Hong Kong Institute of
Certified Public Accountants
香港會計師公會

16 October 2015

Policy and Regulation Department
The State Administration of Taxation

Re: Discussion draft of Implementation Measures for Special Tax Adjustment

The Hong Kong Institute of CPAs (the Institute) is the only body authorised by law to register and grant practising certificates to certified public accountants in Hong Kong. The Institute operates under the Professional Accountants Ordinance and works in the public interest. The Institute has wide-ranging responsibilities, including assuring the quality of entry into the accounting profession through its postgraduate qualification programme and promulgating financial reporting, auditing and ethical standards in Hong Kong. The Institute has responsibility for regulating and promoting efficient accounting practices in Hong Kong to safeguard its leadership as an international financial centre.

The Institute has learned that the State Administration of Taxation is consulting the public on its amendment of Implementation Measures for Special Tax Adjustment, aiming to help taxpayers understand more about China's existing major regulations on transfer pricing and anti-avoidance.

As the paper has a certain impact on Hong Kong organisations that have investment and related party transactions in China, and members of our Institute who are tax practitioners, the Institute's Mainland Taxation Subcommittee has reviewed the discussion draft in detail and submitted its comments, as attached, for your consideration. They include some questions to be clarified in the discussion draft. We hope that you can further explain the relevant regulations and make them clear for effective implementation.

Should you have any enquiries on the submission, please contact Mr. Anthony Tam, vice-chairman of the Institute's Taxation Faculty Executive Committee, at tel.: +852 2909 5604 / email: anthony.tam@mazars.cn or Mr. Wallace Wong, manager of the Institute's Advocacy & Practice Development at tel.: +852 2287 7392 / email: wallacewong@hkicpa.org.hk

Yours faithfully,

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A. Comments on discussion draft of Implementation Measures for Special Tax Adjustment

1. Intangible assets

1.1 The discussion draft (Draft) embodies the State Administration of Taxation (SAT)'s work in localising transfer pricing arrangements relating to intangible assets set out in the Base Erosion and Profit Shifting Actions (BEPS Actions) published by the Organisation for Economic Co-operation and Development (OECD). There is some impact on multinational enterprises (MNEs). While the discussion draft recognises the value contribution of MNEs to intangible assets (and subsequent profit allocation via transfer pricing), it should take into account the contribution of the intermediary value chain (such as manufacturing and trial production) of the Chinese enterprises and their established market-building activities in China. However, it seems that BEPS Actions 8, 9 and 10 do not consider these contributions as the most important factors of creating value for intangible assets. The differences between China and other countries in the proposed treatment in the transfer pricing of intangible assets may give rise to double taxation and may create difficulties for MNEs and Hong Kong companies.

1.2 The Draft proposes to adopt profit split method or value contribution method for transactions involving intangible assets owned by related parties. The value contribution method is discussed in detail in the chapter on value chain analysis, under the requirement of the local file of contemporaneous documentation. This differs from the requirement of the BEPS Actions and the required information may overlap with Country by Country (CBC) Reporting. The situation is similar for the SAT Announcement regarding corporate income tax matters on outbound payments to overseas related parties (SAT Announcement [2015] No.16) in which much information is required on royalty expenses, and deductibility arrangements of outbound service payments. That may lead to the need for extra profit adjustments and an additional burden of transfer pricing compliance by taxpayers.

2. Special tax adjustment provisions

The Draft provides that if transactions in contracts between related parties do not take place as between third parties under equivalent economic circumstances, then these transactions would be denied or would be re-characterised by the tax authorities. However, BEPS Actions indicate that a transaction should not be deemed not to have occurred only because it could not occur among unrelated

parties. Instead, the transaction should be assessed if it has a reasonable business purpose. We would suggest that the SAT take this viewpoint into account in re-characterising transactions during practical application.

Similarly, the discussion draft provides no clear guidance on how to ascertain those intangible assets, which are difficult to evaluate under BEPS Actions (albeit the same problem exists in BEPS Actions too). In addition, the discussion draft does not explain the consequences where intangible assets are valued differently by the taxpayer and tax authorities.

3. Controlled Foreign Company (CFC)

The SAT remains unchanged in its principle on the current definition of CFC and the corresponding exemption / threshold requirements. The Draft integrates part of the viewpoints in BEPS Action 3.

The discussion draft indicates that the following should normally be included within a CFC's income:

(i) Dividends earned by non-securities trading companies;
(ii) Interest earned by non-finance business companies;
(iii) Insurance premiums earned by non-insurance companies;
(iv) Royalties earned from related parties;
(v) Sales and service income earned where goods and services have been bought-in from related parties and no or low value has been added; and
(vi) Excess profits derived from intangible asset or risk transfers.

While the above is a supplement to the practical analysis of BEPS Actions, it also explains three alternative solutions proposed by BEPS Actions (i.e. substantial contribution, transfer pricing analysis, staff / premises). However, the Draft does not clarify which solution should be adopted first and how to apply them. In light of increasing tax law enforcement action against Chinese MNEs that expand their operations outside China, we would propose that the tax authority further explain the specific application of these regulations.

4. Special issue file of contemporaneous documentation

The Draft requires taxpayers to include a master file and local file in their preparation of contemporaneous documentation by reference to BEPS Action 13.

In addition, a special issue file is also requested, which is not required by BEPS Actions. If every country has its own requirements as to the files, taxpayers will take time to adapt different countries' requirements, and could be confused. We would urge the SAT to reconsider the necessity of the special issue file.

5. Location specific factors

The Draft considers and introduces a controversial concept in the BEPS Actions, i.e. location specific factors. However, the discussion on location specific advantages is not totally consistent with the BEPS Actions. Unless the Chinese tax authorities can successfully conclude bilateral advance pricing agreements (APA) or reach consensus under Mutual Agreement Procedures (MAPs) with foreign tax authorities, there could be divergence of location specific factors between the Chinese and foreign tax authorities and which could lead to double taxation.

6. Related party services transactions

The Draft integrates the principle of Announcement 16 which regulates fees paid by enterprises to overseas related parties. The Draft indicates that the tax authorities have the right to implement special tax adjustments by disallowing deductions in situations where an enterprise pays services fees to an overseas related party, which performs no substantive business activities. Many MNEs find this arrangement problematic. The Chinese tax authorities should conduct a thorough functional analysis of an enterprise and its overseas related party before laying down their judgments.

There are a few discrepancies between Announcement 16 and BEPS Actions 8, 9 and 10. BEPS Actions recognise the existence of intangible asset owners. Since owners make only a small contribution to the intangible assets, they should receive a limited profit distribution. However, as Announcement 16 disallows the deductions of royalty expenses paid to intangible asset owners, this may give rise to double taxation.

The Institute thinks that the SAT's viewpoints are reasonable based on the above points 1 to 6. In order to reduce MNEs (including Hong Kong companies)' exposure to the risk of double taxation, we hope the SAT can consider the impact of this risk on the taxpayers when it formulates new regulations.

B. Questions to be clarified regarding the regulations in the discussion draft of Implementation Measures of Special Tax Adjustment

Chapter 3 – Contemporaneous documentation

7. Article 19 of the Draft does not cover taxpayers that engage in related party transactions, the execution of cost-sharing arrangement and the threshold requirement of Thin Capitalization Rule. Does this imply that if taxpayers are involved in the above activities, they should prepare corresponding special documentation?

8. The Draft illustrates that taxpayers engaging in related services transactions should prepare special contemporaneous documentation, while such documentation is not required when services transactions are limited to domestic related parties. If an enterprise has both sales transactions with overseas related parties and services transactions with domestic related parties, should it prepare special documentation of contemporaneous documentation for its services transactions with domestic related parties, as the Draft does not specify clearly?

Chapter 5 – Special tax investigation and adjustment

9. According to Article 47 of the Draft, where an enterprise under investigation has an ultimate overseas holding enterprise, that ultimate overseas holding enterprise should prepare CBC reporting in accordance with the requirement of the country where it is located, and include the enterprise under investigation in its reporting. The tax authorities have the right to ask the enterprise under investigation to provide CBC reporting if certain conditions be fulfilled. If an ultimate overseas holding enterprise of an MNE is based in location where the tax authority does not require CBC reporting (e.g. Hong Kong is not required), does it imply that the Chinese tax authorities cannot require the enterprise under investigation to provide CBC reporting?

   If the Chinese tax authorities require the enterprise under investigation to provide CBC reporting, it will cause difficulties to the enterprise under investigation because it is only one of companies under the MNE group.

10. Article 50 of the Draft indicates that the implementation measures are for the time being not applicable to transactions among domestic related parties. Does this imply that the Chinese tax authorities will not carry out special tax investigations

into these enterprises, even if they have different effective tax rates?

11. Articles 52 and 53 of the Draft point out that the tax authorities can obtain comparables from non-public sources of information in their analysis and evaluation of related party transactions. One comparable target can be chosen only where strong comparability exists. Does it imply that the tax authorities could just choose one comparable target from a non-public source of information when they carry out special tax investigation?

12. Article 65 of the Draft mentions that having received a Notice for Special Tax Investigation Adjustment, an enterprise should pay tax within the timeframe specified by the tax authorities and adjust its accounts accordingly. Where no corresponding adjustment is made, the adjusted taxable income amount will be deemed to be a profit distribution made by the enterprise to its investors and will be taxed according to the relevant regulations. However, in some circumstances, overseas related parties (carrying out related party transactions with the domestic enterprise) are not investors of the domestic enterprise. In such cases, it seems not feasible to consider this as a profit distribution made by the enterprise to its investors.

    In addition, the overseas related party may be a joint venture and not wholly owned by the group. Therefore, commercially, it may not be practical for the domestic enterprise to receive from that overseas related party the adjusted profit which is requested by the Chinese tax authorities.

Chapter 7 – Related party services

13. Article 81 of the Draft mentions the pricing of related party services transactions. Whether or not an enterprise can collect the relevant cost information and calculation from its service recipients, it should compute the corresponding price based on Cost-Plus Pricing method. Does this imply that the Chinese tax authorities accept Cost-Plus Pricing as the only method of calculating the price when domestic enterprises pay their related party service fees? Would the Chinese tax authorities accept other calculation methods (e.g. based on certain percentage of sales income or profit sharing)?