

AN OFFERING FROM THE BDO INTERNATIONAL TAX PRACTICE

INTERNATIONAL TAX AND TP NEWSFLASH



SUBJECT

OBSERVATION BY BDO CHINA — INTERPRETATION OF NEW REGULATIONS ISSUED BY STATE ADMINISTRATION OF TAXATION REGARDING RELATED-PARTY TRANSACTIONS REPORTING AND CONTEMPORANEOUS DOCUMENTATION

OVERVIEW

On June 29, 2016, the State Administration of Taxation ("SAT") issued new regulations to improve the related-party transactions reporting and contemporaneous documentation (SAT Bulletin [2016] No.42) ("Bulletin 42"). Bulletin 42 updates the chapters of related-party transactions reporting and contemporaneous documentation in the existing "Implementation Measures of Special Tax Adjustment (Provisional)" (Guoshuifa [2009] No. 2) ("Circular 2"). Meanwhile, the applicable sections in the Circular 2, i.e., Chapter 2 and 3, Article 74 and 89, and the current Annual Related-party Transactions Reporting Forms (Guoshuifa [2008] No.114) have been repealed.

On September 17, 2015, SAT released "Discussion Draft of Implementation Measures of Special Tax Adjustment" ("Discussion Draft"), which is seen as an upgrade to Circular 2. Bulletin 42 only focuses on the revision and clarification of related-party transactions reporting and contemporaneous documentation. It is expected that SAT will release additional announcements to regulate other matters in the discussion draft, such as intangible assets and anti-avoidance.

The issuance of Bulletin 42 marked a success for the SAT in implementing Action 13 of the Base Erosion and Profit Shifting ("BEPS") project in China. It also marks the conclusion of China's transfer pricing practice under Circular 2. The issuance of Bulletin 42 signals the beginning of a new chapter for China's transfer pricing practice, and is in accordance with international standards.

Should this topic affect your current situation, or should you require further information, then please do not hesitate to contact us.

GORDON GAO

Tax Partner
+86 21 6313 8751
gordon.g@bdo.com.cn

JAY TANG

Transfer Pricing Director
+86 21 6313 9352 * 816
jay.t@bdo.com.cn

BULLETIN 42 HIGHLIGHTS

Bulletin 42 sets out more detailed regulations on related-party transactions reporting; the definition of a related-party relationship; types of related-party transactions; reporting party and content for Country-by-Country reports ("CbCR") and types, contents, thresholds, and submission of contemporaneous documentation.

1. Clarification on Reporting party Obligations

Bulletin 42 clarifies that any resident enterprise subject to tax levied on auditing and any non-resident enterprise that has establishments or offices in domestic China is required to report its related-party transactions in a fiscal year ("FY").

2. Revision of Related-Party Relationship Definition

Bulletin 42 refines the existing definition of a related-party relationship. For example, it clarifies the calculation of debt-to-equity ratio to define whether two parties involved in capital borrowing and lending are in a related-party relationship.

3. Expanding the Types of Related-Party Transactions

Bulletin 42 updates the existing types of related-party transactions under Circular 2 by including the transfer of financial assets between two related parties. Financial assets include account receivables, note receivables, other receivables, equity investment, debt investment and the assets formed by derivative financial instruments.

4. Specification of the Reporting Party and Content of CbCR

CbCRs form an important part of BEPS Action 13. Bulletin 42 has included the CbCR as part of Annual Related-party Transactions Reporting Forms in the annual corporate income tax ("CIT") filing, and requires taxpayers who meet one of the following conditions to submit a CbCR:

- ▶ The ultimate holding company of a multinational enterprise ("MNE"), with consolidated revenues greater than RMB 5.5 billion in the precedent fiscal year; or
- ▶ The entity nominated by its MNE group as the reporting entity.

The ultimate holding company refers to the entity with the ability to consolidate financials of all other member entities within the group, and its financials cannot be consolidated by any other member entity.

The definition of a member entity refers to:

- ▶ An entity that has been included in the consolidated financial statements;
- ▶ An entity that has not been included in the consolidated financial statements but should have been included according to the requirements of the Securities Exchange Commission;
- ▶ An entity that has not been included in the consolidated financial statements due to the size and importance of its business; or
- ▶ Permanent establishments with independent accounting system for financial reporting.

In addition, Bulletin 42 specifies that Chinese tax authorities have the right to request taxpayers to provide a CbCR under any of the following circumstances:

- ▶ MNEs that have not submitted a CbCR in any countries;
- ▶ MNEs that have submitted a CbCR in other countries, but China has not established the information exchange regime with other countries; or
- ▶ MNEs that have submitted a CbCR in other countries and China has established the information exchange regime with those countries, but the Chinese tax authorities have not obtained the CbCR.

5. Improvement of the Contemporaneous Documentation Management

Bulletin 42 modifies the detailed requirements of contemporaneous documentation reports, including the structure, content, thresholds of the transactions and submission deadlines. Comparing with Circular 2 that is currently in force, Bulletin 42 implements a three-tiered framework for transfer pricing documentation, i.e., master file, local file and special issue file, according to Action 13 of BEPS Action Plan. Compared to the discussion draft, Bulletin 42 introduces the requirements for preparing a master file, sets additional thresholds for the local file regarding the transfer of financial and intangible assets between related parties, removes the requirement to prepare special issue file for related-party service transactions, and identifies the deadline for the preparation and submission of the three-tiered transfer pricing documentation report.

The following table summarizes the requirements and exemption of preparing contemporaneous documentation report and the submission deadlines set out in Bulletin 42.

ITEM	BULLETIN 42
Documentation type	Master file, local file and special issue file
Preparation requirements	<p>Master file should be prepared:</p> <ul style="list-style-type: none"> ▶ Where the taxpayer has related-party transactions with overseas related parties during the year, and the taxpayer's ultimate holding company, which consolidates the financial statements of the taxpayer, has prepared a master file; or ▶ Where the annual amount of related-party transactions conducted by the taxpayer exceeds RMB 1 billion. <hr/> <p>Local file should be prepared:</p> <ul style="list-style-type: none"> ▶ Where the amount of purchase/sales of tangible assets is more than RMB 200 million (for toll manufacturing activities, the amount is calculated based on the import/export customs declaration prices); ▶ Where the amount of transfer of financial assets is more than RMB 100 million; ▶ Where the amount of transfer of intangible assets is more than RMB 100 million; or ▶ Where the amount of other related-party transactions is more than RMB 40 million. <hr/> <p>Special issue file should be prepared:</p> <ul style="list-style-type: none"> ▶ Where the taxpayer enters or implements cost sharing agreements; ▶ Where the taxpayer violates the thin capitalization rules for thresholds (non-financial institutions - 2:1, financial institutions - 5:1).
Exempt from preparation	<ul style="list-style-type: none"> ▶ A taxpayer with an Advanced Pricing Arrangement ("APA") is exempted from the preparation of a local file and special issue file if the related-party transactions are covered under the APA; ▶ A taxpayer is exempted from the preparation of a master file, local file and special issue file if its related-party transactions are conducted with domestic related parties only.
Deadline for preparation	<ul style="list-style-type: none"> ▶ A master file should be completed within twelve months of the fiscal year end of the group's ultimate holding company; ▶ A local file and special issue file should be completed by June 30 of the following year.
Deadline for submission	Within 30 days upon the request from the tax authorities.

In addition, Bulletin 42 clarifies the information to be disclosed in the three-tiered transfer pricing documentation. Since master file aims at large-scaled enterprises with tremendous amounts of related-party transactions, the disclosure requirements focus more on the group information, such as the global shareholding structure, group business description, group strategic plan for intangible assets, group financing arrangement and group financial and tax information.

As for local file, Bulletin 42 makes revisions based on Circular 2 by including a value chain analysis, which requires taxpayers to disclose the allocation principles and actual allocation results of group's value chain from research and development to after-sales services, as well as the impact of location-specific factors on the

pricing of transactions, and the portion of value creation from location specific factors shared by taxpayers. In addition, Bulletin 42 adds disclosure requirements for overseas investment and related-party equity transfers. Compared to Circular 2, Bulletin 42 places greater emphasis on related-party services transactions, including the methodology for the determination of services costs, allocation standards, calculation process, as well as the information on any same or similar service transactions that the taxpayer and its group enters into with third parties.

The disclosure requirements of special issue file for cost sharing agreements and thin capitalization in Bulletin 42 are mostly the same as those in Circular 2.

6. Update the Annual Related-party Transactions Reporting Forms

Bulletin 42 attaches a FY2016 version of Annual Related-party Transactions Reporting Forms of the People's Republic of China ("FY2016 RPT Reporting Forms") with detailed filing instructions. FY2016 RPT Reporting Forms increase the total number of forms from nine to twenty-two, with increased information disclosure requirements under the CbCR. Taxpayers that are required to file a CbCR should complete the forms in both English and Chinese. The CbCR forms include the allocation of related-party and third-party sales revenues, earnings before tax, the CIT paid and withheld,

registered capital, retained earnings, number of employees, and tangible assets, as well as the registered address and primary functions of the member entities.

Furthermore, FY2016 RPT Reporting Forms adds a Financial Asset Transaction Form, an Equity Investment Form, a Cost Sharing Agreements Form, an Overseas Related Party Information Form and a Related-Party Transactions Financial Analysis Form, which were previously required by Circular 2 to be disclosed in the local file.

OBSERVATION BY BDO CHINA

The release of Bulletin 42 enables the Chinese tax authorities to obtain more comprehensive information on taxpayers to increase the selection of the transfer pricing audit targets. The implementation of Bulletin 42 demonstrates the Chinese tax authorities determination to strengthen international tax cooperation and to combat tax evasion by actively participating in the BEPS Project.

Bulletin 42 sets higher requirements for disclosing information in contemporaneous documentation. It requires more resources for MNEs with large amounts of related-party transactions to prepare master files. To most Chinese subsidiaries of MNEs, the most significant impact is the additional scope for preparing a local file, especially the disclosure of value chain analysis and related-party service transactions. We expect many taxpayers will have difficulties in collecting, analyzing, and integrating information when preparing the master file or local file for the first year.

It seems that FY2016 RPT Reporting Forms require a significant increase in the amount of information to be disclosed. However, most of the new reporting forms, such as CbCRs, are not applicable to the Chinese subsidiaries of MNEs. In addition, the Enterprise Information Form, Related-party Relationship Form, Overseas Related Party Information Form, and MNE

Entity Information Form can be shared in the following years after first-year reporting.

With the adoption of country-by-country reporting and other related-party disclosure requirements, and the new requirements set out for the three-tiered transfer pricing documentation reports, Bulletin 42 not only improves the transparency of taxpayer's information, but also increases the compliance cost of taxpayers. Bulletin 42 is applicable to contemporaneous documentation and related-party reporting in year 2016 and after. To avoid the hassles in reporting related-party information and preparing contemporaneous documentation report in year 2017, it is recommended that taxpayers, especially large MNEs that are required to prepare master files and local files, communicate with their global headquarters to start the information collection and preparation process as early as possible to ensure the consistency in the disclosure of its transfer pricing arrangement(s) on a global scale. If taxpayers experience uncertainty in information disclosure or difficulty in information preparation, it is suggested that they consult professional firms for advice, and perform a health check on the current transfer pricing arrangement to better cope with and to manage the transfer pricing risks.

Please contact BDO China International Tax team should you have any questions regarding Bulletin 42.

BDO China SHU LUN PAN Certified Public Accountants LLP, a Chinese LLP company, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms.

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 60 offices and over 500 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 1,408 offices in 154 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2016 BDO USA, LLP. All rights reserved.