

China Tax Alert

Issue 23, July 2016

State Administration of Taxation (SAT) Issued Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation

Regulations discussed in this issue:

- The State Administration of Taxation (SAT) of the People's Republic of China's (PRC) Announcement on Transfer Pricing Contemporaneous Documentation requirements ("Announcement 42"), issued on July 13, 2016
- SAT Public Consultation Draft of a Circular on Implementation Measures for Special Tax Adjustments ("Discussion Draft"), issued on September 17, 2015
- SAT Announcement on Regulating the Administration of Cost Sharing Arrangements ("Announcement 45"), issued on 16 June, 2015
- SAT Announcement regarding Corporate Income Tax ("CIT") Matters on Outbound Payments to Overseas Related Parties ("Announcement 16"), issued on 18 March, 2015

Background

On 13 July 2016 the SAT released an Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation (Announcement 42). Announcement 42 replaces the current relevant regulations as prescribed under Chapters 2, 3, Article 74 and Article 89 of SAT Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation), Guoshuifa [2009] No. 2 ("Circular 2") and will be applied to fiscal years beginning from 1 January 2016.

Announcement 42 integrates, into Chinese tax regulations, the OECD/G20 BEPS Action 13 Report recommendations on transfer pricing documentation (i.e. the Master File and the Local File). The Announcement also replaces and modernizes the existing related party transaction reporting forms as specified under SAT Announcement on PRC Annual Reporting Forms on Related Party Transactions, Guoshuifa [2008] No. 114 ("Circular 114") that need to be filed together with corporate income tax returns ("Old Forms"). The third tier of the documentation as outlined in the OECD/G20 BEPS Action 13 Report recommendations, i.e. the country-by-country report ("CBC Report"), is introduced and incorporated in the revised related party transaction reporting forms.

The release of this Announcement may come as a surprise to some readers who have been expecting a Circular on the revised special tax adjustment regulations, following on SAT Public Consultation Draft of a Circular on Implementation Measures for Special Tax Adjustments ("Discussion Draft") released in September 2015 (see [China Tax Alert - Issue 25, September 2015](#)). Although the timing of the release of China's revised comprehensive transfer pricing regulations is uncertain at this stage, Announcement 42 should be considered the first of a series of regulations to localise OECD/G20 BEPS Project recommendations in China (see [China Tax Alert - Issue 28, October 2015](#)).

Regulations discussed in this issue:

- SAT Announcement on Issues Concerning the Reporting of Offshore Investments Made and Income Derived by Resident Enterprises (“Announcement 38”), issued on 30 June, 2014
- SAT Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation), Guoshuifa [2009] No. 2 (“Circular 2”), issued on January 8, 2009
- SAT Announcement on PRC Annual Reporting Forms on Related Party Transactions, Guoshuifa [2008] No. 114 (“Circular 114”), issued on 25 December 2008
- OECD/G20 Report “BEPS Action 13: Transfer Pricing Documentation and Country-by-Country Reporting” issued on 5 October 2015, (“BEPS Action 13 Report”)
- OECD/G20 Report “BEPS Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation” issued on 5 October 2015 (“BEPS Actions 8-10 Report”)
- OECD/G20 Report “BEPS Actions 3: Designing Effective Controlled Foreign Company Rules” issued on 5 October 2015 (“BEPS Actions 3 Report”)

This alert examines the changes to transfer pricing contemporaneous documentation requirements and to the related party transaction forms, as well as their implications to taxpayers.

Main content of Announcement 42

1. Reporting taxpayers of related party transaction reporting forms (Article 1)

Following Article 11 of Circular 2, Announcement 42 requires resident enterprises whose tax is levied according to accounting books as well as non-resident enterprises that have establishments in China and file and pay corporate income tax on an actual basis shall also submit the PRC Annual Reporting Forms on Related Party Transactions (2016 version) (“New Forms”).

2. Related party relationships (Articles 2 and 3)

Announcement 42 has further clarified the circumstances where related party relationships would be deemed to exist.

3. Related party transactions (Article 4)

Announcement 42 primarily formalises transfers of financial assets as a type of related party transactions. It also provides a more comprehensive list of related party financing transactions and service transactions.

4. The reporting, exchange and submission of CBC Report (Articles 5-9)

Announcement 42 builds on the foundation of the Discussion Draft to provide further details on taxpayers’ CBC reporting obligations and tax authorities’ information power.

5. Contemporaneous transfer pricing documentation (Articles 10-26)

Regulations on contemporaneous transfer pricing documentation make up a large portion of Announcement 42. Articles 10-17 sets out the Master File, Local File and Special Documentation structure and content requirements, Article 18 specifies documentation threshold, Articles 19 and 20 indicates the time requirements for preparation and submission of documentation, and Articles 21-26 on the administration of documentation.

6. PRC Annual Reporting Forms on Related Party Transactions (2016 version)

Announcement 42 increases the lengths of related party transaction reporting forms from nine to 22, including both the Chinese and English versions of the CBC Report.

Main changes

Related party relationships

Announcement 42 is more detailed and refined on the types and conditions of related party relationships. Guidance on circumstances where related party relationship would be deemed to have arisen due to debt financing (with a more rigorous formula for thin capitalisation debt-to-equity ratio calculation), connected natural persons and control in business substance are consistent with those provided under the Discussion Draft. These provisions are more stringent and specific than Circular 2.

Related party transactions

Announcement 42 expanded the related party transaction category to include financial asset transactions, comprising of accounts payable, accounts receivable, other payables, equity investments (including equity transfers), bond investments, and assets from derivative instruments, etc. It also provides a more comprehensive list of related party financing transactions and service transactions. All these changes provide clearer requirements to taxpayers' related party arrangement and disclosure.

The reporting, exchange and submission of CBC Report

There are two circumstances that the CBC Report needs to be prepared and submitted by the taxpayers when they submit the related party transaction forms:

- The taxpayer is the ultimate holding company of a multinational group and the annual consolidated revenue of the group in the previous fiscal year exceeds CNY 5.5 billion.
- The company has been designated by the group submit the CBC Report.

Announcement 42 further clarifies the definition of ultimate holding company i.e. the ultimate holding company has the ability to consolidate the financial statements of all legal entities under its umbrella but its own accounts cannot be consolidated by another group. This is consistent with the model legislation provided in BEPS Action 13 Report, i.e. the ultimate holding company owns directly or indirectly a sufficient interest in one or more other group entities of an MNE Group such that it is required to prepare consolidated financial statements under accounting principles generally applied in its jurisdiction of tax residence. However, the definition is not based on the relationships and actual control at management level (e.g. control by Board of Directors). Announcement 42's definition of constituent entity is also consistent with the model legislation of BEPS Action 13, including entities and permanent establishment.

Besides the reporting duty as detailed above, Announcement 42 also stipulates other conditions for the CBC Report to be submitted in China if a taxpayer is under special tax investigation, including:

- The MNE group does not prepare or provide CBC Report to any tax jurisdiction;
- Even if the CBC Report has been submitted to another tax jurisdiction, there is no information exchange mechanism in place for the CBC Report to be provided to the Chinese tax authorities; and

- Even if the CBC Report has been submitted to another tax jurisdiction and there is an information exchange mechanism in place, the exchange of CBC Report did not take place.

The CBC Report provides the legal avenue to tax authorities to obtain overall information of the MNE group's worldwide activities and profits. This increases the burden on taxpayers to disclose such information.

Furthermore, Announcement 42 provides that if information required to be reported in the CBC Report by the ultimate Chinese holding company relates to information that may affect national security, such information is exempted from being included in the Report or the taxpayer may be exempted from preparing the CBC Report altogether. As such, some Chinese MNEs may not need to prepare the CBC Report.

Contemporaneous documentation

Compared with the existing requirements under Circular 2, the four main changes to the contemporaneous documentation requirements as detailed in Announcement 42 include: (i) structure of contemporaneous documentation, (ii) threshold, (iii) deadline for preparing the documentation, (iv) content requirements.

1. Structure of transfer pricing contemporaneous documentation

Under Circular 2, the term of contemporaneous documentation is commonly understood to be a single report that documents and evidences the arm's length nature of related party transactions entered by an enterprise. 'Contemporaneous Documentation' under Announcement 42 now consists of a Master File and a Local File, and the so-called Special Documentation.

The designations of Master File and Local File are drawn from OECD's three-tier structure for transfer pricing documentation as set out in BEPS Action 13 Report. Special Documentation includes documentation for cost sharing arrangements ("CSAs") and documentation for thinly capitalised companies. Although the name of 'Special Documentation' is new, the requirements for companies with CSAs and companies exceeding the thin capitalisation debt-to-equity threshold to prepare contemporaneous documentation is not new, which is currently prescribed under Chapter 7 (Article 74) and 9 (Article 89) of Circular 2.

As mentioned above, the CBC Report has been incorporated into the New Forms. In addition, the Cost Sharing Agreements Form and Financing Form, which are part of the New Forms, can easily identify taxpayers required to prepare Special Documentation.

2. Threshold

The contemporaneous documentation threshold under Circular 2 is the famously known RMB 200m / RMB 40m threshold. Specifically, according to Article 15 of Circular 2, any enterprise shall prepare contemporaneous documentation unless: (i) its related party purchases and sales transactions amount to less than RMB 200m and its other related party transactions amount to less than RMB 40 million in value; (ii) its related party transactions are covered under an in-force advance pricing agreement; or (iii) its foreign owned shares account for less than 50 percent and it conducts related party transactions with domestic related parties only.

Under Announcement 42, companies that are required to prepare Master File includes:

- A company with cross-border related party transactions and the MNE (multi-national enterprise) its ultimate holding company belongs to has already prepared Master File; or
- A company with related party transactions exceeding RMB 1 billion.

Differentiated thresholds are introduced for different types of cross-border activity for Local File as follows:

- Transfers of tangible assets greater than RMB 200 million (processing/toll manufacturing transactions calculated based on declared value of imports and exports during the year)
- Transfers of financial assets greater than RMB 100 million
- Transfers in rights of intangible assets greater than RMB 100 million
- All other transactions (including services, interests on financing transactions greater than RMB 40 million)

Transactions covered under an APA need not be included in the Local File and Special Documentation, and need not be included in determining whether a company meets the threshold to prepare Local File. Companies who not transact with overseas related parties are exempt from preparing contemporaneous documentation. This is an improvement from Circular 2, which provides that such compares are only exempt provided their foreign owned shares account for less than 50 percent. Announcement 42, on the other hand, provides the exemption regardless of foreign shareholding.

Special Documentation must be prepared without regard to thresholds for companies with CSAs and companies exceeding the related-party thin capitalisation debt-equity threshold (5-to-1 for financial institutions and 2-to-1 for all other enterprises), barring transactions covered under an APA or when the related party transactions are domestic only.

3. Deadline

A positive change welcomed by taxpayers is that the date for completion of Local File is moved from 31 May following the tax year in question, under Circular 2, to 30 June of year following the tax year in question. Special Documentation must be prepared by the same date. The Master File must be prepared within 12 months of the ultimate parent's financial year end, consistent with BEPS Action 13 Report recommendations.

Taxpayers are now required to submit contemporaneous documentation within 30 days, as opposed to 20 days under Circular 2, upon being requested by tax authorities.

4. Content requirements

- Master File and Local File

The Master File requirements, which include an organisational chart, description of multi-national enterprise's ("MNE's") business, MNE's intangibles, MNE's intercompany financial activities and MNE's financial and tax positions, are generally in line with the BEPS proposals. Announcement 42 includes a few additional requirements, being the functions, risks, assets and employees of the principal R&D company, bilateral entities entered by all companies with an MNE (BEPS Action 13 Report requires the disclosure of unilateral APAs only), and the name and the location of the legal entity preparing and filing the Country-by-Country Report for the group. In addition, the disclosure requirements set out under Announcement 42 in relation to restructurings are more comprehensive and structured compared with that in BEPS Action 13 Report. Announcement 42 categorises restructuring into two groups, business restructuring (including adjustment of industrial structure, the transfers of functions, risks or assets) and legal restructurings (including debt restructuring, equity acquisition, asset acquisition, mergers and divestitures).

Announcement 42 Local File content broadly follows the structure of Circular 2 to include information on (i) overview of local entity, (ii) related party relationships, (iii) related party transactions, (iv) comparability analysis, and (v) selection and application of transfer pricing methods.

Announcement 42 sets out in quite some detail the level of information disclosure required, compared to broader guidelines provided under BEPS Action 13 Report. This being said, many of the requirements do not deviate in nature from what could reasonably be expected to be included in Local File under BEPS Action 13 Report. An area where Announcement 42 departs significantly from the BEPS Local File is (and this is also additional content which had not been required under Circular 2) is the "value chain analysis" segment within (iii) related party transactions. This requires significant disclosure of information on a MNE's value chain(s) relevant to the Chinese taxpayer. Taxpayers must provide an overview of the attribution of MNE global profits to the different countries within the MNE's value chain, both in terms of how profits are allocated across the value chain and also in terms of the actual amounts of profits earned by each value chain participant. It also demands that standalone and consolidated financial statements for every entity within the MNE value chain be retained in the Local File, and the quantification and attribution of profits arising from location specific advantages (LSAs). What is more, the transaction, goods and funds flows, within each value chain in the MNE group, must be set out, leading from initial design and development of goods, through production, marketing, delivery and after-sales service.. The level of detailed quantitative and qualitative information on MNE global value chains for inclusion in the Local File, depending on how the requirements are applied by the tax authorities in practice, could go well beyond the requirements of BEPS CBC Report, which is much more summary in nature.

In addition to value chain analysis, there are also other requirements with a Chinese flavour. For example, LSAs including location savings and market premium and their impact on pricing must be disclosed in the related party transactions section. This echoes the aforementioned requirement to set out the quantification and attribution of profits arising from LSAs in the value chain analysis. Furthermore, there are requirements to include information on the company's contribution to the systemic profits or excess profits of a MNE regardless of the choice of the transfer pricing method.

Value chain analysis and LSAs analysis, although not currently required under Circular 2 documentation requirements, are often requested during transfer pricing audits /risk-assessment discussions. The inclusion of these analyses in the Local File demonstrates that the SAT is conscientious in ensuring that the Chinese taxpayers are allocated their "fair" share of MNE global value chain profits, and that any potential mismatches can be easily identified in the Local File.

There are also prescriptive requirements on the level of disclosure required on outbound investments, related party equity transfers (content to include due diligence report, valuation report) and related party service transactions as set out under Article 14. Circular 2 did not explicitly require the disclosure of outbound investments and related party equity transfers and its disclosure requirements on related party service transactions are not differentiated from other types of transactions. For outbound investments, Announcement 42 requires the disclosure of quantitative information on outbound investments to include operating numbers. This to some extent reflects the priority focus of the SAT on CFC/Residence rules. Detailed disclosure requirements on related party equity transfers and related party service transactions reflect the continued priority focus of the SAT on M&A transactions, and outbound service payments.

Announcement 42 adds revenue, costs, expenses and profits by business segment and product to the financial data required to be included in Local File, This will enable tax authorities to conduct transfer pricing analyses on a business segment/product basis.

Some information previously required under Circular 2 has been dropped from Announcement 42 Local File content. These include consolidated financial statements of the group which is now required under Master File. The "Function and Risk Analysis Form" has been considered to be too detailed and difficult to use for taxpayers in non-traditional manufacturing business. Its exclusion should therefore be welcomed by taxpayers. Compared with Circular 2, Announcement 42 also clarifies the disclosure of related parties shall include those that directly and indirectly hold shares in the company and those that transact with the company.

- **Special Documentation**

Special Documentation includes documentation on CSAs and thinly capitalised companies. OECD/G20 work on revised transfer pricing guidance on CSAs can be found in BEPS Actions 8-10 Report. Whilst BEPS Actions 8-10 Report does not include specific guidance on documentation, Announcement 42 requirements specified in Article 16 are consistent with what would reasonably be expected under OECD framework. Compared with Circular 2, the only material additional disclosure requirement is the inclusion of expected benefit arising from the CSA. It should be noted that the SAT in last year revised the administration of CSAs through the release of SAT Announcement on Regulating the Administration of Cost Sharing Arrangements (“Announcement 45”) (see [China Tax Alert - Issue 16, July 2015](#)).

Documentation requirements on thinly capitalised companies remain largely the same as Circular 2, except the addition to include analysis on whether independent parties would be able and willing to accept the terms of the financial transactions under analysis.

Changes in the related party transaction forms

The Old Forms under Circular 114 are commonly referred as the Nine Forms due to there being nine forms in total. The New Forms introduced under Announcement 42 includes 22 related party transaction forms. The release of New Forms is to keep pace with the strengthening of overseas related party disclosure requirements and increasing transparency, within China and globally. The table below shows a comparison of Old Forms and New Forms:

Information	Circular 114 (Old Forms)	Announcement 42 (New Forms)
Corporate Information	N/A	Corporate Information Form (compulsory) (G000000)
Related Parties	Form on Relationship between Related Parties (Form I)	Related Party Relationship Form (compulsory) (G000000) Overseas Related Party Form (G112000)
Related Party Transactions	Related Party Transaction Summary (Form II) Purchases and Sales Form (Form III) Services Form (Form IV) Intangible Asset Transaction Form (Form V) Fixed Asset Transaction Form (Form VI) Financing Form (Form VII)	Annual Summary Form on Related Party Transactions (compulsory) (G100000) Transfers of Ownership in Tangible Assets Form (G102000) Transfers of Ownership in Intangible Assets Form (G103000) Transfers of Rights to Use Tangible Assets Form (G104000) Transfers of Rights to use Intangible Assets Form (G105000) Financial Assets Transaction Form (G106000) Financing Form (G107000) Related Party Services Form (G108000) Equity Investment Form (G109000)

Information	Circular 114 (Old Forms)	Announcement 42 (New Forms)
Related Party Investments	Overseas Investments Form (Form VIII) (Repealed by State Administration of Taxation Announcement [2014] No. 38)	N/A
Cost Sharing Agreements	N/A	Cost Sharing Agreements Form
Outbound Payments	Overseas Payment Form (Form IX)	Overseas Payment Form
Financial Analysis Form for Related-party Transactions	N/A (covered by Chapter 3 of Circular 2, requirements on the transfer pricing documentation)	Financial Analysis Form for Related-party Transactions (Unconsolidated) Financial Analysis Form for Related-party Transactions (Consolidated)
Country-by-Country Reporting	N/A	Form on the Global Distribution of Revenue, Tax, and Operating Activities Form on the Global Distribution of Revenue, Tax, and Operating Activities (English) List of Entities within the Multinational Group List of Entities within the Multinational Group (English) Additional Information Additional Information (English)

- Information relating to the enterprise

The format of the new Corporate Information Form requires a very detailed disclosure including: (i) Basic information (such as its full company name in Chinese, identification number, enterprise credit code, scope of business, registered address, in-charge tax authorities at state and local levels, applicable accounting standards and accounting system, the name of ultimate holding company, and the availability of contemporaneous transfer pricing documentation); (ii) Internal organisational structure (such as the responsibility of various departments and business processes, and the average number of employees of each of the departments within the organisation); (iii) Senior management personnel information that includes personal identity information; and (iv) Information on its top five shareholders (for example, personal identity information of the shareholders if they are natural persons and information regarding the start date of shareholding and changes in the shareholding of the enterprise where relevant).

- Information relating to related parties

The New Forms include two forms on related parties, the Related Party Relationship Form (which is a compulsory form to complete) and the Overseas Related Party Form.

In disclosing related party relationships, it is now required to be included in the form related party relationships relating to "natural person". The inclusion of such disclosure is consistent with the expanded definition of related party relationships as detailed in the Discussion Draft. When disclosing "natural persons" as one of the related party relationships, taxpayers will be required to disclose the personal identity information. Additionally, the form now dictates the disclosure of the date of establishment and the dissolution date of every related party as well as the disclosure of the length of a particular related party relationship and whether there were any transactions with the filing entity during a particular tax year. Such disclosure makes it more transparent to the tax authorities any material transactions with related parties in which the relationship may have changed as a result of liquidation, merger and acquisition, or due to other reasons.

The Overseas Related Party Form requires taxpayers to report relevant information of the top 5 overseas related parties. The information required includes the names of the related parties, their registered and operational addresses, business activities (including industry sector), registered and paid-up capital, effective tax rate, tax incentives received, and entity level financial position of the related parties in question. The availability of this information will facilitate review of material cross-border transactions and make future cross-border exchange of information between national tax authorities more convenient and expedient.

- [Information relating to related party transactions](#)

The information required in the New Forms for related party transactions are categorised into seven transactions, i.e. transactions relating to tangible and intangible assets, right of use of tangible and intangible assets, financial asset transactions, financing transactions and service transactions. The related party transactions are categorised into more rigorously defined types, as such tax authorities will be able to easily identify taxpayers with Local File preparation obligations, and perform comparative analysis on different types of transactions based on the information disclosed.

The relevant forms (apart from Financing Form and Equity Investment Form) requires the disclosure of top 5 in transaction amounts, as opposed to the disclosure of any transactions with amounts above 10% of total transaction amounts under the Old Forms. Taxpayers are required to disclose the exact subject of the transaction from a specified list prescribed by the SAT. For example, for transactions involving the transfer of the right of use of intangible assets, taxpayers are required to choose the exact nature of subject intangible from "patent", "unpatented technology", "trade secrets", "trademark", "brand", "customer list", "sales channels", "market research results", "franchise", "government licences", "land use rights", "goodwill", "copyright", and "other intangible assets". This information will assist tax authorities in conducting more targeted review and investigation of different types of related party transactions.

For financial asset transactions, the information required to be disclosed are "accounts payable", "accounts receivable", "other payables", "equity investments in listed companies", "equity investments in private companies", "bond investments", "assets from derivative instruments", and other "financial assets". It should be noted that the change in shareholding of related parties should also be disclosed in this form.

For financing transactions, although the information disclosure requirements have been simplified compared to the Old Forms such as interest rates are no longer required, the guidance contained within the Financing Form has specified types of additional types of financing transactions which were not explicitly covered under the Old Forms. These include entrusted loans, secured financing (e.g. guaranteed loans, collateral loans and pledged loans), discount notes, finance leases, prepayments subject to interest, deferred payments subject to interest, cash pools, and other financing transactions.

The calculation of debt-to-equity ratio for thin capitalisation purposes is quite subjective under the Old Forms. Apart from the need to make judgment on what falls within the scope of intercompany loans and equity for the purposes of the calculation, taxpayers are also required to perform monthly calculations of equity investments and intercompany loans by taking an average of those at the start and at the end of each month. These laborious efforts are not reflected in the form as only the end result is needed to be reported. This gives much challenge to the tax authorities as they do not have visibility over the detailed calculations and the reliability of data cannot be verified.

The New Forms are able to resolve the problems associated with the previous calculation method. A new calculation formula in the New Forms provides that the average intercompany loans is equal to the sum of all intercompany loan balances times the amount of actual days each intercompany loan balance is in place and then divided by 365 days. The new Financing Form has already set out the requirements of the data required for such calculation. Similarly, the Equity Investment Form requires the provision of the weighted average amount of owner's equity for each month of a particular year, the weighted average of the annual paid-up capital and the weighted average of the capital reserves – these are then used to calculate the average equity investment amount. The average amounts relating to debt and the equity investments provided in the two forms are automatically input into the Annual Summary Form on Related Party Transactions to calculate the debt-to-equity ratio for thin capitalisation purposes.

- [Information relating to CSAs](#)

Consistent with the need to prepare Special Documentation for entities that engage in CSAs, the related party transaction forms have also been modernised to include a form to disclose such arrangements. Entities will be required to complete this form with information that includes the duration of the cost sharing agreement, the start and due dates, the actual costs incurred and benefits gained to date, the expected total benefits by the end of the agreement, basic information of cost sharing participants, the total shared costs between the parties, any buy-in payments made by newly added participants and any exit compensation received by the participants leaving the arrangement.

The introduction of this form reflects the spirit of Announcement 45, which revises administration and management of cost sharing agreements from pre-event review and approval to post-event recordal, whereby taxpayers must provide copies of the CSAs to their tax bureau within 30 days after signing the CSAs with their related parties and must disclose such arrangements in the related party transaction forms as part of its annual corporate income tax return.

- [Information relating to outbound payments](#)

Compared with the Old Forms, the New Forms do not require taxpayers to disclose separately the various types of service payments (for example, consulting fee, training fee, after-sales fee) remitted out of China. The New Forms follows the changes seen in the management of foreign exchange remittance procedure which has been simplified, and removes the need to provide information relating to the tax amount withheld and whether the payer enjoys double tax treaty benefits. Additionally, the New Forms explicitly state that the amounts relating to outbound payments will need to be disclosed on an actual received and paid basis, which was not clear under the Old Forms.

- [Financial analysis of related party transactions \(stand-alone and consolidated bases\)](#)

The annual financial analysis required by the New Forms is essentially the same under the existing requirements i.e. segmentation financials between related parties and third parties, and specifically the methodology for the segmentation of the financials. This analysis is currently required to be appended in the transfer pricing documentation per Circular 2. It is also clearly provided under the New Forms that enterprises that prepare consolidated financial statements will be required to submit the financial analysis based on the consolidated financials too.

- [CBC Report](#)

The threshold for the preparation of the CBC Report of RMB 5.5 billion is roughly equivalent to the threshold of Euro 750m as specified under the BEPS Action 13 Report. The format and the information required by the form are also consistent with the template provided under the BEPS Action 13 Report i.e. the report contains 3 tables. Guidance is given under Announcement⁴² where if there were differences in accounting periods between the constituent entities and the ultimate holding company, taxpayers do not have obligations to align reporting revenue, profit and tax to that of the group's consolidated amounts. Differences in the accounting standards between different countries do not need to be adjusted as well.

The CBC Report will provide information for each tax jurisdiction such as revenue, profit before income tax, income tax paid and accrued, number of employees, and assets in each tax jurisdiction (Table 1). Additionally, it requires taxpayers to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in (Table 2). There is a free format table (Table 3) that should be used to explain the source of the data included in the CBC Report, changes that may affect the data source, and explain the nature of the activities of a particular constituent entity if the "Other" column is ticked in Table 2.

CBC Report will help tax authorities obtain a preliminary understanding of how a MNE's profits are spread across various tax jurisdictions and the entities/countries carrying out specific activities along an MNE's value chain, and the relevant tax positions for each of the tax jurisdictions

KPMG observations

Overall, the release of Announcement⁴² on transfer pricing compliance marks the start SAT's efforts and commitment in localising BEPS recommendations into domestic legislation. We summarise the key implications of the changes introduced by Announcement 42, as follows:

Related party relationships and transactions

Announcement 42 refines the type of related party relationships – one that is based on financial control and one that is based on substance. In addition, if two parties have common interest in substance, they may then be regarded as related parties under Announcement 42, thus arguably expanding related party relationships.

The explicit inclusion of financial assets as one of the types of related party transactions indicates that the Chinese tax authorities' growing concern on related party transactions in the financial sector. As a result, affected taxpayers will need to pay more attention to the compliance of Chinese transfer pricing regulations in their business dealings in the future. It is worth noting that equity transfer is also a type of related party transaction under the financial assets category, which is a focus of the Chinese tax authorities.

Considerations in relation to the preparation of Local File

The introduction of differentiated thresholds for different types of cross-border transactions for Local File and exclusion of domestic related-party transactions in determining whether a category of transaction exceeds its given threshold, in general, is likely to see a fall in taxpayers subject to Local File preparation, although a relatively low threshold of RMB 10 million for related party service, interest and leasing/licensing fees may see some taxpayers brought into scope for the first time.

Generally speaking, the requirements set under Announcement 42 are more rigorous compared with Circular 2. Taxpayers will need to disclose at a greater detail and conduct more robust analyses. For example, Announcement 42 requires revenue, costs, expenses and profits by business segment and product to be disclosed, which will enable tax authorities to conduct transfer pricing analyses by business segment and by product. Although the Announcement does not explicitly require taxpayers to analyse related party transactions by segment and by type, taxpayers inevitably will need to spend more effort to demonstrate that all types of related party transactions are arm's length. This means that the days where a broad-brush approach to documentation deemed sufficient may no longer suffice.

The requirement to include in Local File quantitative information on MNE's value chain relevant to the Chinese taxpayer can be difficult to meet in practice as it is very unlikely that local Chinese subsidiaries of MNEs would readily have access to such information. Whilst quantitative value chain information and LSAs analysis are not currently required under Circular 2 documentation requirements, it is often requested during transfer pricing audits / risk-assessment discussions. The inclusion of this in the Local File demonstrates that the SAT is conscientious in ensuring that the Chinese taxpayers are allocated their "fair" share of MNE global value chain profits, and that any potential mismatches can be easily identified in the Local File, without the need to refer to the Master File and CBC Report. The requirement to include information on the company's contribution to the systemic profits or excess profits of a MNE regardless of the choice of the transfer pricing method also reinforces SAT's position to ensure Chinese companies receive the "fair" share of the pie.

The references to LSAs in Announcement 42 do not appear to be at odds with the discussion on location savings and local market features in the BEPS Action 13 Report. However, the discussion on LSAs in the Discussion Draft is far less detailed than in the BEPS Action 13 Report, and latitude is left for local authority interpretation and application. In addition, the level of analysis (qualitative and quantitative) that would be required to satisfy tax authorities' requirements are also not clear.

Although overall the requirements are more rigorous, Announcement 42 modifies the contemporaneous documentation exemption criteria, providing that all companies whose related party transactions are domestic only do not need to prepare contemporaneous documentation, regardless of their foreign shareholding. This should relieve the compliance burden of some taxpayers.

Thin capitalisation

The calculation method to derive the related-party debt-to-equity ratio is more rigorous under the New Forms. The financial instruments that required to be considered as related party debt investments are also expanded to include explicitly balances from cash pools, debt factoring, finance lease, deferred payments subject to interest, etc. As the balances of some of the related party debt investments vary frequently (for example cash pool balances could vary daily), it has become much more difficult to "manipulate" related-party debt-to-equity ratio which was calculated based on month-end balances in the past.

Disclosure of outbound investments, related party equity transfers and related party service transactions

The detailed disclosure requirements on related party equity transfers and related party service transactions in Local File is not surprising, given SAT's priority focus on these areas in recent years.

For related party service transactions, an important outcome from OECD/G20 BEPS Project is the recommendations of a safe harbour and simplified documentation for low value-adding intragroup services as detailed in BEPS Actions 8-10 Report. It appears that the SAT has chosen not to integrate such recommendation, which to some extent reflects its long-term stance that all intragroup service transactions are potentially high risk and have the potential to shift profits out of China. This, coupled with the much more refined benefit test set out in Announcement 16, compared to what would be required under OECD framework, clearly reflects enhanced scrutiny of intragroup service transactions in transfer pricing enforcement practice.

For outbound investments, detailed disclosures to an extent demonstrate SAT's focus on CFC/Residence rules. BEPS Action 3 Report has provided recommendations on effective CFC rules. It will be interesting to watch SAT development in this area over the coming months.

Related party equity transfers has been a focus area for tax authorities over the past few years. Announcement 42 formalises related party equity transfers as a type of related party transactions (under transfers of financial assets) that are subject to transfer pricing regulations, demonstrating that they will continue to be scrutinised heavily going forward. Given that the Corporate Information Form require disclosure of information on a taxpayer's top five shareholders and changes in the shareholding of the enterprise where relevant, and the Related Party Relationship Form requires the disclosure of the start date and end date of a related party relationship, and a specific Financial Assets Transaction Form, tax authorities will find it easier to identify M&A transactions involving the subject enterprise.

Submission of CBC Report

The CBC Report becomes a part of disclosure of tax returns and will need to be filed annually by 31 May. As such, the time to prepare the CBC Report for the affected Chinese MNEs is limited. Although Article 8 provides for the application by the taxpayers to delay the submission of their tax returns, it is not known how the relevant tax authorities will exercise such discretion in practice.

Furthermore, Announcement 42 provides that if information required to be reported in the CBC Report by the ultimate Chinese holding company relates to information that may affect national security, the Chinese MNE is exempted to complete part or all of the CBC Report. However, if this exemption is abused, it could bring about pressure from the international community as one of the main purposes of BEPS is to ensure transparency in tax reporting.

Collection of information through the CBC Report

OECD, in September 2014, released its draft recommendations and introduced a three tier structure to the preparation of transfer pricing documentation i.e. Master File, Local File and CBC Report. This was approved by member countries of the G20 in February 2015.

In the past, China has long stressed that it is important to obtain information regarding the operations of MNE on a global basis, however, there were many obstacles in doing so. With the CBC Report, tax authorities are now able to have a global overview of MNEs' economic activities and perform analysis on the impact of transfer pricing arrangements on the taxable profits of MNEs throughout their global footprints. For example, information on:

- Tax Jurisdictions in which the MNE operates provides an overview of whether the MNE has operations in tax heaven or low tax rate jurisdictions;
- Revenues from related and unrelated parties provides an overview of whether the revenues are influenced by transfer pricing policies;
- Profit (or loss) before income tax provides an overview of the profit and loss positions of the MNE group by jurisdiction;
- Income tax accrued and taxes paid provides an overview of amount of taxes the MNE is liable and whether such taxes are deferred in the jurisdictions it operates in; and
- Stated capital, tangible assets and number of employees provide an overview of the scale of the MNE's operations and substance.

Combining information relating to each of the entities under an MNE in the CBC Report allows readers to gain an overview of the group's operations in each tax jurisdiction quickly, including the functions, returns, and potentially relevant tax positions of the entities in the value chain.

The CBC Report is rather simplified and only contains 2 tables and a free format table. Whilst the information contained in the CBC Report is useful, the CBC Report does not replace the basic and fundamental transfer pricing analyses of functions and risks that need to be carried out in full rigour as suggested by the requirements in the Local File. Thus, whilst the CBC Report can be used as a reference to help tax authorities perform risk assessment, and together with Master File and Local File, identify audit targets, it should not be used as a sole information source to initiate transfer pricing audits.

It is worth mentioning that the disclosure requirements of the CBC Report which are based on tax jurisdictions instead of business registrations are aligned with the purpose BEPS, i.e. to align taxation with value creating activities.

One further point to note is that the CBC Report will have to be prepared in Chinese and English. This provides the foundation for future cross border exchange of information between tax authorities. According to the timetable devised by OECD, BEPS Action 13 recommendations on transfer pricing documentation are expected to be effective from the financial year 1 January 2016, while inter-government exchange mechanism is expected to take place after 31 December 2017 when the first of CBC Reports would have to be filed by.

Changing transfer pricing environment

Although the timing of the release of China's revised comprehensive transfer pricing regulations is uncertain at this stage, we have seen many concepts (such as those relating to intangibles and transfer pricing audits and adjustments) introduced in the Discussion Draft being applied by tax authorities in conducting transfer pricing risk assessments / audits in practice. Taxpayers should be prepared to have tax authorities examine their documentation with reference to the more stringent regulations proposed in the Discussion Draft. In addition, the SAT and tax authorities across the country have invested significantly in developing data monitoring systems to perform comparative analysis and identify transfer pricing audit targets. We fully expect information disclosed in contemporaneous documentation and related party disclosure forms to be input into such data monitoring systems to facilitate SAT carrying out nationally coordinated audits.

With the introduction of the three-tier transfer pricing documentation and a more complex set of related party transaction disclosure forms, taxpayers will need to exercise more rigour in managing their transfer pricing affairs going forward. Transfer pricing policies need to be robust and information disclosure needs to be consistent across Master File, Local File, CBC Report and related party transaction disclosure forms. Taxpayers are urged to take this opportunity to examine and revise appropriately their existing transfer pricing approach to proactively manage transfer pricing detection and technical risks.

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