China alert

Tax and regulatory developments

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TAX

Reinvestment Tax Refund

What do the new rules say?

The State Administration of Taxation (SAT) recently issued two notices—*Guo Shui Han [2005] No. 989* and *Guo Shui Han [2005] No. 1093*—clarifying certain issues in relation to the entitlement of foreign investors to reinvestment tax refunds.

> **Relevant regulations discussed in this issue:**
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> *Notice Guo Shui Han [2005] No. 989 & Notice Guo Shui Han [2005] No. 1093,* announced by the State Administration of Taxation.

As you may know, if a foreign investor uses the dividends from a PRC subsidiary to invest in a new company in China or increase the registered capital of a current company, 40% of the state portion of Foreign Enterprise Income Tax (FEIT) paid by the PRC subsidiary in relation to the reinvested dividends can be refunded. If the PRC subsidiary qualifies as an export-oriented enterprise or an advanced technology enterprise, the reinvestment tax refund will be increased to 100% of the state FEIT paid by the PRC subsidiary in relation to the dividends. In order to keep the reinvestment refund, the foreign investor should hold on to the equity interest in the reinvestment for not less than five years. If the investment is withdrawn in less than five years, part or all of the reinvestment tax refund would be clawed back by the tax authority.

The new notices further clarify the following points:

- **Reinvestment of unrealised profits**

  A foreign investor can only obtain reinvestment tax refunds in respect of dividends paid out of profits which have been realised at the time the foreign investor receives approval from the authorities for the reinvestment. This is so regardless of whether the reinvestment is carried out in lump sum or by instalments. Otherwise, the foreign investor would not be entitled to any reinvestment tax refunds.

- **Reinvestment of pre-acquisition profits**

  A foreign investor which reinvests pre-acquisition profits of a company that it acquires previously shall not be eligible for any

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reinvestment tax refund. The logic behind this ruling is unclear because the transfer value of the equity interest is supposed to have covered the pre-acquisition profits. However, if the following conditions are satisfied, the reinvestment tax refund shall be available:

- The equity interest was previously transferred at cost.
- The transferee is either a foreign investor or a foreign-invested enterprise specifically engaged in investment business.
- Ownership is exclusive, according to one of the following requirements:
  - The transferee is directly or indirectly 100%-owned by the transferor or vice versa; or
  - Both the transferee and transferor are directly or indirectly 100%-owned by the same third-party company.

How may the new rules affect your operations?

Based on the above notice, deciding when to make a reinvestment is crucial to fully enjoying the benefits of the reinvestment tax refund. In addition, in mergers and acquisitions, it is important to bear in mind that pre-acquisition profits would not be subject to reinvestment tax refund.

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