Tax
China

BAKER & MCKENZIE

Client Alert

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China Introduces New Transfer Pricing Documentation Rules to Implement BEPS Country-by-Country Reporting

On 13 July 2016, the State Administration of Taxation (SAT) finally released the long-awaited Bulletin 42[1] to revise the transfer pricing documentation requirements under Circular 2[2]. By introducing the key recommendations under Action Plan 13 of the Base Erosion and Profit Shifting (BEPS) Project, Bulletin 42 will have a far-reaching impact on taxpayers.

In this alert, we will first look at who is affected by Bulletin 42. We will then discuss key provisions introduced under this bulletin and their implications on multinational companies (MNCs). Finally, we will provide some recommendations to MNCs on how to ensure compliance with the new transfer pricing documentation requirements and how to develop appropriate strategies to safeguard their tax interests in China.

1. Who is affected?

Any MNC engaged in a cross-border, related-party transaction can expect to be significantly affected by the transfer pricing documentation requirements in Bulletin 42. MNCs engaged in purely domestic related-party transactions are expressly excluded from these requirements.

Bulletin 42 requires MNCs to prepare transfer pricing documentation for related-party transactions occurring in or after 2016. Non-compliance may lead to a punitive interest penalty equal to the RMB loan benchmark rate published by the People's Bank of China plus 5 percentage points if and when the PRC tax authorities make a final transfer pricing adjustment.

2. What does the bulletin require?

Consistent with the OECD proposals under the Base Erosion and Profit Shifting (BEPS) Action Plan 13, Bulletin 42 requires the taxpayer, subject

1 *State Administration of Taxation's Bulletin on Issues Relating to the Enhancement of the Declaration of Related Party Transactions and Administration of Contemporaneous Documentation*, SAT Bulletin [2016] No. 42, dated 29 June 2016, retroactively effective from 1 January 2016.

2 *Circular of the State Administration of Taxation on Printing and Distributing the Implementing Measures for Special Tax Adjustments (for Trial Implementation)*, Guo Shui Fa [2009] No. 2, dated 8 January 2009, retrospectively effective from 1 January 2008.

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to certain conditions as illustrated below, to provide a three-layer transfer pricing documentation: (i) a master file containing general information about the MNC group's global business operations; (ii) a local file containing detailed information about the related-party transactions of the Chinese enterprise in the group; and (iii) a country-by-country report containing information about the global allocation of the MNC group's income and taxes ("**CbC Report**"). In addition, Bulletin 42 requires the taxpayer to prepare a special file for cost sharing agreements and thin-capitalisation.

2.1 Master file

An enterprise must prepare a master file within 12 months from when the fiscal year ends for the MNC group's ultimate holding company if the enterprise's total related-party transactions exceed RMB1 billion or the MNC group has already prepared a master file.

The master file provides a "blueprint" of the MNC group and contains:

- the MNC group's organizational chart;
- a description of the MNC's business, including profit drivers, supply chain and main geographic markets of major products/services, intercompany service agreements, brief functional and value creation analysis for group entities, and recent restructurings;
- information on the MNC's intangibles, e.g., a list of intangibles important for transfer pricing with legal owners and a general description of the MNC group's transfer pricing policies for R&D and intangibles;
- a description of the MNC's financial arrangements, including related and unrelated financing; and
- documents containing the MNC's financial and tax positions, e.g., the latest consolidated financial statements of the MNC group, a list and a brief introduction of advance pricing agreements (APAs) and tax rulings on income allocation, and the reporting entity for the CbC Report.

Normally, a Chinese affiliate does not have direct access to most (or any) of this information. Therefore, it would be burdensome if not impossible for the Chinese affiliate to prepare the master file by itself.

Fortunately, most Chinese affiliates will not have to prepare the master file from scratch. Since the information required for the master file under Bulletin 42 is basically the same as the information required under the BEPS proposals[3], the Chinese affiliate can modify the master file that has been prepared by the MNC group to satisfy the BEPS requirements and submit that modified file to satisfy the Bulletin 42 requirements. As such, we recommend Chinese affiliates ask the MNC group's parent company

3 Except, Bulletin 42 requires the reporting entity for the CbC Report to be specified in the master file.

to share the most recent BEPS master file whenever the Chinese affiliate prepares the Bulletin 42 master file.

2.2 Local file

An enterprise must prepare a local file for its annual related-party transactions (excluding transactions covered by APAs) by 30 June of the following year if:

- its annual amount of related-party transfers of tangible assets exceeds RMB200 million;
- its annual amount of related-party transfers of financial assets exceeds RMB100 million;
- its annual amount of related-party transfers of intangible assets exceeds RMB100 million; or
- its annual amount of other related-party transactions exceeds RMB40 million.

Although most of the information required for the local file has already been required under Circular 2, Bulletin 42 does require some new information, such as information on value chain analysis, location specific advantages, the enterprise's contribution to the MNC group's overall or residual profits, related-party equity transfers[4], intragroup services, APAs and tax rulings related to the transactions conducted by the enterprise.

Even though Bulletin 42 marks the first time that any regulation will expressly require value chain analysis to be included in transfer pricing documentation, the SAT has consistently instructed local tax authorities to conduct a value chain analysis when making transfer pricing adjustments because the SAT enthusiastically insists that "value chain analysis" is consistent with the BEPS Project's principal objective, i.e., to ensure that "profits [are] taxed in the jurisdiction where economic activities occur and value is created." Notably, the financials of all the related parties along the value chain will have to be provided to the Chinese tax authorities under the value chain analysis. We expect the value chain analysis as part of the local file to encourage the PRC tax authorities to use the profit split method more frequently when determining a Chinese affiliate's proper returns.

2.3 CbC Report

A Chinese resident enterprise must submit a CbC Report when filing its annual tax return if:

- it is the ultimate holding company in an MNC group with a consolidated revenue for the last fiscal year in excess of RMB5.5 billion; or

4 For the first time, Bulletin 42 codifies the tax authority's practical approach in requiring a valuation report to evidence a related-party equity transfer is conducted at arm's length.

- it is designated by the MNC group as a reporting entity for the CbC Report.

Consistent with the BEPS recommendations, the CbC Report under Bulletin 42 requires aggregate country-by-country data about entities (and permanent establishments) in every country, including information about revenue, profits (and losses) before income tax, income tax paid (on cash basis), income tax incurred, stated capital and accumulated earnings, number of employees, and tangible assets other than cash and cash equivalents.

In addition, the PRC tax authorities may request an enterprise under audit to submit a CbC Report if: (i) the MNC group to which the audited enterprise belongs is required to prepare a CbC Report under any jurisdiction's law; and (ii) the PRC tax authorities cannot obtain that CbC Report through an information exchange program[5].

On 30 June 2016, the US Treasury and the Internal Revenue Service released the final regulations implementing CbC reporting[6] ("**US CbC Regulations**"). The US CbC Regulations require every US-parented MNC with an annual group income of USD850 million or more to prepare a CbC Report for reporting periods that begin on or after 30 June 2016. Notably, the US has said it will not participate in the CbC MCAA. Instead, it would enter into bilateral agreements for exchange of CbC Reports to conform with US government practice on international agreements. Thus, before China enters into a bilateral arrangement with the US on the exchange of CbC Reports, a US MNC's CbC Report will not be exchanged to the PRC tax authorities. That being said, with US domestic law requiring a US MNC to prepare a CbC Report, the PRC tax authorities can now request an MNC's Chinese subsidiary(ies) to provide the CbC Report during a transfer pricing audit.

In addition to increasing the compliance burden on MNCs, CbC reporting could pose a risk for MNCs because the PRC tax authorities may attempt to claim a larger share of the MNC's global profits.

2.4 Special file

Although the term "special file" is being used for the first time, the information required for the special file was already required under Circular 2. The new terminology will not have any substantial impact on MNCs.

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5 On 12 May 2016, China signed the Multilateral Competent Authority Agreement on the Automatic Exchange of Information of Country-by-Country Reports ("**CbC MCAA**").

6 The full text of the legislation is available at https://www.federalregister.gov/articles/2016/06/30/2016-15482/country-by-country-reporting.

3. What are the impacts on MNCs?

The PRC Enterprise Income Tax Law (EITL) and its implementing regulations only require taxpayers to provide information relevant to the related-party transactions. Whereas, Bulletin 42 requires information beyond the scope of the taxpayer's related-party transactions, for example, the CbC Report. Technically speaking, the EITL and its implementing regulations should prevail over Bulletin 42 in case of conflict. In practice, however, it would be difficult for taxpayers to challenge Bulletin 42 based on the said conflict.

With more transfer pricing documentation information being required under Bulletin 42 and being disclosed to the PRC tax authorities, we expect more transfer pricing audits and more tax disputes to follow in China. In particular, the SAT may introduce new transfer pricing legislation in the future as weapons to bring more profits to China.

However, as concerning as it may sound, Bulletin 42 and potential transfer pricing regulations to follow, are by no means the end of tax planning in China. After all, China's transfer pricing rules still follow the arm's length principle. Therefore, amid the heightened scrutiny, taxpayers should remain confident in being able to defend their related party transactions before the tax authorities as long as their positions are based on a sound application of the arm's length principle and are supported by high-quality comparable data. In addition, taxpayers can still expect assistance and relief from other involved jurisdictions. Action Plan 14 under the BEPS Project requires jurisdictions to settle disputes within 24 months. In response to this requirement, the SAT has invested vastly in its mutual agreement procedure program. Even if a taxpayer on its own is not able to settle with the SAT, the competent authority of the taxpayer's jurisdictions could always intervene to negotiate with the SAT on the taxpayer's behalf or provide a corresponding adjustment to alleviate double taxation.

Last but not least, the tax administration environment is improving in China. Previously, administrative review and administrative litigation were not used by foreign companies and foreign-invested companies. The past two years have seen more formal controversy, even with some litigation cases against the tax authorities by MNCs. Practice indicates that tax authorities are more motivated to make a compromise if taxpayers are willing to go the distance by pursuing formal dispute resolutions forums up to and including litigating the matter in a court of law. In short, MNCs with a solid legal basis for their structure must be ready, willing and able to vigorously defend their positions.

4. What should MNCs do?

With Bulletin 42 taking effect from 1 January 2016, MNCs will be required to comply with the new transfer pricing documentation requirements. Coupled with the PRC tax authorities' increasing scrutiny on cross-border related-party transactions in a post-BEPS environment, every MNC should consider the following actions to safeguard its tax interests in China:

- invest in human resources and accounting systems to comply with new transfer pricing documentation requirements;
- review and assess existing legal structures and the economic substance of income receiving entities to determine whether these arrangements are defensible;
- manage the tax risks from BEPS by obtaining certainty through APAs where appropriate;
- prepare to challenge tax authority decisions through administrative review processes, litigation, mutual agreement procedures or other procedures when a sound legal basis exists and it is commercially necessary and feasible to do so.

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