

China Tax Alert

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WHT Deferral Incentive for Profit Reinvestment in China

Regulations discussed in this issue:

- On 28 December 2017, the Ministry of Finance, State Administration of Taxation, National Development and Reform Commission, and Ministry of Commerce issued Caishui [2017] 88 (Circular 88), which provides foreign investors with a withholding tax deferral incentive for profit reinvestment in China, effective from 1 January 2017.

Background

With a view to encouraging overseas investors to expand investments in China, the Ministry of Finance ("MOF"), State Administration of Taxation ("SAT"), National Development and Reform Commission ("NDRC"), and Ministry of Commerce ("MC") on 28 December 2017 jointly released *<the notice on the issue that foreign investors' direct investment through distribution of profits will be tentatively exempt from China withholding tax>* Caishui [2017] 88 ("Circular 88") and relevant interpretations, which provide foreign investors with a withholding tax ("WHT") deferral incentive for profit reinvestments in China.

Circular 88 specifies the applicable conditions, procedures and obligations, follow-up administration, departmental coordination mechanism, tax treatment for investment withdrawals and period of execution regarding to this preferential tax policy.

Main contents

Profits derived by a foreign investor from resident companies in China will be entitled to a tax deferral incentive and temporally will not trigger withholding tax provided that they are reinvested in "encouraged projects" and where other conditions are met.

Main contents of Circular 88 include the following aspects:

1. Applicable conditions for obtaining the benefit

A. Definition of direct investment

Circular 88 states that in order to qualify for the tax deferral concession, foreign investors must use distributed profits from China resident companies for equity investment in the form of capital increase, capital injection and share acquisition, specifically include the following:

- increase of paid-in capital or capital reserves of resident enterprises in China;
- setting up a newly incorporated resident enterprises in China;
- acquisition of shares of resident enterprises in China from unrelated parties; or
- any other ways specified by the MOF and SAT.

Importantly, the above withholding tax deferral will not apply to the two specific situations where the profits are used:

- 1) to increase paid-in capital or capital reserves of publicly listed companies or to acquire shares in publicly listed companies unless the investment qualifies strategic investments pursuant to the *<Administrative Measures on Strategic Investment in Listed Companies by Overseas Investors>* (MOC Decree [2005] No. 28); or
- 2) for acquisition of shares from related parties.

B. Eligible distributed profits

The profits distributed to the foreign investors must be dividends, profit distributions and other returns on equity investments that arise from the distribution of realized retained earnings by China resident enterprises, including undistributed earnings in prior years.

C. Profit reinvestment shall be directly transferred

Profit reinvestment must be transferred directly to the accounts of invested enterprise or equity transferor rather than by transferring via a third party.

When the foreign investor makes the direct investment in cash, relevant payments have to be made directly from the account of the profit-distributing companies to the account of the invested companies or transferor in the case acquisition. The payment should not be made to other onshore or offshore accounts prior to direct investment. When the direct investment is made in the form of non-cash payment (i.e., tangible properties and securities etc.), ownership of such non-cash assets must be transferred directly from the profit-distributing enterprise to the invested enterprise or transferor in the case of acquisition, and should not be temporarily held by any other companies or individuals before the direct investment is made.

D. Encouraged foreign investment projects

The encouraged projects refer to the projects that fall within the encouraged foreign investment industry catalogue listed in the *<Foreign Investment Industry Guidance Catalogue>* or within the *<Superiority Industry Catalogue for Foreign Investments in Central and Western Regions>*.

Direct investment by overseas investors in encouraged projects refer to the invested enterprises engage in business activities listed in the two catalogues during the investment period, such as producing products or providing services, investing in construction projects, purchasing equipment and carrying out R&D activities.

Currently, both of the two catalogues above-mentioned are revised in year 2017. Subsequent updates released by the government shall apply to the preferential policy accordingly. Overseas investors may enjoy the policy as long as the invested enterprises engage in encouraged projects within the updated scope of the catalogues at that time.

2. Recordal filing procedures and follow-up administration

Overseas investors that meet the deferral conditions should file tax returns pursuant to relevant tax collection and administration requirements and provide the profit-distributing enterprise with documentations supporting the satisfaction of those conditions. If the profit-distributing companies believe that the foreign investors meet those conditions after reviewing the relevant documentations, the profit-distributing companies can then complete the recordal filing procedures with the in-charge tax authority and do not withhold relevant WHT tentatively.

The relevant tax authorities will conduct follow-up administration in respect of the incentives. If the tax authorities determine that a foreign investor fails to meet the relevant conditions for the tax deferral benefit, the foreign investor will be treated as having failed to file and pay WHT and will be subject administrative punishment, including late payment interest from the date on which the relevant profits were paid except for the case where the situation was caused by the profit-distributing enterprise.

3. Tax treatment for investment withdrawals and potential exemption

Investment withdrawals

If the foreign investor withdraws the direct investments that previously enjoyed the tax deferral benefit pursuant to Circular 88 through the means of equity transfer, buy-back and liquidation etc., the foreign investors should then report and pay relevant WHT to the in-charge tax authorities within 7 days upon receiving the relevant payments for the investment withdrawal.

Continuous entitlement of the benefits in the case of special tax treatment

If the foreign investors withdraw the direct investments that previously enjoyed the tax deferral benefit pursuant to Circular 88 through internal restructuring and such restructuring is eligible for special tax treatment and the foreign investors adopt the special tax treatment, the foreign investors can continue to enjoy the tax deferral benefit.

4. Effective date and retroactive effect

In order to effectively enhance foreign direct investment, Circular 88 has retroactive effect from January 1, 2017. The relief is applicable to profits distributed to overseas investors, on or after that effective date, including dividends and other equity investment proceeds, which are derived from the retained earnings of resident enterprises. Any overseas investors entitled to the concession but have paid WHT previously, can retroactively apply for the benefit and claim the tax refunds within 3 years of the payment.

KPMG observations

For multinational companies intending to make further investment in China, the newly released policy is to be welcomed. As the dividend WHT deferral is allowed for certain direct investments from now, it provides more flexibilities for the multinationals to choose between direct investment in China and traditional investment holding vehicles in Hong Kong or Singapore. This tax incentive demonstrates the determination of Chinese government to effectively attract foreign investment, and enhancing the attractiveness of FIE profits being reinvested in China.

As for the scope of investment proceeds being applied, it is clarified that profits distributed to overseas investors include dividends and other equity investment proceeds, which are derived from the retained earnings of resident enterprises, including the retained undistributed profits in previous years. We understand that the concession may also apply to retained earnings derived from periods prior to 1 January 2017 but not yet distributed.

As for the definition of resident companies in China in Circular 88, it refers to a resident company that legally incorporated in mainland China. In this connection, this definition covers both listed companies and unlisted companies established in China. As such, we understand that the WHT deferral is also applicable to the situation where an overseas investor use distributed profits from a publicly listed resident company to directly invest in “encouraged” projects of an unlisted company.

From the implementation perspective, there are some uncertainties that are to be further clarified in follow-up notices to be issued by the SAT. Such as:

- if the invested enterprise is engaged in multiple projects but not all of them are “encouraged projects”, how to determine if the investment is qualified for the relief? Should the assessment for example, be based on the revenue proportion of encouraged projects over the total revenues?
- in the case of investment withdrawals, how should the relevant tax incentive ‘claw-back’ obligations be completed? Specifically, should the relevant filing obligation be completed by the invested company, the original profit-distributing company, or the overseas investor? If the invested company and the profit-distributing company are located in different provinces, to which authority should they complete the filing and tax claw back payment?
- For dividends distributed by domestic companies to the overseas investor in the form of non-cash payment (i.e., tangible properties and securities etc.), the relevant tax treatment would also need to be further clarified.

It is noteworthy also that the practical interpretations of local tax authorities regarding the tax deferral benefit may be different, and in order to enjoy the tax deferral, enterprises should communicate with the in-charge authority proactively and promptly. Foreign investors would be well advised to closely monitor the further development regarding the implementation rules.

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