

## China Alert

Issue 14 | Dec 2018

### Provisional deferral of withholding tax on direct re-investment in China by foreign investors using profits distributed from tax resident enterprises in China

To further attract foreign investors to expand investments in China, the China Ministry of Finance (“MOF”), State Administration of Taxation (“SAT”), National Development and Reform Commission, and Ministry of Commerce (“MOC”) (referred to as the “Four Authorities”) jointly promulgated “Notice on Provisional Deferral of Withholding Tax on Direct Re-Investment in China by Foreign Investors Using Profits Distributed from Tax Resident Enterprises in China” (Caishui [2017] No. 88, “Circular 88”) on 21 December 2017, which introduced the deferral of withholding tax (“WHT”) on profits distributed from tax resident enterprises (“TREs”) in China that are used for direct re-investment if certain conditions can be met.

The SAT published “Bulletin of the Relevant Issues in Implementing the Provisional Deferral of Withholding Tax on Direct Re-Investment in China by Foreign Investors Using Profits Distributed from Tax Resident Enterprises in China” (SAT Bulletin [2018] No. 3, “Bulletin 3”) and its interpretation (“Interpretation of Bulletin 3”) on 2 January 2018 and 8 January 2018 respectively to clarify the contents of Circular 88 and relevant issues in its implementation.

Both Circular 88 and Bulletin 3 apply to dividends, profit distributions and other returns on equity investments obtained from 1 January 2017 to 1 December 2017.

After that, the Four Authorities published “Notice on Expanding the Applicable Scope of the Provisional Deferral of Withholding Tax on Direct Re-Investment in China by Foreign Investors Using Profits Distributed from Tax Resident Enterprises in China” (Caishui [2018] No. 102, “Circular 102”), which expands the scope of the preferential tax treatment from designated encouraged projects to all the projects and sectors that are not prohibited from foreign investments. The SAT published “Bulletin of the Relevant Issues in Expanding the Applicable Scope of the Provisional Deferral of Withholding Tax on Direct Re-Investment in China by Foreign Investors Using Profits Distributed from Tax Resident Enterprises in China” (SAT Bulletin [2018] No. 53, “Bulletin 53”) and its interpretation (“Interpretation of Bulletin 53”) on 29 October 2018 and 19 November 2018 respectively to clarify the relevant issues in implementing Circular 102.

Despite Circular 88 had been abolished after the issuance of Circular 102 (Bulletin 3 had also been abolished after the issuance of Bulletin 53), Interpretation of Bulletin 53 specifically states that if a foreign investor who is presently entitled to such tax incentive under Circular 88 and Bulletin 3 and has not actually enjoyed it, refund of withholding tax on dividend previously paid is still available.

Circular 102 and Bulletin 53 are applicable to dividends, profit distributions and other returns on equity investments obtained starting from 1 January 2018.



## **Background**

Under current Enterprise Income Tax Law, non-tax resident enterprises (“NTREs”) are subject to a 10% WHT (or preferential tax rate under tax treaties/arrangements) on dividends, profit distributions and other returns on equity investments sourced from China.

With continuous development of China’s open economy, the re-investment activities in China by foreign investors using profits distributed from TREs in China have been increasing. Meanwhile, in an ever-changing and competitive international environment, many countries have announced their own tax incentives to strive for attracting foreign investment.

In this context, in order to further encourage foreign investors to expand investment and operations in China, and promote the development of specific industries, the State Council proposed in “Notice of State Council on Several Measures for Promoting the Growth of Foreign Investment” (Guo Fa [2017] No. 39) that, the WHT on profits distributed from TREs in China that are used for direct re-investment on encouraged foreign investment projects can be deferred if certain conditions can be met.

Circular 88 and Bulletin 3 were issued to implement the above policy, which set out the criteria for the tax deferral treatment, procedures and obligations for enjoying such benefits, post-administration and implementation issues in details. Circular 102 and Bulletin 53 expand the applicable scope of the above preferential tax treatment and clarify relevant issues in implementation of Circular 102.

This China Alert aims at introducing the main content of Circular 102 and Bulletin 53, as well as changes and newly added items comparing with Circular 88 and Bulletin 3.

## **Main Contents**

Foreign investors refer to NTREs under Article 3(3) of the Enterprise Income Tax Law, i.e. without any establishment in China, or those having an establishment in China earning income sourced in China but is not effectively connected with that establishment. Those enterprises should pay enterprise income tax on income sourced from China.

Starting from 1 January 2018, the WHT on profits (i.e. dividends, profit distributions and other returns on equity investments) distributed from TREs in China to foreign investors that are used for direct re-investment on projects and sectors that are not prohibited from foreign investments can be deferred if certain conditions can be met.

### **1. Applicable conditions**

Foreign investors must fulfill all of the following three criteria in order to enjoy the benefit:

### Condition 1: Mode of direct investment

Direct investment refers to direct equity investment including capital increment, establishment of new TREs, equity acquisitions, etc. by foreign investors using the profits distributed from TREs but does not include increasing and acquiring shares in a public listed company (except where conditions for “strategic investment” are met). The scope of direct investment includes:

- Increment in paid up capital or capital reserves of TREs
- Establishment of new TREs in China
- Equity acquisition of TREs from non-related parties
- Other methods stipulated by the MOF and the SAT

Enterprises which are invested by foreign investors through the above methods are collectively known as “invested enterprises”.

It is worthy to note that the following two types of direct investments are excluded from the applicable scope:

- The increase and acquisition of shares in a public listed company except where the conditions for strategic investment are met. Strategic investment refers to investment as stipulated in the “Administrative Measures on Strategic Investment in Listed Companies by Foreign Investors” (the MOC Order [2005] No. 28);
- Acquisition of the equity of related parties.

Besides, considering the growing diversification of direct investment by foreign investors along with China’s economic development, “other methods stipulated by the MOF and the SAT” as stipulated under Circular 102 is used as a catch-all clause to leave room for expansion of applicable scope.

### Condition 2: nature of the distributed profits

The profits distributed to foreign investors refer to dividends, profit distributions and other returns on equity investments distributed by TREs from their realized retained earnings, including undistributed earnings of previous years.

### Condition 3: must be a direct transfer

If the profit distribution for direct investment by foreign investors is in form of cash, the amount of profits must be directly transferred from the account of the profit distributing enterprises to the account of the invested enterprises or equity transferors, to the exclusion of transfer of the amount of profits to other onshore and/or offshore accounts before direct investment.

If the profit distribution for direct investment by foreign investors is in form of non-cash payment such as tangible properties and securities, the ownership of such assets must be directly transferred from the profit distributing enterprises to the invested enterprises or equity transferors. Other enterprises and/or individuals are not allowed to hold or hold temporarily the related assets before the direct investment.







## 2. Post administration

After having enjoyed the WHT deferral treatment by foreign investors, if the tax authorities later verified that the foreign investors were not eligible for such treatment, the foreign investors will be held responsible for late tax payment<sup>1</sup>, and period of the tax in default is calculated from the date when the profits were paid.

If the profit distributing enterprises did not review and confirm the information provided by the foreign investors, resulting in the foreign investors' inappropriate enjoyment of tax deferral treatment, the profit distributing enterprises will be held responsible for not withholding the taxes according to the relevant regulations<sup>1</sup>, and the foreign investors will be held responsible for late tax payment.

If the foreign investors submitted incorrect information which lead to inappropriate enjoyment of tax deferral treatment, in addition to being the responsibility of the profit distributing enterprises, the foreign investors will also be held accountable for late tax payment<sup>1</sup> according to Circular 102.

## 3. Repayment of tax deferred

Foreign investors are required to repay the tax deferred under the following two scenarios:

- Correction of inappropriate enjoyment of tax deferral treatment as prescribed by Circular 102 (see “post administration” above); and
- Foreign investors enjoying the tax deferral treatment withdraw their direct investments through equity transfer, re-purchase, liquidation, etc.

If foreign investors who have enjoyed the tax deferral treatment are required to repay the taxes, they may apply for treaty benefits which were valid when the profits were paid. They cannot enjoy treaty benefits according to any new tax treaties unless otherwise specified in the tax treaties.

Foreign investors are required to submit the forms and supporting documents as prescribed in the “Administrative Measures on Non-residents Enjoying Treaty Benefits” (SAT Bulletin [2015] No. 60) to apply for treaty benefits during tax filing.

<sup>1</sup> According to the Law of the People's Republic of China on the Administration of Tax Collection (Revised in 2015):

Article 32: Where a taxpayer fails to pay taxes within the time limit as prescribed in provisions, or a withholding agent fails to remit taxes within the time limit as prescribed in provisions, the tax authorities shall, in addition to ordering the taxpayer or withholding agent to pay or remit the taxes within a prescribed time limit, impose a fine on a daily basis at the rate of 0.05% of the amount of tax in arrears, commencing on the day the tax payment was defaulted.

Article 64: ...If a taxpayer fails to submit tax returns, fails to pay or underpays the taxes payable, the tax authorities shall seek the payment of the unpaid or underpaid taxes and late payment fines, and impose a fine not less than 50% of and not more than five times the amount of taxes unpaid or underpaid.

Article 69: If a withholding agent fails to withhold or collect an amount of tax which should have been withheld or collected, the tax authorities shall seek the payment of the tax from the taxpayer and impose on the withholding agent a fine of not less than 50% of and not more than three times the amount of tax which should have been withheld or collected but has not been withheld or collected.



#### 4. Retrospective treatment

Foreign investors who can enjoy but have not yet actually enjoyed the tax deferral treatment can apply for the treatment retrospectively within three years from the date the tax payment was actually paid, and claim tax refund accordingly.

#### 5. Reporting obligations and documentary requirements

According to the current tax regulations, the foreign investors are the taxpayers for WHT and the profit distributing enterprises are withholding agents thereof. Therefore, the foreign investors who would like to apply for tax deferral treatment should be assisted by their withholding agents.

If the foreign investors meet all of the aforesaid “applicable conditions” for tax deferral treatment, they should provide the profit distributing enterprises with information which can substantiate their eligibility for such treatment. The profit distributing enterprises should, in accordance with the provisions of Bulletin 53, review the information provided by the foreign investors, and apply for such treatment before performing the following confirmation:

- The information provided by the foreign investors is complete without omission;
- The actual process of profit payment is consistent with the information provided by the foreign investors;
- The information related to the profit distributing enterprises provided by the foreign investors are true and accurate.

After reviewing those information, the profit distributing enterprises should perform record-filing procedures at the tax authority in charge of tax deferral treatment.

According to Circular 102 and Bulletin 53, foreign investors and profits distributing enterprises should provide relevant documents and information based on the following situations:

##### Situation 1:

Foreign investors should complete and submit the “Information Report on Deferral Treatment of Withholding Tax for Non-resident Enterprise” (the “Report”) when they notify their withholding agents that they should be entitled to tax deferral treatment.

Where foreign investors are eligible for tax deferral treatment according to Bulletin 53, the profit distributing enterprises as the withholding agents are required to submit the below documents to their in charge tax authorities within 7 days upon receipt of the distributed profit.

- Withholding tax return prepared by profit distributing enterprises;
- The Report prepared by both the foreign investors and the profit distributing enterprises.



#### Situation 2:

When foreign investors apply for the tax deferral treatment retrospectively, they should submit the Report and relevant contracts, payment evidence and other relevant documents for applying a tax refund to the tax authorities in charge of the profit distributing enterprises.

#### Situation 3:

When foreign investors are required to repay taxes under the following two situations, they should submit the withholding tax return to the tax authority in charge of the profit distributing enterprises:

- Foreign investors have enjoyed the tax deferral treatment but their eligibility are denied during the post administrative procedures of the tax authorities;
- Foreign investors enjoying the tax deferral treatment withdraw their direct investments through equity transfer, re-purchase, liquidation etc., should repay the withholding tax deferred within 7 days upon receipt of the relevant amounts from the withdrawal.

It is worth noting that, during tax administration, the in charge tax authorities can request the relevant parties and individuals such as foreign investors, profit distributing enterprises, invested enterprises, equity transferors etc. to provide information and documents related to the foreign investors' tax deferral treatment within a time limit.

In addition, if a foreign investor fails to pay the tax deferred according to tax regulations, the foreign investors will be held accountable by the tax authority in charge of the profit distributing enterprises for late tax payment, and the period of tax in arrears is counted from the 8th day (inclusive) after the relevant profit was received.

### **6. Foreign investors dispose equity through internal corporate restructuring**

If foreign investors perform internal restructuring during their enjoyment of tax deferral treatment and such restructuring is eligible for special restructuring tax treatment, and the foreign investors adopt the special restructuring tax treatment, the foreign investors can continue to enjoy the tax deferral treatment.

### **7. Other matters**

If a single investment in TRE held by a foreign investor includes two portions, i.e. one has enjoyed the tax deferral treatment but the other does not, the former portion will be deemed as being disposed first when the foreign investor disposes a part of that investment.

Foreign investor and profit distributing enterprise may authorize agent to deal with the related matters as set out in the provisions of Circular 102 and Bulletin 53, but they need to submit an authorization letter to the tax authority.



## **Changes and Newly Added Items**

### **1. Applicable period**

Circular 88 and Bulletin 3      Apply to dividends, profit distributions and other returns on equity investments obtained from 1 January 2017 to 1 December 2017

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Circular 102 and Bulletin 53      Apply to dividends, profit distributions and other returns on equity investments obtained from 1 January 2018 and onwards

### **2. Expansion of applicable scope**

Compared with Circular 88, Circular 102 expands the applicable scope of the withholding tax deferral treatment on direct reinvestment from designated encouraged projects to all projects and sectors that are not prohibited from foreign investments.

### **3. Clarification on the following situations**

Bulletin 53 clarifies the following two situations:

- Foreign investors use the profits obtained to pay the registered capital already committed, increase paid up capital or capital reserves of TREs are classified as “direct investment”.
- Foreign investors use RMB reinvestment accounts to transfer the profits obtained for reinvestment, and if such amounts are transferred from the accounts of profit distributing enterprises to the accounts of invested enterprises or equity transferors through the RMB reinvestment accounts of the foreign investors within the same day, it would be regarded as “direct transfer”.

## **Conclusion**

The introduction of this preferential tax policy can further enhance China’s capability to attract foreign investment. It is absolutely a substantial positive measure. Foreign investors should review their plans for direct investments in China to evaluate the fulfillment of the conditions, as well as eligibility of such preferential tax benefit. If you have any enquiries on such policy, please feel free to contact our professional tax team.





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