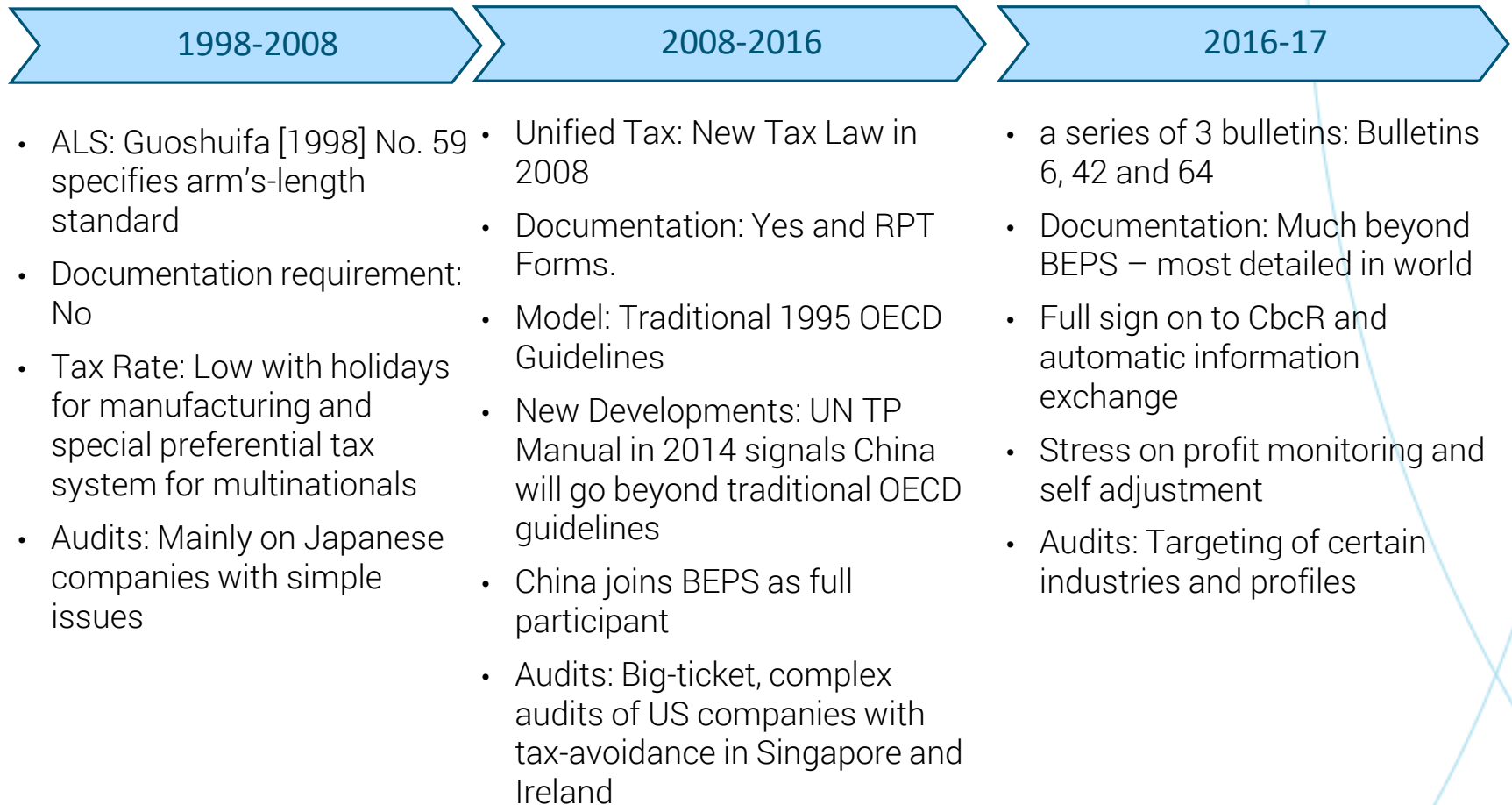


Are you ready for your FY 2016 value chain analysis to be shared with your tax inspector in China?

Steef Huibregtse, Virender Sharma, Ying van Galen Wang

26 June 2017

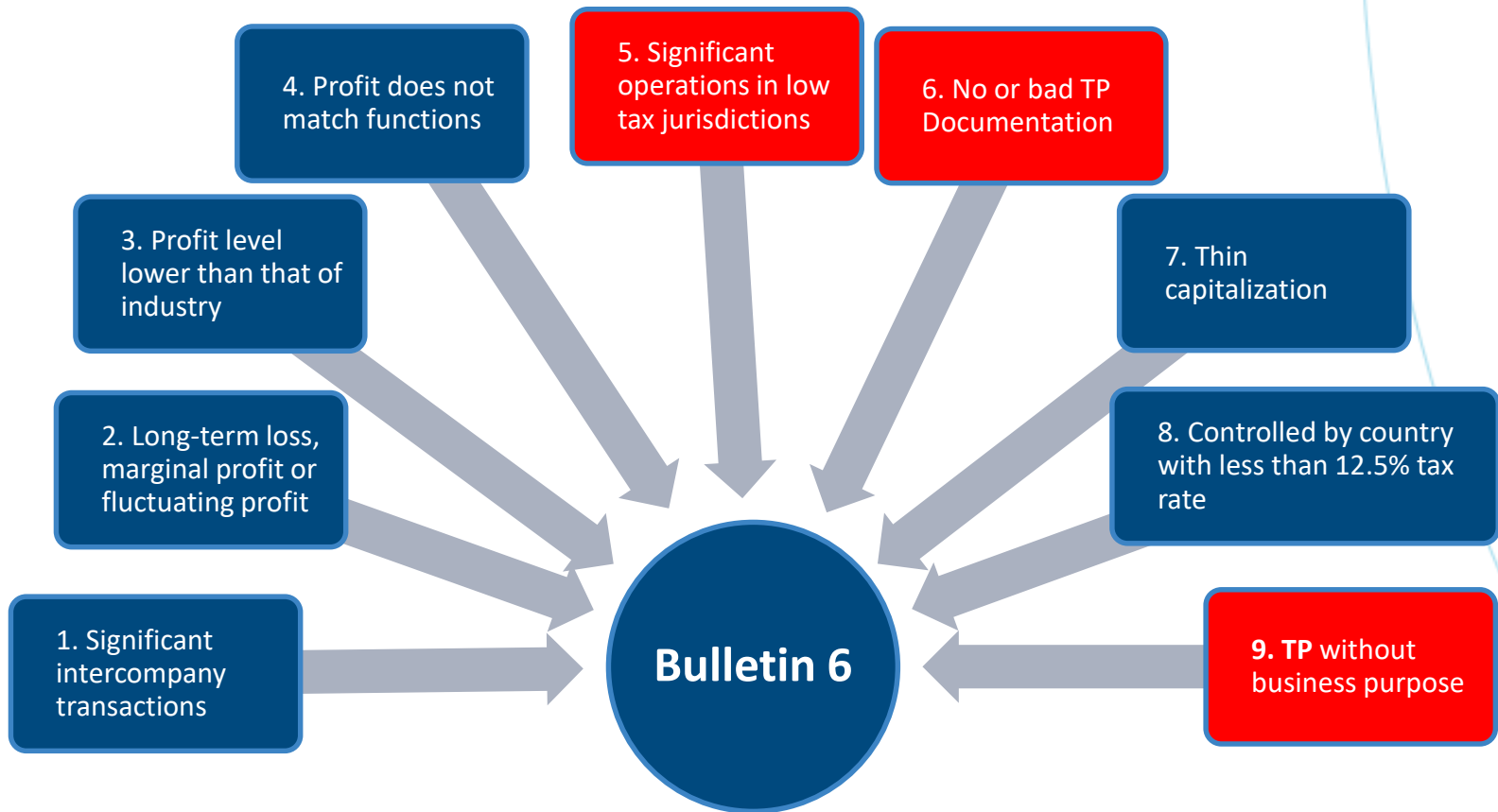
China TP milestones



Series of 3 bulletins

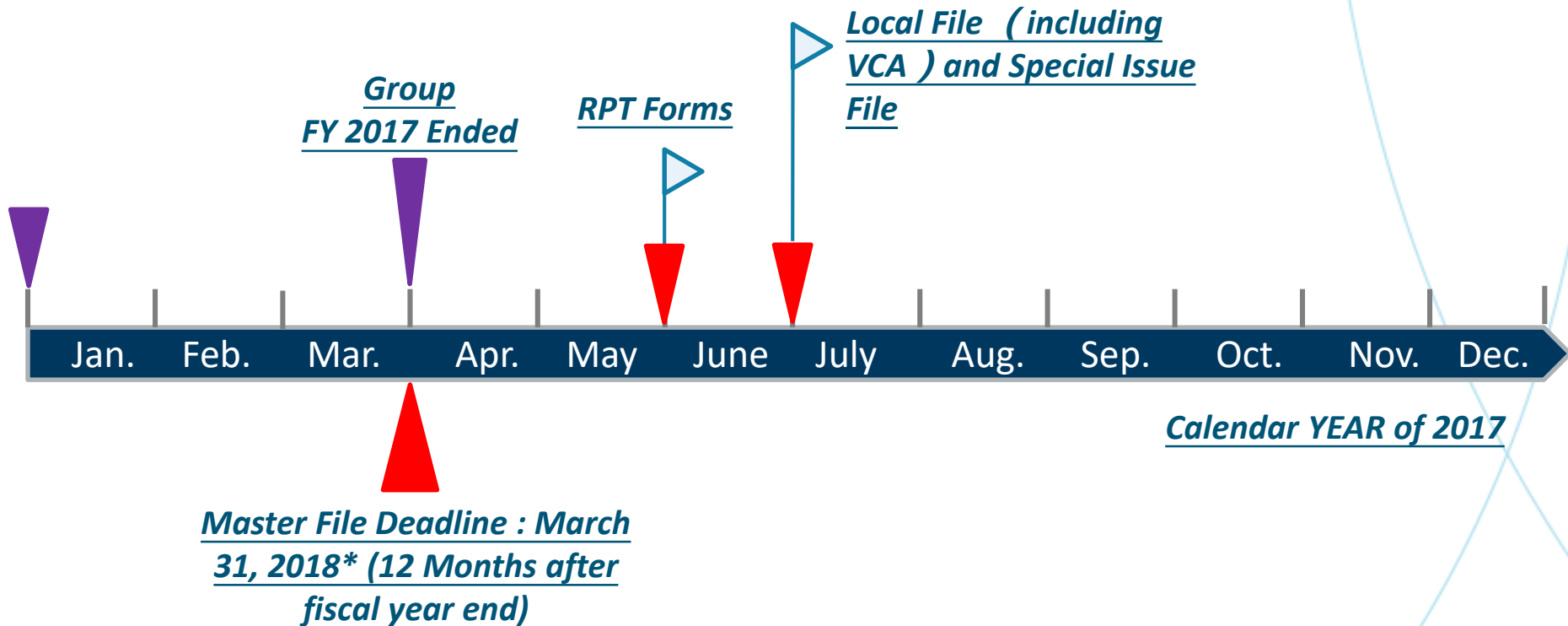
Bulletin Number	Focus	Issue Date	Description
42 (27 articles)	Contemporaneous Documentation	June 29, 2016	The three-tier TPD requirements including master file, local country file and special issue files
			Focus on value chain analysis and LSA requirements
			The new Related Party Transactions Reporting forms
64 (22 articles)	APAs	October 18, 2016	Six step process for APAs
			Identifies priority APA applicants
6 (62 articles)	TP and MAP	March 17, 2017	Covers audit procedures, selection of audit targets, profit monitoring system, self-adjustment procedures, TP methods, royalties, fees, tolling, DEMPEP and MAP procedures

Risk factors



Timing for TP documentation

- Example: Group A with FY2016 fiscal year ended March 31, 2017, And its Chinese entity, which ended up on Dec 31, 2016 for fiscal year, should prepare the TPD and RP forms by the following deadlines.



Example source: Guangdong SAT

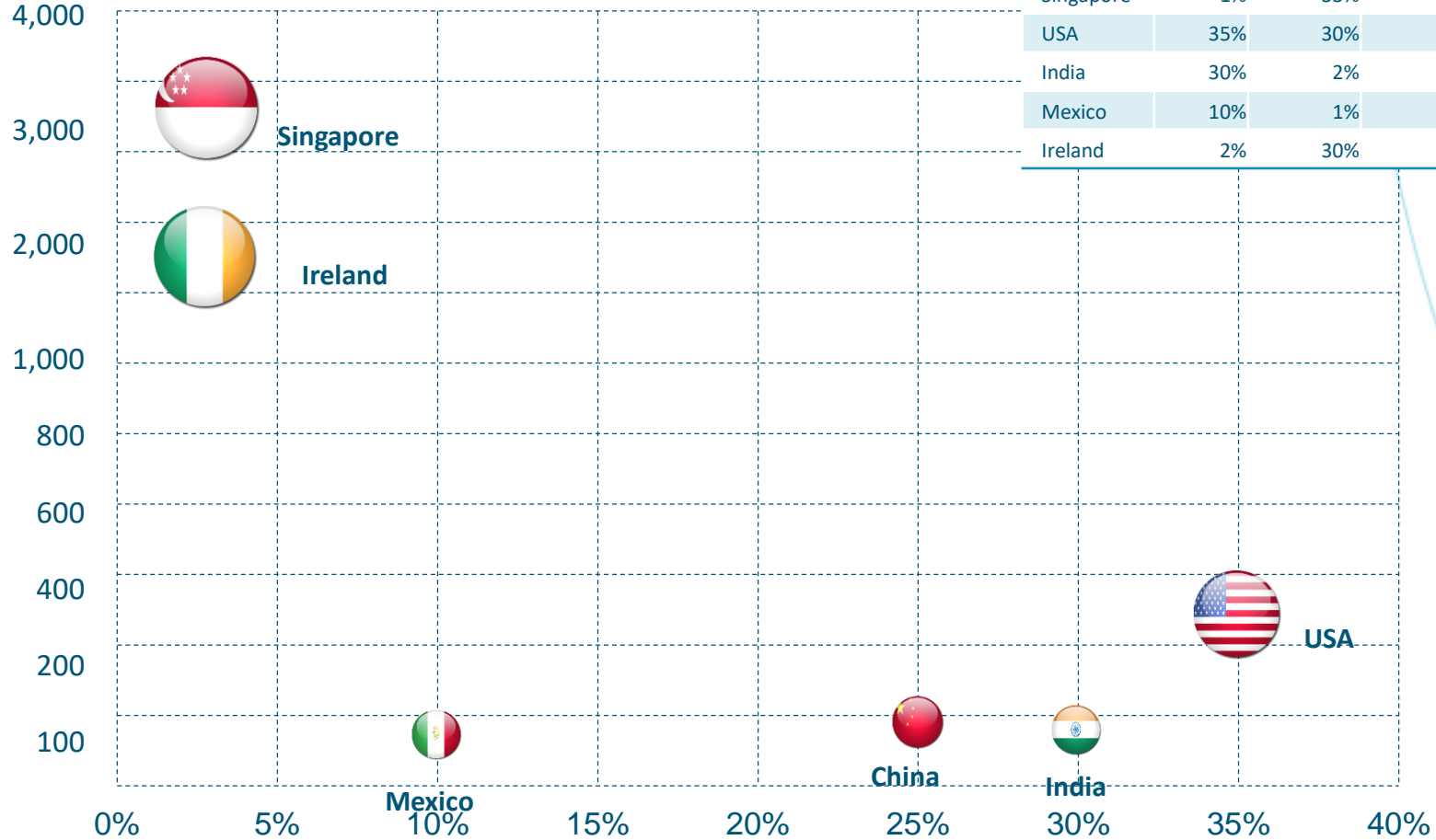
Bulletin 42 – VCA requirement

1. Flows of business, goods and materials, and capitals within the group, including design, development, manufacturing, marketing, sales, delivery, billing and payment, consumption, after-sale service, recycling, other processes related to goods, services or other relevant underlying targets of the related party transactions and all the parties involved.
2. Annual financial statements of each of the aforementioned parties for the immediately preceding fiscal year.
3. Measurement and attribution of value creation contributed by location specific factors.
4. Allocation policies and actual allocation results of the group's profits in the global value chain.

VCA/CbCR risk

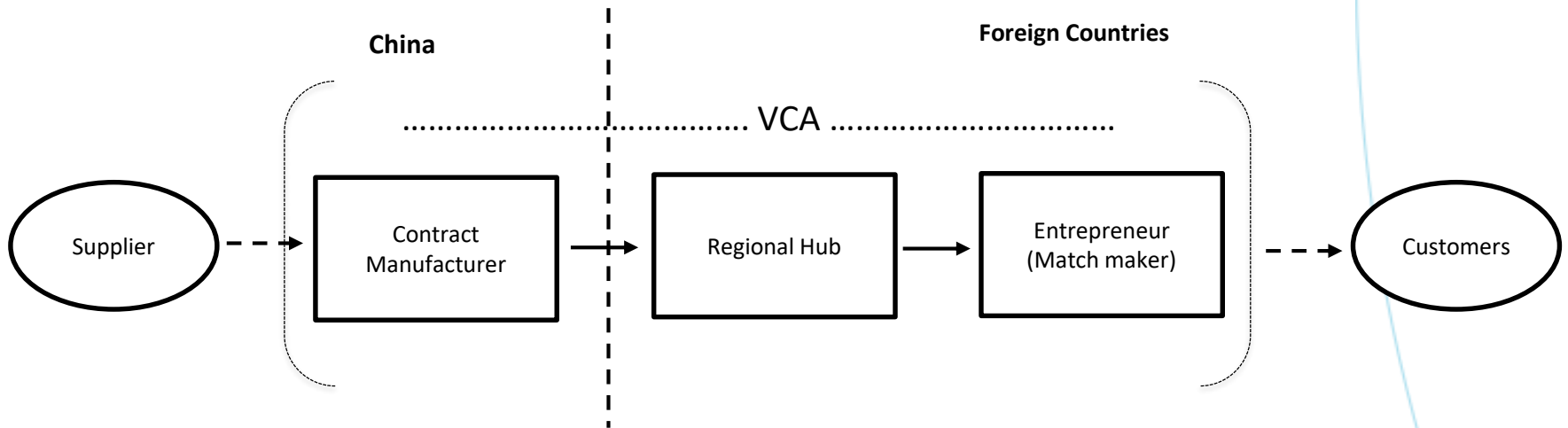
Country	Tax Rate	Share of Profit	Profit per Head (\$/K)
China	25%	4%	30
Singapore	1%	33%	4,000
USA	35%	30%	150
India	30%	2%	20
Mexico	10%	1%	10
Ireland	2%	30%	2,000

Profit per Head (\$/K)



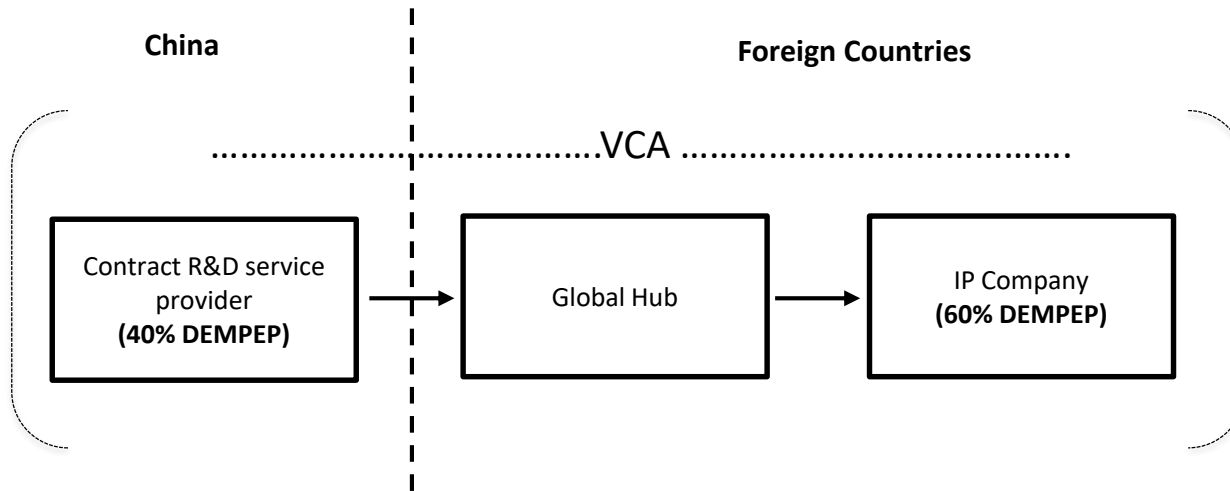
How much of your value chain do you disclose to your tax inspector?

Case study 1 – Chinese contract manufacturer



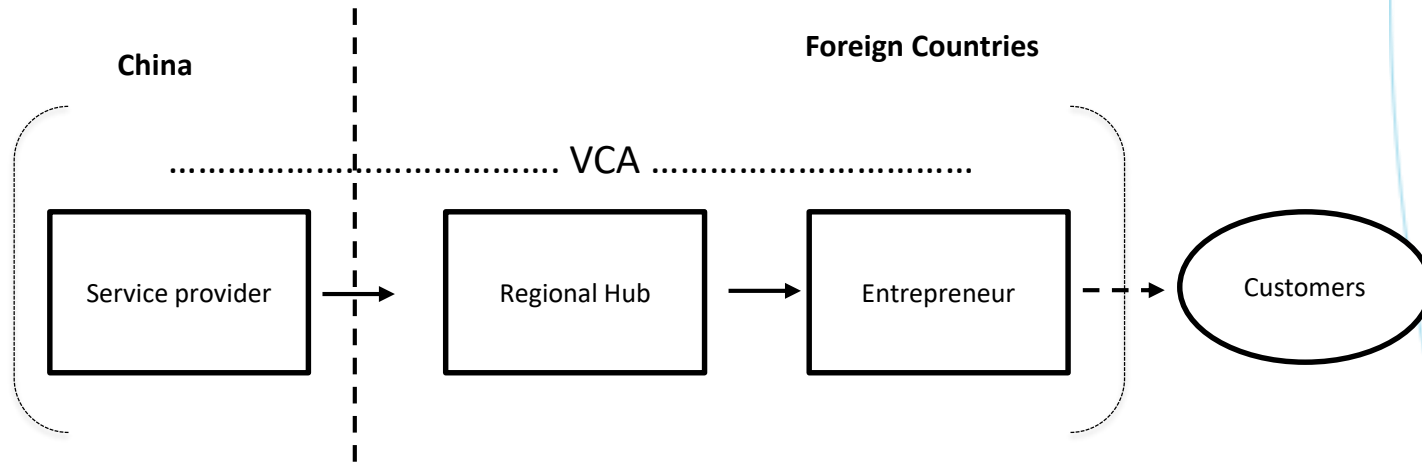
#	Check list (Bulletin 42)	Notes
1	IC transactions & payment flows	
2	IC physical flows	
3	Business and operational activities performed on products/services/other trading objects	
4	Participating entities	
5	Annual accounts of each participating entity	
6	Qualification of "value creation" weights (allocation principal)	
7	Location specific factors	
8	Allocation of profits/revenue principle versus actual (principal versus actual)	

Case study 2 – Chinese R&D service provider



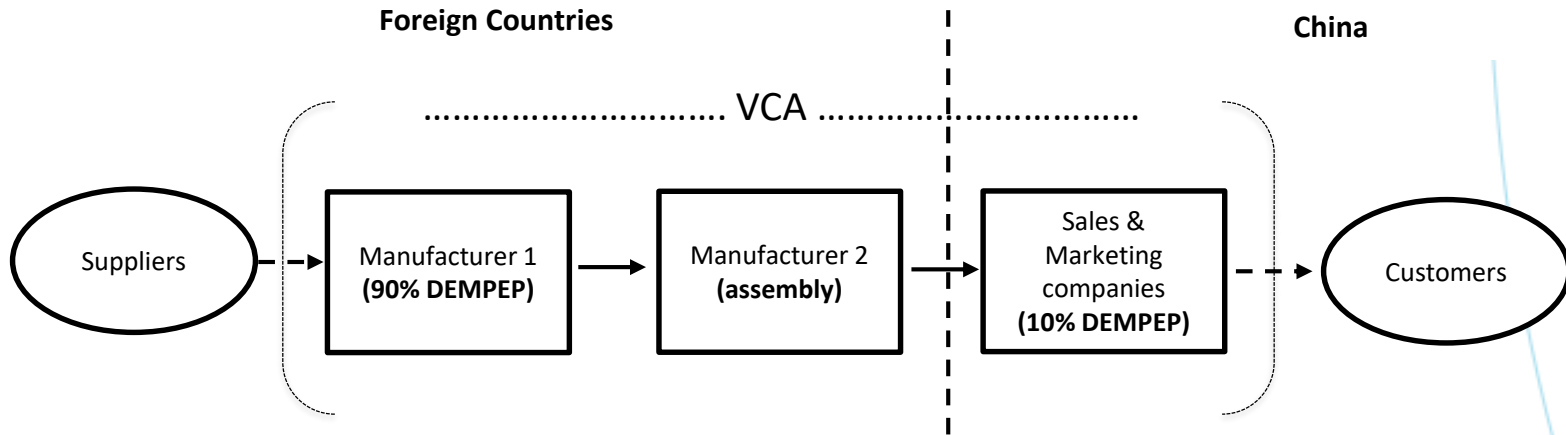
#	Check list (Bulletin 42)	Notes
1	IC transactions & payment flows	
2	IC physical flows	
3	Business and operational activities performed on products/services/other trading objects	
4	Participating entities	
5	Annual accounts of each participating entity	
6	Qualification of "value creation" weights (allocation principal)	
7	Location specific factors	
8	Allocation of profits/revenue principle versus actual (principal versus actual)	

Case study 3 – Chinese service provider



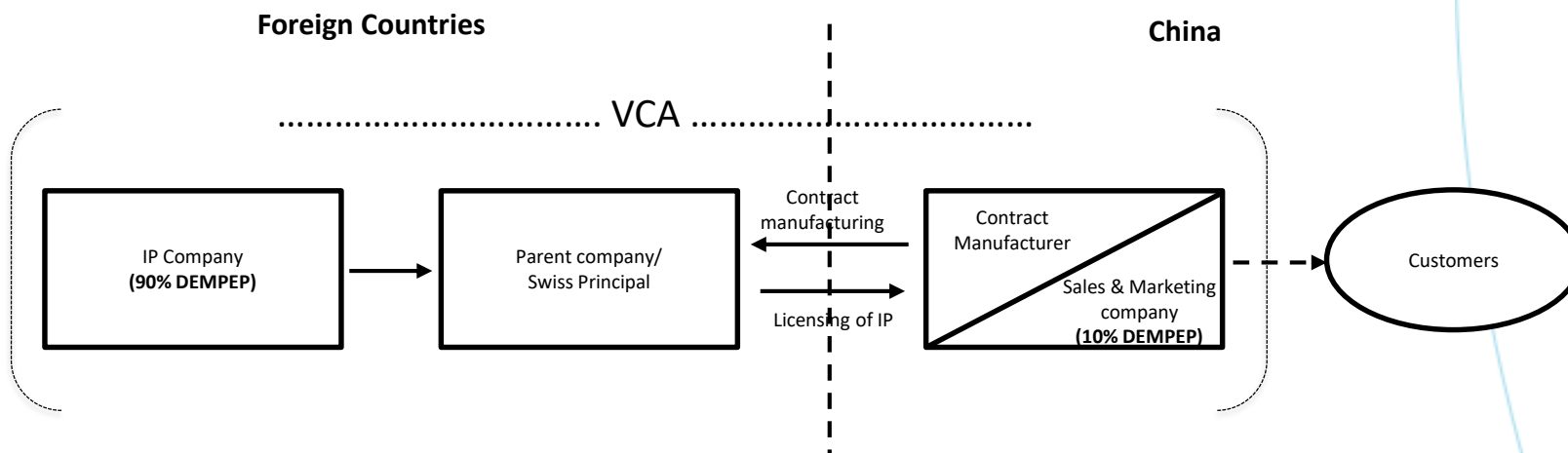
#	Check list (Bulletin 42)	Notes
1	IC transactions & payment flows	
2	IC physical flows	
3	Business and operational activities performed on products/services/other trading objects	
4	Participating entities	
5	Annual accounts of each participating entity	
6	Qualification of "value creation" weights (allocation principal)	
7	Location specific factors	
8	Allocation of profits/revenue principle versus actual (principal versus actual)	

Case study 4 – Chinese sales & marketing entity



#	Check list (Bulletin 42)	Notes
1	IC transactions & payment flows	
2	IC physical flows	
3	Business and operational activities performed on products/services/other trading objects	
4	Participating entities	
5	Annual accounts of each participating entity	
6	Qualification of “value creation” weights (allocation principal)	
7	Location specific factors	
8	Allocation of profits/revenue principle versus actual (principal versus actual)	

Case study 5 – Chinese entity running a dual functionality



#	Check list (Bulletin 42)	Notes
1	IC transactions & payment flows	
2	IC physical flows	
3	Business and operational activities performed on products/services/other trading objects	
4	Participating entities	
5	Annual accounts of each participating entity	
6	Qualification of "value creation" weights (allocation principal)	
7	Location specific factors	
8	Allocation of profits/revenue principle versus actual (principal versus actual)	

Case study 6 – Location specific factors (illustrations quantified)

Scenario 1 - Production cost differentials

Country	Cost base	Method	Profit + addition profit
France	150		
China	100	cost plus 8%	108
Delta	50	8%	4
Total remuneration to China			112

Source: UN TP Manual

Scenario 2 - Size of customer market

Benchmarked operating margin (sales & marketing)	4 - 6%
Size of market premium	10 - 20%
Total remuneration (OM) for China	4.4 - 7.2%

Source: TPA Global

Scenario 3 - Level of DEMPEP involvement

	Profit + addition profit
Contract R&D (without DEMPEP)	Cost plus 8%
R&D (with 20% DEMPEP)	Cost plus 8% + 20% residual

Source: TPA Global

Appendices

Appendix 1 - Key Directions for Bulletin 6

- Profit Monitoring System: SAT will use “Big Data”, desk-top analytics and review of the TP documentation to flag companies for TP risks.
 - ❖ review of related party transaction forms filed with the annual tax returns;
 - ❖ transfer pricing documentation; and
 - ❖ a company’s profit level.
- The Cooperation Model: SAT will stress cooperation over audits by introducing a Special Tax Adjustments Self-payment Form. Many more companies are going to be subjected to TP adjustments, but these adjustments are going to be “voluntary”.
- Hard Line on Tax-Avoidance: With regard to audits, it is clear that companies using low-tax jurisdictions are seen by SAT as the low hanging fruit.
- BEPS and Beyond: Bulletin 6 goes beyond BEPS for example adding P for promotion to DEMPE

Appendix 2 - Threshold for TP documentation

Master file	<ol style="list-style-type: none"> 1) The enterprise that has conducted cross-border related party transactions during the tax year concerned, and the MNE group to which the ultimate holding company that consolidates the enterprise belongs, has prepared a master file; or 2) The annual total amount of the enterprise's related party transactions exceeds RMB 1 billion. 			
Local File	Transfer of ownership of tangible assets	Transfer of financial assets	Transfer of ownership intangible assets	Other related party transactions
	RMB 200 million	RMB 100 million	RMB 100 million	RMB 40 million
Special issue file	Cost sharing arrangement (CSA)	Records a debt-equity ratio exceeding the threshold*		
CbC report	<ol style="list-style-type: none"> 1) China resident enterprise that are the ultimate parents of a multinational group, with consolidated revenue greater than RMB 5.5 billion; or 2) China resident enterprise that are nominated by the multinational group as the reporting entity 			

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

Appendix 3 - DEMPEP

- Western companies state that all IP is owned outside China and is the major profit driver. To quote a SAT official, the “man who labors in the sun” has his value.
- IP is over-valued and labor is under-valued.
- Mr. Liao Tizhong, the deputy director general of SAT, said China would never impose on the world what it does not want for itself, adding that the rules “should be morally based, not strategy-based” and should recognize “the value of people who labor under the sun” as well as those who own intangible assets and contribute capital. “
- The OECD Guidelines identified five relevant functions: development, enhancement, maintenance, protection and exploitation (so-called DEMPE functions). Bulletin 6 adds a sixth function: promotion (i.e., DEMPEP functions).
- Since the promotion is taking place in China, this implies that the Chinese subsidiary is adding to the IP value. Any SG&A in excess of 8% signals creation of local IP.

Appendix 4 - Location savings - 4 steps approach

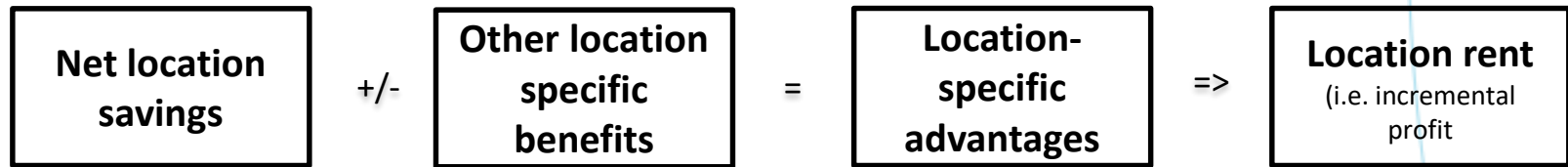
1. Identify if an LSA exists;
2. Determine whether the LSA generates additional profit;
3. Quantify and measure the additional profits arising from the LSA; and
4. Determine the transfer pricing method to allocate the profits arising from the LSA.

Appendix 5 - Location savings



- Labour costs;
- Raw material costs;
- Transportation costs;
- Rent;
- Training costs;
- Subsidies;
- Incentives including tax exemptions; and
- Infrastructure costs

Appendix 6 - Location savings + other types of benefit



Other location specific benefits

- Highly specialized skilled manpower and knowledge;
- Proximity to growing local/regional market;
- Large customer base with increased spending capacity;
- Advanced infrastructure (e.g. information/communication networks, distribution system); or
- Market premium
 - Custom duty savings
 - Preference of foreign products
 - Access to low cost parts manufactured in China



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