



CCA ONTIER

A GLOBAL FIRM
WITH A LOCAL SOUL

*CONFIDENTIAL – The content and images of this document are confidential
and shall not be transmitted without CCA ONTIER consent.*



CCA ONTIER

Transfer Pricing in the PRC

A GLOBAL FIRM WITH A LOCAL SOUL

PORTUGAL / BOLIVIA / BRAZIL / CHILE / CHINA / COLOMBIA
SPAIN / UNITED STATES / ITALY / UNITED KINGDOM / MEXICO / PERU / VENEZUELA

INDEX

1. Setting the Tone
2. What Changed?
3. Overview of Previous Regime
4. Announcement No. 42
5. Closing Remarks

1.

Setting the Tone

Setting the Tone

To keep in mind throughout this presentation:

- Applicable to any related-party transaction carried in the fiscal year of **2016**
- At present date we have limited information on how will this new regime be applied by the State Administration of Taxation (SAT) of the PRC and local tax authorities
- This regime may be unevenly applied depending the province, city or even district of registration of your company
- Direct and constant contact with your local tax authority is advised

2.

What Changed

What Changed?

Announcement No. 42 of the State Administration of Taxation on *Relevant Matters Relating to Improvement of the Filling of Related-Party Transactions and the Management of Contemporaneous Documentation*, issued in **July 13, 2016**
(Announcement No. 42)

This announcement has **implemented Action Plan 13** of the OECD (2013), Action Plan on Base Erosion and Profit Shifting (BEPS), OECD Publishing

What Changed?

Announcement No. 42 partially repeals:

-State Administration of Taxation Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation), Circular No. 2 [2009]

In Practical terms:

-Compliance requirements and **transfer pricing documentation**, as of fiscal year of 2016, will need to observe Announcement No. 42; and

-Existing related-party transaction **reporting forms** to be delivered at your local tax office are replaced to reflect the changes in regulation

3.

Overview of Previous Regime

Overview of Previous Regime

Before heading into the changes of the new regime, we need first to establish:

- What laws and regulations were already in place on the subject
- How were these currently being applied by authorities
- Which of these concepts remain in place after applicability of Announcement No. 42

Overview of Previous Regime

General Regulation:

Enterprise Income Tax Law of the People's Republic of China, issued by Order No. 63 in March 16, 2007

Regulation on the Implementation of the Enterprise Income Tax Law of the People's Republic of China, issued by Order No. 512 in March 16, 2007

Announcement No. 42 does not amend the applicable law, but the changes should still be complied with by local entities.

Overview of Previous Regime

Arm's Length Principle

China utilizes the **arm's length principle** in regards to related-party transactions.

The Implementing Regulations defines “**arm's length principle**” as based in unrelated parties when entering into business transactions under fair price and in accordance with business practice.

Overview of Previous Regime

Reasonable Methods

If the transaction is found not be in conformity with arm's length principle the Chinese authorities may make adjustments pursuant to “reasonable methods”:

- Comparable uncontrolled price
 - Resale price method
 - Cost plus method
 - Transactional net margin method
 - Profit split method
 - Other methods that comply with the arm's length principle
- [Direct reference to international standards but without sufficient definition in Chinese Law]*

4.

Announcement No. 42

Announcement No. 42

- Provides detailed information on the **new compliance requirements** of Chinese entities towards the State Administration of Taxation
- Implementation of **Action Plan 13** of BEPS
- Definitions within Announcement No. 42 are defined as **non-exhaustive** for each type of compliance obligations and principles to be pursued
- As such should be interpreted as general templates and indications of information to be disclosed and practices to be implemented

Announcement No. 42

Related Party Transactions

Generally defined in law and clarified as follows:

- Companies directly or indirectly holding 25% of shares of other party of the transaction;
- Third party directly or indirectly holding 25% of shares of the respective shares of both parties of the transaction;
- When two parties have a shareholding relationship or their shares are jointly held by a third party, below the thresholds identified in the previous items, but the total amount of loans between the parties accounts for at least 50% of either party paid-in capital;
- When two parties have a shareholding relationship or their shares are jointly held by a third party, below the thresholds identified in the previous items, but 10% or more of total loans owed by one party is guaranteed by the other party to the transaction;

Announcement No. 42

Related Party Transactions

- When two parties have a shareholding relationship or their shares are jointly held by a third party, below the thresholds identified in the previous items, but business activities of one party is controlled by the other party to the transaction. “Control” is defined to the right of either party to make decisions on the other party’s financial and operational strategies and having benefits from the other party’s business operations;
- When more than half of a party’s directors or senior management personnel are assigned or appointed by the other party to the transaction or concurrently serve as director or senior management to both parties; and
- When more than half of both party’s directors or senior management personnel are assigned or appointed by a third party.

Announcement No. 42

Type of Transactions Contemplated

- Transfer of ownership or right of use of tangible assets;
- Transfer of ownership or right of use of intangible assets (e.g. trademark rights, patents and other intellectual property);
- Transfer of financial assets (e.g. notes receivable, equity investments, derivative financial instruments and others);
- Financing capital (i.e. all kinds of long-term and short-term loans and interest bearing advanced or deferred payments); and
- Service transactions (e.g. market research, human resources or any other service provided)

Announcement No. 42

Ultimate Holding Company

Definition of **ultimate holding company** is provided in Announcement No. 42 in regards to the Country by country Report obligation. Due to the **lack of another definition in law**, this is the best basis to determine the ultimate holding company in a group for any purpose in regards to transfer pricing matters.

The enterprise that is able to consolidate all the financial statements of the member entities of a multinational group but it cannot be consolidated into the financial statements of any other enterprise considered to be part of this group.

Definition of ultimate holding company is **not related to equity ownership** but rather is a determination pursuant to the consolidation of financial statements

Announcement No. 42

Country by Country Report

A Chinese enterprise must provide a Country by Country Report when filling its Annual Report on the Related-party Transactions if:

- The resident company is the **ultimate holding company of a multinational group** and its aggregate revenue as shown in its annual consolidated financial statement in the last fiscal year exceeds **CNY 5.5 billion**;
- Resident enterprise is **designated as the filling enterprise** for the Country by Country Report by the multinational group.

The contents of the Country by Country Report **must disclose global income** of the multinational group, taxation and business activities of all member entities of the multinational group.

Announcement No. 42

Country by Country Report

SAT may request that a Country by Country Report should be provided within an audit or investigation if the multinational group to which it is affiliated should prepare a Country by Country Report in accordance to its home jurisdiction and if meets any of the following:

- The multinational group has not provided a Country by Country Report to any country;**
- The multinational group has submitted a Country by Country Report, but China has not established any information exchange mechanism with said country; and**
- The multinational group has submitted a Country by Country Report to a country that China established an information exchange mechanism, but Chinese authorities were never given access to the Country by Country Report.**

Announcement No. 42

Master File

Chinese enterprises meeting **any** of the following conditions are required to prepare the Master File:

- The Chinese enterprise has conducted **cross-border related-party transactions** in the current year and the **ultimate holding company** of its group has prepared a Master File;
- The annual amount of the related-party transactions exceeds **CNY 1 billion**.

Master File is intended to disclose an **overview of the global business** of the multinational group

Announcement No. 42

Local File

Chinese enterprises whose annual amount of related-party transactions satisfies **any of the thresholds** below shall prepare a Local File:

- Amount of **tangible assets** ownership transfer (calculated on the basis of customs clearance price for annual import and export) exceeds **CNY 200 million**;
- Amount of **financial assets** transfer exceeds **CNY 100 million**;
- Amount of **intangible assets** ownership transfer exceeds **CNY 100 million**; or
- Aggregated amount of **other related-party transactions** exceeds **CNY 40 million**.

Local File is intended to disclose **detailed information on the related-party transactions**

Announcement No. 42

Special File

A Special Issue File must be produced and submitted if:

- Enterprises enter into or perform **cost allocation agreements**;
- **Thin capitalization** when related-party debt to equity ratio of the Chinese enterprise exceeds the standard ratio.

For each of the cases described above a specific file must be prepared to **explain their compliance to the arm's length principle.**

Announcement No. 42

Contemporaneous Documentation

- Information that must be provided **following a request by SAT in an audit or investigation**
- This term was not previously used in Chinese law

Includes:

- Materials relating to related-party transactions with respect to **prices, the setting of standards for expenses and method of calculation specifications;**
- Materials relating to the related-party transactions with respect to the prices for the **re-sale (transfer) of properties, property rights and services;**
- Materials relating to the related transactions that other enterprises have to provide with respect to the **comparable product prices, pricing strategies, and profit level of the enterprise under investigation;** and
- Expressly includes the Master File, Local File and Special File**

Announcement No. 42

Contemporaneous Documentation

In our opinion the fact that Master File, Local File and Special Issue File were **expressly included** within the definition of the contemporaneous documentation **may convey one of the following:**

- Entities that **were obliged** to provide these documents for the previous fiscal year may be requested to provide these files within 30 (thirty) days of a notification by SAT; or
- Entities that **may not have been obliged to produce** one of these files, more markedly the local file, may be requested to do so within a period of 30 (thirty) days.

Risk averse action is to constantly keep information to produce a local file (and a special file if applicable) even if the entity is not obliged to do so.

Must keep relevant information for future audits for a period of 10 years and must be provided even if within this period the company was subject to a merger or spin off, in which case the surviving enterprises must maintain due records.

Announcement No. 42

- Master File** must be prepared and delivered within 12 months of the end of the fiscal year;
- Local File and Special File** must be prepared and delivered before June 30 of the year following when the related-party transaction occurred;
- Contemporaneous Documentation** and other requested information in an investigation or audit must be prepared and provided within 30 days of the request of tax authorities;
- **Annual Report on Related-party Transactions**, even if the Chinese enterprise does not trigger any other obligation as defined above, must be submitted with the Annual Enterprise Income Tax Return.

Announcement No. 42

Forms

- Corporate Information Form
- Related Party Relationship Form
- Overseas Related Party Form
- Annual Summary Form on Related Party Transactions
- Transfers of Ownership in Tangible Assets Form
- Transfers of Ownership in Intangible Assets Form
- Transfers of Rights to Use Tangible Assets Form
- Transfers of Rights to use Intangible Assets Form
- Financial Assets Transaction Form
- Financing Form
- Related Party Services Form
- Equity Investment Form
- Cost Sharing Agreements Form
- Overseas Payment Form
- Financial Analysis Form for Related Party Transactions
- Form on the Global Distribution of Revenue, Tax, and Operating Activities
- List of Entities within the Multinational Group
- Additional Information Form

5.

Closing Remarks

Closing Remarks

- Substantially higher threshold of compliance and requirement of adequate transfer pricing documentation to be kept by Chinese incorporated companies;
- The added transfer pricing requirements will likely invite higher scrutiny and a higher risk of audit;
- However the environment for foreign companies to request administrative review and pursue litigation based on the principle of arm's length, while proving compliance with the requirements discussed today, also got better. (At least at the biggest commercial and financial centers)
- Any multi national with an entity in Mainland China that may have related party transactions should increase their compliance department and have the necessary documentation to be subject to an audit on matters of transfer pricing and be ready to challenge any adverse decision by the State Administration of Taxation.



CCA ONTIER

A GLOBAL OFFICE WITH A LOCAL SOUL



PORTUGAL BOLIVIA BRAZIL COLOMBIA CHINA ITALY MEXICO PANAMA PARAGUAY PERU SPAIN UNITED KINGDOM USA VENEZUELA



CCA ONTIER

This Guide is provided for information purposes only and is not intended to constitute legal advice. You should seek professional legal advice before taking or refraining from taking any action as a result of the contents of this document. Should you have any questions regarding this Guide, please contact us.

The content of this Guide, including its images, is the intellectual property of CCA ONTIER. Any use is subject to the prior and express authorization of CCA ONTIER.

The information contained in this Guide refers to the date of its publication: February 2017.