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 overseas 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 will only focus on the payment of dividends 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 overseas parent company (Non-Resident Enterprise) or investors by following the below steps.

1. Present the Annual Financial Audit Report (AFAR) issued by a local Certified Public Accountant to prove that the FIE has paid the standard Corporate Income Tax (CIT) of 25%[1] on its gross profit. FIEs are required to file the AFAR to the State Administration of Taxation (SAT) by latest 31 May.

2. Allocate 10% of the net profits to a General Reserve Fund (GRF) until it reaches 50% of the FIE's Registered Capital[2]. Afterwards, payments to the GRF can be halted. The GRF constitutes an accrual of funds that can be used freely for purchases.

[1] Enterprise Income Tax Law of the PRC (2008), Article 4
[2] Company Law of the PRC (2013), Article 166

3. Pay the standard Withholding Tax (WT) of 10%[3] of the remaining amount when transferring the dividend to the overseas NRE or investors.

Please note that in China, dividends 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[4].

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. Today, China has signed DTAAs with more than 100 countries and territories including Hong Kong and the Nordic countries.

According to the latest DTAA between China and Denmark that took effect on 28 December 2012[5], 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.".

In the equivalent DTAAs between China and Sweden, Finland and Norway, the applied WT rates shall not exceed 10%, 10% and 15% respectively.

Beneficial Owner Test

For many years, setting up a holding company in e.g. Hong Kong as the investor of the China subsidiary was a way for foreign investors to benefit from the reduced WT of 5% as stipulated in the signed DTAA between Mainland China and Hong Kong[6].

Although the DTAA refers to the principle of 'Beneficial Owner' whereby the lower WT can only be enjoyed if the HK (holding) company is a 'Permanent Establishment' with an actual branch, office, factory, workshop or place of management, the Chinese tax authorities were for many years not enforcing the requirement.

This has since changed whereby setting up a HK (holding) company is no longer a loophole to reduced WT on profits made in Mainland China. To qualify, the Chinese tax authorities will require documentation from the recipient such as annual financial statements, board resolution, minutes of meeting and tax resident certificate to ensure that the HK holding company is a genuine commercial business generating income.

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[3] Regulations of the PRC on the Implementation of the Enterprise Income Tax Law (2008), Article 91
[4] Enterprise Income Tax Law of the PRC (2008), Article 18
[5] DTAA: "Agreement between the Government of the Kingdom of Denmark and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes and Income" (7 December 2012), Article 10.
[6] DTAA: "Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income" (signed on 11 February 1998) and the revised DTAA: "Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation" (signed on 21 August 2006)."

If the receiving overseas (holding) 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[7].

Inter-company Service Fees

Another common way to repatriate profits is through inter-company payments in which the parent company signs a service agreement with the China subsidiary and charges an ongoing service fee for i.e. management or marketing support. This type of transaction is subject to VAT and WT but can be deducted from the taxable income of the company and thus avoids CIT.

Please note that all service contracts shall be registered by the service recipient in China with the local tax authorities within 30 days from the signature date. Failure to comply can lead to long delays and fines.

In China, any Non-Resident Enterprise (NRE) that provides services to a Chinese entity is subject to WT. To determine the applicable rate, the Chinese tax authorities will in most cases use the 'Deemed Profit Rate' (DPR) method which is 15-50% of the total service fee charged on which the 25% CIT is applied.

The actual DPR applied is settled by the local tax authorities based on the documentation filed for transaction tax clearance. In most cases, the DPR will be set at 40% whereby the applied WT is 10% (25% CIT of 40% DPR) in line with the current CIT regulations.

It is the sole responsibility of the overseas NRE service provider 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.

It is worth mentioning that even the name and contents of the agreement between the parent company and the China subsidiary can affect the DPR. In Shanghai, the local tax authorities will generally apply a 30% DPR on general fees and a 50% DPR on management fees[8].

To ensure that the applied WT is paid by the NRE service provider, the Chinese tax authorities require that the service recipient in China act as the withholding agent[9]. This also applies for regular service agreements between the China subsidiary and any overseas service provider. This often comes as a big surprise to the overseas service provider that does not get the full payment charged to the service recipient.

[7] Presentation by Grace Xie, Partner, Tax China, KPMG: Cross-border remittance in China (12 April 2018), organised by AustCham Shanghai.
[8] Presentation by Grace Xie, Partner, Tax China, KPMG: Cross-border remittance in China (12 April 2018), organised by AustCham Shanghai.
[9] Enterprise Income Tax Law of the PRC (2008), Article 37

Transfer Regulations and Procedures

To further facilitate trade in services, a set of new regulations were introduced by SAFE and jointly with SAT that took effect on 1 September 2013[10] to simplify the procedures for the outbound transfer of foreign exchange from China covering service fees, dividends, royalties, interests and expense reimbursements.

The previous requirement for companies to present a Tax Clearance Certificate together with supporting transaction documents to be verified by a bank for outbound payments above USD 30,000 was removed.

Instead only outbound payments above USD 50,000 need to be recorded in which the company shall submit three copies of a Tax Form together with copies of the transaction documents including the stamped contract and issued invoice to SAT[11]. For the outbound transfer of dividends, the company shall include the annual financial audit report and board resolution on profit distribution to SAT[12].

The reviewing process takes up to 15 working days after which the Tax Form will be stamped by SAT. The company will receive one of the stamped copies to be handed over to the bank for the outbound transfer. The total process will typically take minimum six weeks to complete.

For transfers above USD 50,000, the responsibility for reviewing, verifying and collecting the transaction 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 sent overseas.

Not About 'If' But 'How'

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

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 China subsidiary of the overseas parent company fulfils its tax obligations, China does not prevent the outward transfer of company profits.

To facilitate trade in services, China has in recent years implemented a series of administrative reforms to ease international money transfers.

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[10] Announcement of SAT and SAFE on Taxation Record-filing of External Payments under Trade in Services and Other Accounts, No. 40 (9 July 2013) and Circular of SAFE on the Regulations of Foreign Exchange Administration on Trade in Services, Huifa No. 30 (18 July 2013)

[11] SAFE Guidelines for the Administration of Foreign Exchange Under Service Trade' (2013), Article 9

[12] Circular of SAFE on Further Advancing Foreign Exchange Administration Reform to Enhance Authenticity and Compliance Reviews, Huifa No. 3 (26 January 2017), Article 7

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