lexsina

CHINAjournal

Profit Repatriation Strategies

September 2005

Profit repatriation is a delicate subject under China's foreign direct investment regime. Various regulatory, formality and tax factors surrounding the issue make it worthwhile for investors to define carefully their repatriation strategies, so as to entail tax and profit outcome to the extend that they should be legally entitled to. These strategies may not necessarily be complex or costly, while their effects could be very substantial: in certain cases meaning a tax saving of up to 20% of the turnover. This issue of **CHINA***journal* is intended to shed some lights on the commonly used strategies that may help to optimise profit repatriation out of China.

Mandatory funds allocation and dividends

Enterprise income tax (EIT) for foreign investment enterprises (FIEs) is set at 33% under national law. However, preferential tax rates are applicable to the FIEs established in designated zones or municipalities at reduced level as of 15% or 24%. Besides, manufacturing FIEs in China can enjoy a 2-year holiday and an additional 3-year half tax commencing from the year they start to make profits.

Before distributing after-tax profits, FIEs are required to make up any losses carried forward from previous years. Also, a slice of profits has to be allocated to mandatory funds, including a reserve fund, an expansion fund and a separate fund for staff bonus and welfare. For an equity or cooperative joint venture, there is no minimal or maximal limit on the amount allocated to these funds. The board of directors can decide the allocation ratio on their own initiative. For a wholly foreign-owned enterprise (WFOE), the expansion fund is not required. But a WFOE must set aside a minimum 10% of after-tax profits into the reserve fund until the accumulated reserve fund reaches 50% of the registered capital.

The remaining part is distributable profits from which the board of directors may declare dividends to the investors in proportion to their contribution to the registered capital. For foreign exchange dividends, FIEs could remit directly from their bank accounts or purchase convertible foreign exchanges with banks by presenting a valid board resolution on profit distribution. At present, China does not impose withholding tax (WHT) on the dividends distributed to the foreign investors.

Alternatives of profit repatriation

Foreign investors may charge fees, interests or royalties by enter into transactions with their FIEs in China so that profit repatriation would be partly realized before EIT. While the foreign investors must pay WHT and or business tax (BT) on their incomes arising from such associated transactions, the taxable income base of the FIEs could be reduced. Therefore, a thorough analysis on the regulatory settings and tax consequences of various possible transactions is essential for strategic planning purpose.

Royalty

Manufactory royalties used to be capped at 5% and retailing royalties at 0.3% by the Ministry of Commerce (MOC) under its obsolete regime of approving technology transfer and commercial retailing enterprises. The maximal royalty-charging term was limited to 10 years. Since 2001 (*State Council Order*

No. 331), a file-for-record system has been adopted for most of the cross-border technology transfer, which replaces the pre-approval process. As a result, the commercial terms and conditions for technology transfer such as the royalty level and payment term are no longer subject to the screening by the authority, unless the royalties are so excessive that the transaction could not be at arm's length and thus trigger transfer pricing issue with tax authorities. In 2004, a new regulation (*MOC Order No. 12*) on retailing and other distribution activities greatly reduced the entry barrier for the sector. Accordingly, the former 0.3% cap on retailing royalty was abolished in the call of a more liberal market framework.

Nevertheless, foreign IP owners are required to present necessary documents before royalties could be remitted out of China, as part of the formalities for foreign exchange control that is still in place in China. These include the inter-company agreements that set out the terms of IP transfer, the registration certificates issued by the competent authorities and the tax clearance certificates issued by in-charge tax bureaus. MOC is the responsible body for registering cross-border technology transfer agreements. When it is concerned with trademark transfer, such agreement will need to be filed with the State Administration of Industry and Commerce. Remittance for patent royalties must be accompanied by a return receipt issued by the State Intellectual Property Office.

Royalties are subject to both a 10% WHT and a 5% BT. As BT is deductible for WHT purpose, the effective tax rate on royalties is 14.5%. Apparently, such tax charge is lower than 33% EIT, presenting a valuable case for tax optimization. However, factors such as preferential EIT rates and holiday that most of FIEs in China would enjoy should be taken into account as a trade-off effect. In recent years, BT exemption for high-tech royalties has become more common and easier to obtain due to a national policy [*Zhong Fa (1999) No .14*] to promote high-tech development and innovation. WHT paid in China is creditable in the home country of the IP owner under the applicable double tax treaty (DTT).

Service fees

Foreign investors could provide services and thus get paid under service agreements with their FIEs in China. It is not requested to register or file service agreements with authorities. To remit service fee is therefore subject to less paper work requirement under forex control in comparison with royalties' remittance.

Fees paid by FIEs to their parents for services provided onshore are subject to a 5% BT. In addition, where the servicing period is long enough (more than 6 months in any 12-month period) to constitute a Permanent Establishment ("PE") in China, a 33% EIT will be charged on the deemed profits, which vary from 10% to 40% of the income arising from onshore service. If PE could not be established, EIT is theoretically not applicable. In practice, tax authority would treat the fees as loyalties and levy a 10% WHT. Service fees at arm's length are normally deductible for FIE's EIT purposes. However, "management fees" charged by parents on the basis of inter-group cost sharing program is not deductible.

Offshore services are not exposed to Chinese tax. However, tax authorities are very strict on attributing fees to offshore services. In practice tax authorities would assert 60% of a service as being performed onshore. Any declaration that services are exclusively performed offshore would be challenged. Notably, the employees that are performing services in China are also subject to Individual Income Tax at rates with a range from 5% to 45% on their China source incomes.

Interests

Loan interests paid by FIEs to their parents are subject to a 10% WHT, but with no BT exposure. Such interests paid are deductible for FIEs' EIT purpose.

Much attention should be paid to the regulatory requirements on loan arrangement between a FIE and its foreign patents. China imposes mandatory equity/debt ratio on FIEs. With a given amount of the registered capital, loans that a FIE is permitted to raise are capped. Loans granted by foreign parents will need to go through the foreign-debt registration procedure with the State Administration of Foreign Exchange (SAFE). The remittance of interests is also subject to the approval of the SAFE. Thus, foreign investors should plan the capital structure carefully in advance if it is the intention that debt finance will be provided by the parent company.

R&D cost sharing arrangement

Under a R&D cost sharing arrangement (R&D CSA), participants share the worldwide R&D expenses in proportion to the anticipated benefits each participant might obtain. Each participant would acquire its own piece of IP rights so developed within the local jurisdictions. China did not recognize CSA until the State Administration of Tax (SAT) issued in summer 2004 a private ruling letter, which endorsed an international R&D CSA for a particular FIE. The letter states that a FIE is able to participate in a CSA provided that certain prerequisites and formalities could be satisfied including (1) the FIE would receive specified IP rights and benefits; (2) no royalties would be charged; and (3) documentation for cost sharing pool, allocation mechanism and method adopted should be lodged to SAT for review etc.

Once the clearance with SAT is obtained, a FIE may effect the payment under the R&D CSA and deduct such payment for its EIT declaration. More importantly, such payment will not be treated as royalties and thus no WHT or BT is chargeable. Needless to say, this new tax policy, even though not formulated as an official regulation, does present an important opportunity for profit repatriation and tax optimization. However, as a R&D CSA would move IP rights into China, multinationals may consider to restrict the application only to their wholly-owned operations or to take appropriate measures to protect their IP in China.

Conclusion

Profits repatriation out of China could be realized in different ways. Dividends, royalties, interests and cost sharing arrangement are the possible alternatives. Regulatory formalities, forex control and tax impact for each alternative should be identified and assessed before any strategy could be adopted. China is set to reform its tax system presumably in 2006, aiming to equalize the income tax levies for domestic enterprises and FIEs. As a result, higher EIT rates may apply for FIEs while current preferential treatments would be dampened. Multinationals should take prompt action to evaluate or adjust their strategy of profits repatriation in connection to China operations for achieving an optimal efficiency and competitiveness in Chinese and also global market.

lexsina gmbh
reitergasse 3
8004 zürich, switzerland
t + 41 44 291 6964
f + 41 44 291 6960
www.lexsina.ch