# Cross-border transactions, profit repatriation and funding of SME's in China

DEZAN SHIRA & ASSOCIATES

Corporate Establishment, Tax, Accounting & Payroll Throughout Asia

*- Practical steps to overcome your biggest challenges*

Hannah Feng

23 October 2014

# AGENDA

- Overview of Foreign Exchange System
- Overview of China VAT Reform Program
- Overview of Withholding Taxes For Outward Remittance
- Case Study

# China Foreign Exchange System

# Overview of China Foreign Exchange System

- Foreign Exchange System
  - Current Account
    - Trade in Goods
    - Service
    - Income
    - Current transfer
  - Capital Account
    - FDI
    - Foreign Loan
    - Overseas investment

- The <u>Current Account</u> deals with daily recurring transactions in the ordinary course of business such as trading receipts and payments, service receipts, payments of royalties, repatriation of after-tax profits and dividends, payment of interest on foreign debts, remittances of reimbursement and allocation of expenses, etc;
- The <u>Capital Account</u> deals with imports and exports of capital, direct investments, and loans and securities investment such as repayment of principal on foreign debts, overseas investments, investment in FIEs and remittances by FIEs after liquidation of capital in foreign currency.

# Capital Account of a FIE in China

- Submit required documents to local SAFE;
- SAFE sets the quota on cross-border transfer and forex conversation via its system - Direct Investment Forex Information System ("DIFIS");
- Open a capital account and a foreign currency settlement account with designated foreign exchange banks; No approval from SAFE required
- Banks execute the handling procedures and update related information using DIFIS;
- No need to engage a local CPA firm for capital verification before applying for foreign exchange capital conversion;
- SAFE conducts “off-site supervision” using DIFIS information.

# Foreign Exchange Capital Conversion

- The maximum monthly amount for “daily use” that can be taken from the foreign currency capital account is US$ 100,000 (up to US$ 50,000 per settlement);

- If the amount exceeds US$ 50,000, the bank will need to examine the following:
  - Supporting document: contract, payment notice or official tax invoices (fapiao), commitment letter certifying the purpose of the RMB funds.  The bank will convert and transfer the money from the capital account to the vendor directly within1 day.
  - Supporting document for the last conversion: official tax invoices (fapiao) and the verification proof issued by tax authorities for last transfer.

- Where the accumulative amount of settlement of foreign currency capital reaches 95% of the total registered capital, the rest of 5% of the registered capital amount have to be kept in the capital account unless the bank verifies the fapiao and verification proof issued by the tax authorities for the previous settlements.

# Overseas lending from a FIE in China

- Scope of Borrower:
  - Wholly or partially owned overseas subsidiaries of Chinese entities
  - Overseas related parties of an FIE with direct or indirect shareholding relationship

- Source of Fund:
  - Self-owned foreign exchange of the FIE;
  - Foreign exchange purchased by the FIE using RMB;
  - Foreign exchange from a foreign currency cash pool as approved by SAFE;
  - Foreign exchange loans obtained by the FIE

- The Loan Quota: 30% of the FIE's equity of owners in the latest audited report

# New Forex Regulations under Trade in Goods

- Reform the foreign exchange administration mode in the trade in goods from ‘on-site’ verification and writing-off on a deal-by-deal basis to ‘off-site’ inspection of the total sum;
- Carry out dynamic and differentiated regulation of enterprises and classify the enterprises into three categories A, B and C;
- A FIE in category A can make payment via either commercial invoice, contract or customs declaration form of import;
- Cancel the old ‘written verification and writing-off sheets for export’ practice;
- Set up a new Monitoring System to report the difference between the goods flow and cash flow;
- Monitoring System links with e-Port platform which share information among SAFE, Custom and Bank.

# New Forex Regulations under Service

- Cancel SAFE approval on outward service payments;
- No transaction related documents is required for the payment no more than US$ 50,000;
- Cancel the Tax Clearance Certificate and replace it with a simplified record-filing process for the payment more than US$ 50,000;
- Tax withholding is required no matter the payment is more than US$ 50,000 or not !!!
- Allow the qualified multinational companies to deposit the foreign exchange revenue overseas;
- Broadly allow the qualified multinational companies to open a domestic FX master account and/or international FX master account

# AGENDA

**China VAT Reform Program**

# China Indirect Taxes _ Two Parallel Systems

- Import and domestic supply of goods
- Trading tangible goods
- Processing & repair & replacement
- Export-related activities
- Input VAT may be deductible
- Export exemptions or refunds

**Value Added Tax (VAT) 0%, 13%,17%**

**Business Tax (BT) 3%-5%, 20%**

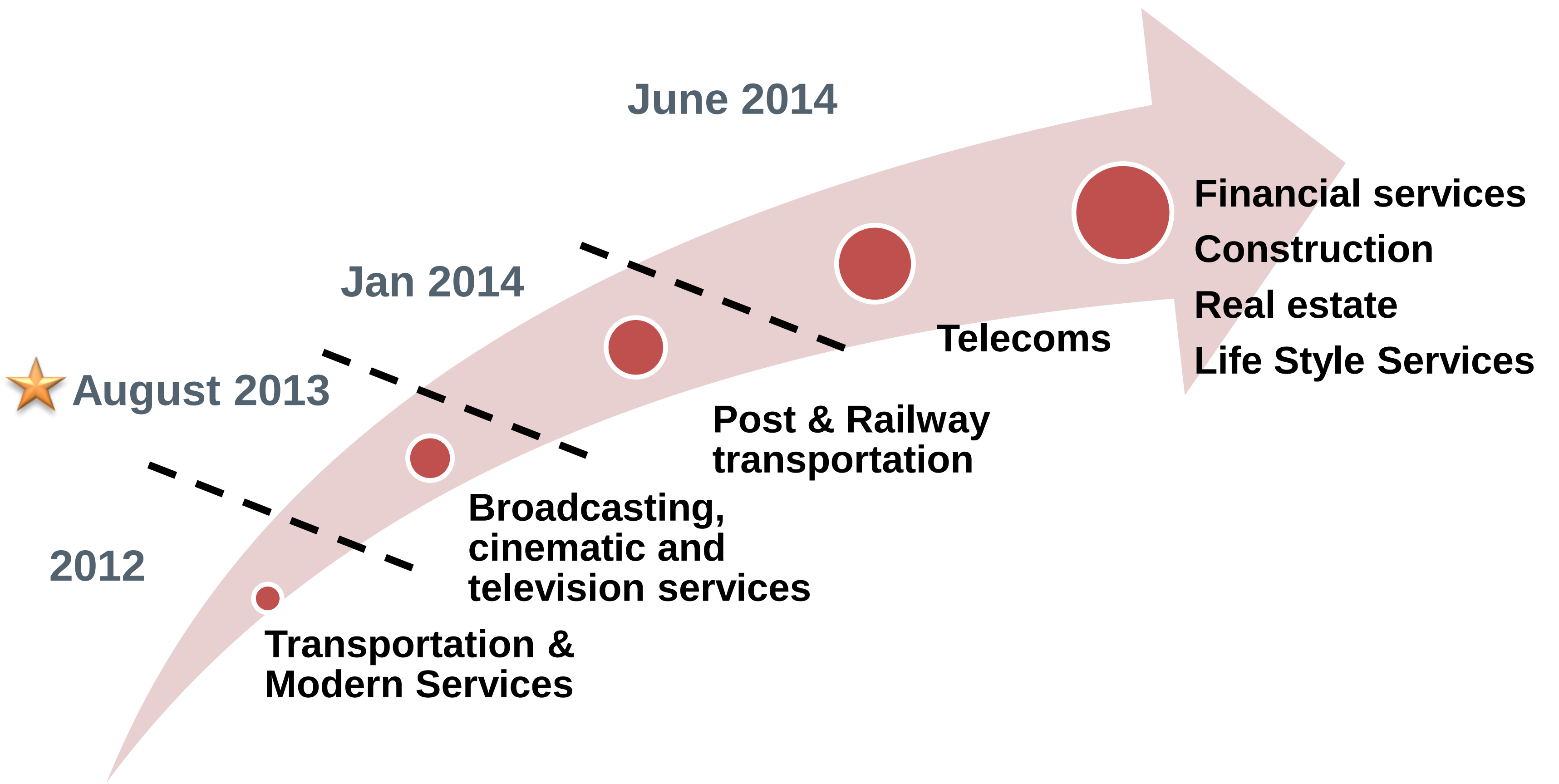
- Provision of services
- Transfer of intangible assets
- Some immovable properties
- No input deductions (“sunk costs”)
- Usually 3-5% / up to 20% for entertainment sector

# VAT Program Implementation

| January 1, 2012 | September 1, 2012 | October 1, 2012 | November 1, 2012 | December 1, 2012 | -------- | August 1, 2013 |
|---|---|---|---|---|---|---|
| Shanghai | Beijing | Jiangsu<br>Anhui | Fujian<br>Guangdong | Tianjin<br>Zhejiang<br>Hubei | | Nationwide |

- 2.594 million companies fall in the scope of pilot VAT Program as of November 30, 2013 (including 467k general taxpayers and 2.127 million small-scale taxpayers)
- Shanghai 2012 revenue was reduced by RMB 20 billion (US$3.28 billion)
- RMB 13.01 billion tax revenue reduction in August 2013, the first month after the nationwide expansion
- RMB 55 billion tax revenue reduction as of February 1, 2013. Estimated RMB 200 billion to RMB 300 billion tax revenue reduction in 2013

# VAT Pilot Program Industry Implementation



# VAT Taxable Services and Rates

| VAT Taxable Services | Standard Rate |
|---|---|
| Tangible movable property leasing services<br>(including finance lease and operation lease) | 17% |
| Transport Services<br>– Land transport services<br>– Waterway transport services<br>– Air transport services<br>– Pipeline transport services<br>– Railway transport services | 11% |
| Postal Services provided by the China Post Group and its affiliated postal enterprises | 11% |
| Telecommunication services<br>– Basic telecom services<br>– Value-added telecom services | <br>11%<br>6% |
| Modern Services<br>(excluding tangible movable property leasing services)<br>– Research and development and technology services<br>– Information technology services<br>– Cultural and creative services<br>– Logistics support services<br>– Authentication consulting services<br>– Radio and television services | 6% |
| Certain taxable services stipulated by the SAT and MOF | 0% |

# Export VAT Incentives

| | | Output VAT | Input VAT |
|---|---|---|---|
| Export of goods or services | Zero-rated | Not payable | Refundable |
| | Exempted | Not payable | Non-refundable |
| | No exemption | Charged | Deductible |

# Zero VAT Rate vs. VAT Exempt Services

Types of services provided or when services provided overseas:

| Zero VAT Rate | VAT Exemption |
|---|---|
| Design services provided to overseas entities (excluding architectural design) | 1) Be subject to simplified taxation method, (e.g., small-scale taxpayer);or<br>2) Have claimed to waive the zero tax rate and opted to the tax exemption |
| R&D and technology design services provided to overseas entities | The same as above |
| International transport services | The first two conditions or one of the following:<br>1) Water transport companies who have not obtained the "Business License for International Shipping"; or<br>2) Road transport companies who have not obtained the "Business License for Road Transport" or "Driving License for International Car Transportation", or whose business scope does not include "international transportation"; or<br>3) Air transport companies who have not obtained the "Business License for Public Air Transport Enterprises", or whose business scope does not include "international air transportation for passengers, goods and mails"; or those who have not obtained the "Business License for General Aviation", or whose business scope does not include the "official business flights" |
| Transport services to and from Hong Kong, Macau and Taiwan | The first two conditions or one of the following:<br>1) Water transport companies who have not obtained the "Business License for Waterway Transportation across the Taiwan Straits", or do not have ships with the "Operation Permits for Ships across the Taiwan Straits", or do not have ships with the "Business License for Routes to Hong Kong and Macau"; or<br>2) Road transport companies who have not obtained the "Business License for Road Transportation", or do not have transport vehicles with the "License for Road Transportation" which directly connect with Hong Kong or Macau; or<br>3) Air transport companies who have not obtained the "Business License for Public Air Transport Enterprises", or whose business scope does not include the "international & domestic (including Hong Kong and Macau) air transportation for passengers, goods and mails"; or those who have not obtained the "Business License for General Aviation", or whose business scope does not include the "official business flights" |
| | Other qualified cross-border services |

# VAT Exemption on Cross-border Service

**Type I: Location of Services and Properties!**

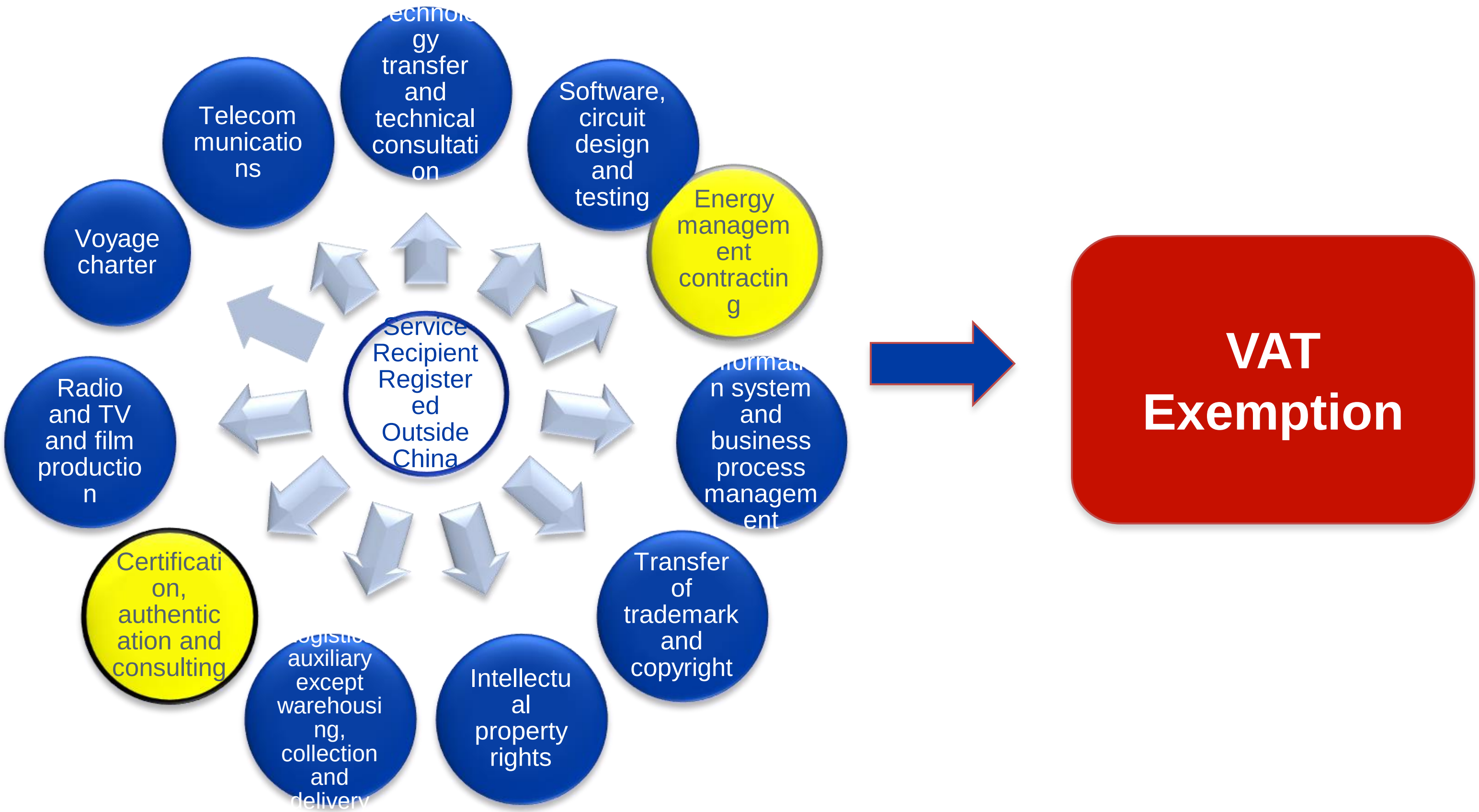
- Exploration and engineering survey
- Convention and exhibition
- Warehousing
- Personal property leasing
- Distribution and broadcasting
- Post, collection and delivery for export goods
- Advertising

→ Services provided outside China or the service objective is located outside China

→ **VAT Exempted**

# VAT Exemption on Cross-border Service

## Type II: Service Receiver Outside China!



# China Nationwide VAT Reform Update
## Cross-border taxable service exemptions
### Public Notice 49; 1 October, 2014

- Identifies cross-border or ‘exported’ services VAT exempted retroactively from August 1, 2013 (Must make application for VAT exemption)

- May apply to recover paid-up VAT for qualified services since December 1, 2012 to August 1, 2013 in Tianjin

- Retroactive exemption and refund application (from December 1, 2012 or August 1, 2013 till now)
    - Local surcharges could also be recovered
    - 2012&2013 corporate financials would undergo revision
    - Recall special VAT invoices

- Application of Exemption

# How to qualify for VAT exemption?

- Prepare a written cross-border services contract

**Tip 1**
Must include contracting parties and the companies' addresses, service object, service location, service fee amount and pricing method, payment terms, payment method, responsibility for breach of contract, etc.;

**Tip 2**
A master or framework contract is NOT suggested!!

# How to qualify for VAT exemption?

- Account for exported services separately in the accounting books and compute the non-creditable input VAT accurately

**Tip 3**

Set up sub-accounts under the general ledger accounts

| | |
|---|---|
| 5101 | 主营业务收入/Revenue from main operations |
| 5101.01 | 销售/Sales |
| 5101.01.01 | 国内销售收入/Domestic sales income |
| 5101.01.02 | 国际销售收入/International sales income |
| 5101.01.03 | 退回/Return |
| 5101.01.04 | 折让/Discount |
| 5101.01.99 | 其他/Others |
| 5101.02 | 服务收入/Services |
| 5101.02.01 | 国内服务收入/Domestic service income |
| 5101.02.02 | 国际服务收入/International service income |
| 5101.02.99 | 其他/Others |
| 5101.03 | 转移定价收入/Transfer Pricing Revenue |
| 5101.99 | 其他/Others |
| 5102 | 其他业务收入/Revenue from other operations |
| 5102.99 | 其他/Others |

| | |
|---|---|
| 2171.01 | 应交增值税/VAT payable |
| 2171.01.01 | 进项税额/Input VAT |
| 2171.01.02 | 已交税金/Taxes paid |
| 2171.01.03 | 转出未交增值税/Transfer-out of unpaid VAT |
| 2171.01.04 | 减免税款/VAT deductions and exemptions |
| 2171.01.05 | 销项税额/Output VAT |
| 2171.01.06 | 出口退税/Refund of export duty |
| 2171.01.07 | 进项税额转出/Transfer-out of input VAT |
| 2171.01.08 | 出口抵减内销产品应纳税额/Export duty deductible from taxes payable on domes sale |
| 2171.01.09 | 转出多交增值税/Transfer-out of overpaid VAT |
| 2171.02 | 未交增值税/Unpaid VAT |

# How to qualify for VAT exemption?

- Account for exported services separately and compute the non-creditable input VAT accurately

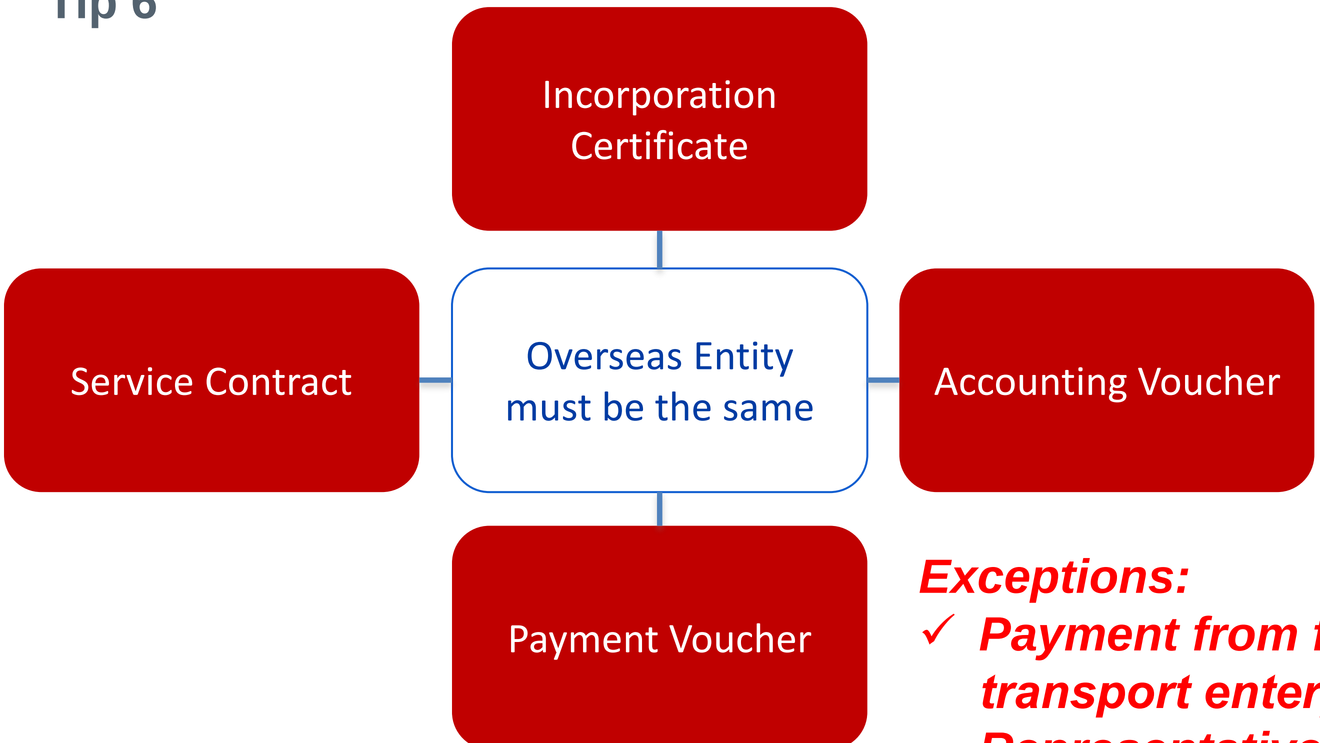
**Tip 4**
Apportionment of input VAT may be more beneficial than tracking the relevant input VAT credits separately, as the proportion of non-creditable input VAT should be calculated on a turnover basis

**Tip 5**
Manage the timing of input VAT verification

# How to qualify for VAT exemption?

- Proof of service recipient's  location in overseas

**Tip 6**




***Exceptions:***

- ✓ ***Payment from foreign aviation transport enterprises' Representative Offices in China;***
- ✓ ***Payment made by the third-party settlement companies.***

# AGENDA

**Withholding Taxes For Outward Remittance**

# Taxes Involved with Cross-border Service Transactions

- Provide Service or Charge Passive Income to Chinese Customer
  - Value Added Tax (VAT) or Business Tax (BT) and its surcharges
  - Corporate Income Tax (CIT)
  - Individual Income Tax (IIT)
  - Withholding Tax (WHT)
  - If no specification on payment terms, normally foreign company shall bear the tax burden

# CIT Liabilities of Foreign Enterprises

- A non-resident enterprise (NRE) with an establishment or place of business in china shall pay corporate income tax on its china-sourced income derived by such establishment or place of business.

- An establishment or place of business includes but are not limited to:
  - *A management establishment, a business establishment or an office*
  - *A factory, farm, or place of extraction of natural resources*
  - *A place where services are provided*
  - *A place where a project of construction, installation, assembly, repair, exploration, etc, is carried out*
  - *Other establishments or places of business where production and business operations are carried out*

- An establishment or place of business is equivalent to the concept of a permanent establishment (PE) in tax treaties.

# PE Test

- "For a period or periods aggregating more than 6 months / 183 days within any 12-months period" relevant to service PE

- 6 months within any 12-months period *Guoshuihan [2007] No.403*

  - from the first month arrived until the last month of service
  - do not necessarily have to be six full months, one day in a month could be also counted
  - if no expatriate in China for performing service within consecutive 30 days, one month is deducted

- 183 days within any 12-months period *Guoshuifa [2010] No.75*

  - from the first day arrived until the last day of service
  - more than one employee is counted as one day

# How are PEs Taxed – Deemed Taxation

- Scope of profits taxable in source country: only profits of an NRE attributable to its PE in China are taxable in China.

- If A PE does not keep separate accounts and profit apportioning is not customarily used, profits of A PE will be determined on A deemed basis.

  Taxable Income = Gross Revenue X Deemed Profit Rate (DPR)

- DPR range

| | |
|---|---|
| 15%-30% | Project engineering, designing and consulting services |
| 30%-50% | Management services |
| ≥ 15% | Other services |

# Procedures for Outward Payment on Overseas transactions

| Procedure | Time |
| --- | --- |
| Contract Registration | 3-5 working days |
| Tax Assessment | 15-20 working days |
| Treaty Benefit Application* | 15-20 working days |
| WHT filing and Payment | 2-3 working days |
| Payment Registration* | 3-5 working days |

# New WHT Procedures

1. CONTRACT REGISTRATION

- Within 30 days after conclusion of the contract
- Different registration form for Service fee and Passive Income (royalty, dividend, capital gain, interest, etc.)

2. TAX ASSESSMENT

- Offshore Service – CIT exemption
- Onshore Service – PE assessment

3. TREATY BENEFIT APPLICATION

- Onshore service but service period not exceeding 6 months or 183 days

# New WHT Procedures

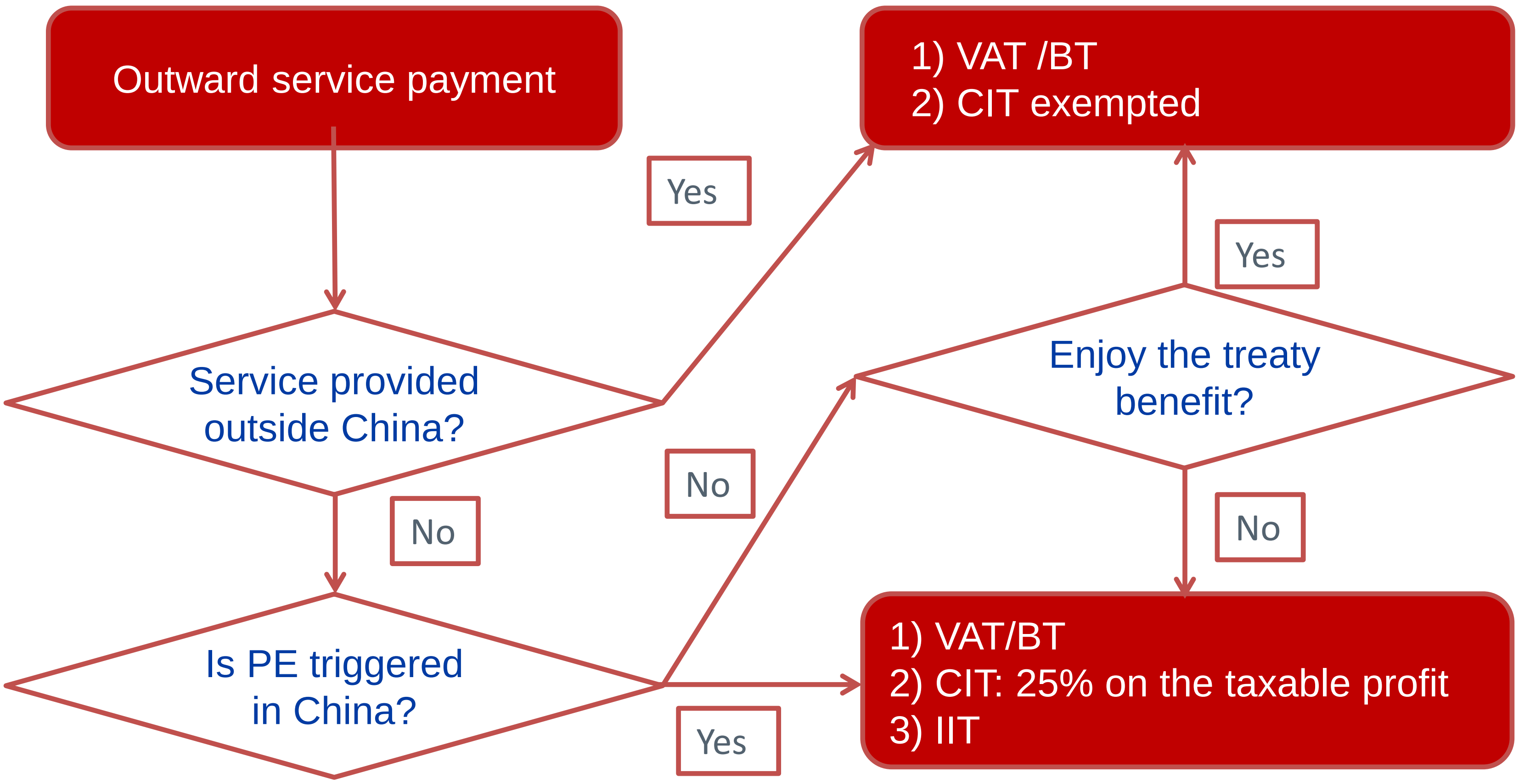
## 4. WITHHOLDING TAX PAYMENT

- Should be filed and paid within the tax filing period
- Late payment surcharge may be imposed by LTB

## 5. PAYMENT REGISTRATION

- Applicable to a single remittance of amount exceeding US$ 50,000
- For some payments, payment registration is not required, such as overseas travel expenses, import & export insurance, commissions, international transportation...

# Tax Assessment – Outward Service Payment



# Tax Assessment – Royalty / Interest

Royalty/Interest

Enjoy the treaty benefit?

Yes

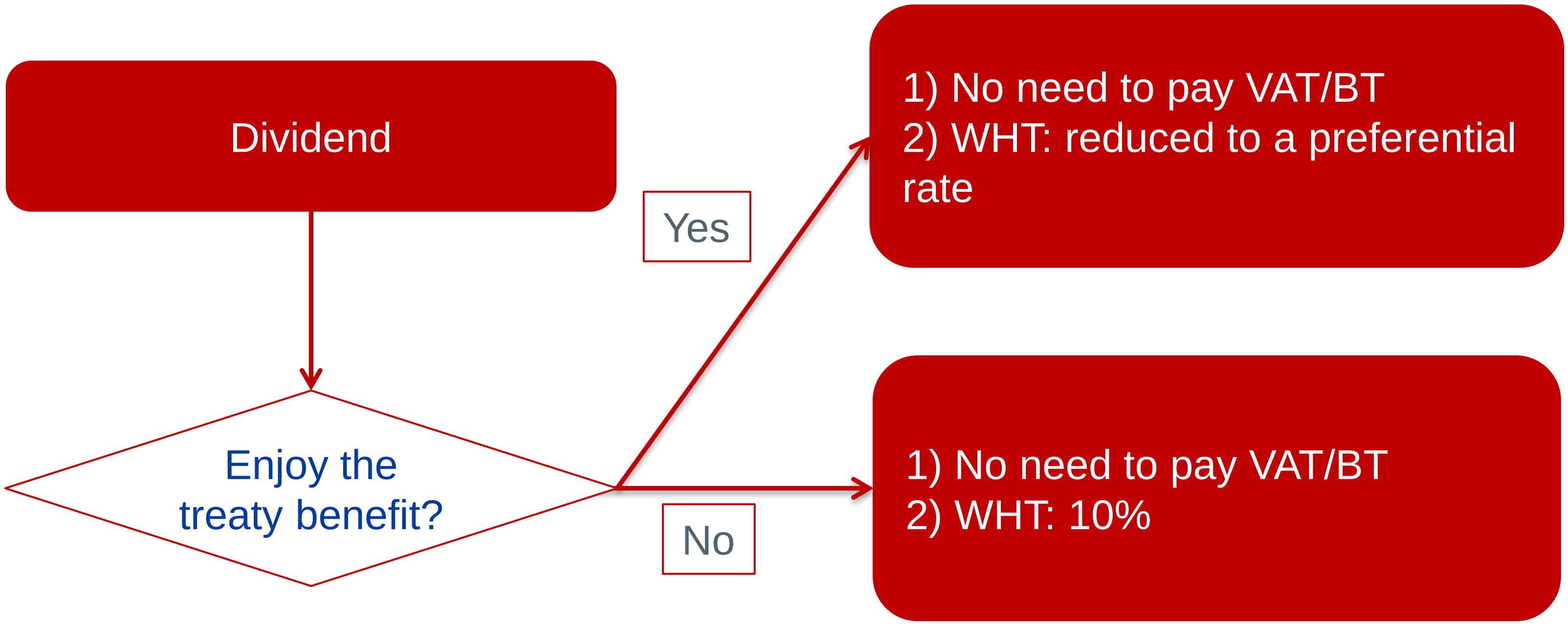
1) VAT 6% on royalty
2) BT 5% on Interest
3) *VAT or BT exemption to special items **
4) WHT: preferential treatment

No

1) VAT 6% on royalty
2) BT 5% on interest
3) *VAT or BT exemption to special items **
4) WHT: 10%

*Note *: VAT and BT exemption needs special approval.*

# Tax Assessment – Dividend



# Taxes Involved with Cross-border Transactions

| Tax | Service Fees | | Royalty/ Interest | Dividend |
|---|---|---|---|---|
| | PE | Non-PE | | |
| VAT / BT & surcharges | Y | Y | Y | N/A |
| 25% CIT<br>(Based on DPR) | Y | N/A | N/A | N/A |
| 10% or less WHT | N/A | N/A | Y | Y |

# CASE STUDY I

How to manage the reimbursement and allocation of expenses between related parties to avoid unwanted tax bureau scrutiny

# Reimbursement and Allocation of Expenses between Related Parties

- <u>Qualified Payment Items</u>
  - ➢ Reimbursement between related entities, such as pre-operating expenses, salaries, overseas insurances, etc.
  - ➢ Allocation of expenses between related entities

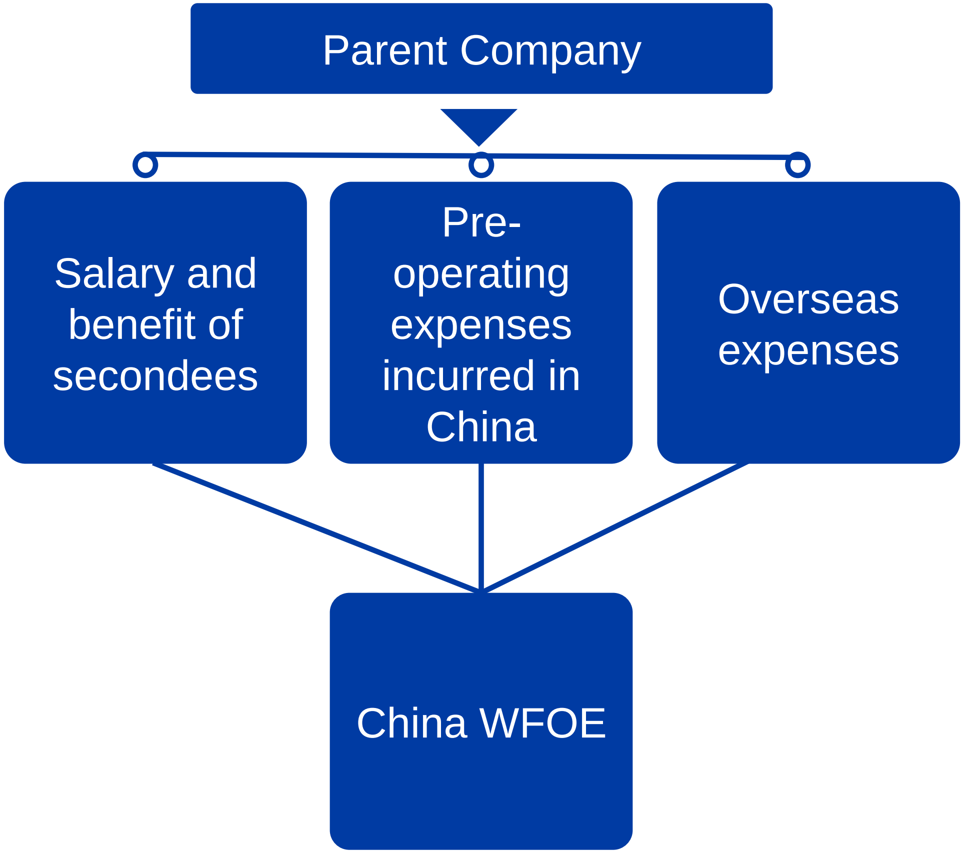
- <u>Document Required</u>
  - ➢ Original contracts between China entity and suppliers
  - ➢ Reimbursement or cost allocation agreement between China entity and the overseas related entity
  - ➢ Payment notice

- <u>Time Limit</u>
  - ➢ Within 12 months

# Case Study I

## Facts

- The parent company would settle the salary and benefits to the secondees and expenditures in the initial setup phase in and outside of China
- The parent company seek to recover such costs from its WFOE in China




## Issues

- Whether the payment for secondees is merely for cost reimbursement or in the nature of service fee?
- Whether the WFOE signs the contract and obtain the official invoices from domestic suppliers?
- Whether  the WFOE is responsible to withhold taxes for overseas suppliers?

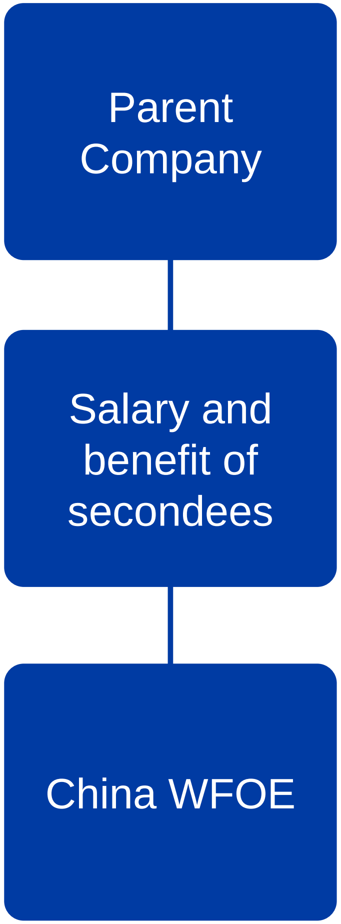
# Case Study I

<u>Secondment vs. Service</u>

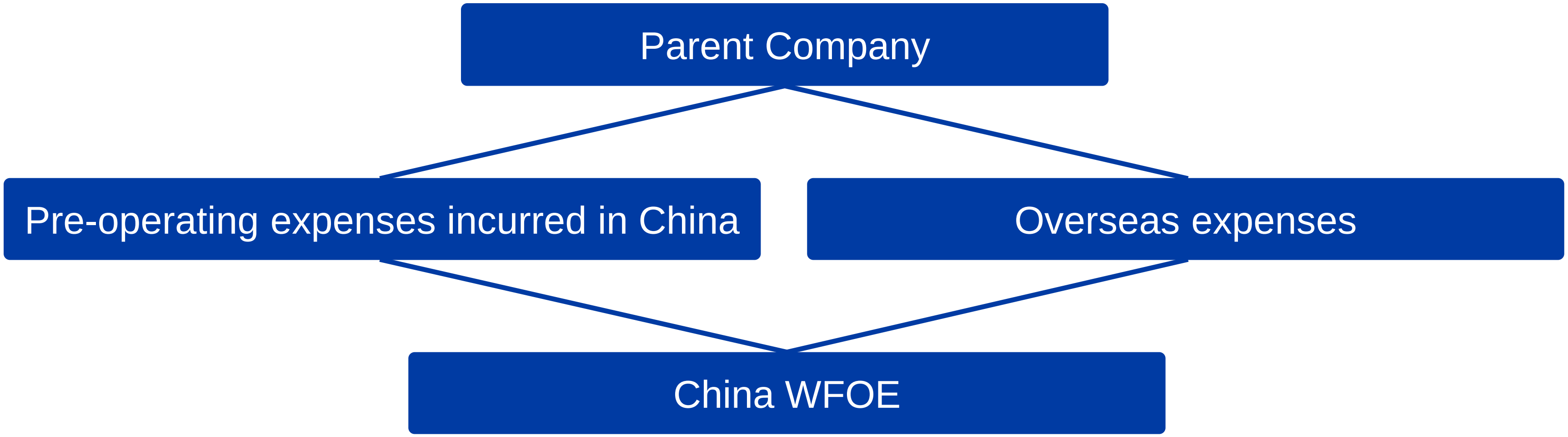
- Main Principles
  - Responsibilities & risks of the secondees' work fully borne by China WFOE
  - Secondees' performance assessed by China WFOE
    
    Double line reporting?

- Factors
  - Parent company would not gain any financial benefits from the secondment arrangement
  - Secondees would fully pay IIT on their income that is borne by China WFOE
  - China WFOE determines the number, qualifications, salary and working location

- Issues
  - Indirect management costs for secondees?
  - No charge back to WFOE ?
  - IIT on time-apportionment?



# Case Study I




<u>Domestic Expenses</u>

- China WFOE should sign the contract with domestic suppliers;
- VAT/BT tax invoices must be issued in the title of China WFOE.

<u>Overseas Expenses</u>

- China WFOE should withhold taxes for either overseas suppliers or the parent company

# CASE STUDY II

How to repatriate or distribute profits and enjoy a lower withholding tax rate on dividends

# Profit Repatriation

## When The Profit Is Allowed To Be Repatriated?

- The WFOE’s registered capital has been injected within the time limits as set out in the Article of Association;
- The WFOE’s prior year’s loss has been fully made up;
- The WFOE has drawn 10% of the rest after-tax profits as the company's statutory common reserve;
- The WFOE’s relevant taxes have been fully paid up;
- The WFOE has sufficient cash for dividend distribution;
- The WFOE’s board of directors approved the distribution through a board resolution.

# Profit Repatriation

## What Documents Are Required?

| Document | Required by Banks | Required by Tax Authorities |
|---|---|---|
| Audit Report for Profit-making Years | √ | √ |
| Annual CIT Returns and quarter and annual tax receipts for profit-making years | | √ |
| Financial Statement in the Year of Profit Distribution | | √ |
| Capital Verification Report | √ | √ |
| Articles of Association of and All Amendments | | √ |
| Board Resolution for Dividend Repatriation and Chinese translation | √ | √ |
| Payment registration record | √ | |

# Profit Repatriation

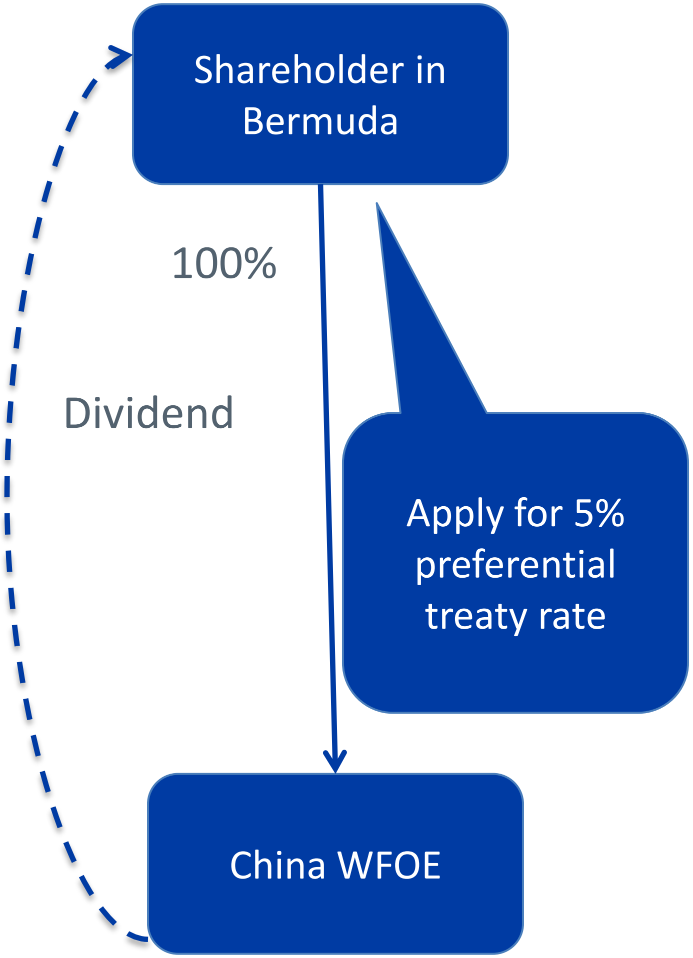
## When The Withholding Obligation For Dividend Remittance Arises?

| Situation | Timing |
|---|---|
| Payment of dividend is after the declaration date | Withholding obligation arises on the day when the dividend is declared |
| Payment of dividend is before the declaration date | Withholding obligation arises on the day when the payment is made |

# Case Study II

## Facts

- The Shareholder of China WFOE is registered in Bermuda but does not need to pay tax in Bermuda according to local tax law;
- The control and management of the shareholder is exercised in Singapore so that it is a tax resident in Singapore;
- The shareholder is listed in Singapore;
- It is an investment holding company holding and managing a large investment portfolio in various countries.



# Beneficial Owner

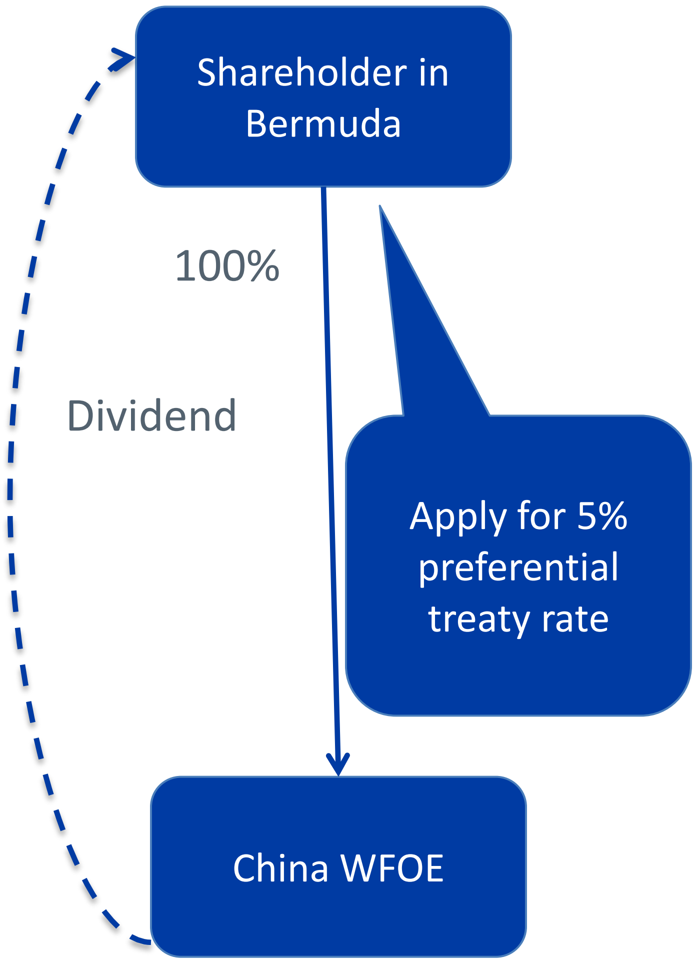
- <u>Beneficial Owner Definition</u>
  - A person that has the ownership and control over the income and rights or properties from which income is derived;
  - Can be an individual, company or any other organization;
  - Generally engage in substantive business activities (i.E. Manufacturing, trading and management activities);
  - Agents and conduit companies shall not fall under the scope of "beneficial owners".

- <u>Unfavorable Factor Tests</u>
  - The applicant is obligated to pay or distribute all or the majority of its income (e.G. 60% and above) to residents of a third country (region) within a stipulated period (e.G. Within 12 months from receipt of income);
  - Except for properties or rights from which income is derived, the applicant has little or no other business activities;
  - Where the applicant is a corporation, its assets, scale of operations and staffing of are relatively small (or lesser) and not commensurate with the amount of the income;
  - The applicant has little or no control or right of disposal over income or properties or rights from which income is derived, and bears no or little risk;
  - The counterparty country (region) of the tax agreement does not levy tax or exempts tax on the relevant income, or the actual levy rate is very low;
  - Except for loan contracts from which interest is derived and paid, there exist other loan or deposit contracts between the creditor and a third party which are similar in respect of amount, interest rate and date of execution, etc.; And
  - Except for transfer contracts for copyrights, patents, proprietary technologies and other use rights from which royalties are derived and paid, there exist transfer contracts between the applicant and a third party pertaining to copyrights, patents, proprietary technologies and other use rights or ownership.

# Case Study II

## Analysis

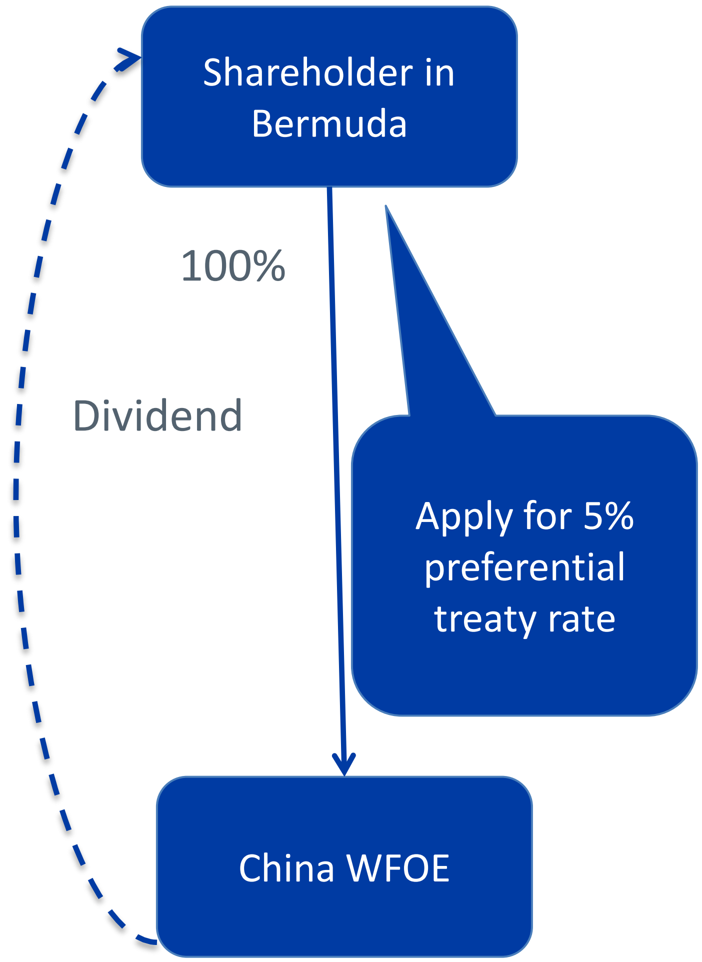
- The shareholder is listed in Singapore;
- It has address in Singapore and has significant amount of total assets;
- It has no staff but has directors who responsible for the portfolio of investment, strategic management, administrative and finance support functions;
- It holds more than one subsidiaries and has recent active merge and acquisitions;
- No tax paid in Singapore but it controls the dividend which would be used to finance the operations and investment activities.



# Case Study II

<u>Conclusion</u>

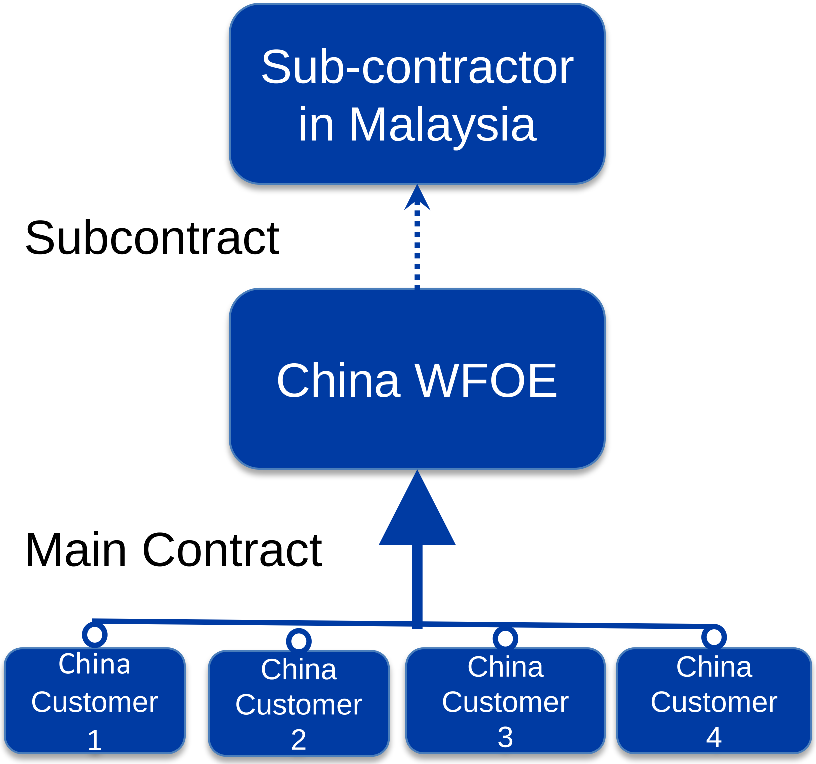
Beneficial Owner is approved by Tax Authorities!



# CASE STUDY III

What are the new cross-border tax withholding rules without need of a Tax Clearance Certificate

# Case Study III




## Facts:

- China WFOE provided technical services for China customers;
- The subcontractor is the WFOE's affiliated company in Malaysia who provides majority of services for WFOE's customers;
- China WFOE signed subcontracts with the Malaysian company for each project separately.
- The Malaysia company arranged personnel to assist the WFOE in providing labor services in China for less than 183 days for each project, but accumulatively more than 183 days.

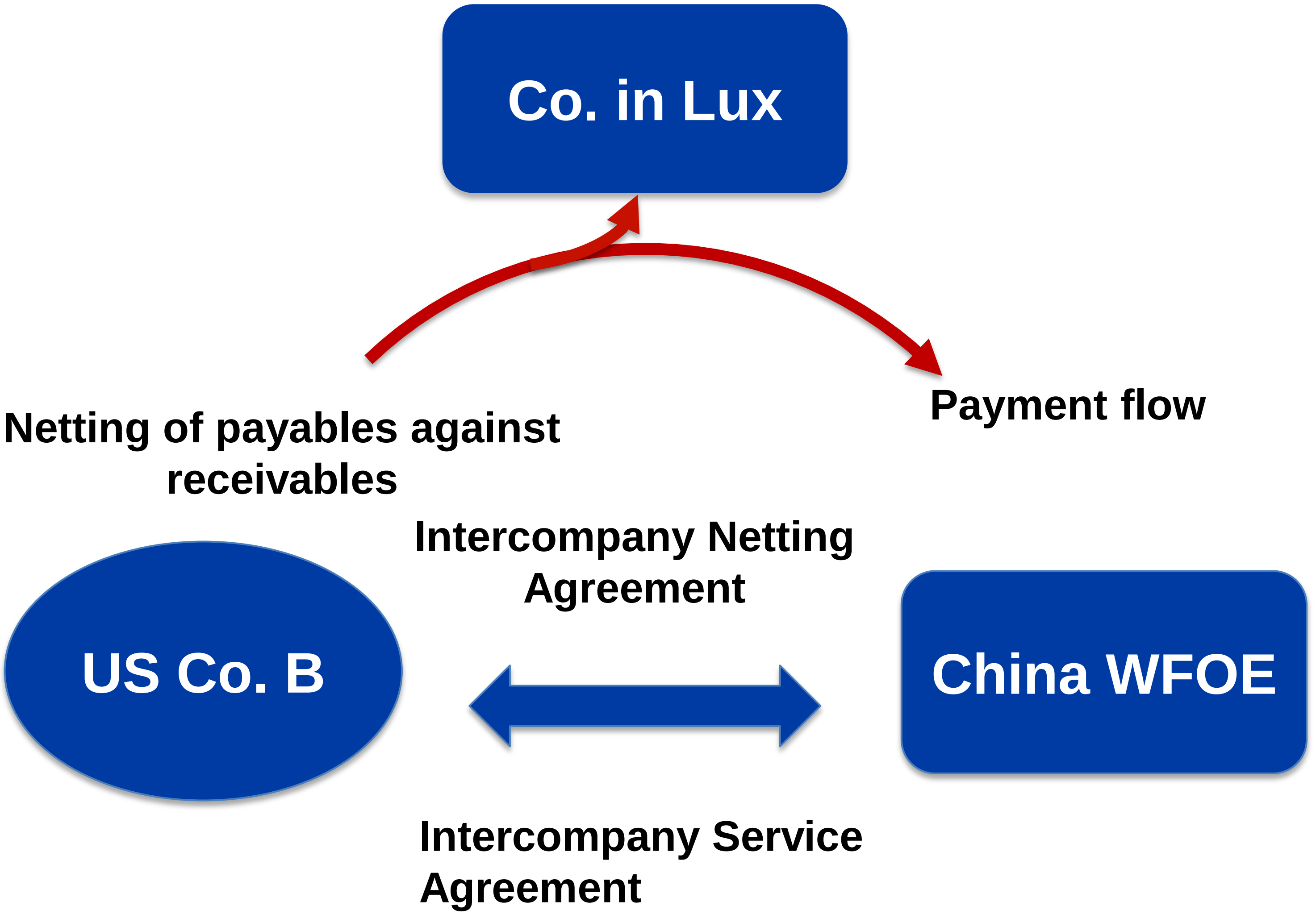
## Issues:

These projects was assessed as connected projects and the Malaysian company was considered to have a PE in China.

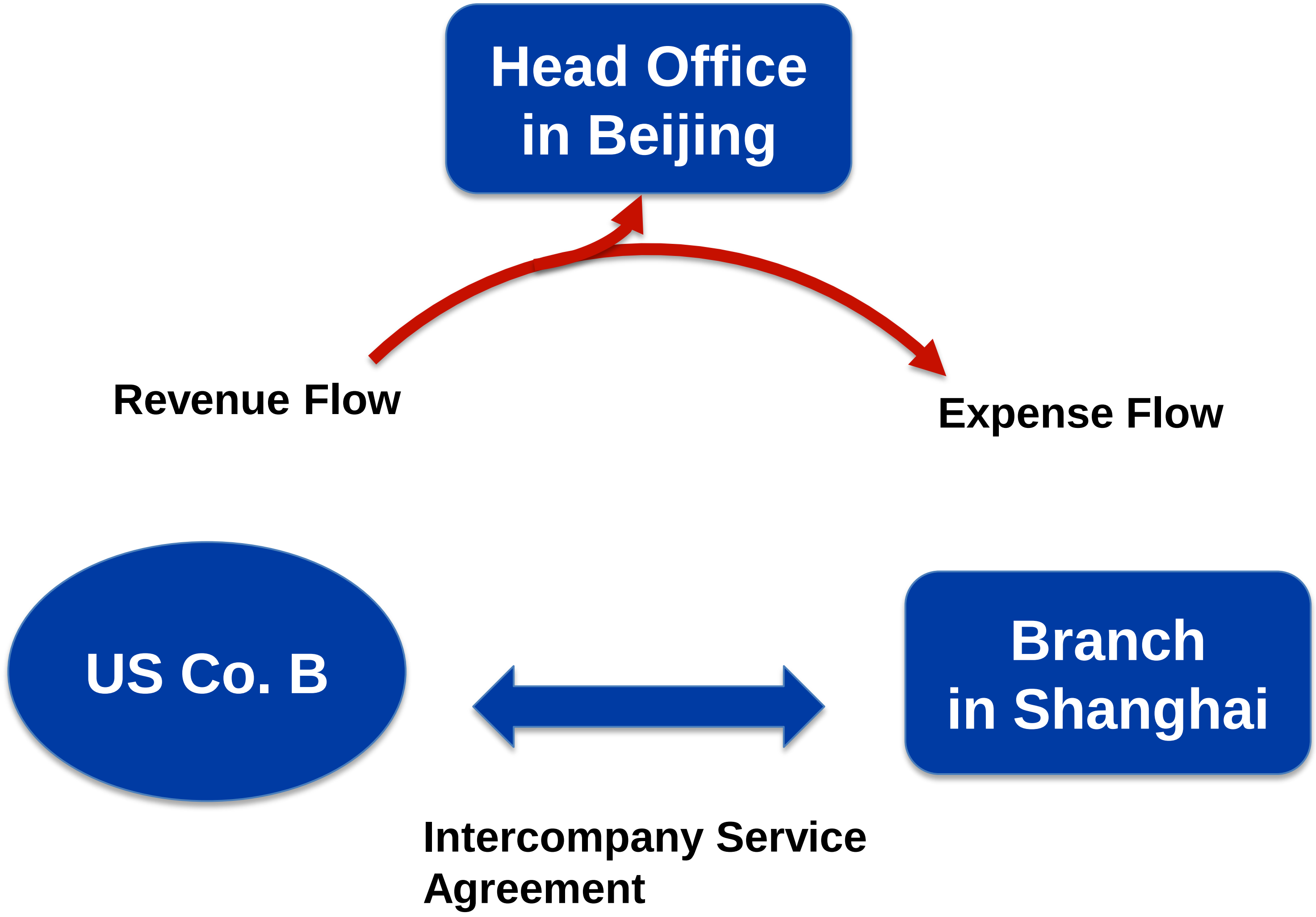
# CASE STUDY IV

How to apply for VAT exemption on cross-border services

# Case Study IV



# Case Study IV



# SUMMARY OF KEY TAKEAWAYS

1. Cross-border FX reimbursement and allocation of expenses among related entities must be completed within twelve months.
2. Corporate profits may be repatriated as dividends under limited circumstances and business decision making will be affected.
3. Although cross-border transactions may be made and withholding taxes paid later, a careful tax assessment beforehand will lower the risk of mistakes and future penalties.
4. To ensure VAT exemption during the provision of cross-border services, taxpayers should maintain a qualifying services contract and supporting documentation.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