



Insights: Transfer Pricing

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China adopts many BEPS proposals and introduces more stringent transfer pricing requirements

Over the last two decades, China has experienced significant economic development and has also actively developed its transfer pricing (TP) landscape. Since the Chinese State Administration of Taxation (SAT) released its first comprehensive TP regulation (i.e., Guoshuifa [2009] No.2) in early 2009, the SAT has aimed to protect China's revenue base by enforcing the arm's length principle for intercompany transactions.

Proposed TP requirements

Following the September 17, 2015 release of the Organisation for Economic Co-operation and Development (OECD)'s base erosion and profit shifting (BEPS) Action Plan¹, the SAT issued a draft circular titled "The Discussion Draft on The Implementation Measures of Special Tax Adjustments" (the Draft Circular).² The Draft Circular adopts many aspects of the BEPS initiatives, including the implementation of various action plans and final deliverables related to TP.³ The SAT's proposals indicate that China will adopt certain guidelines from the BEPS 2015 Final Reports, with the intent to ensure companies are more transparent in information disclosure and analysis requirements.

China's TP documentation requirements beyond BEPS

Among the proposed changes in the Draft Circular, TP documentation requirements seem to be the most comprehensive. While the Draft Circular does not change the threshold for Chinese taxpayers to prepare contemporaneous TP documentation (i.e., RMB 200 million or RMB 40 million), taxpayers must follow a three-tier reporting requirement, which consists of a master file, a local file, and a

¹ See OECD, "BEPS 2015 Final Reports," <http://www.oecd.org/ctp/beps-2015-final-reports.htm>, last accessed December 4, 2015.

² See China State Administration of Taxation, "The Discussion Draft on The Implementation Measures of Special Tax Adjustments," <http://hd.chinatax.gov.cn/hudong/noticedetail.do?noticeid=577376>, last accessed December 4, 2015.

³ Although the Draft Circular also covers other areas such as controlled foreign corporation administration, thin capitalization, and anti-tax avoidance administration, these areas do not directly impact TP and therefore are not discussed in this article.

country-by-country (CbC) report. It is worth noting that the SAT proposed additional documentation requirements beyond what is proposed in BEPS Action 13.

First, the SAT requires taxpayers to disclose greater details and more rigorous analysis in a taxpayer's local file. To align taxation with taxpayers' valuation chain creation, a valuation chain analysis in connection with the related intercompany transactions is required in the local file. The value chain analysis must specifically disclose information related to (i) the multinational enterprise's (MNE) overall business operation flow, product flow, and cash flow; (ii) the MNE's consolidated financial statements and individual financial statements for each MNE entity participating in the overall business operation; and (iii) the allocation principal and results of the MNE's profit globally.⁴ In addition, information regarding foreign investment and equity transfer must be disclosed.

Second, taxpayers involved in intra-group services, cost-sharing agreements, or who face thin capitalization situations must prepare a special issues file. The special issues file is required under the Draft Circular, but not required under the final BEPS Action 13. For example, taxpayers involved in intra-group services must present copies of relevant intra-group services agreements, delineate the covered services and billing details, document the service cost identification and allocation, and document the selection of a TP method to prove the existence of such intra-group services and validity of the pricing.⁵ The Draft Circular also provides a list of information or documents required for the special issues file associated with a cost sharing arrangement and thin capitalization situation.⁶

Third, the Draft Circular includes the value contribution allocation method as a new type of "other methods" in addition to the traditional TP methods specified in the OECD Guidelines. This method is in line with the BEPS focus on the global value creation approach, although the BEPS deliverables do not include this as a specific TP method. The value creation method analyzes the contribution of each value creation factor (e.g., assets, costs, revenue, and/or headcount) on the overall profit of MNEs and accordingly allocates profit among related entities of MNEs. This method can be selected as the most appropriate method when comparables are hard to identify but valuation creation factors and an allocation formula can be reasonably determined.⁷ Considering the lack of reliable financial information for comparable companies in developing countries, this proposed method may be used to potentially allocate more profit to Chinese entities than to the benchmarking companies, which seems to resonate with the SAT's position on bringing more profit to Chinese routine-services entities.

Takeaway

The Draft Circular includes most of the changes proposed in the BEPS Action Plan related to TP documentation. Since China has been actively involved in the BEPS projects during the past two years, this approach was mostly expected for MNEs with a presence in China. However, the degree of information disclosure, documentation requirements, and the proposed methods and measures appears more stringent than the guidelines in the final BEPS package. Although the timing to finalize

⁴ See *supra* note 2, Chapter 3.

⁵ See *supra* note 2, Chapter 7.

⁶ See *supra* note 2, Chapters 9 and 11.

⁷ See *supra* note 2, Chapter 4.

the Draft Circular is not clear at this point, and the new TP rules could be applied for the 2015 tax year, it is recommended that the taxpayers with a significant presence in China reevaluate the impact of the Draft Circular on its business operation, tax planning, and the resources that may be required for documentation compliance.

For more information about the proposed Chinese Transfer Pricing Draft Circular, please contact the author.

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