TAX NEWS CHINA

2025 (No. 07 issue)

July 2025

Reinvestment earns tax credits

In brief

» The Chinese government has introduced in June a new three-year tax incentive policy (effective 2025-2028) that allows foreign investors to claim tax credits when reinvesting dividends into encouraged sectors, while maintaining the existing option to defer withholding taxes on reinvested profits.

» This creates a potential dual tax benefit to qualified investors in priority industries - who can both defer tax obligations and accumulate credits for future offsets.

Feedback

WTS tax news on Wechat

member of wts global

In detail

The new policy is an add-on to the existing incentive granted to profit reinvestment:

- Under the long-standing **Notice 102**, the "*Notice on Expanding Applicability of Temporary Withholding Tax Exemption on Dividends Used in Direct Investment by Foreign Investors*" issued on 1 January 2018, investors can enjoy temporary exemption from the 10% withholding tax (WHT) on dividends reinvested in China, with WHT deferred until the investment is ended (through equity transfer, buyback, or liquidation).

- The newly introduced **Notice 2**, the "*Notice on Tax Credit Policy for Direct Investment Using Distributed Dividends by Foreign Investors*" issued on 27 June 2025, adds a second benefit by providing a tax credit equal to 10% (or a lower rate per the applicable tax treaty) of the reinvested amount, applicable to investments in encouraged industries. This credit can be used to offset future WHT liabilities on various China-sourced income streams including dividends, interest, and royalties.

When combined, these policies create a powerful dual incentive - allowing investors to both defer immediate tax obligations through Notice 102 while accumulating credits for future tax reductions under Notice 2.

This innovative approach not only enhances cash flow management but may ultimately drive the effective tax rate below standard treaty rates, offering particularly valuable advantages for long-term investors committed to China's priority sectors.

Key features of the new policy

Notice 2 has inherited the same definition for reinvestment from Notice 102, which refer to dividends used *directly* in the following:

1. Reinvestment resulting in the increase of paid-in capital or capital reserves of a Chinese entity;
2. Reinvestment in establishing a new Chinese entity; or
3. Reinvestment for acquiring shares of a Chinese entity from a non-related party.

The key differences between the two regimes concern their scope of application and holding period requirement:

- **Scope**: The existing tax deferral regime under Notice 102 applies universally to all reinvestment projects regardless of sectors; the new tax credit incentive under Notice 2 is targeted at reinvestments in encouraged businesses (per the official "*Encouraged Foreign Investment Catalogue*"). This means only those reinvestments directed into encouraged sectors can potentially benefit from both the tax deferral and the additional tax credit - creating a powerful combined incentive for strategic industries.

- **Holding period:** The original deferral regime under Notice 102 imposes no minimum holding period, allowing investors' flexibility in managing their investments. In contrast, the new tax credit system under Notice 2 mandates a five-year lock-in period for reinvested capital, with early divestment triggering claw-back provisions for any tax benefits claimed. This structural difference reflects the new policy's intentional design to reward long-term investment commitments in priority sectors.

The major features of the two sets of tax incentives are summarized below:

Aspects	Notice 2 policy (new)	Notice 102 policy (existing)
Incentive nature	Tax credit	Tax deferral
Applicability	Limited to encouraged sectors	All non-prohibited sectors
Incentive amount	10% (or a lower rate per the tax treaty) of reinvestment amount can be credited against forthcoming WHT	WHT is exempted (deferred) until the investment is disposed of or withdrawn
Targeted WHT	WHT on dividends, interests or royalties	WHT on dividends
Holding period	5 years lock-in	None
Compliance	Registration	Tax reporting
Validity	2025 – 2028	No expiry

Practical implications

We illustrate how profit reinvestment could be affected by the new policy in three cases.

➢ **Case 1**

During 2025, Company B has declared a distribution of dividend (1,000) to its foreign parent, Company A. Then,

- 2025: Company A has reinvested the entire dividend amount as capital in Company C (in encouraged business); and
- 2026: Company B pays royalties of 200 to Company A.

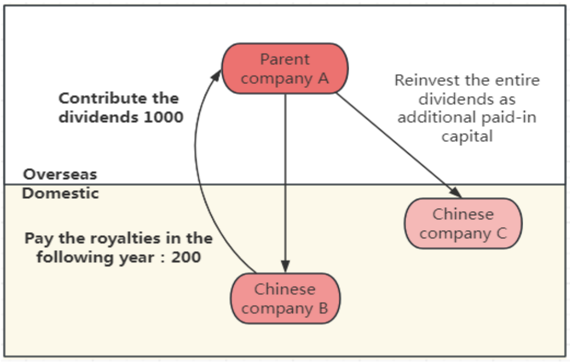

Figure 1

➢ **Analysis:**

1. Company A's dividend income (1,000) is qualified for WHT deferral of 100 (calculated as 1,000 × 10%), per the old policy. In addition, Company A is eligible for a tax credit of 100 (calculated as 1,000 × 10%) for its reinvestment in Company C, per the new policy.

2. Company A's royalty income of 200 from Chinese Company B is subject to a WHT of 20 (calculated as 200 × 10%) but can be fully offset by the tax credit of 100, meaning Company A effectively pays no WHT on its royalty income. The remaining tax credit balance of 80 (100 - 20) can be carried forward, potentially to offset WHT on eligible income in future years.

➢ **Case 2**

Based on the same situation as case 1, and that Company A has held the shares in Company C <u>over</u> five years. Thus,

- At the time of share disposal, the deferred WHT of 100 needs to be paid back, but the tax credit of 20 having been used to offset the royalty WHT will not be clawed back.
- The remaining credit balance of 80 can be carried forward for future use.

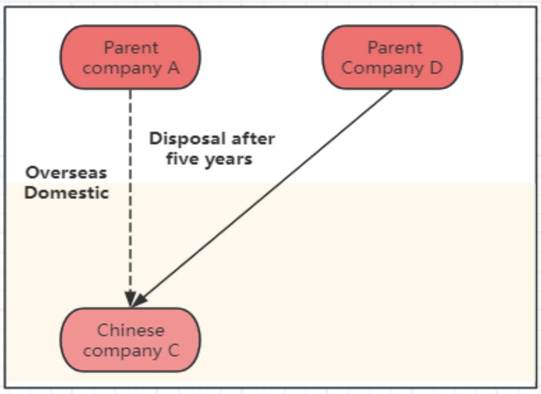

Figure 2

➢ **Case 3**

Based on the same situation as case 1, except that Company A has held the shares in Company C less than five years. Thus,

- The deferred WHT (100) has to be clawed back;
- The reinvestment is not qualified for tax credit; the tax credit (20) has to be clawed back too; and
- The remaining credit balance of 80 is forfeited.

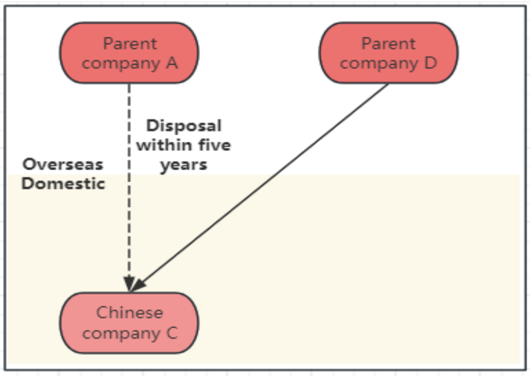

Figure 3

WTS China's observation

China's initiative to enhance tax incentives for profit reinvestment was first unveiled in February 2025 as part of the precision-guided strategy outlined in the "*2025 Action Plans to Stabilize Foreign Investments*".

The newly introduced policy under Notice 2 serves as a key implementation measure of this strategy, specifically designed to promote long-term capital commitment within China, particularly in sectors that align with the nation's strategic economic development goals.

For qualifying investments in encouraged sectors, this policy creates a valuable opportunity to significantly reduce the effective WHT rate applicable to China-sourced dividends, interest, and royalties over the coming years.

Given that the incentive window is limited to profit reinvestments made during the 2025-2028 period, foreign investors should conduct prompt assessments and make timely decisions to fully capitalize on these benefits before the opportunity expires.

2025 (No. 07 issue)

July 2025

WTS China Co., Ltd.
Unit 06-07, 20th Floor, Building 1, Shengbang International Tower, No.1318 North Sichuan Road, Hongkou District, Shanghai, China 200080
www.wts.cn
info@wts.cn

member of wts global

WTS Global website: www.wts.com
WTS Global contacts: wts.com/global/locations

China Contact

Martin Ng
Managing Partner
martin.ng@wts.cn
+ 86 21 5047 8665 ext.202

Ened Du
Partner
ened.du@wts.cn
+ 86 21 5047 8665 ext.215

Yiming Chen
Consultant
yiming.chen@wts.cn
+ 86 21 5047 8665 ext.207

This edition was developed with the support of Christine Cai (intern).