

CHINA TAX ALERT

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Implementation of Announcement 16

Relevant regulations:

- Guidance on Tax Risk Management in Relation to Outbound Payments to Overseas Related Parties, released on 30 June 2015 by Zhejiang Provincial Office, SAT
- Announcement of the State Administration of Taxation (SAT) Regarding Corporate Income Tax ("CIT") Matters on Outbound Payments to Overseas Related Parties ("Announcement 16"), issued on 18 March 2015
- SAT's April 2014 letter to the UN working group on TP issues
- Announcement of the State Administration of Taxation on Monitoring and Administration of Special Tax Adjustment [2014] No. 54, issued on 29 August, 2014

Background

Announcement of the State Administration of Taxation (SAT) Regarding Corporate Income Tax ("CIT") Matters on Outbound Payments to Overseas Related Parties ("Announcement 16"), issued in March this year, is China's response to tackling base erosion and profit shifting ("BEPS") through payments made to overseas parts of MNE's operations for services provided and intangibles licensed.

Announcement 16, which follows on from SAT's April 2014 letter to the UN working group on TP issues, and an SAT initiative in 2014 to have local tax authorities survey substantial outbound payments of service fees and royalties since 2004 (see [China Tax Alert: Transfer Pricing Focus, Issue 1, August 2014](#)), reinforces the arm's length principle, provides that the tax authority in charge may request relevant documents demonstrating the arm's length nature and authenticity of the transaction for record purposes, lays out a range of circumstances in which payments made to overseas related parties are to be denied tax deductions, and provides a 10-year window for raising special tax adjustment enquiries in this area.

Since the introduction of Announcement 16, tax authorities across the country have strengthened their administration and management of cross-border payments of service fees and royalties to various degrees. Whilst we have not witnessed a significant increase in formal Announcement 16 transfer pricing audits per se, these varying levels of tightened efforts have led to many challenges to taxpayers. This alert looks at the key areas of Announcement 16 and some of the different practices adopted by tax authorities across the country.

KPMG observations

- Extensive self-adjustment requests: Perhaps unsurprisingly is that many tax authorities have asked taxpayers in their jurisdictions to self-assess the underlying transactions and self-adjust where necessary. Most of tax authorities have taken a targeted approach, focusing their efforts on taxpayers with the largest and most at-risk outbound payments, some have casted a wider net to all taxpayers in their jurisdictions. For example, No. 2 Branch of the Beijing Municipal Office, SAT has met (or will meet) with each taxpayer within its jurisdiction and asked all of them to self-assess.

Nevertheless, so far we have only seen a few self-adjustments made by those with transactions that have clearly deviated from the arm's length principle.

- Collateral damages: Although Announcement 16 is intended to examine the deductibility of outbound non-trade payments by the Anti-Avoidance departments of the tax authorities; it has been used by other departments to advance their own agendas. For example, when Guangdong Provincial Office, SAT initiated a provincial-wide self-assessment request to selected taxpayers, it required taxpayers to self-assess withholding tax obligations in addition to transfer pricing. In some cases, for example the Inspection department of a tax authority launched an audit onto the authenticity of a taxpayer's cross-border service payments, and indicated that if the authenticity cannot be ascertained the taxpayer will be subject to a penalty of between 50% and 5 times the tax evaded. This case was fairly controversial, and was only resolved through the tax authority opining that Announcement 16 related audits shall be initiated by the Anti-Avoidance department only.
- Detailed guidance to be clarified: A question often asked by taxpayers is what kind of documents would be considered adequate in proving the arm's length nature and authenticity of the underlying transactions. Whilst Announcement 16 misses such detailed guidance, Zhejiang Provincial Office of the SAT has recently released its own guidance on documentation expected. A close read sees extensive documentation beyond what would typically be included in contemporaneous transfer pricing documentation being requested, including detailed information on the underlying transaction, analyses demonstrating that the payments do not fall under any of the four non-deductible categories specified under Announcement 16, and a value contribution analysis of the Chinese taxpayer if a profits based method has been used to test the underlying transactions.
- Retrospective application of Announcement 16: Although Announcement 16 provides a 10-year enquiry window; it was not clear whether the arguably more stringent criteria that need to be met to secure deductibility of cross-border non-trade payments could be retrospectively applied to historical arrangements. Our experience, unfortunately, is that it does appear that tax authorities are applying Announcement 16 to enquiries opened before the release of the Announcement. This may open room for more disputes and can potentially lead to more double taxation that could be difficult to eliminate.

Key takeaways

It has been a few months since the release of Announcement 16 and it is appropriate to examine how it has been implemented by tax authorities across the country to help taxpayers become prepared in this area. As discussed above, self-assessment requests are extensive and implementation practices do differ from province to province. These, couple with the retrospective application and collateral damages calls taxpayers to not only take Announcement 16 into consideration going forward, but also to examine their existing arrangements and restructure, if necessary, with these more stringent criteria to minimise potential risks and double-taxation.

We welcome the detailed guidance issued by Zhejiang, and its detailed documentation requirements could be followed or referenced by other tax authorities. However, such extensive documentation requirements do appear to go against, in particular, G20/OECD BEPS Project's effort in reducing administrative burdens for taxpayers in relation to low value services. There is an imminent need from taxpayers for the SAT to issue a more detailed, clearer guidance that can be relied upon by taxpayers across the country, and for any additional documentation requirements to strike a balance between the materiality (qualitative and quantitative) of the underlying transactions and the effort exerted by taxpayers in demonstrating their arm's length nature.

Khoonming Ho

Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang

David Ling
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Tianjin

Eric Zhou
Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

Qingdao

Vincent Pang
Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing

Lewis Lu
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Chengdu

Anthony Chau
Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Hangzhou

John Wang
Tel. +86 (571) 2803 8088
john.wang@kpmg.com

Guangzhou

Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen

Maria Mei
Tel. +86 (592) 2150 807
maria.mei@kpmg.com

Shenzhen

Eileen Sun
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong

Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

Northern China

David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Vaughn Barber

Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

David Chamberlain

Tel. +86 (10) 8508 7056
david.chamberlain@kpmg.com

Tony Feng

Tel. +86 (10) 8508 7531
tony.feng@kpmg.com

John Gu

Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Helen Han

Tel. +86 (10) 8508 7627
h.han@kpmg.com

Naoko Hirasawa

Tel. +86 (10) 8508 7054
naoko.hirasawa@kpmg.com

Josephine Jiang

Tel. +86 (10) 8508 7511
josephine.jiang@kpmg.com

Kevin Lee

Tel. +86 (10) 8508 7536
kevin.lee@kpmg.com

Li Li

Tel. +86 (10) 8508 7537
li.li@kpmg.com

Thomas Li

Tel. +86 (10) 8508 7574
thomas.li@kpmg.com

Simon Liu

Tel. +86 (10) 8508 7565
simon.liu@kpmg.com

Paul Ma

Tel. +86 (10) 8508 7076
paul.ma@kpmg.com

Alan O'Connor

Tel. +86 (10) 8508 7521
alan.oconnor@kpmg.com

Vincent Pang

Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Shirley Shen

Tel. +86 (10) 8508 7586
yinghua.shen@kpmg.com

Joseph Tam

Tel. +86 (10) 8508 7605
laiyiu.tam@kpmg.com

Michael Wong

Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Jessica Xie

Tel. +86 (10) 8508 7540
jessica.xie@kpmg.com

Irene Yan

Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Sheila Zhang

Tel. +86 (10) 8508 7507
sheila.zhang@kpmg.com

Tiansheng Zhang

Tel. +86 (10) 8508 7526
tiansheng.zhang@kpmg.com

Tracy Zhang

Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

Eric Zhou

Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

Central China

Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Anthony Chau

Tel. +86 (21) 2212 3206
anthony.chau@kpmg.com

Cheng Chi

Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Cheng Dong

Tel. +86 (21) 2212 3410
cheng.dong@kpmg.com

Alan Garcia

Tel. +86 (21) 2212 3509
alan.garcia@kpmg.com

Chris Ho

Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Dylan Jeng

Tel. +86 (21) 2212 3080
dylan.jeng@kpmg.com

Sunny Leung

Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Michael Li

Tel. +86 (21) 2212 3463
michael.y.li@kpmg.com

Christopher Mak

Tel. +86 (21) 2212 3409
christopher.mak@kpmg.com

Henry Ngai

Tel. +86 (21) 2212 3411
henry.ngai@kpmg.com

Yasuhiko Otani

Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

Amy Rao

Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Janet Wang

Tel. +86 (21) 2212 3302
janet.z.wang@kpmg.com

John Wang

Tel. +86 (21) 2212 3438
john.wang@kpmg.com

Jennifer Weng

Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

Henry Wong

Tel. +86 (21) 2212 3380
henry.wong@kpmg.com

Grace Xie

Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Bruce Xu

Tel. +86 (21) 2212 3396
bruce.xu@kpmg.com

Jie Xu

Tel. +86 (21) 2212 3678
jie.xu@kpmg.com

William Zhang

Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

Hanson Zhou

Tel. +86 (21) 2212 3318
hanson.zhou@kpmg.com

Michelle Zhou

Tel. +86 (21) 2212 3458
michelle.b.zhou@kpmg.com

Southern China

Lilly Li
Partner in Charge, Tax
Southern China
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Lu Chen

Tel. +86 (755) 2547 1068
lu.l.chen@kpmg.com

Vivian Chen

Tel. +86 (755) 2547 1198
vivian.w.chen@kpmg.com

Sam Fan

Tel. +86 (755) 2547 1071
sam.kh.fan@kpmg.com

Ricky Gu

Tel. +86 (20) 3813 8620
ricky.gu@kpmg.com

Angie Ho

Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Jean Jin Li

Tel. +86 (755) 2547 1128
jean.j.li@kpmg.com

Kelly Liao

Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Donald Lin

Tel. +86 (20) 3813 8680
donald.lin@kpmg.com

Grace Luo

Tel. +86 (20) 3813 8609
grace.luo@kpmg.com

Maria Mei

Tel. +86 (592) 2150 807
maria.mei@kpmg.com

Eileen Sun

Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Michelle Sun

Tel. +86 (20) 3813 8615
michelle.sun@kpmg.com

Bin Yang

Tel. +86 (20) 3813 8605
bin.yang@kpmg.com

Lixin Zeng

Tel. +86 (20) 3813 8812
lixin.zeng@kpmg.com

Hong Kong

Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR
Tel. +852 2826 7165
ayasha.lau@kpmg.com

Chris Abbiss

Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern

Tel. +852 2826 7166
darren.bowdern@kpmg.com

Yvette Chan

Tel. +852 2847 5108
yvette.chan@kpmg.com

Rebecca Chin

Tel. +852 2978 8987
rebecca.chin@kpmg.com

Matthew Fenwick

Tel. +852 2143 8761
matthew.fenwick@kpmg.com

Barbara Forrest

Tel. +852 2978 8941
barbara.forrest@kpmg.com

Sandy Fung

Tel. +852 2143 8821
sandy.fung@kpmg.com

Stanley Ho

Tel. +852 2826 7296
stanley.ho@kpmg.com

Daniel Hui

Tel. +852 2685 7815
daniel.hui@kpmg.com

Charles Kinsley

Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos

Tel. +852 2685 7457
john.kondos@kpmg.com

Kate Lai

Tel. +852 2978 8942
kate.lai@kpmg.com

Jocelyn Lam

Tel. +852 2685 7605
jocelyn.lam@kpmg.com

Alice Leung

Tel. +852 2143 8711
alice.leung@kpmg.com

Steve Man

Tel. +852 2978 8976
steve.man@kpmg.com

Ivor Morris

Tel. +852 2847 5092
ivor.morris@kpmg.com

Curtis Ng

Tel. +852 2143 8709
curtis.ng@kpmg.com

Benjamin Pong

Tel. +852 2143 8525
benjamin.pong@kpmg.com

Malcolm Prebble

Tel. +852 2684 7472
malcolm.j.prebble@kpmg.com

Nicholas Rykers

Tel. +852 2143 8595
nicholas.rykers@kpmg.com

Murray Sarelius

Tel. +852 3927 5671
murray.sarelius@kpmg.com

David Siew

Tel. +852 2143 8785
david.siew@kpmg.com

John Timpany

Tel. +852 2143 8790
john.timpany@kpmg.com

Wade Wagatsuma

Tel. +852 2685 7806
wade.wagatsuma@kpmg.com

Lachlan Wolfers

Tel. +852 2685 7791
lachlan.wolfers@kpmg.com

Christopher Xing

Tel. +852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung

Tel. +852 2143 8753
karmen.yeung@kpmg.com

Adam Zhong

Tel. +852 2685 7559
adam.zhong@kpmg.com