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## A Brief Analysis of the Notice on Temporarily Deferring Withholding Tax on Profits Distributed to Foreign Investors Used for Direct Investment

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On December 28, 2017, the Ministry of Finance, the State Administration of Taxation, the National Development and Reform Commission, and the Ministry of Commerce jointly promulgated the Notice on Temporarily Deferring Withholding Tax on Profits Distributed to Foreign Investors Used for Direct Investment (Cai Shui [2017] No.88, the “Notice”). The Notice specifies that such deferred tax benefits shall be retroactively applicable since January 1, 2017.

### Background

The Chinese government’s tax policy on foreign investors’ income acquired within China has evolved through different stages since China was open to foreign investment:

1. At the early stage of China’s economic reform, the Chinese government provided attractive preferential tax policies to encourage foreign investments. According to the *Corporate Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises*<sup>1</sup>, issued in 1991, foreign investors’ income generated from foreign invested enterprises (the “FIEs”) can be fully repatriated without any income tax being levied.

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2. On January 1, 2008, the *Corporate Income Tax Law of the People's Republic of China*<sup>2</sup> and the *Implementation Regulations for the Corporate Income Tax Law of the People's Republic of China*<sup>3</sup> became effective, and the *Corporate Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises* expired at the same time. As a result, there are no preferential policies on foreign investors' income generated on the profits of the FIEs; and, up until now, foreign investors need to pay withholding taxes on their dividend income from the FIEs, as well as their other incomes from China. The specific applicable withholding tax rate depends on the jurisdiction where the foreign investor is from. Under current regulations and practices, foreign investors' dividend income are generally subject to a 10% withholding tax, unless there are any other discounted rates under applicable bilateral taxation treaties between China and the jurisdiction where the foreign investors are from.
3. In August of 2017, the State Council promulgated the *Notice of the State Council on Several Measures for Promoting Foreign Investment Growth*<sup>4</sup>, issuing 22 guidelines for promoting foreign investments in China, among which tax policies encouraging foreign investors to expand investment in China are also included. Such tax policies referred to the guideline that, if foreign investors' dividend income from the FIEs are directly re-invested in encouraged investment projects and complies with other applicable requirements, the deferred tax policy shall be applicable and the withholding income tax shall be temporarily suspended.

We understand that the Notice was issued under the above-mentioned guideline and specifies the relevant details of the deferred tax policy. Below, we provide a brief overview of the main contents of the Notice.

## Introduction

### I. Preferential Deferred Tax Policy

The Notice provides that foreign investors' dividend income from distributed profits paid by resident enterprises in China on or after January 1, 2017 and which are directly re-invested in encouraged investment projects and complied with certain other conditions (further discussed below), may enjoy the deferred tax policy and the withholding income tax are temporarily suspended.

It is worth mentioning that, (a) the foreign investors referred herein are the non-resident enterprises, as defined in the *Corporate Income Tax Law of the People's Republic of China*; which means if the foreign individuals directly hold the equities of the FIEs, the preferential policy specified under the Notice shall not be applied to such foreign individuals; (b) the preferential policy specified under the Notice does not exempt the foreign investors from withholding income tax, but rather grants a deferral treatment on withholding

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income tax under certain conditions, which means when the foreign investors eventually recoup its investments and repatriate such investment income from China, the foreign investors shall still pay the deferred taxes in accordance with the relevant regulations.

### II. Conditions for Preferential Policy

Article 2 of the Notice specifies the four conditions which must be satisfied for the foreign investors to enjoy the preferential deferred tax policy:

1. The distributed profits which may enjoy the preferential deferred tax policy must be the stock interest, dividend, and other earnings from equity investment as realized retained earnings from the resident enterprises in China and which are actually distributed to the foreign investors.
2. The foreign investors' direct investment must be used for applicable equity investment activities, including establishment of new entities, capital increase or equity acquisition of exiting entities, and etc. Except for strategic investment<sup>5</sup> by the foreign investors to public companies, equity investment activities in public company or affiliates, including new investments or re-investments in public companies, acquisition of issued shares of public companies, or investment or acquisition of the foreign investors' affiliates in China, do not meet the conditions for enjoying the preferential deferred tax policy.

"Equity investment activities" include (a) new increase or transfer of the paid-in capital or capital reserve of resident enterprises in China; (b) new establishment of the resident enterprises in China; (c) acquisition of shares of resident enterprises in China from non-affiliates; and (d) others specified by the Ministry of Finance or the State Administration of Taxation.

3. The foreign investors must invest in encouraged investment projects to enjoy the preferential deferred tax policy. The so-called "encouraged investment projects" refer to the re-invested enterprises (the "**Re-invested Enterprises**") doing business activities which fall within the activities listed under the Encouraged category as specified under the *Catalogue of Industries for Guiding Foreign Investment* or listed under the *Catalogue of Priority Industries for Foreign Investment in Central and Western China*<sup>6</sup>. If the tax authorities are not certain of whether the investment projects are the "encouraged investment projects", they may ask for opinions from the development and reform authority and/or the department

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of commerce at the same level.

4. The distributed profits which the foreign investors used for direct investment must be, (1) if the profits are distributed in cash, paid directly from the profit distributing enterprises (the “**Profit Distributing Enterprises**”) to the Re-invested Enterprises or the transferor of equity, or (2) if the profits are distributed in kind or in securities, transferred directly from the Profit Distributing Enterprises to the Re-invested Enterprises or the transferor of equity. Moreover, such distributed profits must not be paid or transferred intermediary to any third party, otherwise the preferential deferred tax policy may not be applicable.

### **III. Procedure for Applying the Preferential Policy**

When a foreign investor is informed that its invested enterprise in China intends to distribute profits to it; and the foreign investor considers itself qualified for the preferential deferred tax policy, such foreign investor may provide relevant information and supporting materials to the Profit Distributing Enterprise in accordance with Article 3 of the Notice. After the Profit Distributing Enterprise reviewed the materials submitted by such foreign investor and considered such foreign investor qualify under the Notice, the Profit Distributing Enterprise shall not withhold any applicable withholding taxes which should be levied on the distributed profits, and shall pay or transfer the entire amount of the distributed profit to the Re-invested Enterprise, and make the applicable registration procedure to the applicable tax authority of such Profit Distributing Enterprise.

### **IV. Collection of the Deferred Tax**

According to Article 7 of the Notice, when the foreign investors, whose distributed profits enjoyed the preferential deferred tax policy, eventually recoup their investments using such distributed profits through share transfer, redemption, liquidation, etc., the foreign investors shall file and pay to the tax authority any applicable deferred tax within 7 days after receiving income.

Concerning the collection of the deferred tax, we would like to draw everybody’s attention to the following two points:

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1. During the period when the foreign investors hold the equities of the Re-invested Enterprises, if the Re-invested Enterprises are restructured and the Re-invested Enterprises choose to apply the special tax treatment of enterprise restructure under relevant regulations, the foreign investors may continue to enjoy the preferential deferred tax policy and need not pay the deferred tax when the equities in the original Re-invested Enterprises are replaced by the equities in the restructured enterprises.
2. Article 7 of the Notice is not clear on the deferred tax collection practice. For instance, how to calculate the tax due upon final exit? Whether the taxable profits upon the final exit are calculated, the profits shall be calculated separately (i.e. the profits generated at the Profit Distributing Enterprise and the profits generated at the Re-invested Enterprise) or calculated together? The applicable tax withholding rate shall be the applicable upon the initial distribution and re-investment or upon the final exit? Further, according to the current Chinese tax policies, the withholding obligation is levied on the payer, i.e. the Re-invested Enterprise or the relevant transferee of the applicable equities upon the final exit; however, how much shall such payer deducts, only for the profit generated at the Re-invested Enterprise or also for the profit generated at the Profit Distributing Enterprise (which is the investment cost of the re-investment)? In addition, under the current foreign exchange practice, the relevant banks which handle the profit repatriation will not process the remittance application until they receive the tax payment certificate on the repatriating earnings; then whether they should wait until the tax payment certificate of the re-investment profit or the initially deferred profit as well? Also, theoretically speaking, the foreign investors can pay the deferred tax within 7 days after receiving the final distributions. However, once the distributions are paid outside China, there will be practical issues, including where the deferred tax shall be paid to, etc. All the above questions need to be further clarified by tax authorities.

### **V. Retroactive Application**

The Notice is retroactively applicable from January 1, 2017 (inclusive). If any foreign investors made direct investment qualified under the Notice on or after January 1, 2017 and such foreign investors paid the applicable withholding tax, the foreign investors may apply for return of the paid withholding tax within three years after the day of relevant tax payment under the preferential deferred tax policy. However, if the foreign investors intend to remit abroad the returned tax as stock interest or dividend, such foreign investors shall still pay the withholding tax for the portions remitted abroad.

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### **VI. Supervision by Relevant Authorities**

Article 4 of the Notice emphasizes the monitoring responsibility of the relevant tax authorities. If there are any incompliance found, the relevant foreign investors will be imposed liabilities on any delay of tax payment; unless such delay shall be attributed to the Profit Distributing Enterprises.

### **Summary**

The promulgation of the Notice reflects that Chinese government wishes to encourage foreign investors to expand their investments in China to improve the utilization of foreign exchange reserve; by offering tax deferral treatment, so to allow the foreign investors to pursue future returns by re-invest their profits generated from their original investments in China, especially the portion of the profits which should be paid to the government as tax. We will continue to follow any further development to clarify the uncertainties under the Notice.

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<sup>1</sup> Order No.45 of the President, promulgated by the National People's Congress on April 9, 1991, abolished on January 1, 2008.

<sup>2</sup> Order No.63 of the President, promulgated by the National People's Congress on March 16, 2007, amended on February 24, 2017.

<sup>3</sup> State Council Order No.512, promulgated by the State Council on December 6, 2007.

<sup>4</sup> Guo Fa [2017] No.39, promulgated by the State Council on August 16, 2017.

<sup>5</sup> The strategic investment qualified under the *Administrative Measures on Strategic Investment in Listed Companies by Foreign Investors* (Ministry of Commerce, China Securities Regulatory Commission, State Administration of Taxation, State Administration of Industry and Commerce, and State Administration of Foreign Exchange Order No.(2005)28, promulgated by the Ministry of Commerce, China Securities Regulatory Commission, State Administration of Taxation, State Administration of Industry and Commerce, and State Administration of Foreign Exchange on December 31, 2005, amended on October 28, 2015).

<sup>6</sup> The two catalogues mentioned above are all revised in 2017.