2015/15
October 2015

China flexes its BEPS muscle

Contacts

China

Martin Ng
Managing Partner
martin.ng@wts.cn
+ 86 21 5047 8665. 202

Maggie Han
Senior Manager
maggie.han@wts.cn
+ 86 21 5047 8665. 206

In brief

- The State Administration of Taxation (SAT) released the discussion draft of "Implementation Measures of Special Tax Adjustments" (known as "Circular 2") for public consultation on 17 September 2015.
- The most significant changes include expanded related party transaction scope, new TP documentation requirements, more complicated TP methodologies, enlarged TP audit scope, meticulous assessments for intangible assets, and incorporation of profit level monitoring.
- The public consultation period will end on 16 October 2015.

In detail

SAT released the draft Circular 2 for public consultation on 17 September 2015. Various recommendations suggested in Base Erosion and Profit Shifting (BEPS) action plans are adopted in the draft Circular 2 which signals the localization of BEPS actions by the Chinese tax authorities. Significant amendments are made to related party reporting, TP documentation, cost sharing agreement, advanced pricing arrangement (APA), TP audit and adjustment, controlled foreign companies (CFC), thin capitalization, TP risk management and general anti-avoidance rule (GAAR).

We have summarized the major changes of the draft Circular 2 below:

1. **Expanded related party transaction types**

   Besides the transfer of tangible / intangible assets, financing, and service provisions, the draft Circular 2 has further expanded the related party transactions to transfer of financial assets, cash pooling, and transfer of shares. Taxpayers shall ensure all these related party transactions are properly reported when filing the annual corporate income tax return.

2. **New TP documentation requirements**

   Multi-national corporations (MNCs) will be required to submit a master file, a local file, a special issues file (which are engaging in intercompany services, cost sharing agreements, or falling within thin capitalization requirements) and a country-by-country (CbC) report to the tax authority, if the reporting threshold is met. The new requirements have significantly increased the disclosure burden to MNCs and introduced a more holistic TP assessment by the Chinese tax authorities.

3. **More complicated TP methodologies**

   The draft Circular 2 has introduced the allocation on value contributed method and the asset evaluation method as the “other methods” in addition to the traditional five TP methods. The tax authority will assess the arm’s length principle more strictly and holistically on related party transactions. In addition, extra costs of asset evaluation could be incurred by taxpayers if the asset valuation method is required.

4. **Enlarged TP audit scope**

   TP audit scope is enlarged to include MNCs which exceeding the thin-capitalization threshold, CFCs in low tax rate jurisdictions, arrangements without business purposes, entities ready to liquidate and entities with reducing or no dividend distributed by CFC without reasonable purposes.

5. **Meticulous assessments for intangible assets**

   The gist of BEPS action plan for intangible assets has been adopted by the draft Circular 2, which has stipulated that the income generated from the intangible assets shall match the value contributed to such intangible assets by taxpayers. Taxpayers shall properly allocate the income derived from the intangible assets amongst the group members by assessing the attributes of intangible assets such as development, value adding, maintenance, protection, functions undertaken in application and promotion, assets used, risks borne, resources invested, and ways of value recognition.

6. **Profit level monitoring**

   A profit level monitoring mechanism is incorporated in the draft Circular 2 for monitoring MNCs’ profit level on their related party transactions. Alerts will be issued or even TP audits will be launched by the tax authorities to MNCs classified as high TP compliance risks.

WTS observation

The draft Circular 2 is regarded as one of most important enforcements of BEPS actions by the Chinese tax authority. Taxpayers especially MNCs will be subject to a more aggressive and disciplined TP environment. Taxpayers are advised to conduct a more specialized and holistic analysis on their TP arrangements in line with the new regulations.

[Notes: see appendix on the summary of amendments]

APPEDIX (Comparison between the old and draft Circular 2)

Old Circular 2	Draft Circular 2	Remarks
1. General provision	1. General provision	No significant change.
2. Related party reporting	2. Related party reporting	The scope is expanded to include cash pool and share transfer.
3. TP documentation	3. TP documentation	Taxpayers shall submit “master file”, “local file”, “CbC report”, “special issues file” to the tax authorities if the reporting thresholds are met.
4. TP methodology	4. TP methodology	Two more TP methods: “allocation based on value contribution” and “asset evaluation” can be used when assess the related party transactions.
5. TP audit & adjustment	5. TP audit & adjustment	TP audit scope is enlarged to include taxpayers under CFC and thin capitalization requirements. The location savings and market surplus shall be considered for TP adjustment.
	6. Intangible asset	The allocation of income derived from the intangible asset amongst the MNC group members shall match the contributions made.
	7. Intercompany service	The intercompany service transactions shall pass the beneficial test and arm’s length test. Special intercompany service documentation shall be filed by taxpayers.
6. APA	8. APA	Well prepared APA application (i.e. with consideration of location savings and market surplus, etc) can have priority to be proceeded by the tax authority.
7. Cost sharing agreement	9. Cost sharing agreement	SAT approval is no longer required. Special cost sharing agreement documentation shall be filed by taxpayers to the local competent tax authority.
8. CFC	10. CFC	Profits attributed to domestic controlling entities shall be regarded as deemed dividend in China subject to CIT.
9. Thin capitalization	11. Thin capitalization	The use of cash pool and current liabilities shall be included in calculating the intercompany debt to equity ratio. Special file shall be submitted by taxpayers if the intercompany debt to equity ratio is over the limit.
10. General Anti-avoidance rule	12. GAAR	It is reemphasized that the abuse of tax treaties, preferential tax treatments, organizational structures and tax harbors shall subject to GAAR.
	13. Profit level monitoring	It restates the TP risk management procedures undertaken by tax authorities.
11. Mutual agreement procedure (MAP)	14. MAP	No significant change.
12. Legal responsibility / penalty	15. Legal responsibility / penalty	No significant change.
13. Supplementary provisons	16. Supplementary provisons	No significant change.

Author

WTS China Co.,Ltd.

WTS Shanghai
Unit 031, 29F, Hang Seng Bank Tower
1000 Lujiazui Ring Road
Pudong New Area,
Shanghai 200120 PRC
Tel: +86 21 5047 8665
Fax: +86 21 3882 1211
www.wts.cn

WTS Beijing

Unit 601, Landmark Tower1,
8 North Dongsanhuan Road,
Chaoyang District, Beijing,
100004 PRC
Tel: +86 10 6590 6338
Fax: +86 10 6590 7903

Contact

China
Martin Ng
Managing Partner
martin.ng@wts.cn
+ 86 21 5047 8665 ext. 202

Maggie Han
Senior Manager
maggie.han@wts.cn
+ 86 21 5047 8665 ext. 206

Germany
Xiaolun Heijenga
Partner
xiaolun.heijenga@wts.de
+ 49-69-1338 456 340

WTS tax news on Wechat

Disclaimer