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Increase Your Profitability

By Chris Devonshire-Ellis

Utilizing America's double tax agreements

Many American investors in China are unaware that they are missing out on tax concessions made possible by the many double tax agreements (DTAs) the US has signed. This is maybe because of the somewhat negative name – "Double Tax? No way!" – and possibly because most American executives tend to use legal counsel rather than tax experts when it comes to incorporation procedures. In China, tax planning is – or should be – an important component of getting your business's financial modeling right. Yet it often gets neglected as a post-incorporation issue, and then buried under the actual organizing of standard accounting and tax filing duties.

Before it will grant double taxation relief, the State Administration of Taxation must be satisfied that the applicant company is indeed the "beneficial owner" of the Chinese subsidiary. This can pose a significant problem, especially for companies that were established many years ago through a holding company in Hong Kong, and thus did not consider their future qualification as "beneficial owners." Therefore, conducting a preliminary assessment of a company's situation is typically the first step taken by Dezan Shira and Associates professionals to determine the likelihood of approval prior to submitting an application for double taxation relief.

The US has had a DTA in place with China since 1987. It ensures that companies and individuals don't get taxed in both countries, and lays out the tax reporting mechanisms to ensure this need not be so. But the treaty does more than that: it describes specific trade in service situations that, if used correctly, can minimize tax.

Would you rather pay 25 percent tax or 10 percent?

One example lies within Article 11 of the treaty, which refers to "royalties" and dictates the terms of tax that can be charged on the provision of such services. Many American companies may not be aware that they can charge their China subsidiary for the use of royalties. This can include use of the company brand names, as well as trademarks and patents.

Not charging royalties to the Chinese subsidiary means that excess money left in China is ultimately charged at the Chinese profits tax rate of 25 percent, and is then subject to a further 10 percent dividends tax if those profits are repatriated. But using the US-China DTA means that, under certain conditions, royalty fees can be imposed upon the China entity. In that case, the China entity pays a 10 percent withholding tax. That is quite a saving. Would you rather pay 25 percent tax or 10 percent? The US-China DTA provides such options.

However, these tax reduction mechanisms do not automatically appear. They need to be properly planned, and a strategic mechanism to approach the Chinese tax bureau agreed upon and implemented. This involves preparing supporting documentation – which needs to be presented in Chinese – and will require head office administrative help in addition to professional assistance in China. But the profitability of the business model and tax dollars saved are worth far more than the time and fees spent in invoking treaty benefits with the Chinese tax bureau.

The US also has DTAs with many other countries in Asia. Examining each of these as part of a profit-enhancing strategy for your Asia operations is something that all American subsidiaries in Asia should be looking into.