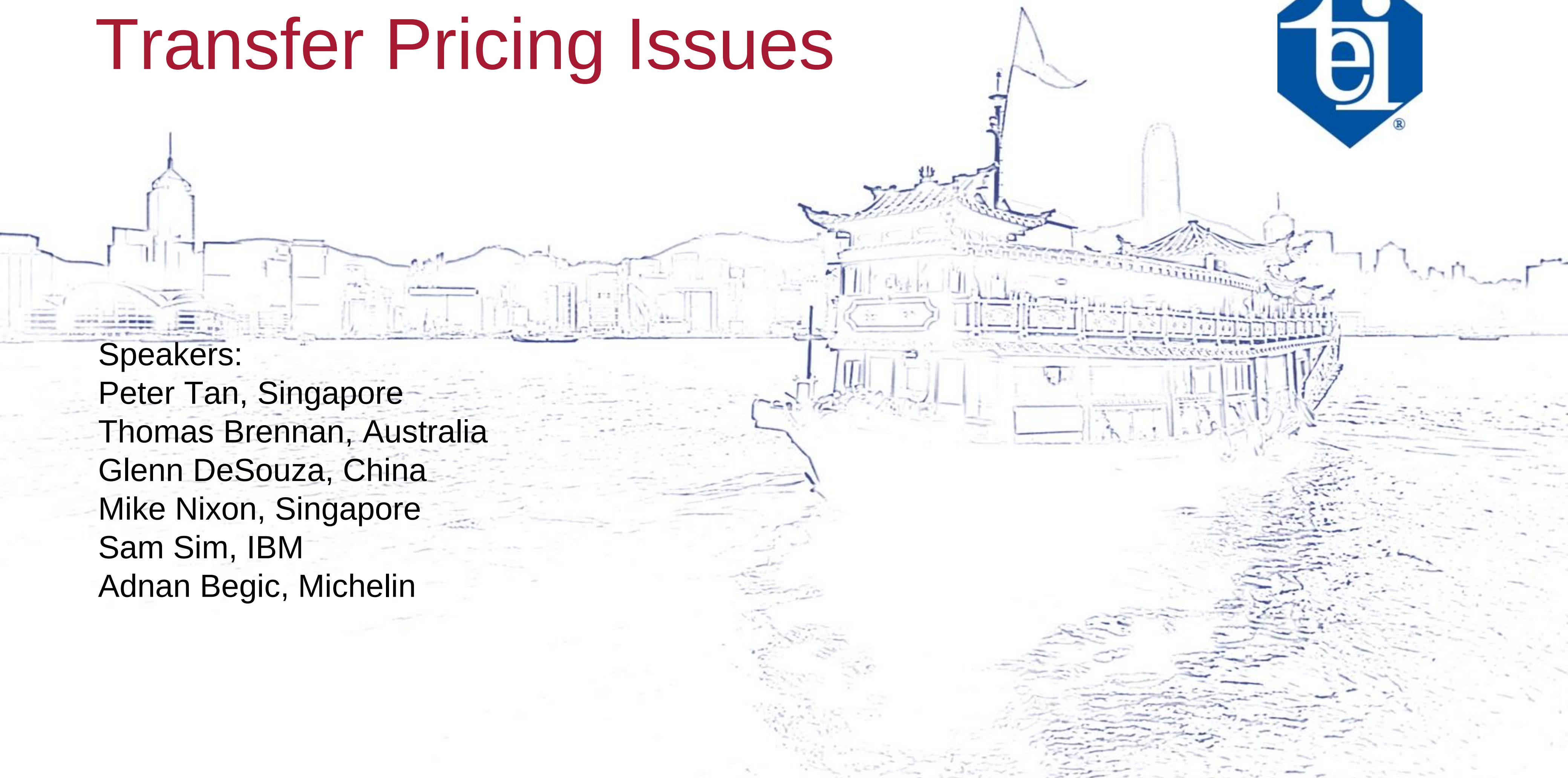

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