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7.4. Profit Repatriation and Group optimization (RC)

Introduction

While international Groups consolidate their subsidiaries and in their financial statements it would not really matter where the profits are being earned, they often have requirements regarding the payment of dividends of their shareholders or the consolidation of liquidity in their headquarters for extending business operations. Additionally, getting profits out of China can be a tiresome process with a lot of pitfalls and therefore also from the risk perspective it might be beneficial to consolidate the earnings in one central place. This chapter will make some simple comparisons regarding the repatriation of profits to the holding company.
Please note that while in theory this is easy, especially the sensitive topic of transfer pricing can bring additional risks of money outflow due to penalties at the local entity.

Scenario 1: Comparison base

Let us assume the following situation as a very simplified starting point: You have a local entity which belongs 100% to the holding company and therefore gets consolidated in their financial statements. The holding sells exactly one good with production cost of 50k to the local entity for the price of 100k which resells the goods for the price of 200k to the local market.

For the sake of this example, let us assume:

- We have only one currency
- There are no fixed costs for holding and local entity
- Transport + Insurance is 4% of the Cost of Goods
- Customs Duty is calculated based on the landed costs of the goods, meaning Cost of Goods including Transport and Insurance. Customs duty in this example is 10%.
- Corporate Income Tax is 25%. For the payment of Dividends, 10% Withholding Tax is due.
- We assume that the company already fulfilled the requirement of it´s statutory common reserve before dividends repatriation
- We ignore the corporate income tax of the Holding since it does not have any influence on the comparability of the different calculations
- We also do not regard VAT since it does not influence the comparability of these calculations. Import VAT is calculated on the basis of Landed costs of Goods + Customs duty.

You can see the detailed calculation in the following diagram, also indicating a comparison baseline for the other scenarios.

			Holding	Local Entity
Profit from Goods	-Cost of Goods		- 50.000	
	+Revenue		100.000	
	=Profit from Goods		50.000	
Subsidiary	- Cost of Goods			- 100.000
	- Transport + Insurance	4%		- 4.000
	- Customs Duty	10%		- 10.400
	+Revenue			200.000
	=Profit before Tax			85.600
	-Corporate Income Tax	25%		- 21.400
	=Profit after Tax			64.200
	-Withholding Tax	10%		- 6.420
	=Transferred Profit			57.780
Total Profit before Tax: Holding	Profit from Sales of Goods	46%	50.000	
	Profit from License Fees	0%	-	
	Profit from Dividends	54%	57.780	
	Total Profit before Tax	100%	107.780	

Figure 17: Group Optimization: Example base

Scenario 2: Transfer Price Increase

One way to repatriate profits is the increase of transfer prices which makes the cost of goods for the local entity much more expensive which leads to

- an increase of the direct profits from at the holding
- a decrease of profits of the local entity
- an increase of money outflow of the company due to transport, insurance and customs duty

While for the local entity it leads to a big decline of the profits, for the group this is very

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beneficial as you can see in the total profits before tax.

			Holding	Local Entity
Profit from Goods	-Cost of Goods		- 50.000	
	+Revenue		150.000	
	=Profit from Goods		**100.000**	
Subsidiary	- Cost of Goods			- 150.000
	- Transport + Insurance	4%		- 6.000
	- Customs Duty	10%		- 15.600
	+Revenue			300.000
	=Profit before Tax			**128.400**
	-Corporate Income Tax	25%		- 32.100
	=Profit after Tax			96.300
	-Withholding Tax	10%		- 9.630
	=Transferred Profit			**86.670**

Total Profit before Tax: Holding	Profit from Sales of Goods	54%	100.000	
	Profit from License Fees	0%	-	
	Profit from Dividends	46%	86.670	
	Total Profit before Tax	100%	**186.670**	

Figure 18: Group Optimization:Increase of transfer prices

Scenario 3: License Fees

Additionally, the introduction of license fees could be considered by the holding under certain circumstances, e.g. for using the brand or technology of the holding.
This leads to an

- additional outflow of profits from the local entity
- additional outflow of profits from the whole group since for license fees also Withholding Tax, VAT and surcharges which are calculated on the basis of the VAT have to be considered.

While this has another strong influence on the local profits of the company, for the whole group it is beneficial due to the lower taxation rates compared to the corporate income tax.

			Holding	Local Entity
Profit from Goods	-Cost of Goods		- 50.000	
	+Revenue		150.000	
	=Profit from Goods		**100.000**	
Subsidiary	- Cost of Goods			150.000
	- Transport + Insurance	4%		6.000
	- Customs Duty	10%		15.600
	+Revenue			300.000
	-License Fees (Cost)	10%		30.000
	=Profit before Tax			**98.400**
	-Corporate Income Tax	25%		24.600
	=Profit after Tax			73.800
	-Withholding Tax	10%		7.380
	=Transferred Profit			**66.420**
Transferred Profits from License fees	License Fees (Revenue)		30.000	
	-Withholding Tax	10%	- 3.000	
	-VAT	6%	- 1.908	
	-- Urban Construction Tax	7%	- 134	
	--Education Surcharge	3%	- 57	
	--Local Education Surcharg	2%	- 38	
	=Profit from License Fees		**24.863**	

Total Profit before Tax: Holding	Profit from Sales of Goods	52%	100.000	
	Profit from License Fees	13%	24.863	
	Profit from Dividends	35%	66.420	
	Total Profit before Tax	100%	**191.283**	

Figure 19: Group Optimization: License Fees

Common pitfalls

- If a license fee gets charged by the group for services which could get paid directly by the local entity with tax incentives as deductibles for the corporate income tax, e.g. overseas Research & Development, the business case might not be valid anymore.
- Possible profit repatriation is reduced by
    - The requirement of an audited financial statement
    - The obligatory statutory common reserve
    - The requirement that all formerly accumulated losses must be offset by the accumulated profits
- All of the above calculations are excluding VAT. VAT for incoming goods is calculated on the basis of the landed price of the cost of goods including transportation, Insurance and customs duty.
  Even while this will not have an effect on any profitability, this will influence your liquidity planning.
- Transfer pricing, including the introduction of license fees, is a sensitive topic which can lead to penalties and problems for the local entity. Please refer to the chapter about transfer pricing to

DRAFT

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see possible limitations regarding transfer pricing and license fees. For all transfer price related topics it must be ensured that they are at “arm´s length principle”.

- Local companies mostly see the influence on their local profit and loss calculation leading to tension towards the headquarter. At the same time, the responsible tax authorities or auditors for the holding might put up additional requirements regarding the taxation of local entities if they have the concern that the holding does not get enough profit contribution especially in multi-stage production and sales channels.
- All of the percentages regarding taxes, surcharges, fees and customs duties are examples. Depending on your real situation, e.g. the country your holding or your local entity is located at or the products you are selling, the rates might differ.
- Royalties are only tax-deductible for the Corporate income tax of the local entity if a set of specific conditions is met, e.g. they are directly beneficial for the company, are directly related to their business and the receiving party is the beneficial owner.
- Royalty agreements are similar to service fees but due to their nature they have to be registered with the trademark bureau.

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8. General Trade Management

Introduction

This chapter is supposed to give you a short overview about relevant aspects considering especially regarding the supply chain and logistics, e.g.:

- How to evaluate suppliers and vendors
- Implications of the “International Commercial Terms” (INCOTERM) regarding Logistics
- Import Regulations, e.g. what kind of licenses you need
- The importance of protecting your own Intellectual property and some basic steps how to do so
- Some basic considerations regarding Anti-Trust-Law which might protect you from corresponding lawsuits.

Very often problems arise because you are either not following the laws and regulations or because you are not choosing optimal contract terms: This chapter can help you by avoiding some of these common problems.

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