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Tax Newsflash

New tax credit issued for foreign investors reinvesting distributed profits

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On 30 June 2025, China's Ministry of Finance, State Taxation Administration, and Ministry of Commerce jointly issued the Bulletin on the Tax Credit Policy for Foreign Investors Using Distributed Profits for Direct Investment (Bulletin [2025] No. 2, hereinafter referred to as "Bulletin 2"), which grants a tax credit (hereinafter referred to as the "Tax Credit Policy") to foreign investors who use distributed profits for qualified reinvestment in China.

The existing tax rules allow for a deferral of the 10% withholding tax on profits distributed by a Chinese resident company to its foreign investor if the profits are used for qualified reinvestments in China as from 1 January 2018 (hereinafter referred to as the "2018 Policy"). The tax deferral applies until the foreign investor disposes of the reinvestment. Following the 2018 Policy, Bulletin 2 now provides for a tax credit, aiming to further encourage foreign investors to increase or expand their long-term investments in China.

Highlights of Bulletin 2

1) Overview of the Tax Credit Policy

For profits distributed by a Chinese resident company (distributing company) to a foreign investor, if the investor directly reinvests such profits in encouraged industries from 1 January 2025 to 31 December 2028, the investor may benefit from a tax credit, provided all conditions can be met. Specifically, 10% of the investment amount (or at a lower dividend treaty rate, if applicable) can be used to offset the withholding tax payable on dividends, interest, and royalty income received by the foreign investor from the distributing company after the reinvestment date. Any unused credit can be carried forward to subsequent years indefinitely.

An example for purposes of illustration

A Chinese company ("Company 1") decides to distribute a dividend of 1,000 to its foreign parent company ("Company A") in July 2025. Company A uses the total dividend income as registered capital to establish a Chinese company ("Company 2") in the same month. Company 1 pays an annual royalty of 100 to Company A every December. From 2025 to 2030, Company 1 does not distribute further profits and has no loan arrangements with Company A. Company 2 pays an annual royalty of 50 to Company A every December.

Assuming Company A's reinvestment in Company 2 meets all conditions of both the 2018 Policy and the Tax Credit Policy (and not considering the application of any tax treaties), the tax implications for Company A are as follows:

- Under the 2018 Policy, Company A is temporarily exempt from paying withholding tax of 100 on the dividend received in July 2025 (i.e., 10% of 1,000).
- Under the Tax Credit Policy, Company A receives a tax credit of 100 due to the qualified reinvestment (i.e., 10% of 1,000).
- In December 2025, Company A receives royalties from Company 1 and Company 2, with withholding taxes of 10 (i.e., 10% of 100) and 5 (i.e., 10% of 50) to be paid in China, respectively. The tax credit can only be used to offset the withholding tax on royalties paid by Company 1 (so no actual cash tax is paid by Company A), but not for the tax on royalties paid by Company 2. The remaining tax credit of 90 can be used to offset Company A's qualified withholding taxes in future years.
- Similarly, in December 2026, Company A can continue to use the tax credit to offset the withholding tax of 10 on royalties from Company 1, with the remaining balance of 80 carried forward.

2) Conditions to be met to qualify for the Tax Credit Policy

The conditions for qualifying for the Tax Credit Policy are generally consistent with those for the 2018 Policy. For example, the distributed profits must be used in a "direct equity investment," which includes increasing the paid-in capital or capital reserve of an existing Chinese resident company, establishing a new Chinese resident company, or acquiring equity interests in an existing Chinese resident company from an unrelated party. Profits that are distributed in cash must be transferred directly from the account of the distributing company to that of the investee company or equity transferor.

Notably, compared to the 2018 Policy, there are two key differences:

- During the reinvestment period, the investee company must be engaged in industries that fall within the scope of the national encouraged industries listed in the Catalogue of Encouraged Industries for Foreign Investment. This is stricter than the 2018 Policy, which only prohibited investments in certain projects or areas.
- The foreign investor must hold the reinvestment in China for at least five years (i.e., 60 months). The 2018 Policy did not set a holding period requirement, and disposing of the reinvestment would generally trigger repayment of the previously deferred dividend withholding tax.

3) Tax treatment upon exit from the reinvestment

As mentioned, the reinvestment must be held for at least five years to benefit from the Tax Credit Policy. Bulletin 2 specifies the tax treatment of foreign investors depending on whether the investment is held for at least five years upon withdrawal:

- **Investment held for five years or more:** Upon withdrawal, the investor must declare and pay the deferred dividend withholding tax within seven days to the tax authority where the distributing company is located. Any unused tax credit can be used to offset the tax due.
- **Investment held for less than five years:** Upon withdrawal of all or part of the qualified investment, the corresponding distributed profits used for such investment are deemed ineligible for the credit. The investor must not only pay the deferred dividend withholding tax but also proportionally reduce the tax credit balance. If the tax credit actually used exceeds the adjusted balance, the excess amount must be repaid within seven days.

Examples for purposes of illustration

Investment held for five years or more: Continuing the previous example, if Company A sells all its equity interests in Company 2 to a third party in November 2030:

- Under the 2018 Policy, Company A must declare and pay the previously deferred dividend withholding tax of 100 within seven days.
- Since the holding period requirement for the Tax Credit Policy is met, the remaining tax credit balance (after offsetting 10 per year for five years, totaling 50, with 50 remaining) can still be used to offset other qualified withholding taxes.

Investment held for less than five years: If Company A sells all its equity interests in Company 2 in January 2027:

- Similarly, Company A must repay the deferred dividend withholding tax under the 2018 Policy.
- Since the holding period requirement for the Tax Credit Policy is not met, the total tax credit of 100 is lost. However, a tax credit of 20 has already been used to offset withholding taxes on royalties paid in 2025 and 2026, so Company A must repay this amount within seven days.

4) Effective date

Only reinvestments made with distributed profits from 1 January 2025 to 31 December 2028 are eligible for the tax credit. Any unused credit balance available on 31 December 2028 can continue to be used.

Reinvestments made from 1 January 2025 to the issuing date of Bulletin 2 can retroactively be eligible for the tax credit, which can be used to offset withholding taxes arising from income received after the issuing date of Bulletin 2. Reinvestments made before 1 January 2025 are not eligible for the tax credit.

Comments

The introduction of the Tax Credit Policy undoubtedly increases the tax incentives for supporting long-term foreign investment in China. Foreign investors should revisit their investment strategies in China and comprehensively consider the tax benefits on their group tax costs and cash flow:

- Provided the five-year holding period is met, foreign investors may combine the benefits of the 2018 Policy and the Tax Credit Policy, offsetting future withholding taxes on specific China-source income up to 10% of the investment amount, with the ability to carry forward unused credits indefinitely.
- The tax credit can be used not only to offset future dividend withholding taxes but also withholding taxes on interest and royalties.
- The tax credit can be used in the year the reinvestment is made, rather than waiting until the five-year period is completed, which helps reduce cash outflows in the early stages.

Some technical and practical issues remain unclear, requiring further clarification from the tax authority, including but not limited to:

- Whether the specific conditions for the Tax Credit Policy can be interpreted with reference to the detailed documents of the 2018 Policy, given that some of the conditions for both policies are generally consistent.
- How to use the tax credit in cases involving the application of the preferential withholding tax rates under tax treaties, especially if the investor's treaty status changes between the time of reinvestment and subsequent income receipt, including how to calculate the tax credit in such cases.
- Whether the repayment of deferred dividend withholding tax under the 2018 Policy upon withdrawal can be offset by any unused tax credit.

In addition, procedures such as how foreign investors should apply for the tax credit and fulfill information reporting requirements still need to be clarified. Companies should closely monitor the progress on the implementation of the new policy and maintain active communication with the authority of commerce, tax authority, and professional advisors.

It is expected that foreign investors will need to submit various information and supporting documents to different authorities (such as to record each profit distribution, reinvestment, and withdrawal, and to record the usage, carryforward, and adjustments of tax credits). Companies should adjust their internal controls and tax management processes, ideally through digital solutions to improve efficiency in information collection and document maintenance.

Furthermore, considering that Pillar Two rules have been locally implemented in many jurisdictions, large multinational groups also need to analyze the potential effect of China's Tax Credit Policy on their group income tax expenses and effective tax rate calculations, based on the implementation progress of Pillar Two in relevant jurisdictions.

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