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CHINA TAX ALERT

ISSUE 16 I July 2015

Standardization of the Administration on Cost Sharing Agreement

Regulations discussed in this issue:

- *Announcement on Standardizing the Administration of Cost Sharing Agreement* ("Announcement 45") promulgated by the State Administration of Taxation ("SAT") on June 16, 2015
- *Decision of the State Council on Cancelling Items Requiring Non-administrative Approval*
- Article 69 of the *Implementation Measures for Special Tax Adjustments (Provisional)* ("Circular 2")
- New requirement on filing the *Related Party Transaction Disclosure Forms*

Background

The State Administration of Taxation ("SAT") has promulgated *the Announcement on Standardizing the Administration of Cost Sharing Agreement* ("Announcement 45") on June 16, 2015. The Announcement aims to implement *the Decision of the State Council on Cancelling Items Requiring Non-administrative Approval* (the "Decision"*)*, streamline the administration process, as well as strengthen the follow-up administration, so as to improve and standardize the administration of cost sharing agreements.

Announcement 45 is issued to replace the Article 69 of *the Implementation Measures for Special Tax Adjustments (Provisional)* ("Circular 2"), which originally addressed the administration of cost sharing agreement. Announcement 45 has made updates in the following aspects:

- **Streamline the administration process by repealing the "Reporting to the SAT" requirement**
  According to Article 69 of Circular 2, "*The enterprises should report the cost sharing arrangement to the SAT within 30 days of the arrangement being concluded.*" Announcement 45 repealed the former regulation on reporting with the SAT, while requiring the enterprises to "*submit the agreements to the in-charge tax authorities*" instead.

- **New requirement on filing *the Related Party Transaction Disclosure Forms***
  The sign-off and renewal of the cost sharing agreement indicates the occurrence of transactions with related parties. As such, Announcement 45 requires taxpayers signing cost sharing arrangement to file *Related Party Transaction Disclosure Forms* along with its corporate income tax annual tax returns, regardless of whether the cost sharing agreement is in effect or not.

- **Replaced the former process of "Examination" with strengthened follow-up administration**
  According to Article 69 of Circular 2, "The tax authorities will report to the SAT to examine whether the cost sharing arrangement complies with the arm's-length principle." Announcement 45 has repealed the former process of examination, and replaced it with strengthened follow-up administration.

KPMG's Observation

We summarized below our understanding of the implications of the announcement, as well as the future development of the administration on cost sharing agreement:

- **Simplify former administration procedures and reinforce follow-up administration**
  Announcement 45 is issued to implement the Decision, and therefore the repeal of the "Reporting" and "Examination" process is, to a large extent, in line with the mainstream trend of streamlining the national administration procedures. However, this change will shift the focus of the tax authorities more towards follow-up administration and investigation.

  In practice, in order to obtain certainty in implementing cost sharing agreements, taxpayers still need to communicate in advance, and reach consensus, with the tax authorities. Applying for an Advanced Pricing Arrangement ("APA") is one practical way to achieve this goal. However, currently, when applying for a unilateral APA it is reviewed by the in-charge tax authorities and be submitted to SAT for final review and approval.

- **Emphasis on the "Arm's Length Principle" and the "Principal of Costs and Benefits Being Commensurate"**
  Announcement 45 emphasizes the application of the "Arm's Length Principle" and the "Principal of Costs and Benefits Being Commensurate". However, the Announcement does not make explicit rules and standards on how to assess whether these two principles are satisfied or not.

  Currently, the Discussion Draft on Cost Sharing Agreements of the BEPS Action Plan is still under public consultation and discussion. There still exists great uncertainty whether or not China's future administration of cost sharing agreement will follow the final suggestions of the BEPS Action Plan.

- **Remaining issues to be solved**
  Announcement 45 reiterated the importance of the "Arm's Length Principle" and "Principal of Costs and Benefits Being Commensurate", but did not specify implementation details. Specifically, Announcement 45 did not give answers to a series of implementation issues, such as how to determine the "Arm's Length Price", the implications of Business Tax and Value-added Tax under the cost sharing agreement, the treatment of balancing payments (such as true-ups) of cross-border transactions, etc.

The issuance of Announcement 45 may be viewed as a positive signal by SAT on the administration of cost sharing arrangements. Announcement 45, however, demonstrates the resolution of the tax authorities to permit the use of cost sharing agreements under close administration. At the same time, enterprises should be well-prepared, and engage in active communications with their in-charge tax authorities, when implementing cost sharing agreements.

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