

Tax Analysis

SAT Issued New Rules on Reporting of Related Party Transactions and Contemporaneous Documentation

On 29 June 2016, the State Administration of Taxation (SAT) issued new regulations¹ (i.e. SAT Bulletin [2016] No. 42, or Bulletin 42) to improve the reporting of related party transactions and contemporaneous documentation. Bulletin 42 will replace the existing transfer pricing documentation regulations in Circular Guoshuifa [2009] No. 2 (Circular 2). In contrast with Circular 2, which comprehensively covered various aspects of special tax adjustments, Bulletin 42 is only concerned with the reporting of related party transactions and contemporaneous documentation. Our understanding is further regulations will be issued to complete the revision of Circular 2². Bulletin 42 will apply from 2016 and onwards, and the applicable sections in the old regulations (i.e. Chapters 2 and 3, and Articles 74 and 89 of Circular 2; and Circular Guoshuifa [2008] No. 114) will be repealed.

Bulletin 42 introduces a three tier documentation framework, as set out in the OECD's framework in BEPS Action 13, while requiring technical analysis and consideration of positions that are familiar to the China market – for example, the impact of location specific advantages on pricing arrangements. Requirements that were signaled in the September 2015 discussion draft revision to Circular 2, including country-by-country reports, master and local files, the special issue file, and value chain analysis are covered as well by Bulletin 42.

Bulletin 42 addresses issues that have been the focus of the Chinese tax authorities for a number of years, addressing practical issues they have experienced, and provides a new landscape for transfer pricing practice and management in China. Additionally, the localization and implementation of BEPS Action 13 in China is a new milestone in the internationalization of China's transfer pricing practice.

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¹ See full text in Chinese: http://www.tax.sh.gov.cn/pub/xxgk/zcfg/ssxd/201607/t20160713_425681.html

² A discussion draft revision to Circular 2 was published on 17 September 2015 for public consultation, see full text in Chinese of the draft: <http://hd.chinatax.gov.cn/hudong/noticedetail.do?noticeid=577376>

I. Recognition of related party relationships and related party transactions

Bulletin 42 updates the related party relationship definitions from the discussion draft, refines the existing rules, and expands them to ensure that relationships between natural persons are taken into account when considering the relationship between two parties, as well as clarifying certain issues such as the determination of ratio of debts to equity. It has also been provided that two parties will be considered related if they have "other substantial common interests". There are also some changes to reflect public comments on the detailed rules in respect of relationships involving directors on boards, and senior management personnel. In addition, the regulation recognizes that related party relationships may change, and relationships should be recognized during the periods when they exist.

The types of covered related party transactions are updated from the existing Circular 2 definitions to more comprehensively cover the types of transactions that take place between related parties – expanding the potential coverage of special tax adjustments. The changes in this final regulation are effectively the same as those signaled in the September 2015 discussion draft, and cover tangible assets, financial assets (e.g. equity investment), intangible assets, financing transactions (e.g. cash pooling, guarantee fees, and all kinds of interest accrued advances and deferred payments, etc.) and service transactions.

II. Reporting of related party transactions

Key changes

Bulletin 42 includes the formal templates and filing instruction for the Annual Related Party Transactions Reporting Forms (the "New Forms"). These New Forms entirely replace the previous "nine forms", and increase the total number of forms to fourteen. Overall the information disclosure requirement is increased and the New Forms also include the Country-by-Country reporting form (CbC Form). Please refer the appendix for a comparative analysis of the Original Forms and New Forms.

The New Forms will take more time to complete given the increase in the number of forms and more detailed information required. The design of the forms reflects the enhanced requirements of tax authorities on disclosure, especially for related party relationships and transactions, while also trying to streamline the preparation and reduce uncertainty in the filing process. The inclusion of the CbC form also shows how China has adopted the requirements of BEPS Action 13, and lays the foundation for future CbC information exchanges.

Taxpayers will need to pay close attention when the forms are prepared, to ensure consistency across all of the forms, as well as with the transfer pricing documentation, audit report and other associated documents.

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CbC reporting

The SAT has included the CbC Form into the reporting forms of related party transactions, and seems to require taxpayers to provide both Chinese and English versions at the same time. Consistent with the treatment in the previous discussion draft, a CbC Form will be required for a taxpayers in the following circumstances:

- China resident enterprise which is the group ultimate parent of a multinational enterprise group, with consolidated revenue greater than RMB 5.5 billion in the last fiscal year; or
- China resident enterprise that is nominated by the multinational group as the filing entity.

Bulletin 42 covers a number of definitions for the purpose of determining the group parent, and member entities – consistent with the definitions in BEPS Action 13. Of interest to some taxpayers, the regulation also partially or entirely exempts the CbC filing obligation for Chinese enterprises if the information relates to "national security". Such an exemption has already been adopted by a few other countries. There are also provisions that allow the Chinese authorities to request copies of CbC reports from overseas tax authorities, as well as provisions to require the information from local entities if the overseas tax authorities do not provide the information.

Submission deadline

The filing deadline of the New Forms should generally be the same date as income tax annual filing, which is 31 May of the following year.

III. Contemporaneous documentation

A major focus of the feedback on the discussion draft was the three tier framework for transfer pricing documentation. Overall the requirements for the master and local file are similar to those signalled in the September 2015 discussion draft with revisions to the thresholds for preparation, while the requirement for the special issue file for service transactions has been removed – although the analysis for service transactions is now required to be incorporated into the local file along with information regarding equity transfers. Of particular note, the regulation retains the high disclosure requirements of the September 2015 Discussion Draft, meaning the value chain analysis, location specific advantages and other matters of concern to the SAT will be required. It has been confirmed that transactions with related parties in Hong Kong, Macau and Taiwan will also be considered as cross-border related party transactions. The deadlines for preparing the documentation have also been revised.

The following table compares the requirements of Bulletin 42 and the existing Circular 2 for the thresholds to prepare the contemporaneous documentation.

Item	Circular 2 (Chapter 3)	Bulletin 42
Report structure	China country file only	Three-tier framework (i.e. master file, local file and special issue file)
Threshold for preparation	<ul style="list-style-type: none"> • The annual sum of related party-purchases and sales is greater than RMB 200 million (for toll manufacturing business, the amount shall be calculated based on the import/export customs declaration prices); or 	<p><u>Master file:</u></p> <ol style="list-style-type: none"> 1) An enterprise has transactions with overseas related parties for during the year, and the ultimate holding company of the enterprise group, which consolidates the enterprise into its financial statements, has prepared a master file; or 2) An enterprise has related party transactions the aggregate of which exceeds RMB 1 billion during the year.

Item	Circular 2 (Chapter 3)	Bulletin 42
Threshold for preparation (continued)	<ul style="list-style-type: none"> The annual sum of other related-party transactions is greater than RMB 40 million (for related party financing, the amount is calculated based on the interest received/paid) <p>The value of related party transactions under a cost sharing arrangement (CSA) or advance pricing agreement (APA) will not be counted in determining the above annual sum of related party transactions.</p>	<p><u>Local file:</u></p> <ol style="list-style-type: none"> The annual sum of related party purchases/sales is greater than RMB 200 million (for toll manufacturing activities, the amount is calculated based on the import/export customs declaration prices); The annual sum of related party purchase/sales of financial assets or intangible assets is greater than RMB 100 million; or The annual sum of other related party transactions is greater than RMB 40 million. <p>The value of related party transactions under a concluded APA will not be counted in determining the above annual sum of related party transactions.</p> <p><u>Special issue file:</u></p> <ol style="list-style-type: none"> An enterprise enters or implements CSAs; or An enterprise with debt-to-equity ratio exceeding the threshold³ wishes to prove its related party financing's compliance with the arm's length principle
Exempt from preparation	<ul style="list-style-type: none"> Related party transactions are covered under an effective APA; or The foreign shareholding percentage is lower than 50% and related party transactions only incur among domestic associated parties. 	<ul style="list-style-type: none"> If the enterprise's related party transactions are only between the enterprise and its domestic related parties, the enterprise may be exempted from the preparation of the master File, Local File and Special Issue file. For enterprises with an APA, related party transactions that are covered under the concluded APA may be exempted from the preparation of local file and special issue file.
Deadline for preparation	By 31 May of the following year	<ul style="list-style-type: none"> Master file: within twelve months of the fiscal year end of the group's ultimate holding company Local file and special issue file: by 30 June of the following year
Deadline for submission	Within 20 days upon a request from the tax authorities	Within 30 days upon a request from the tax authorities

The disclosure requirement for the master file is consistent with BEPS Action 13, while the information required for the special issue file aligns with the requirement for CSAs and thin capitalization under Circular 2. However, Bulletin 42 has significantly expanded the scope of information disclosure in the local file. Special attention should be paid to the following new requirements:

³ The standard related party debt-to-equity ratio is 2:1 for non-financial enterprises and 5:1 for financial enterprise (see Circular Caishui [2008] No. 121 issued by the Ministry of Finance and SAT on 23 September 2008).

- **Value chain analysis:** details on the transaction flow, physical flow of goods and cash flow within the group; allocation principles and actual allocation results of group profits amongst the global value chain; and annual financial statements for the latest fiscal year of each of the group entities involved in the value chain;
- **Financial data:** financial data for each type of business and products;
- **Equity transfer analysis:** an overview of equity transfers, information on the equity transferred, due diligence reports and valuation report of any underlying asset for the transferred equity;
- **Related party services analysis:** separate analysis on related party services, including the benefits for each party from the service transactions, methodology for determining the service costs, service items, service amount, allocation standards, calculation process and results, etc. as well as the information on any same or similar service transactions the enterprise and its group enters into with third parties; and
- **Location specific factors:** the impact of location specific factors such as location savings, market premiums, etc. on the pricing of transactions, and the portion of value creation from location specific factors shared by the enterprise.

A comparison of the local file requirements of Bulletin 42 are compared with the existing requirements under Article 14 of Circular 2 is set out below:

Disclosure requirement in local file	Article 14 (Chapter 3 of Circular 2)	Bulletin 42
A – Overview of the local entity	Organizational structure, management structure, industry description <ul style="list-style-type: none"> • The group’s organizational structure and shareholding structure; • The group’s consolidated financial statements. (the above information is now required in the master file) 	<ul style="list-style-type: none"> • Business strategy: work flow, mode of operation and value contribution factors for each department and segment; • Financial data: financial data for each type of business and product, including details of turnover, costs, expenses and profit; • A description of reorganizations or transfers of intangibles in which the local enterprise is involved or affected, and how the change affects the local enterprise
B – Related party relationship	No significant change on the disclosure requirement, which includes information on related parties, tax rates applicable for each related party and any preferential tax treatments, and changes in related party relationships during the fiscal year	
C – Related party transactions	Description and details of related party transactions, business processes for related party transactions, description of functions and risks, the impact of intangible asset on the pricing of related party transactions, financial information for the related party transactions	<ul style="list-style-type: none"> • The impact of location specific factors on the pricing of related party transactions; • Value chain analysis; • Outbound investment: information on outbound investment, overview of outbound investment projects, and project data of the outbound investment project; • Related party equity transfer; • Related party services: benefits to each party, methods to determine the service costs, service items, service amount, allocation standards, calculation process and results; • APAs in foreign countries and other competent authorities' tax rulings which are directly related to the enterprise's related party transactions

Disclosure requirement in local file	Article 14 (Chapter 3 of Circular 2)	Bulletin 42
D – Comparability analysis	No significant change on the disclosure requirement, which includes factors considered in the comparability analysis, information on functions, risks and assets of comparable enterprises, the search method, source, selection criteria and rationale for the comparables, financial information of the comparable uncontrolled transactions and comparable enterprises and adjustments to the comparable data	
E – Selection of transfer pricing methods	The selection of the transfer pricing method, and the rationale for the selection; any assumptions and judgements made in the process of determining the arm's length prices or profits; application of the reasonable transfer pricing methods and results to determine the arm's length prices or profits; and other information to justify the selection of the transfer pricing method	
	Explanation on the enterprise's contribution to the group's overall profit or residual profit, <i>only</i> where a profit-based transfer pricing method is applied	<ul style="list-style-type: none"> • The selection of the tested party and the rationale; • Analysis and conclusion of whether the arm's length principle is complied with; and • Explanation on the enterprise's contribution to the group's overall profit or residual profit, irrespective of the selected method

In addition, it should be noted that Bulletin 42 only replaces the documentation regulations of the existing Circular 2. Deloitte is of the opinion that some other transfer pricing circulars in relation to the contemporaneous document are still valid (notably circulars Guoshuihan [2009] No. 363 and Guoshuihan [2009] No. 188). This means that loss-making foreign-owned enterprises with limited functions and risks, and enterprises during the follow-up periods should continue to file contemporaneous documentation regardless of whether they have reached the thresholds prescribed in Bulletin 42.

IV. Legal liabilities

The legal liabilities of taxpayers to follow the regulation have not changed. If an enterprise fails to file the reporting forms of related party transactions or the contemporaneous documentation on time, the tax authorities may require the enterprise to make a correction, and impose a penalty of no more than RMB 2,000. For serious violations, such as continued non-compliance, penalties between RMB 2,000 and RMB 10,000 could be imposed. Of more significance than the direct penalties, non-compliance means that when conducting special tax adjustments, the tax authorities may charge an additional 5% interest above the RMB base loan rate published by the People's Bank of China. In addition to the aforementioned penalties, enterprises that fail to file the contemporaneous documentation on time will be exposed to higher risk on transfer pricing audit according to the related regulations.

Bulletin 42 confirms that the aforementioned additional 5% interest may be waived if the enterprise has appropriately reported its related party transactions, submitting the contemporaneous documentation and other relevant materials. Such a waiver is provided to encourage compliance with the transfer pricing documentation requirements.

Deloitte observation

There is no doubt that Bulletin 42 will require multinational enterprises to invest more time and resources to meet China's contemporaneous documentation and reporting requirements. In particular for the master file requirements, in the absence of a consistent threshold or filing requirement from the OECD means that China's regulations may be different from other countries'. There could be some difficulties where a foreign parent company is not required to prepare a master file in the country where it is located while its Chinese subsidiary is required to prepare a master file according to the Chinese domestic law.

Additionally, Bulletin 42 requests taxpayers to provide some sensitive and complicated information in the New Forms and in the contemporaneous documentation, and in some cases communication between the local filing enterprises and their overseas related parties is required. The depth and scope of the content that needs to be analyzed has increased significantly. Taxpayers need to take early action to ensure that they are ready for this significant change – ensuring that they are communicating with their related parties to ensure information can be gathered on time. Furthermore, given the increased disclosure requirements, and collaboration and sharing between tax authorities, taxpayers will need to improve the efficiency of information collection, control the compliance cost and keep the consistency of the transfer pricing information disclosed globally.

It is worth noting that the Multilateral Convention on Mutual Assistance in Tax Collection comes into force for China from 1 February 2016 with implementation from 1 January 2017⁴. More than 130 countries will be able to exchange tax information with China by that time. On 12 May 2016, as one of the most important results of the tenth Forum on Tax Administration (FTA), the SAT signed the "CbC Multilateral Competent Authority Agreement" along with Canada, India and other countries, agreeing to the automatic exchange of CbC reports for multinational enterprise groups. Up to the end of June, the number of signatories to the agreement had reached 44. At the same time, the US, Japan, and many developed countries are drafting or have announced their national regulations for CbC reports. Therefore, multinational enterprise groups will face stricter requirements on information transparency and compliance.

The OECD has recently published additional guidance on filing requirements for CbC reports. The guidance has made further suggestions on several outstanding issues including the filing of CbC reports during the transition period, and effects of fluctuations of exchange rates on the filing threshold. Attention should be paid to whether the additional guidance will cause any changes to filing regulations in different countries.

Overall, information required to be disclosed (e.g. comprehensive analysis and disclosure of group value chains and related party transactions) through the reporting of related party transactions and contemporaneous documentation will be more transparent and the information exchange between tax authorities of different jurisdictions will be much more extensive and efficient. This will enable the Chinese tax authorities to obtain much more control than before over taxpayers' information for the purpose of risk assessment, determining the targets of tax audits, and will allow the SAT to more actively participate in global anti-tax avoidance action.

If you would like to discuss any questions about Bulletin 42, or obtain an unofficial English or Japanese translation of Bulletin 42, please feel free to contact the Deloitte China team.

⁴ See SAT Bulletin [2016] No. 4

Appendix: Comparative Analysis of the Original and New Forms

Content	Original Forms	New Forms	Comparative analysis and points to note
Basic information	Cover page	Cover page and form number index	The New Forms' cover page and form number index are in similar formats as "Annual Enterprise Income Tax Return of the People's Republic of China (Type A, 2014 Version)" ("EIT Return")'s, with requirements on the statements and signature of legal representative, and the signature of taxpayer, agency and tax authorities.
		Reporting Enterprise Information Form (G000000)	Under the current practice, the Original Forms are generally submitted with the EIT Return as an appendix and taxpayer's relevant information is not required. For the New Forms, it appears to be a separate reporting package. A taxpayer now is required to provide information on organization structure, senior management and shareholders apart from the basic information.
Summary of Forms	Summary of Related Party Transactions Form (Form 2)	Summary of Annual Related Party Transactions of Enterprises of the People's Republic of China (G100000)	In the New Forms, the order of forms has been adjusted and both related party debt and equity information, and information on CSAs are required to be listed separately in the summary form, echoing the requirements of the two kinds of special issue files and reflecting the regulatory focus. In addition, on whether or not the filing of contemporaneous documentation is required, the summary form also reflects the new three-tier structure of the documentation in Bulletin 42.
Related Party Relationship Disclosure	Related Party Relationships Form (Form 1)	Related Party Relationships Form (G101000)	The New Forms require the identification of the type of related party relationships and information on the dates of starts and ends/changes of related party relationships.
Transactions on Tangible Assets	Purchase and Sales Form (Form 3), Fixed Assets Form (Form 6)	Tangible Assets Ownership Transaction Form (G102000), Tangible Assets Use Right Transaction Form (G104000)	<p>The New Forms no longer differentiate between goods and fixed assets. Instead, the two forms are designed based on the nature of related party transactions (ownership and right to use).</p> <p>For goods purchases and sales transactions, the New Forms cancelled the requirements to provide details for "foreign parties and transactions which account for more than 10% of the total exports", "foreign parties and transactions which account for more than 10% of the total imports", the amount of unrelated party purchase and sales and the pricing method of related party transactions, etc.</p> <p>The New Forms require the taxpayer to disclose the transaction details of related parties with the highest five total amount of related party transactions.</p>

Content	Original Forms	New Forms	Comparative analysis and points to note
Transactions on Intangible Assets	Intangible Assets Form (Form 5)	Intangible Assets Ownership Transaction Form (G103000), Intangible Assets Use Right Transaction Form (G105000)	<p>Similarly the two forms are now designed based on the nature of related party transactions (ownership and right to use), rather than the types of different intangible assets.</p> <p>The New Forms require the taxpayer to disclose the transaction details of related parties with the highest five total amount of related party transactions. Taxpayers should ensure the disclosure is consistent with any information of intangible asset contracts (e.g. licensing agreements with foreign parties) which was already been disclosed to the tax authorities when the relevant contract was filed for tax purposes.</p>
Transactions on Financial Assets (new)		Financial Asset Transaction Form (G106000)	<p>With the increasing number of tax avoidance investigations on related party equity transfers, tax authorities are paying attention to profit shifting through financial asset transactions. The introduction of the Financial Asset Transaction Form will help gather information on this new transfer pricing area.</p>
Financial transactions	Financing Form (Form 7)	Financing Form (G107000)	<p>The Financing Form requires the disclosure of transaction-by-transaction detail information. According to the examples in filing instruction, this new Financing Form will cover the disclosure of bill discounting, financing leases, group cash pooling, etc. In addition, the filing instruction also provides more examples to illustrate the broad definition of interest for transfer pricing purpose.</p>
Related party service transactions	Service Transaction Form (Form 4)	Related Party Service Transaction Form (G108000)	<p>Similarly, the Related Party Service Transaction Form also requests disclosure of the top five related parties with transaction details and amounts. Pricing method is no longer requested. The filing instruction to this form lists detailed examples of related party service transactions which need to be disclosed. Taxpayers should ensure the disclosure consistent with any service contract information which was already been disclosed to the tax authorities when the relevant contract was filed for tax purposes.</p>
Equity Investment (new)		Equity Investment From (G109000)	<p>The form is newly introduced to disclose monthly equity investment, dividend distribution of taxpayers, etc.</p>

Content	Original Forms	New Forms	Comparative analysis and points to note
Cost Sharing Agreements (new)		Cost Sharing Agreements Form (G110000)	The form is newly introduced to disclose preliminary information of cost sharing agreements between filing taxpayers and their related parties, which could be the basis for tax authorities to further review the relevant special issue files.
Outbound payments	Outbound Payment Form (Form 10)	Outbound Payment Form (G111000)	<p>Compared with the old form, this new form has been simplified. All the service-related payments are now categorized into a single line item as "service payment". Additionally, disclosure of trademark royalty payments and technology royalty payments are combined in the new form. The new form also removes some items including "enterprise income tax withheld" and "preferential tax treatments due to tax treaties". The filing instruction to the New Forms also clarifies that an accrued expense will not be considered as an "outbound payment" for disclosure purposes (which is not the case as required by the filing instruction to the Original Forms).</p> <p>Considering that outbound "service payments" and "royalty payments" are under scrutiny by tax authorities, taxpayers should review their significant outbound payments considering the benefit test⁵ and relevant supporting documents to better manage potential tax risks associated with information disclosure. For relevant outbound payment matters, taxpayers should prepare supporting information in advance.</p>
Overseas Related Party Information (New)		Overseas Related Party Information Form (G112000)	This new form requires the information of overseas related parties which have been disclosed in previous forms, i.e. the overseas related parties included in any top-five disclosures of the other forms. In addition to basic information, this new form specifies the disclosure of effective tax rates (ETR) together with instructions on the method of ETR calculation. This form is intended to focus on the signs of profit shifting to low tax rate jurisdictions through the related party transactions.

⁵ See SAT Bulletin [2015] No. 16

Content	Original Forms	New Forms	Comparative analysis and points to note
Financial Information Analysis (New)	Originally required as an appendix to contemporaneous documentation	Financial Analysis Form of Annual Related Party Transactions (Standalone information) (G113010); Financial Analysis Form of Annual Related Party Transactions (Consolidated Information) (G113020)	The new forms advance the filing of related party transactions ahead of contemporaneous documentation as a means of strengthening transfer pricing risk management. However, the filing instruction does not specify any guidance on segmentation methodology and therefore taxpayers should determine the segmentation themselves. Such practice might lead to different understandings of the segmentation between tax authorities and taxpayers.
CbC Report (New)		CbC Report-Country Distribution of Income, Tax, Business Activities (Chinese and English G114010, G114011); List of Multinational Group Entities (Chinese and English G114020, G114021); Additional Information Form (Chinese and English G114030, G114031)	These forms are consistent with the templates in OECD's BEPS Action 13.

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