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CHINA TAX ALERT

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SAT solicits public comments on new China transfer pricing and special tax adjustments guidance discussion draft

Regulations in this issue:

- The State Administration of Taxation (SAT) of the People's Republic of China's (PRC) Public Consultation Draft of a Circular on Implementation Measures for Special Tax Adjustments, ("Discussion Draft"), issued on September 17, 2015
- SAT Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation), Guoshuifa [2009] No. 2 ("Circular 2"), issued on January 8, 2009
- Announcement of the State Administration of Taxation (SAT) Regarding Corporate Income Tax ("CIT") Matters on Outbound Payments to Overseas Related Parties ("Announcement 16"), issued on 18 March 2015
- OECD Report "BEPS Action 10: Modifications to Chapter VII of the TP Guidelines relating to Low-Value Adding Intra-Group Services" issued on 3 November 2014, ("BEPS TP Low-Value Services Report")

SAT issues draft revision of Circular 2

On 17 September 2015 the SAT released the long-awaited public discussion draft of its guidance concerning the implementation of 'Special Tax Adjustments' for public consultation. The finalization of the Discussion Draft, anticipated by the end of 2015, would replace the existing SAT guidance on Special Tax Adjustments in Circular 2 [2009], which provides guidance on the Chinese Transfer Pricing (TP) rules and the key Chinese tax law anti-avoidance rules.

The Discussion Draft issuance looks to be timed to coincide with the imminent release of the 2015 Deliverables of the G20/OECD Base Erosion and Profit Shifting (BEPS) international tax reform project. The Discussion Draft integrates elements of the BEPS proposals for TP and for Controlled Foreign Company (CFC) rules. However, it also, in parallel, formalizes many of the 'novel' China TP concepts which the SAT has developed in recent years, thus 'localizing' the BEPS TP work for a China context.

The Discussion Draft is a highly significant document, clarifying the Chinese approach to TP investigations and analysis, introducing new TP methodologies, and significantly expanding TP documentation requirements. The guidance spells out, more clearly than ever, the types of transactions and the nature of the TP adjustments which the PRC tax authorities consider themselves entitled to investigate and make, respectively. At the same time, the Discussion Draft gives great latitude to local tax authorities in applying the often broadly drafted rules and ultimately it remains to be seen in practice what precise effect the new guidance will have. It is considered that incidents of double taxation for Multinational Enterprises (MNEs) may be set to increase in the future, and MNEs may in many cases be compelled to adjust their existing business models and/or transfer pricing policies.

KPMG is planning to draft a submission to the SAT, encompassing industry feedback, requesting the SAT to provide further clarifications and proposing amendments which may allow the new rules to function more effectively.

Regulations in this issue:

- OECD Report "BEPS Action 8: Guidance on Transfer Pricing Aspects of Intangibles" issued on 16 September 2014, ("BEPS TP Intangibles Report")
- OECD Discussion draft "BEPS Actions 8, 9 and 10: Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, re-characterization and special measures)" issued on 19 December 2014 ("BEPS TP Risk Draft")
- OECD Discussion draft "BEPS Action 8: Revisions to Chapter VII of the Transfer Pricing Guidelines on Cost Contribution Arrangements" issued on 4 May 2015 ("BEPS TP CCA Draft")
- OECD Discussion draft "BEPS Action 8: Hard-to-Value Intangibles" issued on 4 June 2015 ("BEPS TP Hard to Value Intangibles Draft")
- UN Practical Manual on Transfer Pricing For Developing Countries ("UN TP Manual"), Chapter 10.3 "China Country Practices", issued by the United Nations Committee of Experts on International Cooperation in Tax Matters in June 2013
- SAT's April 2014 letter to the UN working group on TP issues on related party service fees
- OECD Discussion draft "BEPS Action 3: Strengthening CFC Rules" issued on 12 May 2015 ("BEPS CFC Draft")
- OECD Discussion draft "BEPS Action 4: Interest Deductions and other Financial Payments" issued on 18 December 2014 ("BEPS Interest Deductions Draft")

The Discussion Draft changes in overview

The Discussion Draft is a substantial document, comprising of 16 chapters and 168 articles in length. The Discussion Draft encompasses an expansive range of source materials including (i) the existing TP guidance in Circular 2 and other records of the SAT's TP views, particularly in the UN TP Manual, (ii) the evolution of the TP enforcement approach of the Chinese tax authorities observed in recent years, and (iii) the proposals emerging from the BEPS process. This Alert focuses on the changes that we consider will be, in practice, of most significant impact for MNEs, looking at:

1. Changes to TP practices and approaches
2. Enhancements to TP documentation and TP administration
3. Special and general anti-avoidance rules

1. Changes to TP practices and approaches

The Discussion Draft makes a significant number of clarifications on how the SAT will conduct TP analysis and adjustments, including the introduction of new TP methodologies. The changes are considered under the following headings: Clarified Scope of TP rules, Location Specific Advantages, Intangible Assets, New TP Methods, Special Tax Adjustment Provisions.

Clarified Scope of TP rules

The Discussion Draft is far more specific than Circular 2 as to the precise scope of China's TP rules. This is part of a general trend in the SAT's recent tax guidance to be more explicit on the type of transactions and arrangements considered to fall within the scope of Chinese tax provisions, and it provides a more solid basis for local tax authorities to investigate and adjust such transactions.

The definition of related party relationships has been expanded in a way that may potentially bring more taxpayers within the scope of the TP rules besides through share ownership relationships. This mainly includes related party relationships arising from the appointment of the managerial personnel (definition expanded) of one entity by another entity (with exceptions provided for State Owned Enterprises), and arising from 'family and other relationships' (three generations for family relationships). Additionally, the definition of intangibles has been expanded to include goodwill and going concern value (added in line with the BEPS TP Intangibles Report changes). Equity transfers, transfers of financial assets, cash pooling arrangements and prepayments and delayed payments which should have been subject to interest are now explicitly clarified as being addressed by TP rules.

Interestingly, domestic related party transactions are explicitly excluded and are not subject to the provisions in the Discussion Draft. It remains to be seen whether the SAT will introduce separate regulations dealing with the investigation of domestic related party transactions conducted between parties with tax rate differentials, or whether such transactions will be entirely excluded from any TP investigations going forward.

Outbound Service Fees

The Discussion Draft adds a new chapter on related party services which had not existed in Circular 2. It moves to integrate the SAT's approach, developed through enforcement practice and detailed in previous SAT announcements, for determining whether and to what extent outbound service fee payments, from a Chinese taxpayer to an overseas related party, can be tax deducted by the Chinese taxpayer.

Alongside a requirement that the service payment made must be one which an independent enterprise would also have willingly made (equivalent to the OECD's 'benefit test'), the Discussion Draft demands an examination of the 'direct or indirect economic benefit' of a given service for a service recipient Chinese taxpayer. Such language had been used in SAT Announcement 16

Regulations in this issue:

- SAT Circular on Guidelines for Tax Risk Management of Large Enterprises (Trial Implementation), Guoshuifa [2009] No. 90 ("Circular 90"), issued on May 5, 2009
- SAT Announcement on Administrative Measures on Taxpayer Creditworthiness (Trial Implementation), SAT Announcement [2014] No.40 ("Announcement 40"), issued on July 4, 2014
- SAT Announcement on Issues Relating to Withholding Tax on Payment of Interest by Domestic Organisations to Overseas Branches of Chinese Banks, SAT Announcement [2015] No.47 ("Announcement 47"), issued on June19, 2015
- SAT Circular on Tax Services and Management Discipline at Large Enterprises, Guoshuifa [2011] No.71 ("Circular 71"), issued July 13, 2011
- SAT Announcement on Regulating the Administration of Cost Apportionments, SAT Announcement [2015] No.45 ("Announcement 45"), issued June 16, 2015
- Administrative Measures for implementation of the General Anti-Tax Avoidance Rule (for Trial Implementation), SAT Order No.32 ("Order 32"), issued on December 2, 2014
- SAT Announcement on Issues Relating to the Reporting by Resident Enterprises of Information on Outbound Investment and Related Income, SAT Announcement [2014] No.38 ("Announcement 38"), issued on June 30, 2014
- SAT Circular on Proper Reporting of Overseas Investments and Income Information by Resident Enterprises, Shuizonghan [2015] No.327 ("Circular 327"), issued on June 18, 2015

[2015] and this test is linked to the tests of duplication, value creation, incidental benefit, remuneration and need set out in that document and reflected in the Discussion Draft. There have been indications that, in order for a positive assessment to be reached that a service has generated a 'direct or indirect benefit' for the service recipient, a Chinese taxpayer may have to demonstrate a connection between the service fee payment and an incremental marginal profit. This approach would go beyond what the equivalent OECD rules would demand to see. It remains to be seen what evidence would be deemed sufficient to substantiate 'direct or indirect economic benefit' in practice.

The Discussion Draft also integrates the guidance in Announcement 16 on payments to 'low function entities'. This denies outright deductions for service fee payments to such entities, a harsher approach than envisioned under OECD rules. Further, the SAT chose not to integrate the 'safe harbour', proposed by the OECD BEPS work, for 'low-value adding services' on the basis that all intra-group services are high risk transactions.

Special Documentation including extensive recording and reporting of information on the pricing of related party service transactions is also provided for under the services chapter, with a separate services section in the Local File under Contemporaneous Documentation also now required.

Location Specific Advantages (LSAs)

The Discussion Draft integrates the Chinese LSA concepts, outlined in a SAT contribution to the UN TP Manual in 2013 and applied by the Chinese tax authorities in practice for a number of years, into its guidance. The SAT had described LSAs (specifically 'cost savings' and 'market premium') as advantages for production arising from assets, resource endowments, government industry policies and incentives, etc, which exist in specific localities. The use of LSAs in TP analysis is underpinned by the SAT's position that certain upstream value chain activities (e.g. product design) and certain downstream value chain activities (e.g. original brand building), typically conducted by foreign MNEs outside China, have been given too large a weighting in the TP practices evolved in developed countries. LSAs 'correct' for this by emphasizing the unique advantages of China in the 'middle-value chain', such as manufacturing.

The OECD BEPS TP work acknowledged local market features and location savings as factors worthy of consideration in a TP comparability analysis. The Discussion Draft replicates this reference for LSAs, along with multiple other references to LSAs, e.g. that LSAs need to be considered in determining whether the Profit Split Method (PSM) should be used, and LSAs need to be considered in attributing the gains from intangible assets.

Intangible Assets

The Discussion Draft seeks to integrate (into a new Chapter 6) the SAT's unique TP approach to Intangible Assets, developed over a number of years, alongside the approach taken in the OECD TP BEPS Intangibles report. The SAT's TP intangibles approach, set out in particular in the China chapter of the UN TP Manual, is, like the LSA concepts, driven by the SAT position that certain upstream and downstream value chain activities have been over-emphasized in the TP practice developed in Western countries.

The Chinese tax authorities have therefore sought to identify intangible assets developed by the efforts of MNE Chinese subsidiaries and 'economically' owned by the latter, as well as seeking compensation for enhancement contributions to intangible assets held overseas. The authorities have pushed for PSM where transacting related parties possess intangible assets. The particular SAT view on intangibles in a China context means that integration of this with the OECD BEPS approach may produce some deviations from the intent of the BEPS proposals.

- Intangible assets examples: In the examples of Intangible Assets, the Discussion Draft sets out technology and marketing related intangibles as two distinct categories, and goes on to emphasis certain items, such as customer lists, sales channels, market research analysis outputs, special operating permits, and government licenses, frequently referred to by the Chinese tax authorities in TP audits

- DEMPE (Development, enhancement, maintenance, protection and exploitation): The BEPS TP Intangibles report provides that the contributions of MNE group members to the value of intangible assets is to be evaluated by examining DEMPE functions performed, assets used and risks assumed. This DEMPE analysis is the basis for allocating income from the use/transfer of intangibles, as the legal owner of intangibles will be expected to 'compensate' MNE group members for their contributions.

  Both the BEPS report and the Discussion Draft are opposed to simply allocating all residual profit, after a limited return to those providing functions, to the owner of intangibles, and emphasize the necessity of a full DEMPE analysis having regard, inter alia, to LSAs. While much of the Discussion Draft reference to the DEMPE approach is fully in line with the BEPS work there are certain differences which may prove significant, depending on how they are emphasized in practical application.

  The Discussion Draft sets out a 'DEMPEP' approach, including a final 'P' for promotion alongside the BEPS DEMPE factors. This reinforces the historic Chinese emphasis on the importance of China market promotion and Chinese consumer product awareness building as value drivers for foreign brands, supported in the past by the Chinese local marketing intangibles concept. This emphasis is bolstered by a further statement on the key importance of taking into account market factors and product localization in determining contributions to intangible value.

  In setting out the 'important functions', which need to be focussed on in the DEMPEP analysis, the Discussion Draft includes some of the 'important functions' identified by the OECD but changes their emphasis. So while the OECD provided that design and control of research and marketing programmes were important functions, the Discussion Draft expresses this as management control of research projects and design of marketing programmes. In fact, while the OECD emphasizes the centrality of 'control' of functions and risks to allocating intangibles profits, the Discussion Draft barely mentions control as a factor (and does not mention decision making at all). Beyond this, the Discussion Draft includes as 'important functions' matters which the OECD does not consider important in contributing to the value creation of intangibles (e.g. adaptation of products for the local market, market research, maintenance of customer relationships, enablement of mass production, trial production, establishment of marketing channels, CRM, and brand promotion). Further, the Discussion Draft does not mention some of the functions which the OECD considered important (e.g. management of development budgets, and intangibles legal defence).

  The Discussion Draft also introduces a concept (not present in the BEPS work) that the 'economic ownership' of intangibles may rest with a party (other than the legal owner) who contributes to the value of intangibles (the OECD simply speaks of compensating this party). Whether this has any real distinguishing effect in practice though remains to be seen.

  The Discussion Draft also emphasizes, as the SAT did in the UN TP Manual, that royalties paid for intangibles licensed from overseas parties may need to be adjusted over time. This is needed to reflect change in the intangibles (e.g. the dating of technology), adjustment mechanisms that would be included in contracts in accordance with general business principles, changes in the functions, assets and risks relevant to use of the intangible, and DEMPEP contributions by the Chinese taxpayer to the foreign intangibles.

  Similar to the services guidance, the Discussion Draft provides that tax deductions can be denied if the licensed intangibles do not provide the Chinese taxpayer with an economic benefit. It remains to be seen what evidence would need to be furnished to demonstrate economic benefit in practice.

While the Discussion Draft clearly recognizes both technology and marketing related intangibles as two distinct categories, it appears to suggest that only the joint development of technology related intangibles can be subject to cost sharing arrangements (CSAs). The practical ramifications of this, considering that provisions of group marketing strategies are services that can clearly be subject to CSAs, remain to be seen.

- Low function entities: The Discussion Draft integrates and nuances the Announcement 16 approach to deductions for payments of royalties to related parties overseas. Announcement 16 could be read as entirely ruling out deductions for payments to overseas entities which have not contributed to intangibles value creation. The Discussion Draft provides that the foreign entities will be entitled to no return from intangibles where they have just the legal rights to intangibles and they have made no contribution to the value creation of the intangibles, and just a financing return where they have just contributed funds. This approach, in line with BEPS and more positive for business, indicates a downward adjustment to the tax deduction to eliminate the profit of the non-contributing foreign company, but does not necessarily completely eliminate tax deductions.

- Non-comparables-based TP methods: The Discussion Draft envisions the use of non-comparables-based TP methods in instances where the related parties to a transaction or arrangement possess significant intangible assets.

  The BEPS TP Intangibles report concedes that where a transacting party possesses 'unique and valuable' intangibles (i.e. intangibles which are not comparable to intangibles used by or available to other parties, so rendering direct comparison impossible) then, unless reliable comparability adjustments can be made, one-sided TP methods may not be appropriate and non-comparables based methods may need to be used. To this degree there is some alignment between the BEPS and SAT approaches. However, the Discussion Draft makes no distinction between 'unique and valuable' and 'routine' intangibles. The OECD takes the position that where routine intangibles are in point one-sided methods may still be used.

  The Discussion Draft implies that the Transactional Net Margin Method (TNMM) should not be used where transacting enterprises possess 'significant intangible assets' and that PSM is typically to be used where transactions between related parties involve 'unique and valuable contributions'. The terms 'significant intangible assets' and 'unique and valuable contributions' are not defined, and it is not clear whether the SAT is concerned by possession of such assets (or making of such contribution) by just the potential tested party, or by either party.

New TP Methods

- *Value Contribution Method:* The Discussion Draft introduces the Value Contribution Apportionment Method (VCM) as one amongst the 'Other TP Methods'. Under VCM MNE profits are to be allocated across the value chain based on analysis of how value creating contributions have been made to group profits, with reference being made to assets, costs, sales, number of employees. It is stated to be appropriate to use where comparability information is difficult to obtain and where, at the same time, the consolidated profit for the MNE and value creating factor contributions can be reasonably determined.

- *Valuation Methods*: In parallel with the focus on transactions in intangible assets and equity transfers in the Discussion Draft, Valuation TP Methods (cost, market, and income methods) are also introduced to support TP analysis of these transactions. The extensive new section added to the TP documentation local file on equity transfers and the comprehensive information in the master and local files on intangibles will support the use of these methods.

Special tax adjustment provisions

The Discussion Draft introduces a re-characterization provision, as well as a special provision dealing with toll manufacturers, among other key changes.

- *Re-characterization:* The Discussion Draft re-characterization rules provides that if a contract for transaction between related parties would not have occurred under equivalent economic circumstances between unrelated parties then the transaction may be deemed not to have occurred or may be re-characterized by the tax authorities. Furthermore, where the functions conducted/risks borne by a related party for another related party exceed that which an independent party would have been willing to do then compensatory arrangements will be made.

  As this provision is phrased rather broadly, and no further guidance is provided, it remains to be seen whether the Chinese tax authorities would use the provision in the same cases where the OECD BEPS work considers re-characterization appropriate. The BEPS TP Intangibles report states that re-characterization situations might include cases where the actual conduct of transactions departs from the contractual terms, such that the parties are not following the contract, or where a transaction would prove to be uneconomic from perspective of one of the related parties, as well as cases where 'very important' DEMPE functions, unlikely to be outsourced between independent parties, are outsourced between related parties. The BEPS work on risk and profit splits include further examples. It might be noted that, in contrast to the OECD work, the Discussion Draft includes no substantive discussion on the Chinese TP approach to the analysis and treatment of contractual risk, nor does it give any indication of what emphasis and weight the SAT would put on the capacity of an enterprise to control the contractual risks that it bears.

- *Toll manufacturing:* Adopting the SAT's position, as set out in the UN Manual on adjustments which need to be made in order to calculate appropriate profits for toll manufacturers, the Discussion Draft provides that the tax authorities may make adjustments for the value of materials and equipment legally held in the ownership of the offshore principal when determining the appropriate profit for a toll manufacturer.

- *Reversing tested party:* The Discussion Draft explicitly sets out that, in cases where a foreign company transacting with a Chinese taxpayer is low-tax and has a limited function/risk profile, then the foreign company can be used as the tested party in a TP audit. There is a danger that a reverse TNMM approach could be applied which awards a limited return to an overseas company for its functions, with the entire residual profit in the global value chain being allocated to China.

- *Adjustment to median:* While the previous Circular 2 provides that tax authorities *may* adjust a taxpayer's profitability to median when a range concept has been used to set pricing, the Discussion Draft now requires that profitability *should* be adjusted to no lower than the median of the interquartile range.

- *Secondary adjustments:* While the previous Circular 2 lacked specific provisions on secondary adjustment, the Discussion Draft provides that accounting books shall be adjusted following a special tax adjustment. However, aspects such as what accounting entries and how they shall be adjusted and whether other taxes,.e.g. VAT, Customs duty, shall be adjusted remain unclarified.

- *No adjustment*: In a positive change, the Chinese tax authorities will now issue a confirmation to letter to taxpayers where they have conducted a special tax adjustment investigation and concluded that no adjustment is warranted. This is aligned with the approach in the recent GAAR Administrative Measures [2014].

2. TP documentation and TP administration changes

Complementing the significant changes to Chinese TP practice and approaches outlined above, the Discussion Draft also provides for:

- A significant expansion of the information resources available to the Chinese tax authorities through bulking up TP documentation and taxpayer reporting requirements
- Increasing the effective use, by tax authorities, of the information at their disposal to target audit and review activity through guidance on establishment of taxpayer risk ratings and monitoring
- Clarifications on regime for Advance Pricing Agreements (APAs)
- Clarification of how Cost Sharing Arrangements (CSAs) will apply

Related party filing

The September 2014 BEPS Report on TP documentation set out a three-tier structure for TP documentation: Master File, Local File and Country-by-Country (CBC) Reporting. The G20-agreed BEPS CBC implementation rules were subsequently set out in February 2015. Under BEPS CBC reporting an MNE group with revenue above a certain reporting threshold must disclose to the tax authorities the distribution of its revenues, income, staff, assets and paid taxes across the countries in which it has operations. The CBC information is to form an input to TP risk assessment and audit selection by tax authorities. The Discussion Draft provides for the roll-out of these new BEPS TP documentation requirements in China.

The Discussion Draft adopts the CBC reporting thresholds and mechanisms broadly in line with the G20 agreement, to which China was party. Under these, where an MNE has its top holding company in China and the group has more than RMB5bn in global revenue (broadly equivalent to the EUR750m G20-agreed threshold) then the CBC report is to be provided by this company to the Chinese tax authorities as part of the annual related party reporting. Alternatively if a foreign MNE were to designate a Chinese group company as a global filer then this company would similarly include the CBC reporting in its annual related party filing. In the alternative, if a special tax adjustment investigation is underway, then the Chinese tax authorities may demand to be supplied with the CBC reporting prepared by a foreign company – namely, if the foreign parent does not make the CBC reporting in its own home state, or the Exchange of Information (EOI) mechanisms for transferring the CBC data to China are inadequate, then the local China subsidiary of the foreign MNE will need to make the CBC filing.

Contemporaneous Documentation

'Contemporaneous Documentation' under the Discussion Draft now consists of a Master File and a Local File, and so-called 'Special Documentation'. The designations of Master File and Local File are drawn from OECD's three-tier structure for TP documentation. The Discussions Draft formally expands the scope of parties who must prepare the Master File and Local File from those exceeding the existing RMB 200m (buy-sell transactions) or RMB 40m (other transactions) transactions thresholds to also cover entities with limited risk and function profiles but which despite this incur losses. The requirement for the latter to prepare the Master File and Local File exists without reference to a transaction threshold (This requirement is a slight modification from Circular 363 [2009] which provided that single function entities which incur losses shall prepare TP documentation). The Discussion Draft also expands the exemption from preparing the Master File and Local File, where companies only have inter-China RPTs, from companies which are less than 50% foreign-owned to all companies.

A very interesting addition to 'Contemporaneous Documentation' is a separate category of documentation called 'Special Documentation'. There is now a new requirement for Chinese taxpayers engaging in related party services transactions and CSAs, as well as those companies exceeding the Thin Cap threshold, to prepare Special Documentation without a transaction threshold.

The requirement for Chinese taxpayers engaging in related party services transactions to prepare Special Documentation certainly demonstrates the SAT's focus on service transactions, and continues the trend of developments in this area in the last year or two.

Master File and Local File

The Master File requirements, which include an organizational chart and information on description of MNE's business, MNE's intangibles, MNE's intercompany financial activities, MNEs financial and tax positions, are in line with the BEPS proposals. The Discussion Draft includes only one additional requirement, being the name and the location of the legal entity preparing and filing the CBC report for the group.

The Discussion Draft Local File content includes (i) Company profile (including management team, business lines, and industry profile), (ii) Related party relationships, (iii) Related party transactions, (iv) Comparability analysis, and (v) Selection and use of a TP method. Throughout the description of the contents, the Discussion Draft sets out in finer detail, than is done in the BEPS Local File description, what precise details must be set out. This being said, at least in respect of (i), (ii), (iv) and (v), the detail does not significantly expand on what could reasonably be expected to be included in the BEPS Local File (though there is a requirement to set out related party effective tax rates similar to documentation requirements under existing Circular 2, not included in the BEPS Local File).

Where the Discussion Draft does significantly depart from the BEPS Local File (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. 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.

Value Chain Analysis, although not currently required under Circular 2 documentation requirements, is often requested during transfer pricing audits / risk-assessment discussions. The inclusion of Value Chain Analysis 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.

In addition, there are also prescriptive requirements on the level of disclosure required on Outbound Investments, Transfers of Equity in Related Parties (including valuation reports), and Related Party Services in the Local File. These additions to Local File reflect the priority focus of the SAT on CFC/Residence rules, M&A transactions, and outbound service payments.

Tax authority monitoring systems

Chapter 13 of the Discussion Draft, 'Monitoring and Management of Profit Levels', sets out to guide local tax authorities in the establishment and enhancement of their information systems to leverage the greater information set to be put at their disposal.

The above-mentioned enhanced TP Contemporaneous Documentation may be combined with information from annual related party transaction reporting, internal control testing information, historic records of taxpayer compliance, and information shared from other tax authorities and government agencies to set a tax risk classification for individual taxpayers. Specific government database sharing mechanisms are specifically mandated to be established by local tax authorities in Chapter 13, and build on earlier efforts, including those involved in establishing the current TP comprehensive indicator system.

Under this rating system (being adopted by the SAT from experience in other countries) low risk and high risk taxpayers will receive differential levels of scrutiny and audit, so ensuring a better deployment of resources. The rudiments of this tax rating system had already been set in SAT Announcement 40 [2014] and Announcement 47 [2015].

Linked to the above system, the Discussion Draft Chapter 13 directs tax authorities to conduct tests of taxpayers internal control systems. This builds on the SAT's earlier efforts in SAT Circular 90 [2009] and SAT Circular 71 [2011], and with the establishment Large Enterprise Department and Tax Compliance Agreement initiatives, to encourage large enterprises to establish and oversee a structured and comprehensive tax risk management system. Routine evaluation of tax risk management systems had already been integrated since 2013 into the normal process for tax "self-investigation" for selected large accounts, and the Discussion Draft now takes this further. The mechanics of the 'self-adjustment' system itself, already largely formalized under SAT Circular 54 [2014], are further clarified by Chapter 13.

Advance Pricing Agreements (APAs): Refinements have been made to guidance on APAs, providing that priority attention will be given to APA applications by taxpayers who provide thorough value chain analysis and/or have duly considered LSAs. The concept of median, reinforced as discussed in the special tax adjustment provisions section above, is further reinforced in the APA provisions. The Discussion Draft provides that the tax authorities may adjust the pricing or profitability to the median of the agreed range if the pricing or profitability falls outside the agreed range for any particular year during the APA. Further, the tax authorities may adjust the weighted average pricing or profitability to the median of the agreed range if it is below the median of the agreed range (even if within range). In addition, the Discussion Draft provides that tax authorities may turn away extension applications from taxpayers whose weighted average pricing or profitability fell below the median of the agreed range (even if within range) during its in-force APA period. The Discussion Draft also made changes to the administrative proceedings. The notable ones include the requirement to provide the application materials with the submission of the "Letter of Intent" and the abolishment of pre-filing meetings taking place on an anonymous basis.

Cost Sharing Agreements (CSAs): The CSA guidance in the Discussion Draft builds on the recently eased CSA application requirements set out in the recent SAT Circular 45 [2015], which have encouraged some MNEs to look again at the possibility of doing CSAs with China. This is being spurred on by the pressure which BEPS, internationally and in China, is putting on the CSA arrangements used by some MNEs in the past for development and ownership of their global IP in low tax countries (e.g. Ireland CSAs by US MNEs). The Discussion Draft guidance does make certain clarifications consistent with the OECD work, e.g. it requires all participants to have reasonably measureable expected benefits, but one important divergence is that it does not explicitly require participants to have an ability to control risks associated with CSAs, unlike the latest draft of the BEPS guidance. In addition, there is a lack of clear guidance on circumstances in which differences between expected benefits and actual benefits would be considered 'significant', so requiring 'true-ups'.

3. SAARs and GAAR

The existing Circular 2, while it deals primarily with TP matters, also extends to dealing with the Corporate Income Tax (CIT) Law's Special Anti-Avoidance Rules (SAARs), including Controlled Foreign Company (CFC) Rules and Thin Capitalization (Thin Cap) Rules, as well as the PRC General Anti-Avoidance Rule (GAAR), and these are now updated by the Discussion Draft. A significant change for both the GAAR as well as the SAARs is that the statute of limitations for these measures has now been extended to 10 years. This had always been the case for TP cases but the extension of the time limit for the other rules will have a significant impact on tax risk management for MNEs.

Updates in the Discussion Draft from Circular 2 in relation to the GAAR bring the latter into conformance with the recently issued GAAR Measures in SAT Order 32 [2014] (see *China Tax Alert Issue 1, January 2015*). In this regard the Discussion Draft notes that SAARs and treaty anti-avoidance rules will be used in priority to the GAAR and reiterating the GAAR as a purpose-focused test, but also add new clarifications. It is clarified that tax authorities are to determine whether a tax benefit results from an arrangement by considering the economic substance and results of the arrangement in point and then comparing this with a chosen transaction which has equal business rationale but lacks the tax avoidance outcomes. It is further clarified that, where trust or agency arrangements have been used to conceal related party transactions, that the tax authorities can, in accordance with economic substance, deem the existence of related party transactions.

For Thin Cap rules, debit balances under cash pooling arrangements and interesting-bearing current and long-term liabilities (including interest-bearing trade payables) are now considered to be related party debt investments. Furthermore, the calculations for related-party debt and equity are revised; this may become highly complicated if a taxpayer engages in a cash pool, as its debit balance is different on a daily basis, but the rules are likely less prone to manipulation going forward. The SAT has declined to introduce the earnings stripping or group limitation rules proposed by the BEPS Interest Deductions Draft. It is understood that this may be partly due to the fact that an update the CIT Law itself would have been necessary to facilitate the roll out of these measures, and the SAT was disinclined to push for CIT law change.

With regard to CFC rules, the SAT have drawn some insights from the BEPS CFC work into the Discussion Draft alongside clarifications on the control rules to determine whether the CFC rules should apply in the first instance. China has only recently started to use its CFC rules in practice, with two enforcement cases, in Shandong and Hainan, being reported earlier this year, and understanding of the rules amongst the tax authorities and taxpayers is still rather limited. At the same time the SAT has been stepping up the CFC reporting requirements, with Circular 38 in 2014 and Circular 327 in 2015. It remains to be seen whether the CFC rule changes, inspired by BEPS, will be accompanied by a strong new push on enforcement and key in this regard may be the CBC reporting for Chinese MNEs (details yet to be announced).

Circular 2 had provided a number of exclusions for foreign subsidiaries (i.e. CFCs) of Chinese tax residents from the application of the CFC rules, which would otherwise impose CIT on the profits of the former prior to distribution back to China. The exclusions applied (i) where the revenue of the foreign subsidiary was mainly generated from 'active operations', (ii) where the annual income of the CFC fell beneath RMB5m, and (iii) where the company was not in a low tax country, i.e. with a tax rate of less than 50% of the Chinese 25% CIT rate (i.e. 12.5%) on an effective tax rate basis. While the latter exclusion is retained, the other exclusions have been altered. Going forward, the CFC rule exclusion will apply where the profits left in the CFC (and not distributed) fall beneath RMB5m, rather than the total annual profits of the CFC as previously. Furthermore, the 'income from active operations' exemption is now replaced with a test of whether less than half the CFC income is 'includable income'.

The Discussion Draft now clarifies that in determining whether CFC income is 'includable' as taxable income of a Chinese taxpayer, one needs to analyze (i) whether there has been a 'substantial contribution' of the CFC's employees to generating the CFC income, (ii) the income which the CFC would earn from its deployed assets and assumed risks if the members of the corporate group were to act as independent parties, (iii) whether the CFC has sufficient staff, technical ability, and premises corresponding to the income it earns. In light of such analysis it is observed that a number of circumstances should typically give rise to includable income; (i) dividends earned by non-securities trading companies, (i) interest earned by non-finance business companies, (iii) insurance premiums earned by non-insurance companies, (iv) royalties earned from related parties, (iv) sales and service income earned where goods and services have been bought-in from related parties and no or low value has been added, (vi) excess profits derived from intangible asset or risk transfers.

It is further clarified that the CFC rules will not apply where there is a reasonable business need for not distributing the profits and where the profits are reinvested in real economic activity.

KPMG observations

A thorough analysis of the Discussion Draft identifies a multitude of implications for MNEs and the most significant of these are highlighted below.

- *Clarified scope of TP rules:* In China the SAT and local tax authorities have broad interpretative flexibility in relation to tax rules. Nonetheless the SAT has been pushing for greater consistency in application of tax law by local tax authorities and for more definite and explicit tax guidance. The clarification of the scope of TP rules in the Discussion Draft supports the basis for TP adjustments for specific transaction types (e.g. equity transfers) and this is aligned with the enhancements to TP documentation (e.g. on equity transfers) and the new TP methods (e.g. Valuation methods for equity transfers).

- *Outbound service payments:* It remains to be seen what would constitute sufficient evidence for demonstrating that a service has met the 'direct or indirect economic benefit' test. An implicit 'incremental profit' approach could make it very challenging for MNEs to support their deductions for outbound service fees.

  Equally, for the denial of deductions for payments to 'low function entities', there is as yet no guidance on when an entity would be considered to possess sufficient activity and resources. It remains to be seen whether these requirements under TP rules will have any correspondence to the 'substance' requirements under China's treaty relief rules and under the CFC rules. Such matters would be particularly important to clarify for overseas group shared services centre arrangements, in cases where the service centre has bought in and then recharged services (from external/related service providers) to all group entities.

  The Special Documentation for related party services will create additional burden for taxpayers. Taking this together with the Local File value chain analysis and the CBC reporting information, service fee payments are likely to be under scrutiny like never before.

- *LSAs:* The references to LSAs in the Discussion Draft do not appear to be at odds with the discussion on location savings and local market features in the BEPS TP report. However, the discussion on LSAs in the Discussion Draft is far less detailed than in the BEPS TP Intangibles report, and latitude is left for local authority interpretation and application. Notably, while the BEPS paper discusses how location savings may ultimately dissipate, being passed on to independent customers or suppliers, the Discussion Draft makes no such observation.

  Neither does the Discussion Draft indicate, as the BEPS report does, that where there is availability of reliable local market comparables, with other companies in the market having access to the benefit of equivalent location savings or local market features, then the need for making any LSA comparability adjustments may be dispensed with. Furthermore, while the BEPS report does not indicate that presence of LSAs could lead to application of a non-comparables based TP method, the Discussion Draft indicates just that.

  In the BEPS TP report, the OECD urges restraint on the part of taxpayers and tax authorities in rejecting potential comparables. However, the SAT has frequently taken the position that the existence of unique Chinese LSAs may deprive available potential comparables of their validity (reliable adjustments being argued to be not possible) and local tax authorities have been actively using this rationale as a basis for pushing for PSM to be used. The LSA references in the Discussion Draft now provide a useful reference point for tax authorities when making such challenges, and may also be leveraged in pushing use of the new VCM going forward.

- *Intangible Assets:* The Discussion Draft 'DEMPEP' approach, and the description of 'important functions' as those typical 'middle value chain activities' frequently carried out by MNEs in China (e.g. manufacturing, trial production etc) as well as China market-building activities, could readily lead to a divergence between TP profit attributions from intangible assets by Chinese and foreign tax authorities, with the potential for double taxation this brings. It is also quite possible, drawing on past China enforcement practice and the practical absence of references to 'control' in the Discussion Draft, that the Chinese tax authorities will focus on the 'performance' of DEMPEP functions, to a greater degree than on their 'control' (the preference of the OECD).

  The open wording of the Discussion Draft, concerning the circumstances in which ownership of intangibles (or contribution to their value creation) by transacting related parties might invalidate use of one-sided methods, is expected to be leveraged by the Chinese tax authorities to push for more use of PSM and VCM. This would be in line with, and further support, the frequent current assertions by the Chinese tax authorities in TP audits that local intangibles (in the same way as LSAs) render potential comparables unusable and beyond reasonable adjustment. The use of the term 'significant intangibles' could, for example, include local marketing intangibles, which might not be considered 'unique and valuable' by the OECD but might readily be argued by the Chinese tax authorities to be 'significant'.

  The identification by the Discussion Draft of an 'economic owner' of Intangible Assets is not expected to have a major impact on TP outcomes. However, it remains to be seen whether the concept might also be used, outside the TP space, by other tax authority departments, leading to further complexity (e.g. withholding taxes on transfer).

  The clarifications on deductibility of royalties paid to overseas related parties may be viewed as positive, and may assist in securing deductions for payments to overseas IP holding companies (in danger with the previous (mis)reading of Announcement 16). Still there is a pressing need for more clarification on the required level of 'substance' in overseas entities.

- *New transfer pricing methods:* With the explicit introduction of the new VCM method, it remains to be seen whether, going forward, the Chinese tax authorities will be even more inclined to dismiss potential comparables, on grounds of LSAs, local intangibles or other factors, and use the 'absence' of comparables to push in the direction of using this new method.

- *Special tax adjustment provisions:* The exact application of the broadly worded re-characterization provision remains unclear. It would be preferred if the Chinese tax authorities will allow for regard to be had to the relevant BEPS guidance in negotiations with taxpayers over whether re-characterization should be applied.

- *TP Contemporaneous Documentation:* 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 reporting, which is much more summary in nature. It might also be noted that the threshold for preparing this information will be the standard China TP contemporaneous documentation thresholds, i.e. RMB200m cross-border trading transactions or RMB40m 'other' transactions, rather than the RMB5bn threshold for CBC reporting.

  It can clearly be seen that the enhanced Master-Local File documentation provides the fuel for the Chinese tax authorities to apply PSM and VCM TP methods. Thus, to the extent that the Chinese tax authorities wish to leverage the various provisions of the Discussion Draft which argue against application of TNMM and which assert that LSAs and local intangibles may make use of comparables-based methods unworkable, then the authorities will have a ready resource in the new TP documentation to apply PSM and VCM.

The introduction of 'Special Documentation' without a transaction threshold for Chinese taxpayers engaging in related party services transactions and CSAs, as well as those companies exceeding the Thin Cap threshold, will also a much greater burden on taxpayers.

- *TP administration:* The pooling of information by tax authorities, taxpayer tax ratings, and the planned frequent review of tax risk management systems clearly all necessitate greater attention to tax compliance systems going forward. For APAs, the concept of median if reinforced, applications materials need now be provided with the submission of "Letter of Intent" and taxpayers no longer have the option conduct pre-filing meetings anonymously. For CSAs, some guidance continues to diverge from the OECD approach. While the potential demand for China CSAs is there, serious barriers to use of CSAs in a Chinese context continue to exist, namely difficulties with remitting CSA payments due to absence of clear FX regulatory categorization for buy-in payments, balancing payments and exit payments, lack of clear VAT treatment for the above, and lack of clarity as to whether joint economic ownership of IP under a CSA would be sufficient to satisfy the requirements of the High and New Technology (HNTE) incentive.
- *SAARs and GAAR:* The Discussion Draft specifies in far greater detail, than was previously the case under Circular 2, how the CFC rules are to operate. Given that the Chinese tax authorities are now serious about enforcing the CFC rules the detailed implementation guidance is expected to have a real impact. The Thin Cap rules are also more expansive, and managing them will require greater care.
- *Discussion Draft entry into effect:* The Discussion Draft is expected to be finalized and issued in late November/early December and to go into effect for the 2016 tax year. Cases initiated, but not concluded, prior to the entry into effectiveness of the new rules will be dealt with under the new rules.
- *Discussion Draft consultation:* The SAT is accepting comments on the Discussion Draft until 16 October 2015 and we would urge all interested parties to contribute. KPMG will be drafting a detailed submission to the SAT, seeking clarifications and proposing amendments which will allow the new rules to function more effectively. If you wish to contact us we would be happy to consider your suggestions for inclusion in our submission.

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