

Client Alert

October 2018

For further information, please contact:

Beijing

Jinghua Liu (Tax and Dispute Resolution)
+86 10 6535 3816
jinghua.liu@bakermckenziefenxun.com

Abe Zhao (Tax and Transfer Pricing)
+86 10 6505 3862
abe.zhao@bakermckenziefenxun.com

Jason Wen (Tax)
+86 10 6535 3974
jason.wen@bakermckenzie.com

Shanghai

Brendan Kelly (Tax)
+86 21 6105 5950
brendan.kelly@bakermckenzie.com

Nancy Lai (Tax)
+86 21 6105 5949
nancy.lai@bakermckenzie.com

Hong Kong

Amy Ling (Tax)
+852 2846 2190
amy.ling@bakermckenzie.com

San Francisco

Jon Eichelberger (Tax)
+1 415 984 3857
jon.eichelberger@bakermckenzie.com

New York

Shanwu Yuan (Tax and Transfer Pricing)
+1 212 626 4212
shanwu.yuan@bakermckenzie.com

China expands scope of reinvestment incentive to all MNC projects

On 26 September 2018, to further encourage foreign investment and arguably respond to some changes in other home country rules designed to encourage pulling money back to places like the United States, the State Council resolved to increase the number of enterprises eligible to defer the dividend withholding tax on dividends reinvested in Chinese enterprises. To implement this resolution, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) released Notice 102¹ three days later. Notice 102 replaces Notice 88² and rescinds its requirement that the Chinese enterprise receiving the reinvestment operates in an "encouraged" industry in order for the withholding tax to be deferred on the reinvested dividends. Now, as long as the Chinese enterprise does not operate in a "prohibited" industry, the dividend withholding tax can be deferred. Notice 102 is effective as of 1 January 2018.

In this alert, we will first discuss the key changes introduced under Notice 102 and their major implications for multinational companies (MNCs). Then, we will outline how MNCs can obtain the dividend tax deferral treatment under Notice 102.

1. Expanded tax deferral eligibility

Like Notice 88, Notice 102 provides that non-resident enterprises do not need to pay the 10% (or less, depending on the applicable tax treaty) Chinese dividend withholding tax when receiving a dividend distribution if the non-resident enterprise reinvests the dividend in China and meets other requirements. This tax can be deferred indefinitely until the enterprise recovers the investment by way of share transfer, redemption, liquidation, etc.

More importantly, Notice 102 relaxes the industry limitation on the tax deferral eligibility by only requiring the invested enterprise not operate in an industry in which foreign investment is prohibited. Previously, under Notice 88, non-resident enterprises needed to ensure the invested enterprise was operating in industries in which foreign investment was encouraged. However, non-resident enterprises often had trouble to satisfy this requirement as the enterprise, into which they would like to invest, may only partially operate or even not operate in encouraged industries. Notice 102 largely eliminates this difficulty since the non-resident enterprise now only needs to verify that the invested enterprise does not operate in any prohibited industries. Since foreign-invested enterprises cannot operate in a prohibited industry as a matter of law, Notice 102 effectively expands the deferral to all dividends reinvested in any foreign-invested enterprise operating legally.

¹ *Notice of the Ministry of Finance, the State Administration of Taxation, the National Development and Reform Commission and the Ministry of Commerce on Expanding the Deferral of Withholding Tax on Dividends Directly Invested by Foreign Investors*, Cai Shui [2018] No. 102, issued on 29 September 2018 and effective on 1 January 2018.

² *Notice of the Ministry of Finance, the State Administration of Taxation, the National Development and Reform Commission and the Ministry of Commerce Concerning the Deferral of Withholding Tax on Dividends Directly Invested by Foreign Investors*, Cai Shui [2017] No. 88, issued on 21 December 2017 and effective on 1 January 2017.



Except for relaxing the industry limitation on the deferral, Notice 102 maintains all other Notice 88 requirements. Those requirements are:

- The non-resident enterprise must use the dividends for direct investment, which refers to equity investments in the form of a capital increase to an existing resident enterprise, a capital contribution to a newly formed resident enterprise, or a share acquisition of a resident enterprise from an unrelated party.
- The dividends must actually be distributed from the accumulated earnings of the distributing enterprise.
- Cash dividends must be directly transferred from the distributing enterprise's bank account to: (i) the invested enterprise's bank account if the dividend is reinvested to increase the equity in an existing Chinese enterprise or to form a new Chinese enterprise; or (ii) the transferor's bank account if the dividend is reinvested to acquire a Chinese target enterprise in an equity purchase. This requirement on which bank account the dividend must be transferred to is known as the "fund flow" requirement.

For a detailed analysis on all of these requirements, please refer to our [client alert in January 2018](#).

2. Outstanding issues

Notice 102 still fails to address some issues with the withholding tax deferral in practice.

- Like Notice 88, Notice 102 does not define "unrelated party" when stating that resident enterprise shares acquired from an unrelated party qualify as a direct investment.
- Notice 102 could complicate an MNC's negotiation and structuring of funds transfer in a deal since Notice 102 prohibits the common equity transfer practice of placing the equity into escrow before closing.
- In an equity transfer, Notice 102 could create foreign exchange difficulties for the distributing enterprise when it attempts to remit dividends to the non-resident seller's offshore bank account because no actual underlying transaction exists between the seller and the distributing enterprise.

Taxpayers are hopeful the SAT will soon issue a bulletin to provide implementing guidelines for Notice 102 and resolve some of these issues.

3. Recommendations

By rescinding the requirement that invested enterprises should operate in encouraged industries for reinvested dividends to be eligible for the dividend withholding tax deferral, Notice 102 will allow more MNCs to receive the dividend withholding tax deferral. This deferral could be especially valuable for MNCs whose home country does not tax or only levies limited tax on the dividends and thus any Chinese withholding tax would not be fully credited against the tax payable on the dividends in the home country. Any MNC that has accumulated profits in China should assess whether it can enjoy a



meaningful benefit from the dividend tax deferral and proactively arrange its plan to better satisfy the deferral's eligibility requirements.

Indeed, a MNC's main challenge now is how to arrange its fund flow to satisfy the deferral's eligibility requirements to enjoying the tax deferral. Like Notice 88, Notice 102 requires the distributing entity to directly remit the funds to the invested enterprise or the seller (in the case of equity transfer). This fund flow requirement may create practical challenges for MNCs, such as complicating the negotiation and the structuring of the funds transfer and triggering foreign exchange concerns when remitting funds to offshore sellers in equity transfers. Until additional rules are issued to resolve these problems, MNCs should carefully plan ahead to comply with the fund flow requirement and pay attention to the potential practical difficulties. MNCs should also carefully manage how the investment funds are transferred and meticulously document those transfers.



Appendix

Unofficial Translation Prepared by Baker McKenzie

Notice of the Ministry of Finance, the State Administration of Taxation, the National Development and Reform Commission and the Ministry of Commerce on Expanding the Deferral of Withholding Tax on Dividends Directly Invested by Foreign Investors

(Document ref. Cai Shui [2018] No. 102

Dated 29 September 2018. Effective from 1 January 2018).

To the Departments (Bureaus) of Finance, the Development and Reform Commissions, the competent Commerce Bureaus of all provinces, autonomous regions, and municipalities directly under the Central Government and cities directly under State planning, the Tax Bureaus under the State Administration of Taxation of all provinces, autonomous regions, and municipalities directly under the Central Government and cities directly under State planning and the Development and Reform Commission and the Finance Bureau of the Xinjiang Production and Construction Corps:

In order to thoroughly implement the decisions and arrangements of the Central Committee of the Communist Party of China and the State Council, to further encourage foreign investors to invest in China, policies on the deferral of withholding tax on dividends directly invested by a foreign investor are hereby announced as follows:

1. The policy that dividends derived by a foreign investor from a resident enterprise within China and then directly invested within China are not subject to immediate withholding tax is expanded from encouraged projects for foreign investments to all projects or industries in which foreign investment is not prohibited.
2. A foreign investor may defer the dividend withholding tax if:
 - (i) The foreign investor uses the dividends received for direct investment, including for equity investments such as a capital increase into an existing enterprise, formation of a new enterprise, or share acquisition of an enterprise from an unrelated party, but not including equity investments such as capital increase into and share acquisition of a listed company (unless the investment constitutes a qualified strategic investment into the listed company). Specifically, direct investment includes:
 - a) An increase of the paid-in capital or capital reserve of a resident enterprise within China;
 - b) Formation of a new resident enterprise within China;
 - c) Share acquisition of a resident enterprise within China from an unrelated party; and
 - d) Other methods as provided by the Ministry of Finance and the State Administration of Taxation.



An enterprise receiving any of these direct investments from a foreign investor is hereinafter referred to as the "invested enterprise".

- (ii) The dividends derived by the foreign investor are earnings from equity investment such as dividends and bonuses that are actually distributed from retained earnings realized by a resident enterprise within China.
 - (iii) If the dividends to be used for direct investments by the foreign investor are paid in cash, the relevant funds must be directly transferred from the account of the profit-distributing enterprise to the account of the invested enterprise or the transferor in a share transfer and must not be transferred to another domestic or offshore account before the direct investment; if the dividends to be used for direct investments by the foreign investor are paid in a non-cash form such as in-kind payment or negotiable securities, the ownership of the respective assets must be directly transferred from the profit-distributing enterprise to the invested enterprise or the transferor in a share transfer and must not be held by another enterprise or individual as a nominee or temporary owner before the direct investment.
3. A foreign investor satisfying the conditions under Article 2 of this notice must make a declaration in accordance with the relevant taxation administration requirements and submit supporting documents of eligibility for the dividend tax deferral to the profit-distributing enterprise. After a proper review of the documents, the profit-distributing enterprise may temporarily be exempt from withholding income tax in accordance with Article 37 of the Enterprise Income Tax Law after fulfilling the recordal procedure with its in-charge tax authority.
4. The tax authority should enforce subsequent administration in accordance with the law. If the tax authority verifies that a foreign investor deferred withholding tax without being eligible as provided in this notice, the foreign investor shall be deemed as not having declared and paid enterprise income tax in accordance with the relevant regulations and shall be liable in accordance with the law for the late tax payments as of the dividend payment date unless the unpaid tax was caused by the profit-distributing enterprise.
5. A foreign investor who is eligible to defer dividend withholding tax in accordance with this notice but has not actually enjoyed the deferral may apply for the deferral within three years from the actual tax payment date and claim a refund of the tax paid.
6. If the foreign investor's direct investment is recovered by way of share transfer, redemption, liquidation, etc., and the foreign investor has deferred the dividend withholding tax on that direct investment, the foreign investor must declare and pay back the deferred tax to the tax authority in accordance with established procedures within seven days from actual receipt of the payments.
7. If, after a foreign investor defers the dividend withholding on a direct investment as provided in this notice, the invested enterprise undergoes a restructuring that qualifies for and actually enjoys the special tax



treatment, the foreign investor has no obligation to pay back the deferred tax in accordance with Article 6 of this notice.

8. A "foreign investor" as used in this notice refers to a non-resident enterprise as provided under Article 3.3 of the Enterprise Income Tax Law; a "resident enterprise within China" as used in this notice refers to a resident enterprise established within China in accordance with PRC law.
9. This notice takes effect from 1 January 2018. The *Notice of the Ministry of Finance, the State Administration of Taxation, the National Development and Reform Commission and the Ministry of Commerce Concerning the Deferral of Withholding Tax on Dividends Directly Invested by Foreign Investors* (Cai Shui [2017] No. 88) is repealed at the same time. The notice is applicable to earnings from equity investment such as dividends and bonuses derived by a foreign investor on or after 1 January 2018. If tax has been withheld and paid on those earnings, Article 5 shall apply.

The Ministry of Finance, the State Administration of Taxation, the National Development and Reform Commission and the Ministry of Commerce

29 September 2018

www.bakermckenzie.com

Suite 3401, China World Tower 2
1 Jianguomenwai Dajie
Beijing 100004, China
Tel: +86 10 6535 3800
Fax: +86 10 6505 2309

14th Floor, Hutchison House
10 Harcourt Road, Central
Hong Kong SAR, China
Tel: +852 2846 1888
Fax: +852 2845 0476

Unit 1601, Jin Mao Tower
88 Century Avenue, Pudong
Shanghai 200121, China
Tel: +86 21 6105 8558
Fax: +86 21 5047 0020

This client alert has been prepared for clients and professional associates of Baker & McKenzie. Whilst every effort has been made to ensure accuracy, this client alert is not an exhaustive analysis of the area of law discussed. Baker & McKenzie cannot accept responsibility for any loss incurred by any person acting or refraining from action as a result of the material in this client alert. If you require any advice concerning individual problems or other expert assistance, we recommend that you consult a competent professional adviser.

©2018 Baker & McKenzie. All rights reserved. Baker & McKenzie International is a global law firm with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner or equivalent in such a law firm. Similarly, reference to an "office" means an office of any such law firm. This may qualify as "Attorney Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.