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Upcoming key changes to China's special tax adjustment regime

This article was written by Bill Ye and Jessie Yu.

On 17 September 2015 the State Administration of Taxation (SAT) issued the Implementation Regulation for Special Tax Adjustment (Draft for Comment) (referred to as the "Discussion Draft").

The Discussion Draft is a revision of the Implementation Regulation for Special Tax Adjustment (Trial) (referred to as "Circular No. 2") issued in 2009 in the context of the OECD Base Erosion and Profit Shifting (referred to as the "BEPS") and the updating of China's domestic tax law.

Summary of key changes:

Intangibles: New chapter. The Discussion Draft introduces a distinction between the legal and economic ownership of intangibles. Income from intangible property cannot be distributed to enterprises with legal ownership of it if they have not contributed to the development of the intangible property.

If an enterprise pays a royalty to a related party but the licensed intangible does not bring an economic return to the enterprise, then the tax authority can impose a special tax adjustment and deny the deduction of the royalty in the enterprise's income tax return. This view is consistent with the regulations issued by SAT earlier this year.

Intragroup services: New chapter. Only an intragroup service that is both beneficial to the enterprises and arm's length can be validly recognized. Where an intragroup service has no benefit (for example it is: redundant, shareholding related, not necessary, etc.), the tax authority can deny the deduction in an enterprise's income tax calculation. This is also consistent with previous regulations.

Enterprises that have intragroup services must prepare a special report illustrating the authenticity, cost base and allocation, pricing method, any comparable transaction in the group and other relevant justification.

Three-tier documentation: a master file, a local file, a country file (for enterprises with group consolidated annual income exceeding RMB 5 billion yuan)and special reports regarding intragroup services, cost sharing, and thin capitalization.

The Discussion Draft reinforces the analysis of profit distribution among a group in a master file and a value chain analysis in a local file. Enterprises that only have transactions with domestic related parties are exempt from having to prepare this documentation.

Special tax adjustment: The Discussion Draft emphasizes the procedural requirements. It introduces a more detailed approach to investigation and analysis, Similar to the exemption for documentation, the special tax adjustment is not applicable to domestic related party transactions.

Transfer pricing method: the Discussion Draft formally introduces two new transfer pricing methods, namely a value contribution method and a valuation method. Profit contribution analysis must be included in the transfer pricing analysis under each transfer pricing method.

Preliminary observations

There are other wide ranging changes in the Discussion Draft. Eye catching are the frequent appearances of key phrases such as: value chain analysis/contribution, location specific advantages (market premium, location saving), and local marketing intangibles. The changes in the regulations reflect SAT's view on BEPS actions and the tone for the going forward administration of transfer pricing in China. The three-tier documentation and special reporting system will give SAT a complete picture of the MNC and provide it with more information from the perspective of the total group. KWM will undertake more in-depth analysis of the Discussion Draft at a later date.

The Discussion Draft will be open for public comments by 16 October 2015. If you have any comment, you may make it to SAT and you are also welcome to contact our tax service team to voice your opinion or to seek advice.

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Key contact

Ye Yongqing (Bill)
Senior Consultant

Shanghai
T +86 21 2412 6000