

Notice regarding the Provisional Deferral Treatment for Withholding Tax on Direct Re-investment by Foreign Investors Using Profits Distributed from Tax Resident Enterprises in China

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On December 21, 2017, the Ministry of Finance, State Administration of Taxation, National Development and Reform Commission, and Ministry of Commerce jointly released the “Notice Regarding the Provisional Deferral Treatment for Withholding Tax on Direct Reinvestment by Foreign Investors Using Profits Distributed from Tax Resident Enterprises in China” (Caishui [2017] 88, hereinafter, “the Circular”). The Circular specifies the applicable conditions, procedures, obligations, follow-up administration, etc. for the “measures to allow foreign investors to enjoy a withholding tax deferral treatment (hereinafter, “tax deferral treatment”) on the direct re-investment of profits distributed from Chinese tax resident enterprises into China’s encouraged projects”, which is included in the “Notice Regarding Measures on Promoting the Growth of Foreign Capital in China” (Guofa [2017] No.39, hereinafter, Circular 39) released by the State Council on August 18, 2017. The Circular took effect retroactively to January 1, 2017.

1. Background of the Policy

Under the existing Enterprise Income Tax Law, interest, dividends and other equity investment profits paid to a non-resident company are subject to a withholding tax of 10% or of a preferential tax rate under certain tax treaties.

Meanwhile, many countries are introducing preferential tax treatment policies that encourage investment in order to further attract foreign capital. Likewise, China released a tax deferral treatment in Circular 39. The treatment is intended to encourage foreign companies to continue expanding their investments in China by presenting a preferential policy to reduce tax costs incurred in re-investing dividends.

2. Details of the Policy

The Circular specifies the applicable conditions, procedures, etc. for the tax deferral treatment, which was released in Circular 39, as outlined below.

- (1) **All of the following conditions (a to d) need to be met** for the tax deferral treatment to be applied.
 - a. Direct investments in Chinese companies specified below (refer to [Fig.1] for details)
 - b. The profits distributed to a foreign company should be equity investment profits such as declared dividends or realized retained earnings of China resident enterprises
 - c. The funds (assets) to be reinvested must be directly paid or transferred to a Chinese resident company or the third-party seller disposing the Chinese company’s equity interests
 - d. Reinvestments must be made to one of the designated encouraged industries set forth under the Foreign Investment Industrial Guidance Catalogue or the Catalogue of Priority Industries for Foreign Investments in the Central and Western Regions

[Fig.1] The Specific Content of Direct Investment

1	Increase in the paid-in capital or capital reserves of an existing Chinese resident company
2	Establishment of a new Chinese resident company
3	Acquisition of equity interests in Chinese resident companies from third party (s)
4	Other forms of investment activities permitted by the Ministry of Finance and/or State Administration of Taxation

(2) Application to authorities and internal procedures

Foreign investors that meet the deferral conditions need to declare and provide the profit-distributing enterprise with documents supporting the fulfillment of those conditions. If the profit-distributing enterprise considers that the documents submitted by foreign investors are in conformity with the regulations, the profit-distributing enterprise may temporarily not withhold the withholding tax and shall complete filing procedures with its competent tax authorities.

(3) When it is determined that the conditions are not met

If the relevant tax authorities, through follow-up administration, determine that a foreign investor that is enjoying the tentative tax deferral treatment fails to meet the conditions for the tax deferral benefit, the foreign investor will be treated as having failed to file and pay withholding tax and be subject to late payment interest from the date on which the relevant profits were paid, except if the situation was caused by the profit-distributing enterprise.

(4) Deadline for application/Retrospective treatment for investments before the release of the Circular

Foreign investors who are eligible for the withholding tax deferral treatment but are yet to apply for it can do so retrospectively within 3 years from the date the tax was paid and claim a fund. The Circular is applicable to equity investment profits received by foreign investors on or after January 1, 2017.

(5) Withdrawal from reinvestments (equity transfer, liquidation, etc.)

If a foreign investor that has enjoyed the treatment withdraws their direct reinvestments through equity transfer, equity buyback, liquidation, or other means, they should report and settle the deferred taxes with the relevant tax authority within 7 days from the receipt of the relevant payments from the withdrawal.

(6) Benefits in the case of special tax treatment

After a foreign investor has enjoyed the preferential tax treatment, if an investee enterprise undergoes restructuring which qualifies for special restructuring and was processed based on special restructuring tax treatment, the foreign investor may continue to enjoy the preferential deferred tax treatment.

3. Impact on Enterprises

The Circular enables foreign investors to reinvest by using the profits from their subsidiaries in China and be exempt from withholding tax if they meet certain conditions. Foreign investors that are generating profits in existing investment projects in China and considering reinvesting those profits in encouraged projects may become eligible for the preferential tax treatment by reviewing their investment schemes. As there still are many unclear matters in terms of actual operations, we need to pay attention to developments on this topic. We will continue to follow up on related information and share it as appropriate.

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