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# Transfer Pricing in PRC and Hong Kong

7 March, 2019

Webinar



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# 1. China's transfer pricing rules





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## 1.1 Background



# 1.1 Background

- On 13 July 2016, the State Administration of Taxation (SAT) released an Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation (Announcement 42).
- Announcement 42 provides new transfer pricing compliance requirements in China including:
  - Increased annual reporting for related party transactions.
  - Country by country (CbC) reporting.
  - Transfer pricing documentation: A three-tiered approach (Master, Local and Special Issues files).
- All of these new requirements represent substantial changes compared with the previous requirements under Guo Shui Fa [2009] No.2 (old laws).
- Announcement 42 applies to fiscal years beginning from 1 January 2016.
- Announcement 42 is generally in line with the BEPS Action Plan 13 and should be considered as an crucial step of a series of regulations in China to come into alignment with the OECD/G20 Action Plan for Tax Base Erosion and Profit Transfer Projects (the BEPS Action Plan).



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## 1.2 An overview of Announcement 42



## 1.2 Main features of Announcement 42

- Reporting taxpayers of related party transaction reporting forms (Article 1)
- Related party relationships (Articles 2 and 3)
- Related party transactions (Article 4)
- Reporting, exchange and submission of CbC reports (Articles 5-9)
- Transfer pricing documentation (Articles 10-26)
- PRC annual reporting forms for related party transactions





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## **1.3 Key changes introduced by Announcement 42**



## 1.3 Key changes introduced by Announcement 42

### Related party relationships

- The types and conditions of related party relationships are further clarified.
- Compared to the old laws, the provisions are more stringent and specific.
- In addition, if two parties have common interest **in substance**, they may then be regarded as related parties under Announcement 42 and hence expanding the definition of related party relationships.

## 1.3 Key changes introduced by Announcement 42

### Related party transactions

- Announcement 42 expanded the related party transaction category to further include:
  - Financial asset transactions
  - A more comprehensive list of related party financing transactions and service transactions
- Equity transfer is also defined as a type of related party transaction under the financial asset transactions category. This indicates that the Chinese tax authorities' growing concern on related party transactions in the financial sector.

## 1.3 Key changes introduced by Announcement 42

### Contemporaneous documentation – Structure

- Announcement 42 adopts a three-tiered documentation structure as set out in the final reports under Action 13 of the OECDs BEPS Action plan.

## 1.3 Key changes introduced by Announcement 42

### Contemporaneous documentation - Thresholds

#	Types of TPD	Preparation Criteria	Timeframe
1	Master File	① Holding company prepared Master File	Within 12 months from end of accounting of holding company
		② Transaction amount > RMB 1 billion.	
2	Local File	① Amount of transfer of ownership of tangible assets > RMB200 million	Before 30 June of the following year
		② Amount of transfer of financial assets > RMB100 million	
		③ Amount of transfer of ownership of intangible assets > RMB100 million	
		④ Other related party transactions > RMB40 million	
3	Special Matter File	① For cost-sharing agreement: entered into or executed a cost-sharing agreement	Before 30 June of the following year
		② For thin capitalization: related-party debt-to-equity ratio of Company exceeds the standard ratio	

## 1.3 Key changes introduced by Announcement 42

### Contemporaneous documentation – Deadlines

- **Master File:** Must be prepared within 12 months of the ultimate parents financial year end.
- **Local File:** 30 June of the year following the tax year in question.
- **Special issues file:** 30 June of the year following the tax year in question.

# 1.3 Key changes introduced by Announcement 42

## Contemporaneous documentation – Content

### Master File

- The master file is focused on providing details of the overall operations of the multinational enterprise group.
- The disclosure requirements are generally consistent with BEPS Action 13 recommendations, however also contain additional requirements.
- Announcement 42 requires the master file to broadly contain the following:
  - Functions performed, risks assumed, assets employed.
  - Business restructurings and any transfers of functions, risks or assets within the group.
  - Development of any R&D.
  - Organizational chart (names and locations of entities located globally).
  - Description of business.
  - Intangibles.
  - Intercompany financing activities.
  - If applicable, a list and description of the group's bilateral advanced pricing arrangements (APAs).

## 1.3 Key changes introduced by Announcement 42

### Contemporaneous documentation – Content

#### Local File

- Compared with the old laws contained in Guo Shui Fa No.2, the local file requirements under Announcement 42 require significantly more information disclosure and transfer pricing analysis.
- The local file broadly should contain the following:
  - Overview of the entity; basic information, revenue, costs, expenses and profits by business segment.
  - Related party relationships.
  - Related party transactions (including value chain analysis including an overview of the attribution of profits to different countries within the value chain, location specific advantages and its impact on pricing).
  - Intragroup services detailing the nature of the services, the benefit received/provided etc.
  - Further, there are requirements to provide information in respect to related party investments and equity transfers.
  - Comparability/benchmark analysis.
  - Selection of transfer pricing method.



## 1.3 Key changes introduced by Announcement 42

### Contemporaneous documentation – Content

#### **Special Issues File**

- The special issues file is required for taxpayers engaging in cost sharing arrangements or those falling under thin capitalization requirements.

## 1.3 Key changes introduced by Announcement 42

### Related party transaction forms

- Related party transaction forms are required to be submitted along with the annual CIT return.
- Under the old laws, only 9 forms were required.
- Under Announcement 42, 22 related party transaction forms are now required.
- The forms require additional information to be disclosed in respect to the following:
  - The enterprise
  - Related parties
  - Related party transactions
  - Cost sharing arrangements
  - Outbound payments
  - Financial analysis
  - CbC report



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## **1.4 Announcement 6: China's improved tax monitoring system on transfer pricing**



# 1.4 Special tax investigations – Announcement 6

## Overview

- In March 2017, China further improved its tax monitoring system by issuing a new regulation on transfer pricing investigations, the “Announcement on Promulgation of the Administrative Measures on Special Tax Investigation, Adjustment and Mutual Agreement Procedure” (SAT Announcement [2017] No.6).
- This Announcement further clarifies the transfer pricing investigation procedures and expands the investigation scope.

## 1.4 Special tax investigations – Announcement 6

### Special tax investigations

- Announcement 6 states that the PRC tax authorities shall focus in particular on enterprises with the following characteristics when conducting special tax investigations:
  - Enterprises with significant amount of related party transactions
  - Enterprises with continuous losses, low or fluctuating profit
  - Enterprises with profit levels lower than those other enterprises in the same industry
  - Simple function entities
  - Payments made to low substance entities



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## 1.5 Key takeaways



## 1.5 Key takeaways

- Announcement 42 and Announcement 6 shows the SATs commitment to adopting BEPS recommendations into the China's domestic law, however with some 'China' touches/additional requirements.
- Taxpayers are now required to disclose greater, more detailed information.
- Taxpayers should review their related party transactions to see if they meet the new thresholds requiring them to prepare transfer pricing documentation.
- Although Announcement 42 does not specifically state taxpayers are required to analyze related party transactions by category, type etc., **taxpayers must ensure that all related party transactions are arm's length in nature and that this can be demonstrated.**
- Taxpayers should prepare for more stringent investigations/queries from their local tax bureaus. Any documentation will likely be examined more closely to ensure compliance with the new rules.



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## 2. Hong Kong's transfer pricing rules







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## 2.1 Background



## 2.1 Background

- On December 29, 2017, the Inland Revenue (Amendment) (No. 6) Bill 2017 (“BEPS Bill”) was gazette in Hong Kong; it was formally introduced in to the Legislative Council on January 10, 2018. The BEPS Bill marks a significant step up in Hong Kong’s transfer pricing enforcement regime.
- The objectives of the BEPS Bill were to codify transfer pricing rules into Hong Kong’s Inland Revenue Ordinance (IRO). The BEPS Bill is also designed to introduce transfer pricing documentation requirements, and implement other measures set out in the OECD’s BEPS program.
- The BEPS Bill formally became law of Hong Kong on 13 July 2018.



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## 2.2 Overview of the Hong Kong's new TP laws



## 2.2 Key provisions of Hong Kong's BEPS Bill

### The arms length principle

- The BEPS Bill proposes fundamental transfer pricing rules (FTP) – on the basis of the arm's length principle - that further empower the IRD. This includes the ability to adjust the profits or losses of an enterprises, and specifically in cases where the actual provision made between two associated persons departs from the provision that would have been made between independent persons.
- The BEPS Bill does not contain any safe harbor rules in respect to the FTP. This means that the FTP applies to both cross-border and domestic transactions of any size. In practice, the IRD will consider the overall Hong Kong tax position of the transactions involved in the application of TP rules.
- In addition, the FTP applies to all types of tax, including profits tax, property tax and salaries tax.

## 2.2 Key provisions of Hong Kong's BEPS Bill

### Documentation requirements

- Hong Kong entities are required to prepare Master File and Local File for accounting periods beginning on or after 1 April 2018 when both tests below are met:

<b>Business size test</b> <b>Meeting any <u>2</u> of the following:</b>	<b>RPT test</b> <b>Meeting any <u>1</u> of the following:</b>
a) Total annual revenue exceeding HKD400m b) Total value of assets exceeding HKD300m c) Average number of employees exceeds 100	a) Annual amount of buy-sell transactions of tangible goods exceeds HKD200m b) Annual amount of transactions in respect to financial assets / transfer of intangible assets exceeds HKD110m c) Annual amount of other transactions exceeds HKD44m

## 2.2 Key provisions of Hong Kong's BEPS Bill

### Intangibles – deeming provision

- Section 15F aims to impose tax on Hong Kong taxpayers if they ever carried out value creation activities such as development, enhancement, maintenance, protection or exploitation functions in Hong Kong that contributed to intellectual property (IP) held by an overseas related party.

## 2.2 Key provisions of Hong Kong's BEPS Bill

### Valuation of trading stock

- Change of intention from trading account to capital account (or vice versa) will mandate arms length value to be used at that time (Section 15BA)

## 2.2 Key provisions of Hong Kong's BEPS Bill

### Attribution of Profits to a Permanent Establishment

- Specific provisions introduced relating to PEs; TP rules will apply to any non-resident who has a PE that carries on a trade, profession or business in Hong Kong.



## 2.2 Key provisions of Hong Kong's BEPS Bill

### Advance pricing arrangements

- BEPS bill provides for a formal advanced pricing arrangement (APA) regime.

## 2.2 Key provisions of Hong Kong's BEPS Bill

### Penalties

- The BEPS bill also sets out penalties and creates offences.

## 2.2 Key provisions of Hong Kong's BEPS Bill

### Dispute resolution

- The BEPS bill provides for a statutory dispute resolution mechanism.



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## 2.3 Key takeaways



## 2.3 Key takeaways

- Now that Hong Kong has formalized transfer pricing rules, it is expected that the HKIRD will be asking more challenging questions which may lead to tax adjustments and/or penalties.
- We suggest Hong Kong corporate taxpayers to revisit their TP policies to ensure that they are up to date and adequately reflect all of the assets employed, risks assumed and functions being performed.
- The HKIRD is also expected to release a Departmental Interpretation Practice Note (DIPN) which will serve as an informal guide as to how the IRD will apply the various provisions of the BEPS bill.



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## 3. Key contacts



## 3.1 Key contacts



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