

Enforcement of BEPS in China

1. Significant amendments made to TP regulations echoing BEPS deliverables

On 17 September 2015, China's State Administration of Taxation (SAT) released a public consultation draft of a Circular on Implementation Measures for Special Tax Adjustments (the Discussion Draft). Once finalized this Circular will replace the existing SAT Circular on Special Tax Adjustments (Circular 2) which was published in January 2009 and essentially represented China's transfer pricing guidance.

The Discussion Draft includes elements of the BEPS proposals for transfer pricing and clarifies the SAT's approach to transfer pricing audits, introduces new transfer pricing methodologies and expands the Chinese transfer pricing requirements.

Key points of the Discussion Draft are summarized below:

- **New transfer pricing documentation requirements**

The Discussion Draft provides that multinational companies will be required to prepare a master file, a local file and a so-called 'special documentation' file. The latter will be required for companies engaging in intercompany service transactions or cost sharing agreements and those exceeding a thin cap threshold. The proposed requirements significantly increase the level of disclosure required of MNCs and provide for more effective use by the tax authorities of the information that will be available to them.

- **More complicated transfer pricing methodologies**

In addition to the traditional five transfer pricing methods, the Discussion Draft introduces new transfer pricing methods: the Value Contribution Apportionment Method (VCM) and Valuation Transfer Pricing Methods. The VCM is based on allocating value across the value chain of a group based on value creation and with reference to assets, costs, sales and the number of employees.

- **Guidance for tax authorities**

The Discussion Draft provides guidance to local tax authorities in establishing systems for reviewing the greater volume of taxpayer information that will be at their disposal going forward. Government databases are expected to be established for the sharing of information between local tax authorities. Further, a mechanism for grading taxpayers as low risk or high risk and conducting an audit with a corresponding level of scrutiny is planned.

- **Meticulous assessments for intangible assets**

The BEPS action plan for pricing intercompany transactions involving intangible assets has for the most part been adopted in the Discussion Draft. The Discussion Draft stipulates that the contribution to the value of intangibles by related parties shall be evaluated by considering their contribution in respect of development, enhancement, maintenance, protection and exploitation (DEMPE) to the intangibles in question. In addition, the Discussion Draft introduces 'protection' to the DEMPE analysis.

The Discussion Draft is expected to be effective in 2016. Taxpayers, especially MNCs, will be required to disclose more information for transfer pricing purposes and are advised to conduct a focused review of their transfer pricing arrangements in line with the draft regulations.

2. China's next actions for further enforcement of BEPS

Following the release of the BEPS final reports by the OECD on 5 October 2015, the SAT published the Chinese version on its official website and restated its action plan of further enforcement of BEPS concepts. This included plans:

- To incorporate BEPS action plans within domestic tax laws and regulations.
- To establish more offshore tax and transfer pricing teams within tax authorities.
- To establish a national tax risk monitoring system, including a pilot program to enable local tax authorities to monitor and review filings by multinational groups.

Multinational groups are advised to study how the enforcement of BEPS action plans by China could impact their current business arrangements and future operational plans.