Understanding Profit Repatriation from China

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In China, the inflow and outflow of foreign exchange is tightly regulated by the State Administration of Foreign Exchange (SAFE). With **strict capital controls** in place, it is important that foreign companies planning to operate in China understand the available options and requirements for repatriating their profits in the most cost-efficient way.

In the following, we only focus on **Dividend Payments** and **Inter-company Service Fees**.

Dividend Payments

The most common way to repatriate profits from China is for the local Foreign-Invested Enterprise (FIE) to pay dividends directly to the foreign parent company or investors by following the below steps.

1. File the Annual Audit Report issued by a Chinese Certified Public Accountant (CPA) together with the CIT Reconciliation Report to verify that Corporate Income Tax (CIT) has been paid on the gross profits. The standard CIT is 25% but other rates may apply according to national or local preferential policies.
2. Prepare Profit Distribution Resolution to be approved by the Board of Directors or Executive Director of the FIE.
3. Allocate 10% of net profits to a General Reserve Fund (GRF) until it reaches 50% of the total Registered Capital after which the contributions to the GRF can be stopped. The GRF constitutes an accrual of funds that can be used freely for operational expenses.
4. Pay the standard Withholding Tax (WT) of 10% (or 5%) of the remaining amount when transferring the dividends to the overseas parent company or investors.

Please note that profits can only be repatriated overseas after the **Registered Capital** has been paid within the time limit as stated in the **Articles of Association** of the FIE.

Moreover, profits can only be paid out based on **accumulated profits** in which previous year's losses can be carried forward for up to five (5) years.

Double Taxation Avoidance Agreements

The actual WT rate applied depends on the signed Double Taxation Avoidance Agreement (DTAA) signed between China and the country of the parent company or investors. Today, China has signed DTAAs with more than 100 countries and territories including the Nordic countries.

According to the latest **DTAA between China and Denmark** that took effect on **28 December 2012**, the charged WT "… shall not exceed:

a) 5% of the gross amount of the dividends if the **beneficial owner** is a company (other than a partnership) which holds directly at least 25% of the capital of the company paying the dividends
b) 10% of the gross amount of the dividends in all other cases.".

As such, most Danish parent companies or investors in China can enjoy the reduced WT of 5% on overseas dividend payments.

It is the sole responsibility of the overseas parent company or investors to apply for any treaty benefits and reduced WT according to the signed DTAA with China. It is therefore important to seek prior assistance from a local tax specialist to secure any tax benefits.

Beneficial Owner Test

To qualify, the Chinese tax authorities will require documentation from the overseas recipient such as annual financial statements, board resolution, minutes of meeting and tax resident certificate to ensure that the overseas company is a genuine business generating income.

If the receiving overseas company lacks substantive business activities, 50% or more of the received dividend is transferred to a third country or the recipient is located in a low tax rate jurisdiction, the Chinese tax authorities will be less inclined to approve the Beneficial Owner status.

Inter-company Service Fees

A common practice to reduce the CIT burden is via inter-company service fees in which the parent company signs a service agreement with the FIE for actual services delivered and charges a service fee for i.e. IT or marketing support according to the arm's length principle. The signed service agreement needs to be filed for registration within thirty days after the signing.

This type of inter-company transaction is subject to service VAT and Surcharges but can be deducted from the taxable income of the FIE and thus avoids CIT.

If the provided services are considered a **Permanent Establishment** (183 days or more within 12 months) additional Withholding CIT of 25 % applies calculated on the **Deemed Profit Rate** (DPR) of 15-50%.

The actual DPR applied is determined by the local tax authorities based on the documentation filed for transaction tax clearance but the following DPRs typically apply: Construction Projects, Design and Consulting Services: 15-30%, Management Services: 30-50%, and Other Operating Services: Minimum 15%.

It is recommended not to use the term "management fee" in service agreements as this can be interpreted by the local tax authorities as a way to manipulate the actual profits made to reduce the CIT whereby they may rule that CIT has been underpaid, refuse the management fee to be deducted before CIT and impose penalties.

It is important to mention that paying service VAT and Surcharges (and Withholding CIT) also applies to Non-Resident Enterprises (NRE) that provide services to clients in China.

Moreover, if staff is sent to China to provide services on the ground and the duration of the stay is 183 days or more within a 12 month period, Individual Income Tax also applies.

To ensure that the applied taxes are paid by the NRE service provider, the Chinese tax authorities require that the service recipient in China act as the **Withholding Agent**.

This often comes as a big surprise to the overseas service provider that does not get the full payment from the service recipient that was invoiced. It is therefore important that the parties to a service agreement clarify in writing who will cover the WT.

Transfer Regulations and Procedures

To further facilitate trade in services, a new set of regulations were introduced jointly by SAFE and the State Administration for Taxation (SAT) that took effect on 1 September 2013 to simplify the procedures for the outbound transfer of foreign exchange from China that covers service fees, dividends, royalties, interests and expense reimbursements.

Only **outbound payments above USD 50,000** need to go through a record-filing with the local SAT in which the FIE shall submit a completed tax form together with a copy of the stamped contract and other relevant transaction documents such as the issued invoice. For the outbound transfer of dividends, the FIE shall also include the Annual Audit Report and Profit Distribution Resolution.

The reviewing process takes up to **15 working days** after which the tax form will be stamped by SAT. The FIE will receive one stamped copy to be handed over to the bank for the outbound transfer. The total process typically takes **minimum six weeks** to complete.

For **outbound payments below USD 50,000**, the responsibility for reviewing and verifying the required documents including the stamped tax form lies with the banks. After the bank's approval, the total amount in RMB will be converted at the daily exchange rate and transferred overseas.

Not About 'If' But 'How'

Many negative stories exist about foreign companies not being able to get their profits out of China, but this is often due to the lack of proper understanding and compliance with the existing regulations and procedures.

The Chinese authorities do have strict foreign exchange controls in place and have previously imposed temporary measures to stem the excessive outflow of capital from China. But as long as the FIE fulfils its tax obligations, China does not prevent the outward transfer of company profits overseas.

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